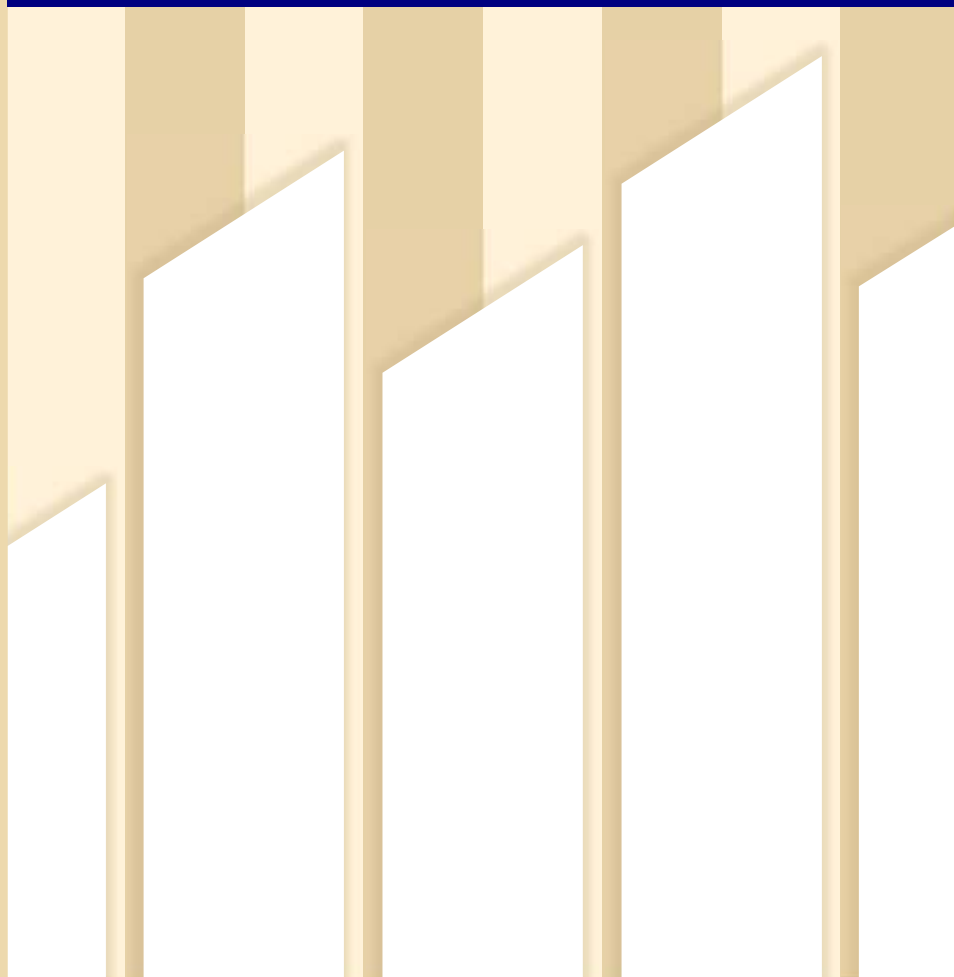




BANK OF GREECE
EUROSYSTEM

MONETARY POLICY

**INTERIM REPORT
2006**



OCTOBER 2006

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EUROSYSTEM

**MONETARY
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To the Greek Parliament and the Council of Ministers

The present Interim Report on Monetary Policy is submitted to the Greek Parliament and the Council of Ministers in accordance with the Statute of the Bank of Greece. The Report examines economic developments in the euro area and Greece during the current year, the sixth since Greece became a full member of EMU and began implementing the Eurosystem's single monetary policy. The Report is summarised in Chapter I.

Chapter II examines the international economic environment, as well as monetary and credit developments and the course and outlook for inflation and economic activity in the euro area. This examination makes it easier to understand the decisions of the European Central Bank's Governing Council from December 2005 onwards to raise its key interest rates, decisions which affect the Greek economy directly.

Chapter III examines developments in the money, credit and capital markets in Greece and assesses the stability of the Greek banking system. The overall conclusion of this analysis is positive. It is found that the exposure of Greek banks to credit and market risk is still relatively low, whereas their profitability and capital adequacy provide a sufficient buffer to ensure the stability of the Greek banking system. However, there is a need to continuously monitor and control the risks assumed by banks, as well as the possible impact of these risks on their balance sheet items and capital adequacy ratios. In order, for one, to minimise the risks from the cross-border expansion of Greek banks, domestic credit institutions must keep their capital adequacy ratios high, increase their provisioning for non-performing loans (NPLs), further consolidate their portfolios and reduce their NPLs-to-total loans ratio.

Chapter IV analyses the determinants and outlook for inflation in Greece, as well as its differential vis-à-vis the euro area average. Other issues examined include the developments and prospects for economic activity and employment during the current year, fiscal developments and the state of the balance of payments. This chapter also includes a brief exposition of the reasons why foreign direct investment is lower in Greece than in other countries.

The Report's estimates concerning the key aggregates of the Greek economy are that gross domestic product will increase this year by 3.8%, that this growth of economic activity has been accompanied by a rise in employment and a drop in the rate of unemployment and that average annual inflation will come to 3.3%, i.e. almost as much as in 2005.

In spite of the broadly satisfactory macroeconomic performance, the Greek economy still faces serious challenges on account of its structural weaknesses. As mentioned in the Report's fifth and closing chapter, these weaknesses are reflected in the country's rate of inflation, which continues to exceed the euro area average, its large current account deficit, which is projected to widen this year to 11% of GDP, its exceptionally high public debt-to-GDP ratio, and its rate of unemployment, which remains relatively high in spite of its decrease. The need for further progress in dealing with these weaknesses is all the more pressing in view of (i) globalisation, which entails an intensification of international competition, and (ii) population ageing, the implications of which, if adequate policy measures are not taken in a timely manner, will put considerable pressure on public finances and adversely affect the productive capacity of the economy.

The increase in ECB key interest rates that began in December 2005 is expected to contribute in the future to a reduction in inflation in the euro area as a whole and in Greece. However, given the size of the inflation differential vis-à-vis the euro area as a whole, achieving price stability in Greece will also require the contribution of fiscal policy, wage and unit labour cost growth at levels compatible with price stability, and structural reforms which

improve productivity, increase market flexibility and strengthen competition.

The continuation of structural reforms across a wide range of sectors will also be required to transform the Greek economy into one where growth is export- and business investment-led, so as to ensure high growth rates on a permanent basis.

Athens, October 2006

Nicholas C. Garganas
Governor

Monetary Policy Council of the Bank of Greece

Chairman

Nicholas C. Garganas

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I. Summary

Since late 2005 the monetary policy stance in the euro area has become less accommodative, in an international environment where monetary policy has tightened in many economies. The Governing Council of the European Central Bank (ECB) raised its key interest rates five times since December 2005,¹ by 125 basis points in total, and continues to monitor closely all economic and monetary developments so as to prevent upward risks to inflation and ensure price stability over the medium and long term. Upside inflationary risks in the euro area are associated with possible further increases in oil prices, a stronger pass-through of past rises into consumer prices, further hikes in administered prices or indirect taxes, as well as stronger than expected wage developments. Additional risks also stem from the continued strong growth of both M3 and credit to the private sector, against a backdrop of already excess liquidity, improved economic conditions and strong price rises in the property market.

Certainly, since key interest rates remain low, despite having increased in nominal and real terms, and at the same time – as already mentioned – M3 and credit continue to grow strongly and liquidity remains ample in the euro area, the ECB monetary policy remains accommodative. If, however, the ECB assumptions and baseline scenario concerning economic and monetary developments and prospects continue to be confirmed, it will remain warranted to further withdraw monetary policy accommodation. A timely intervention to prevent and contain inflationary pressures is essential in order to keep medium- and long-term inflation expectations in line with price stability, so that the single monetary policy can make

¹ Specifically, in October 2006 the minimum bid rate on the main refinancing operations stood at 3.25%, the marginal lending facility rate at 4.25% and the deposit facility rate at 2.25%.

an ongoing contribution towards sustainable economic growth and job creation in the euro area.

Increases in the key ECB rates contributed to a rise in euro area short-term interest rates in 2006. Long-term interest rates also recorded an overall increase, with some fluctuations, from the very low levels of 2005. Short- and long-term interest rate hikes affected bank interest rates on new deposits and new loans. In addition, stock prices in the euro area registered an overall increase, again with some fluctuations.

The annual growth rate of the Greek contribution to the euro area M3 (excluding currency in circulation) picked up gradually from January to August 2006, when it stood at 12.1% (second quarter of 2006: 9.7%, fourth quarter of 2005: 6.9%). This development is associated with portfolio shifts away from assets not included in M3 (mainly bond fund shares/units) to assets included in M3 (mostly deposits with an agreed maturity of up to two years), as well as an acceleration in the annual rate of increase in the total financing of the economy (notably general government financing). The annual growth rate of the Greek M3 has been higher than that of the euro area since the second quarter of 2006.

The annual rate of increase in the total financing of the economy by domestic Monetary Financial Institutions (MFIs, i.e. banks and money market funds)² edged up further during the first eight months of 2006, as in 2005, to stand at 19.6% in August (fourth quarter of 2005: 14.0%). This largely reflected developments in the rate of change in MFI financing of general government (August 2006: 12.8%, fourth quarter of 2005: -0.7%), as MFI holdings of government securities rose, after a period of continuous reduction in banks' government securities holdings in the context of portfolio restructuring. At the same time,

the growth rate of financing of enterprises and households also rose slightly (August 2006: 21.8%, fourth quarter of 2005: 20.1%) and remains high.

The annual rate of increase in bank loans to enterprises picked up in the January-August 2006 period (August 2006: 15.9%, fourth quarter of 2005: 12.7%, including corporate bonds). The share of corporate bonds in total bank lending to enterprises rose to 14.5% in August 2006 (December 2005: 12.0%). However, given that these bonds (issued by enterprises mostly because of the tax advantages they offer) are exclusively held by MFIs, they are virtually similar to typical bank lending. As regards developments in the breakdown of bank lending by sector of economic activity, the annual growth rate of loans to commercial firms slowed down (a trend which started in 2005) and the corresponding rate for loans to industrial firms picked up.³

The annual growth rate of credit to households remains high, showing only a slight deceleration during the first eight months of 2006 (August 2006: 29.1%, fourth quarter of 2005: 30.6%, including securitised loans). This reflects developments in the rates of increase in both housing and consumer loans. As the growth rate of loans to households remained high, households' total lia-

² The rate of change in the total financing of the economy by MFIs comprises the change in the outstanding balance of MFIs' corporate loans, loans to households and to general government, as well as the change in the outstanding amount of government debt securities and corporate bonds held by MFIs. It should be noted, however, that the change in these balances does not include the effects of loan write-offs and securitisation by banks during the reference period.

³ The growth rate of loans to non-bank financial corporations, in particular leasing companies, was also high and accelerating. However, credit to this sector is expected to fall significantly in the future (and credit to the other sectors is expected to rise commensurately), since, after the recent enactment of Law 3483/2006, financial institutions are allowed to pursue leasing activities themselves, hence it is possible that leasing companies will be absorbed by their parent banks.

bilities towards MFIs (including securitised loans) rose to 41.2% of GDP in August 2006 (December 2005: 38.0%). If securitised loans are not taken into account, MFI loans to households stood at 38.3% of GDP in August 2006, while the corresponding euro area rate was 53.4%.

Rates on bank deposits in Greece rose from January to August 2006, in line with the ECB key interest rates. Deposit rates in the euro area also increased (in the January-July period), and the rise was faster for deposits with an agreed maturity of up to one year. Thus, Greek rates on overnight deposits (the major deposit category in Greece) were by 21 basis points higher than the corresponding euro area average in July 2006 (almost the same as in December 2005), while for deposits with an agreed maturity of up to one year the positive differential narrowed to 14 basis points in July (from 24 basis points in December 2005).

In general, bank lending rates in Greece followed an upward course from January to August 2006, after falling significantly in the previous five years. In the January-July 2006 period, the rise in lending rates in the euro area was stronger than in Greece in most loan categories. Thus, the positive interest rate differential between Greece and the euro area has shrunk for corporate loans and tends to be eliminated for housing loans, but has widened for certain consumer loan categories.

The positive spread between the average weighted interest rate on total new bank loans and the corresponding interest rate on new bank deposits in Greece is larger than in the euro area. However, from December 1998 (well before Greece's euro area entry) to August 2006 there has overall been some progress, as the spread between lending and deposit rates narrowed by 344 basis points in Greece. Moreover, during the same period, Greek interest rates converged

towards the corresponding euro area interest rates; as a result, the positive differential between them has gradually shrunk.

The fact that the spread between bank lending and deposit rates in Greece remains wider than in the euro area is connected with such factors as Greek banks' higher operating costs, weaker competition in Greece than in the euro area, lower maturity of certain loan markets in Greece (in comparison with the corresponding markets in the euro area), higher cost (mostly size-related) of interbank borrowing for Greek banks and a higher non-performing loans (NPLs) to total loans ratio than in the euro area (as a result of which the risk premium incorporated in lending rates is higher).

The narrowing of the spread between bank lending and deposit rates is a long procedure which will continue as both the NPLs ratio and operating costs as a percentage of banks' assets decrease, markets mature, competition strengthens, Greek banks grow in size and financial market integration proceeds in the euro area – especially in the retail banking market, which lags behind in terms of integration. Characteristically, for certain consumer loan categories, the interest rate differential between Greece and the euro area remains wide, reflecting either banks' high administrative costs (e.g. for loans through credit cards) or the relatively lower level of collateralisation (e.g. for consumer loans with an interest rate fixation of over one and up to five years). By contrast, as already mentioned, for housing loans the interest rate differential between Greece and the euro area tends to be eliminated. Furthermore, interest rates on corporate loans (notably loans of over one million euro) have largely converged.

Generally, ensuring the stability of the banking sector is one of the main objectives of the Bank of Greece as competent supervisory authority, given

the key position of banks in the Greek financial system, the stability of which plays a very important role in the smooth functioning of the economy. Greek banks' exposure to credit and market risk, despite increasing slightly this year, is still relatively low, and their profitability and capital adequacy –which determine their capacity to absorb adverse shocks in the economic environment– continue to provide a satisfactory buffer for ensuring the stability of the Greek banking system. However, there is a need to monitor and control continuously the risks assumed by banks, as well as the possible impact of these risks on their balance sheet aggregates and capital adequacy ratios over the medium and the long term.

Greek banks' cross-border expansion, mainly to Southeastern European countries, has continued in recent years. Given the small size of the domestic market and stronger competition, by expanding abroad banks seek to take advantage of growth opportunities in these foreign markets, diversify their income and portfolio and increase their size, which is still relatively small in comparison with EU banks' average size. However, in order to minimise the risks from this expansion, domestic credit institutions must keep their capital adequacy ratios high, increase loan-loss provisioning, further consolidate their portfolios and, in particular, reduce their NPLs ratios (which remain relatively high in comparison with the euro area), as well as upgrade their internal control systems.

As regards developments in capital markets, the yields of Greek government bonds in the secondary market followed a steep upward path until June 2006, reflecting similar trends in international bond markets (mainly in the euro area), which were favourably affected by the release of positive macroeconomic data, the rise in oil prices and investors' estimates that the monetary policy stance would become less accommodat-

ive. Subsequently, these developments were more than offset by investors' uncertainty regarding the impact on the world economy from geopolitical instability and a possible slowdown in the US economy, which led to a decline in bond yields. The value of transactions in such securities on the Electronic Secondary Market for Securities (HDA) fell slightly in the first nine months of 2006 over the corresponding period of 2005, but remained close to the last five years' average. Moreover, at end-September 2006, the yield on the Greek ten-year government bond stood at 3.97%, i.e. 46 basis points higher than at end-December 2005. In the primary market for Greek government securities, the total amount of funds raised in the first nine months of 2006 decreased. The bulk of total bond issuance regarded bonds with maturities of ten years or more, while Treasury bill issues remained low this year as well.

In the period between January and September 2006, the main characteristics of the Greek stock market were a broad fluctuation of share prices and a considerable increase in transactions, as well as in the funds raised by firms. The improved profitability of firms listed on the Athens Exchange (Athex), the conclusion of important business deals, as well as investors' positive assessment of progress in the programme for flotations and privatisations of companies in which the state holds a stake boosted share prices in the Athex, in particular up to mid-May. Thereafter, until end-June 2006, the composite share price index of the Athex followed a steep downward path, mainly due to sales of shares by foreign institutional investors. However, in the July to September 2006 period, the successful initial public offering of the Postal Savings Bank and the privatisation of Emporiki Bank, the confirmation of investors' estimates about a considerable improvement in the profitability of Athex-listed firms in the first half of

2006 and the fall in long-term interest rates during the third quarter led to a rebound in share prices. Thus, at end-September 2006, the Athex composite index stood 7.3% higher than at end-December 2005. Furthermore, in the first nine months of 2006, both the average daily value of transactions and the funds raised through the stock market increased considerably year-on-year.

* * *

The *international economic environment* remains favourable in 2006, since the world GDP growth rate has remained around 5% for the third consecutive year and global growth is becoming more broadly based across geographical regions as euro area GDP growth picks up. Underlying the strong expansion of the world economy in recent years are the dynamism of emerging economies (in particular China and India), which led to a major increase in world trade; very low nominal and real interest rates; and the expansionary fiscal policies pursued in certain advanced economies (mainly the USA) since the beginning of the 2000s. Inflation in advanced economies has been rising since 2003, chiefly due to the large increase in oil prices, but generally remains low. The main reasons for the containment of inflation are the strong pressures exerted by international competition, the increasing penetration of products from low-cost countries into the world market, as well as the consistency and credibility of central banks' monetary policies, which are aimed at maintaining price stability.

However, the favourable outlook of the world economy is subject to risks, associated, first, with the impact of high oil prices, to the extent that they tend to become persistent (irrespective of short-term fluctuations), and, second, with the way in which global and domestic economic imbalances will evolve in an environment where

monetary policy is becoming tighter. As for inflation, there are elements of uncertainty concerning both the indirect impact of rising oil and other commodity prices on the prices of other goods and services and any eventual second-round effects these increases will have on wages.

The economic upturn in the *euro area* in 2006 appears to be more firmly based than in the recent past, as both external and domestic demand are forecast to increase at a satisfactory rate. According to ECB, European Commission and IMF projections and forecasts, the average annual growth rate of euro area GDP will be around 2.5% in 2006 (from 1.3% in 2005) and 2% in 2007, while average annual inflation is expected to be over 2% in the current year and in 2007.

Underlying the pickup in GDP growth during the first half of 2006 are both stronger domestic demand (private consumption and investment) and higher net exports. Although monetary policy, as already mentioned, has begun to take a less relaxed stance, nominal and real interest rates in the euro area remain low, bolstering economic activity. It is also expected that the implementation of structural reforms (such as those included in the Lisbon Strategy) may have a beneficial effect on the dynamism and economic prospects of the euro area.

HICP inflation in the euro area remained above 2% in the first eight months of 2006. Oil prices were the main reason underlying price increases during this period, while the indirect impact of rising energy prices and raw materials also played a part. In September, however, inflation fell markedly (to 1.8%, according to Eurostat provisional estimates), almost exclusively as a result of the fall in oil prices in the same month. In the period until the end of 2006, it is possible that inflation will once again rise: the outcome

will depend mainly on the evolution of oil prices and on their indirect effects on the prices of other products.

According to ECB staff projections (completed *before* the fall in oil prices and the noticeable drop in inflation in September), inflation in the euro area is expected to stand, at average annual levels, between 2.3% and 2.5% in 2006 and between 1.9% and 2.9% in 2007. These projections are based on the assumption that the rise in oil prices and other raw materials will have only limited second-round effects on wages; that there will be a further steady increase in productivity (and thus the increase in unit labour costs will generally be limited); and that there will be no major inflationary pressures from non-commodity import prices.

As far as the *Greek economy* is concerned, it is estimated that the large increase in domestic demand and the improvement of foreign demand have helped it maintain its high growth rate in 2006. At the same time, however, the rise in domestic demand, which is not matched by domestic supply, has led to an increase in goods imports. This increase, together with the hike in the oil import bill (as a result of rising international oil prices until August), has driven the current account deficit to alarmingly high levels and kept inflation around the (relatively high) levels of 2005.

In more detail, GDP growth at constant prices (4.1% in the first half of 2006 and an estimated 3.8% for 2006 as a whole, compared with 3.7% in 2005) is mainly driven by a strong rise in domestic demand, as well as by faster goods exports growth. By contrast, services exports (at constant prices) have increased only a little, since the rise in travel receipts seems to be offset by the small decrease or no change in transport (mainly shipping) and "other" services receipts. Furthermore, the increase in domestic demand (which mainly

concerns non-domestically produced goods, e.g. various consumer durables and capital goods) is largely met by goods imports, which push up considerably the deficit of the real external balance on goods and services (on a national accounts basis). It is also estimated that private consumption has risen sharply as a result of an increase in households' real disposable income, continued rapid consumer credit expansion, the cumulative rise in the market value of households' wealth in recent years and employment growth. Total investment is increasing strongly in 2006, after a small decline in 2005, owing to, on the one hand, faster business investment growth and, on the other hand, a rebound in residential investment (which decreased slightly in 2004 and 2005) and public investment (which was drastically cut in 2005).

The annual growth rate of total employment was 1.7% in the first half of 2006. During the same period, the employment rate (i.e. the ratio of the employed aged 15-64 to the total population of the same age) rose to 60.7%, while the unemployment rate fell to 9.2% (8.8% in the second quarter of 2006). The increase in employment stemmed from the services sector.

The current account deficit is expected to widen by around three percentage points and approach 11% of GDP in 2006 (after growing by one and a half percentage points of GDP in 2005). Underlying this development are mainly the impact from rising oil prices until August, a considerable increase in goods and services import volumes (including ships) and higher interest payments on debt securities held by non-residents, which more than offset the favourable effect of the faster goods export growth.

Average annual HICP inflation is expected to be around 3.3% in 2006, i.e. almost at the same level as in 2005, since the fading-out of the effect from

the indirect tax increases in April 2005 is mainly offset by the impact from the rise in international oil prices (until August) and a stronger increase in unit labour costs in 2006 than in 2005 (whole economy: 3.8%, from 2.2%, business sector: 4.5%, from 2.3%). Core inflation (as measured by the annual rate of change in the HICP excluding energy and unprocessed food) is expected to decline to 2.8%, from 3.2% in 2005, exclusively owing to the fading-out of the effect from last year's indirect tax hikes (as already mentioned).

The fact that average annual inflation in Greece exceeds the corresponding figure in the euro area as a whole (by 1.3 percentage points on average in the 2001-2005 period and one percentage point in the first eight months of 2006) and that the differential of the average annual increase in unit labour costs between Greece and the euro area as a whole is even wider (two percentage points in the 2001-2005 period and 2.9 percentage points in 2006) leads to price competitiveness losses. It is estimated that the real effective exchange rate (vis-à-vis Greece's 27 main trading partners) based on consumer prices (i.e. the relative consumer prices expressed in a common currency) has cumulatively risen by approximately 14% between 2000 and 2006, while the relative unit labour costs in manufacturing expressed in a common currency rose by 34% in total. In the same six-year period, the nominal euro exchange rate (weighted on the basis of Greece's external trade) rose cumulatively by almost 9% (appreciation of the euro).

* * *

Living standards in Greece, despite being boosted by continuous GDP growth during the last 13 years, still fall short of the EU-15 average (measured by *per capita* GDP in purchasing power standards). (However, it is expected that

this shortfall will be reduced considerably on the basis of the revised GDP data for the period from 2000 onwards.⁴) At the same time, the poverty and inequality indicators exceed the EU-15 averages, implying that economic growth is not diffused sufficiently.

Generally speaking, the Greek economy still faces serious challenges because of the structural weaknesses that continue to exist and are reflected in the country's relatively high rate of inflation, large current account deficits, exceptionally high public debt-to-GDP ratio, and the rate of unemployment, which remains relatively high in spite of its decrease. The need for further progress in dealing with these weaknesses is all the more pressing in view of (i) globalisation, which entails new opportunities, but also an intensification of international competition, and (ii) population ageing, the implications of which, if adequate policy measures are not taken in a timely manner, will put considerable pressure on public finances and adversely affect the productive capacity of the economy.

First of all, the fact that price stability has not yet been achieved and that inflation remains higher than in the euro area adversely affects Greece's international competitiveness and, ultimately, its economic growth and employment prospects. Furthermore, this obviously also entails a higher cost of living for consumers in Greece, i.e. it erodes the purchasing power of incomes, particularly of the economically weaker and of those whose nominal income is practically fixed. It is well known that the single monetary policy is geared towards achieving price stability in the euro area as a *whole*. Moreover, the recent increases in the ECB key interest rates are also consistent with the goal of disinflation in Greece:

⁴ The detailed data on the GDP revision were not available when this report was going to press.

therefore, the increases in the ECB interest rates can be expected to contribute to the reduction of inflation in Greece in the future. However, given the size of the inflation differential vis-à-vis the euro area as a whole, achieving price stability in Greece will require the contribution of other policies, namely fiscal policy, wage and unit labour cost growth at levels compatible with price stability, and structural reforms which improve productivity, increase labour and product market flexibility and strengthen competition.

The fiscal deficit was substantially reduced in 2005 and 2006. In addition, the structural fiscal adjustment that has been achieved is not negligible, but remains insufficient. Reducing public debt to below 60% of GDP within a reasonable time horizon and coping with the greater strain that population ageing will put on public finances will require a permanent further improvement in Greece's fiscal position as well as sizeable primary surpluses. In order to improve the efficiency of the public sector and generate sizeable primary surpluses, measures will need to be taken both on

the revenue side (mainly to curb tax evasion substantially) and on the expenditure side of general government finances (to ensure an efficient control of primary expenditure).

Also, the transformation of the Greek economy into one where growth is export- and business investment-led, so as to ensure high growth rates on a permanent basis, will require a continuation of structural reforms across a wide range of sectors. The objectives of these reforms should be, *inter alia*, to attract foreign direct investment, encourage the creation of large export-oriented enterprises and, more generally, strengthen the forces of competition, achieve a more efficient functioning of the product and labour markets and of the public sector, ensure the viability of the pension system, upgrade the education system and promote Research and Development (R&D), cut down on bureaucracy and modernise public administration, and deal with corruption. Fiscal consolidation and structural reforms can, at the same time, contribute substantially to the reduction of poverty.

II. The international economic environment and economic developments and prospects in the euro area

1. The international economic environment¹

1.1 Overview

The international economic environment remains favourable in 2006, as the growth rate of global GDP has been maintained for the third consecutive year at around 5% and global growth is more broadly based in geographical terms, with the acceleration of euro area GDP growth. The strong expansion of the world economy in recent years is due to the dynamism of emerging economies (particularly China and India), which brought about a major increase in world trade; to very low nominal and real interest rates; and to the expansionary fiscal policy pursued in certain advanced economies (particularly the USA) since the beginning of the 2000s. Inflation in the advanced economies has been increasing since 2003, chiefly due to the steep rise in oil prices, but generally remains low (see Table II.1). The main reasons for the containment of inflation are the strong pressures exerted by international competition, the growing penetration of products from low-production-cost countries into the world market, as well as the consistency and credibility of central bank policies aimed at maintaining price stability. However, the favourable outlook of the world economy is subject to risks, associated, first, with the impact of high oil prices, to the extent that these tend to become more permanent (irrespective of short-term fluctuations) and, second, with

¹ The following analysis is based on macroeconomic developments until the end of September 2006, on analyses and estimates by the Economic Research Department of the Bank of Greece, and on forecasts by international organisations. Where no new data exist, forecasts by the IMF (*World Economic Outlook*, September 2006), the European Commission (*Spring 2006 Economic Forecasts*, May 2006, and *Interim Forecasts*, September 2006) and the OECD (*Economic Outlook*, June 2006) have been used.

Table II.1

Key macroeconomic aggregates of the world economy (2004-2006)

	Number of countries	Share in GDP ¹ (%)	GDP (annual percentage changes in volume)			Inflation ² (annual percentage changes)			Fiscal balance (% of GDP)			Current account balance (% of GDP)		
			2004	2005 ³	2006 ³	2004	2005 ³	2006 ³	2004	2005 ³	2006 ³	2004	2005 ³	2006 ³
World total	174	100.0	5.3	4.9	5.1	–	–	–	–	–	–	–	–	–
1. Advanced economies	29	52.3	3.2	2.6	3.1	2.0	2.3	2.6	–3.3	–2.7	–2.3	–0.8	–1.4	–1.6
USA		20.1	3.9	3.2	3.4	2.7	3.4	3.6	–4.6	–3.7	–3.1	–5.7	–6.4	–6.6
Japan		6.4	2.3	2.6	2.7	0.0	–0.6	0.3	–6.3	–5.6	–5.2	3.8	3.6	3.7
United Kingdom		3.0	3.3	1.9	2.7	1.3	2.0	2.3	–3.2	–3.3	–3.2	–1.6	–2.2	–2.4
Euro area	12	14.8	2.1	1.3	2.4	2.1	2.2	2.3	–2.7	–2.2	–2.0	0.9	0.0	–0.1
2. Emerging and developing economies	145	47.7	7.7	7.4	7.3	5.6	5.3	5.2	–1.7	–0.9	–0.5	–	–	–
China		15.4	10.1	10.2	10.0	3.9	1.8	1.5	–1.5	–1.3	–1.2	3.6	7.2	7.2

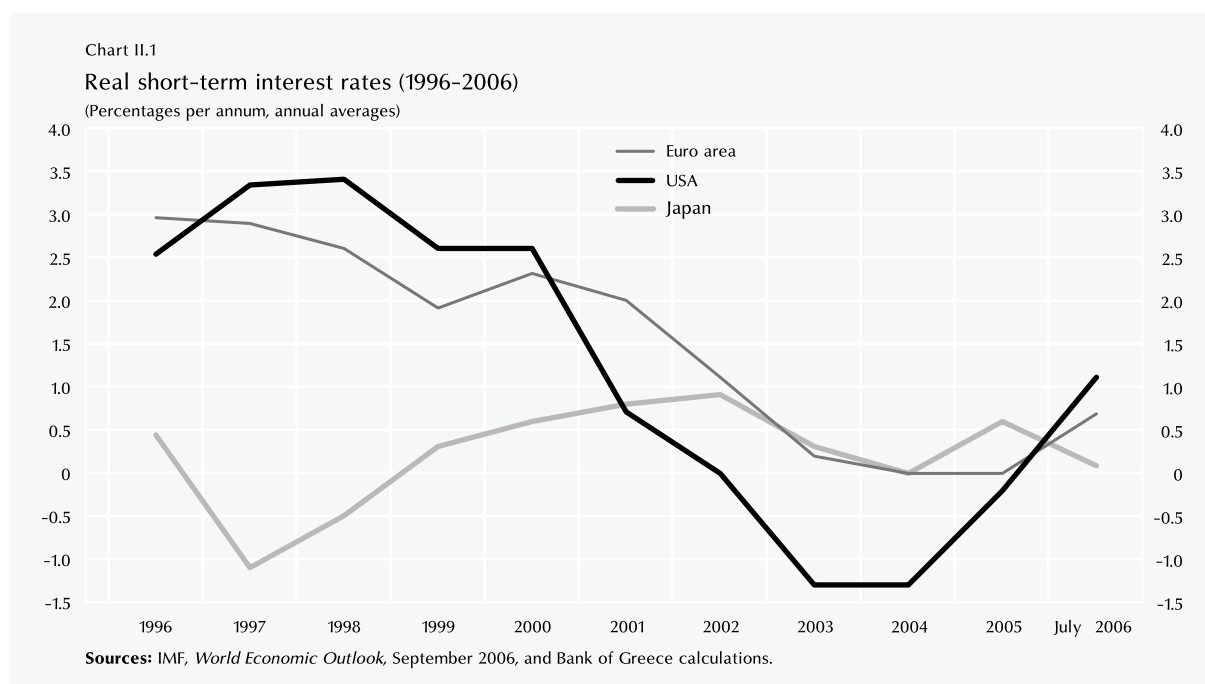
1 Percentage share in world GDP in 2005, on the basis of exchange rates that take into account differences in purchasing power parities.

2 HICP for the euro area and the United Kingdom, CPI for the other countries.

3 2005: estimates, 2006: forecasts.

Note: According to IMF classification: Advanced economies: EU-15, the four new industrial economies in Asia (Korea, Singapore, Taiwan-Chinese province and Hong-Kong-SEZ) and USA, Japan, Canada, Australia, Switzerland, Iceland, Israel, Cyprus, Norway, New Zealand. Emerging and developing economies: Africa (48), Central and Eastern Europe (15), Commonwealth of Independent States (13 incl. Mongolia), Developing Asia (23), Middle East (13) and Western Hemisphere (33).

Source: IMF, *World Economic Outlook*, September 2006.



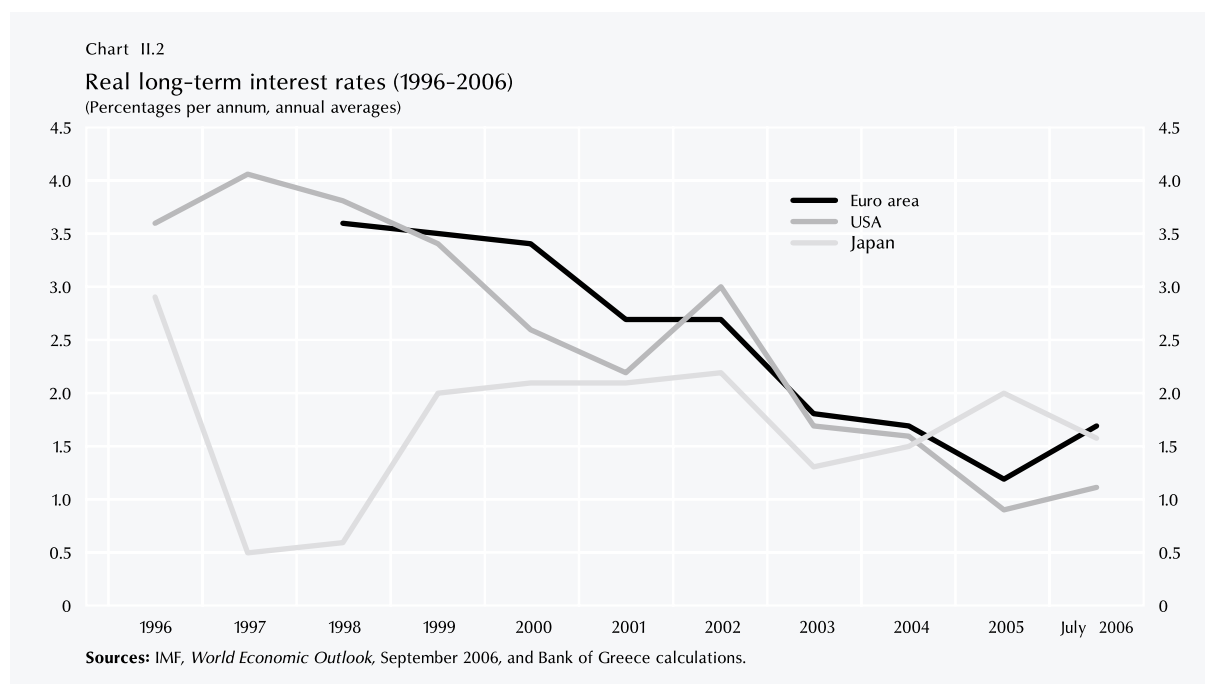
the way in which global and domestic economic imbalances will evolve in an environment where monetary policy is becoming tighter. As for inflation, there are elements of uncertainty concerning (i) the indirect impact of the rising price of oil (until August) and of other commodities on the prices of other goods and services and (ii) any eventual second-round effects these increases will have on wages.

In the first six months of 2006 the development of global economic activity remained generally satisfactory, despite high and increasing fuel prices and a partial reversal – in the second quarter of the year – of the favourable climate in the financial markets. The prices of commodities on international markets, chiefly metals and fuel, continued to move upwards, strengthening inflation expectations and inflation and thus leading many central banks to adopt a policy of raising key rates to reduce increased liquidity. However, despite the rise in short-term interest rates, financial conditions remain favourable as long-term real rates are still low,² despite having increased

(see Charts II.1 and II.2). The growth rate of global GDP in 2006 is forecast to continue to be higher than the long-term trend (1970-2005: 4.3%) and to remain high in 2007. More specifically, in 2006 it is estimated that this rate will accelerate slightly to 5.1% (from 4.8% in 2005), supported by the high growth rates recorded in international trade and business investment, which are boosted by the satisfactory level of business profitability. In 2007 global GDP growth should fall slightly to 4.9%. Economic growth in 2006 is expected to be more balanced in geographical terms, with a significant acceleration of the growth rate in the euro area and a small acceleration (in the *average annual rate*³) in the USA, which, together with China, remains the driving force of world economic growth.

² The IMF forecasts that the weighted nominal rate on ten-year government bonds in the seven largest advanced economies, minus inflation, will rise to 2.1% in 2006, from 1.3% in 2005, the lowest real interest rate since 1981.

³ Although the USA's GDP growth rate slowed in the second quarter (in comparison with the first), the average annual rate for 2006 as a whole is forecast to be slightly higher than in 2005.



GDP growth in the advanced economies as a whole is expected to accelerate to 3.1% in 2006, from 2.6% in 2005, while in emerging and developing economies it will remain high (2006: 7.3%, 2005: 7.4%). Among the seven largest advanced economies, the USA has continued to exhibit the highest rate of economic growth (3.4% in 2006) since 2003. However, the downturn in the real estate market in the USA heightens the risk of a slowdown in GDP growth (which will fall to 2.9% in 2007, according to the IMF). The Japanese economy in 2006 will continue to grow at a satisfactory pace (2.7%). As for emerging and developing markets, the convergence, at high levels, of economic growth rates in the main regions is notable. GDP growth rates in the developing economies of Latin America and the Middle East are forecast to accelerate in 2006 to 4.8% and 5.8% respectively, while the highest rate (8.7%) is once again expected to be reported by the developing economies in Asia (among which China, 10.0%, and India, 8.3%). The GDP growth rate in the developing economies of Africa is forecast to remain

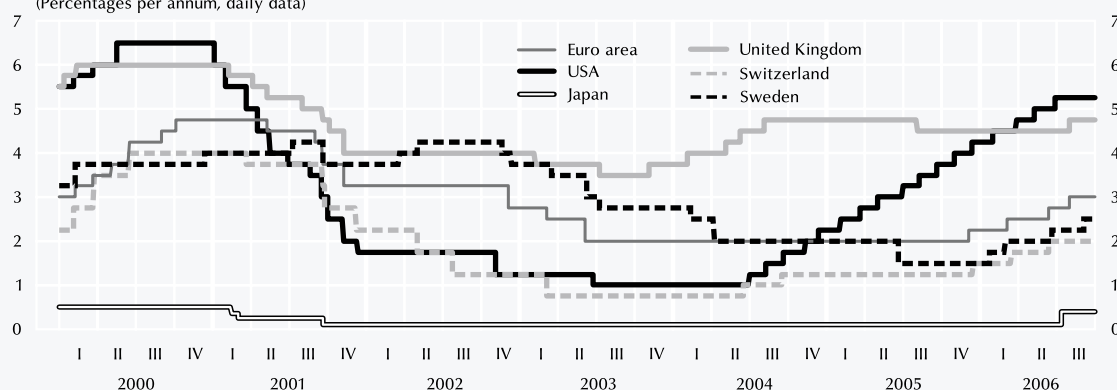
unchanged at 5.4%, exceeding 5% for the third consecutive year.

Fiscal policy in the main advanced economies as a whole became slightly more restrictive in 2006. The IMF expects the general government deficit to fall for the third consecutive year in 2006, remaining, however, relatively high (3.2% of GDP, compared with 3.6% in 2005, 4.8% in 2003 and just 0.2% in 2000). This improvement was almost entirely due to the reduction in the structural deficit in these economies, which fell to 3.1% of potential GDP, compared with 3.4% in 2005. Despite the progress noted in recent years, Japan and the USA continue to report high fiscal deficits, 5.2% and 3.1% of GDP respectively, while the United Kingdom's deficit also remains large (3.2%). In the euro area the fiscal deficit is also expected to show a small reduction in 2006, but to remain relatively large in certain countries (see Section 2 of this chapter for fiscal developments in the euro area). The gross public debt as a percentage of GDP is expected to remain essentially unchanged in the US and Japan at 62.5% and 181.8% respectively.

Chart II.3

Central bank key rates (1 January 2000 – 30 September 2006)

(Percentages per annum, daily data)



Note: On 5 October 2006, the Governing Council of the ECB decided to increase the key interest rates further, by 25 basis points.

Sources: Euro area: European Central Bank (ECB), minimum bid rate on main refinancing operations.

USA: Federal Reserve, intended federal funds rate.

Japan: Bank of Japan, official discount rate.

United Kingdom: Bank of England, repo rate.

Switzerland: Central bank of Switzerland, intended ceiling on the three-month Libor.

Sweden: Central bank of Sweden, repo rate.

Monetary policy in 2006 moved towards a more restrictive stance in many advanced economies (see Chart II.3).⁴ The expansionary monetary policy pursued chiefly in the US and Japan in the period 2001-2003, aimed at avoiding the risk of economic recession and deflation, gradually led to a high level of liquidity in the global monetary system. The fall in both nominal and real interest rates to historically low levels contributed indeed to a strong upturn in the world economy as well as to a simultaneous rise in share and bond prices. Also, it led to a rapid increase in real estate prices in many advanced economies. As the economic upturn became entrenched, the need to reverse the stance of monetary policy, which began in the United Kingdom and the USA in 2003-2004, became more pressing from the end of 2005, chiefly in order to limit the inflationary effect of high and rising international crude oil prices.

Economic developments in the Balkan countries are particularly interesting as commercial and economic relations in general between these

countries and Greece have grown significantly in recent years. Box II.1 presents the major economic developments and prospects of three neighbouring countries, Bulgaria, Romania and Turkey. These three countries are Greece's main trading partners in the region and together account for approximately 14% of Greece's exports and 5% of its imports.⁵

⁴ More specifically, after raising the short-term key rate 13 times in 2004 and 2005 (from 1.0% to 4.25%), the US Federal Reserve raised it a further four times in 2006, each time by the same amount, bringing it up to 5.25% on 29 June 2006. Between December 2005 and October 2006 the ECB raised its key rate from a historically low level of 2.0% to 3.25% (see Section 3 of this chapter). After raising the key rate from 3.5% to 4.75% between November 2003 and August 2004, the Bank of England cut it to 4.5% in August 2005, while on 3 August 2006 it returned the rate to 4.75%. The National Bank of Switzerland and the Central Bank of Sweden are also in a phase of increasing key rates. The former raised the key rates gradually from 1.25% to 2.0% (increases implemented on 15 Dec. 2005, 16 March 2006 and 15 June 2006) and the latter from 1.50% to 2.50% (increases on 25 Jan. 2005, 1 March 2006, 21 June 2006 and 6 Sept. 2006). In Japan, where the positive inflation rate and economic upturn are quite recent developments, the Bank of Japan raised the key rate on 14 July 2006 to 0.40%, from the 19 Sept. 2001 figure of 0.10% as part of its programme to restructure monetary policy gradually.

⁵ NSSG data for 2005.

BOX II.1

Economic developments and prospects in Bulgaria, Romania and Turkey

As is the case to varying degrees for other Balkan countries, Bulgaria, Romania and Turkey have been in a stage of strong economic growth in recent years, and their efforts to stabilise their economies and implement major reforms have begun to bear fruit. The GDP growth rate in these countries has varied between 4% and 9% in the last three years, while inflation followed in general a downward course (until 2005). However, in the current year a resurgence in inflation and a widening current account deficit have been observed, chiefly due to the high rate of credit expansion and the increase in domestic demand, and, especially in the case of Turkey, to the impact of disturbances affecting financial markets in emerging economies in general. The prospect of EU accession for each of these countries (with a different time horizon for each country¹) enhances their stability but at the same time makes it more pressing to continue their efforts to achieve economic stabilisation and enhance their international competitiveness.

In *Bulgaria*, the GDP growth rate was 5.5% in 2005 and, according to the IMF, it is expected that this figure will remain in effect unchanged in the current year (5.6%), accelerating to 6.0% in 2007. Inflation reached 5.0% in 2005 but the figure rose this year to 8.5% in May – a development attributable to strong domestic demand, increased indirect taxation and the sharp rise in energy prices. In August inflation fell to 6.8%, while its average annual level for 2006 is expected to be 7.4%. The current account deficit reached 11.8% of GDP in 2005 and is forecast to rise to 12.4% of GDP this year, remaining at approximately the same level in 2007. One positive aspect is the fact that most of the deficit is funded by an inflow of foreign direct investment. The country's monetary and exchange rate policies have, since 1997, been governed by a currency board (which initially used the German mark as its reference currency, followed by the euro from 1999), a fact which played a decisive part in scaling down inflation. The net capital inflow in recent years has led to a significant rise in the country's reserve assets, which stood at \$8 billion at the end of 2005. However, this massive inflow of capital also makes it difficult to control liquidity under a

stable exchange rate regime. Fiscal policy (it is estimated that the fiscal surplus in the current year will be 3% of GDP²) is expected to contribute towards restraining the increase in domestic demand.

In *Romania*, GDP growth was 4.1% in 2005 and, according to the IMF, it will reach 5.5% in the current year, remaining at this level in 2007. Inflation, which was exceeding 10% up to the end of 2004, fell to 9.0% in 2005 and is forecast to fall further to 7.8% in the current year. However, the high growth rates of wages and domestic demand, combined with other special factors such as the increase in indirect taxes and administered prices, make it difficult to bring down inflation. The current account deficit was 8.7% of GDP in 2005 and is forecast to widen to approximately 11% of GDP this year, remaining at about the same level in 2007. Roughly half of the current account deficit has been covered by the inflow of foreign direct investment in recent years. This large capital inflow, combined with the extensive intervention of the central bank in the foreign exchange market, resulted in a major increase in the official reserve assets to approximately \$20 billion at the end of 2005. The fiscal adjustment has continued in recent years, as the general government deficit was reduced from 4% of GDP in 2000 to 0.4% of GDP in 2005. However, the fiscal deficit is forecast to increase to 2.3% of GDP in 2006, with an even greater increase in 2007.³

In *Turkey*, GDP growth was particularly high in 2004 (8.9%), but fell to 7.4% in 2005 and is expected to move towards more sustainable levels, around 5%, in 2006 and 2007. The fiscal consolidation has been particularly significant in recent years, with the general →

¹ Bulgaria and Romania are "acceding" countries and it is expected that they will join the EU on 1 January 2007 provided that they satisfy the relevant conditions (the European Commission report of 26 September 2006 was positive for both countries). Turkey is a "candidate country". The decision to initiate accession negotiations was taken by the European Council in December 2004.

² European Commission, *Spring 2006 Economic Forecasts*, May 2006.

³ European Commission, *op. cit.*

→ government deficit falling to 1.2% of GDP in 2005, from 11.3% in 2003 and 5.7% in 2004. The high current account deficit, around 6.5% of GDP (on the basis of the 2005 figures and forecasts for 2006), is considered a cause for uncertainty, as the proportion covered by the inflow of foreign direct investment is generally small, despite increasing in 2005. Disturbances on the money markets of emerging economies in the second

quarter of 2006 had an impact on the Turkish economy (with a significant capital outflow and a drop in the Turkish lira on the foreign exchange markets) and led to a significant rise in interest rates by the central bank. Inflation, which had been on a downward course in recent years, rebounded in 2006, reaching 10.3% in August, from 7.9% in January and 8.2% on average in 2005.

The generally positive short-term prospects for world growth and inflation are subject to risks and uncertainties. The world economy is now being called upon to tackle a complex problem, the impact from the adjustment of accumulated global imbalances (which characterise the balance of payments in several countries) and, possibly, from the adjustment of prices of major assets in an environment of high energy product prices and more restrictive macroeconomic policy.

It is felt that the most serious risks are posed by:

(a) The *high* and sharply *fluctuating* international price of crude oil (which was rising until August but then fell), whose effect on inflation and the growth rate of advanced economies may not yet be fully evident. While excess demand was a characteristic feature of the oil market in 2003 and 2004, supply side restrictions have gradually become more important, leaving international markets and economies more vulnerable.

(b) The wide and expanding current account deficit in the USA, which is reflected in the high surpluses of oil exporting countries, Japan, China and other emerging Asian economies. While the funding of the American deficit goes on unhindered so far, the widening of the deficit entails the risk of a sudden correction, which could have an adverse impact on the world economy. For the adjustment of the deficit to be carried out in a controlled manner, a policy mix is

required which will be based on increased domestic savings in the US (chiefly via reduction of the fiscal deficit), an increase in demand in other economies which have a current account surplus, as well as greater flexibility in exchange rate fluctuations.

(c) The uncertainty surrounding the interplay of rising interest rates and accumulated economic and financial imbalances. Increasing globalisation and the major changes in relative prices heighten such uncertainty and make it essential that a policy be adopted to narrow fiscal deficits and structural reforms be implemented to increase the adaptability of economies.⁶

1.2 World trade and international prices of oil and other commodities

The volume of world trade in goods and services continued to increase fast in 2006, due both to strong international demand and to the ever-increasing interdependence and integration of product markets. The growth rate of world trade volume is expected to accelerate to 8.9% in 2006 (2005: 7.4%), exceeding both the average for the last five years (5.4%) and the long-term average (1970-2005: 7.4%). Emerging and developing economies continue to exhibit significantly faster growth in trade volume in comparison with

⁶ See BIS, *Annual Report*, June 2006.

advanced economies.⁷ China turned in the best performance, with a continuously growing share of world trade (6.6% in 2005, from 4.0% in 2001). However, the interruption to the “Doha Round” trade negotiations organised by the World Trade Organisation and the failure to reach agreement on a date to recommence negotiations entail a risk of increased pressures worldwide towards protectionism. The Doha Round began in 2001 and was aimed at further liberalising and strength-

ening multilateral trade in goods and services and at incorporating developing markets more fully into the international trade system to help them overcome their development deficiencies (see also Box II.2).

⁷ Export volume in emerging and developing economies is expected to have increased by 10.7% in 2006, with a corresponding figure of 8.0% in advanced economies. Import volume rose by 13.0% and 7.5% respectively.

BOX II.2

The Doha Round: developments and prospects

On 24 July 2006, the World Trade Organisation (WTO) agreed to suspend the multilateral trade negotiations taking place as part of the “Doha Development Agenda” following formal recognition that the talks among the main parties (the EU, the US, Japan, Australia, Brazil, India) had reached a deadlock. The negotiations ended in deadlock, first because of the unwillingness of countries with advanced economies to go ahead with bold reductions both in subsidies for their own agricultural produce and in tariffs they impose on agricultural produce imported from third countries and, second, because of the unwillingness of countries with developing economies to take major steps to remove barriers against imports of goods and services.

The “Doha Development Agenda” is the most recent round of international multilateral trade negotiations.¹ The “Agenda” began in Doha, Qatar in November 2001 (during the 4th Ministerial Conference of the WTO²). The goal initially was to complete the negotiations by 1 January 2005, though the deadline was later extended to the end of 2006. The Doha Round represents an opportunity to renegotiate international trade regulations to the benefit of developing economies and, at the same time, to provide substantial impetus for trade and development within the world economy. In addition, the Agenda is the first round of negotiations to include fully the services sector. This sector, the source of 2/3 of world GDP, represents just 20% of world trade. The complete programme of the Round is rather extensive and ambitious. The proposed tariff cuts, both

for agricultural and industrial products, are greater than those decided upon during previous Rounds.

The cost of failure to complete the negotiations, i.e. the loss of the ability to expand economic activity, will have a negative effect on both advanced and developing economies, though the impact on the latter will be greater. The OECD estimates that the potential benefit of fully eliminating tariffs on agricultural and industrial products approaches \$100 billion. The corresponding potential benefit to the services sector, the fastest growing sector, is estimated to be much greater, about \$500 billion. Successful completion of the negotiations to abolish other barriers, illegal tariffs, procedural obstacles, etc. could, as estimated by the OECD, bring a potential benefit of \$100 billion. From this potential total benefit of \$700 billion, it is estimated that around 2/3 would be reaped by emerging and developing economies.³ Another major impact of suspending the Doha Round is thought to be the →

¹ The previous “Uruguay Round” lasted from 1986 to 1994.

² According to the charter of the WTO, which began to operate on 1 January 1995 as the institutional successor to the General Agreement on Tariffs and Trade (GATT), the Ministerial Conference of all the Member States (149 at present) is the Organisation’s highest body and convenes at least once every two years. The most well known Ministerial Conference was the 3rd (held in Seattle, USA, in 1999), at which efforts to set up a new round of multilateral trade negotiations failed completely.

³ See the text by Angel Gurría, Secretary General of the OECD, “Doha: the low-hanging fruit,” 21 August 2006.

→ risk that, instead of achieving general strong consensus on a multilateral basis, there could be a trend towards greater levels of trade protectionism and trade disputes and a turn towards regional co-operation (rather than multilateral collaboration at a global level).

As for mid-term prospects, however, it is expected that any suspension of negotiations will only be temporary, as the cost of any irrevocable collapse of negotiations and the reversal of progress made over the last five years would be high.⁴

The Finance Ministers and the Governors of the Central Banks of the Group of 7 (G-7), who met in Singapore on 16 September 2006, stressed in their announcement how important it is for world growth to promote multilateral liberalisation of world trade and

to reduce poverty. They encouraged all parties involved to show political decisiveness and flexibility in order for the work of the Doha Round to recommence as soon as possible.

The Group of 20 developing nations (G-20), which includes Brazil, Argentina and India, met in Rio in September to re-examine the possibility of restarting the negotiations. A meeting of the “Cairns Group”⁵, i.e. the 18 nations with major exports of agricultural products, was also held in Australia.

⁴ Note that, due to the principle of the “single undertaking”, all agreements reached to date since the beginning of the Round will remain valid only if the negotiations are completed.

⁵ The “Cairns Group” was named after the city in Australia in which it was established in 1986.

The increase in crude oil prices, which began in early 2002, continued for the first eight months of 2006. The price of Brent crude oil reached a new historical high on 9 August (\$78.2 per barrel), but fell later following announcement of the ceasefire in Lebanon; the drop was particularly marked in September. In euro terms, the Brent price rose in the first eight months of 2006 by 24%, compared with the average price in 2005.⁸ Developments in 2005 and 2006, which were marked by high volatility in the current and forward price of crude oil, appear to have been influenced chiefly by geopolitical tension⁹ and the uncertainty surrounding the future adequacy of oil supplies in a market which is already under strain. These factors have contributed to increased speculation on the crude oil forward market. The increase in total demand for oil has slowed and the rates are now as expected (1.3% in 2005 and 1.4% in 2006),¹⁰ unlike 2004, when the rise in the price of oil was chiefly due to a strong and mostly unexpected rise in global demand (4.1%).¹¹

The dollar prices of non-fuel commodities rose significantly in 2006 (25% from the start of the year

until the end of August), especially basic metal prices, while the market as a whole was marked by sharp fluctuations. Institutional investors’ increasing strategic interest in investing in the commodi-

⁸ According to the technical assumptions used by ECB staff (September 2006), based on forward prices at the end of July – start of August 2006 (i.e. *before* the marked drop in oil prices), the average price of crude oil is forecast to rise to \$71.0 per barrel in the current year and to \$77.6 per barrel in 2007, from \$54.4 per barrel in 2005 (see ECB, *Monthly Bulletin*, September 2006). Following recent developments, these projections may need to be revised downwards (at least for 2006). In the estimation of the IMF, a considerable proportion of the impact of the present oil crisis will not be of a temporary nature. According to a recent study by the Fund (April 2006), the increase in oil prices from 2003 until today has led the US current account deficit to widen by more than 1% of GDP and at the same time reduced the balance of payments surplus of non-oil producing countries in Asia.

⁹ The future of Iran’s nuclear programme, developments in the Middle East and the drop in oil exports due to terrorist attacks on oil-producing units in Iraq and Nigeria have all caused further concern for markets in 2006 and contributed to a new round of price rises. Note that the combined oil production of Iran, Iraq and Nigeria represents 11% of world crude oil production. Other recent factors causing concern about the adequacy of oil supplies in the future include the coming hurricane season in the North Atlantic and the closure of one of the main units operated by a major oil company in Alaska.

¹⁰ See International Energy Agency, *Monthly Oil Report*, July 2006.

¹¹ The slowdown in the growth rate of demand worldwide implies that it has already begun to adapt to higher prices, while, at the same time, an increase can be observed in strategic and commercial reserves.

ties forward market to diversify portfolio risks is thought to have contributed to the increase in the price of crude oil and basic metals. A decisive role in this development was also played by the rising international demand for basic metals (particularly on the part of China) as a result of the growth of the world economy, the limited increase in basic metal production and the relatively low levels of the respective reserves.¹² It is indicative that, according to the IMF (September 2006), basic metal prices have risen since 2002 by 180% in real terms, a greater rise than that observed in the price of oil (157% in real terms).

2. Macroeconomic developments and prospects for the euro area^{13, 14}

The economic upturn in the euro area in 2006 appears to have a more stable base than in the recent past,¹⁵ as both external and domestic demand are forecast to increase at a satisfactory rate. Although monetary policy has begun to move towards a less relaxed stance (see Section 3 of this chapter), nominal and real interest rates in the euro area remain low, bolstering economic activity. Also, it is expected that the implementation of structural reforms (such as those included in the Lisbon Strategy) may have a beneficial effect on the dynamism and economic prospects of the euro area. According to IMF forecasts, the average annual growth rate of euro area GDP will reach 2.4% in 2006 (from 1.3% in 2005) and will decelerate to 2% in 2007, while average annual inflation is expected to stand at more than 2% in the current year and in 2007. These forecasts are similar to those made by ECB and European Commission experts.

2.1 Inflation

HICP inflation in the euro area remained above 2.0% in the first eight months of 2006, reaching

its highest level (2.5%) in May and falling slightly thereafter to 2.3% in August. The price of oil was the main reason for price increases during this period, while the indirect impact of rising energy prices and other raw materials also played a part. In September, however, inflation fell markedly to 1.8% (according to provisional estimates from Eurostat), almost exclusively as a result of the fall in oil prices in the same month. In the period up until the end of 2006, it is possible that inflation will once again rise: the figure will depend mainly on the evolution of oil prices and on their indirect effects on the prices of other products.

According to ECB staff projections, inflation in the euro area is expected to stand, at average annual levels, between 2.3% and 2.5% in 2006 and between 1.9% and 2.9% in 2007.¹⁶ These projections (which were completed *before* the fall in oil

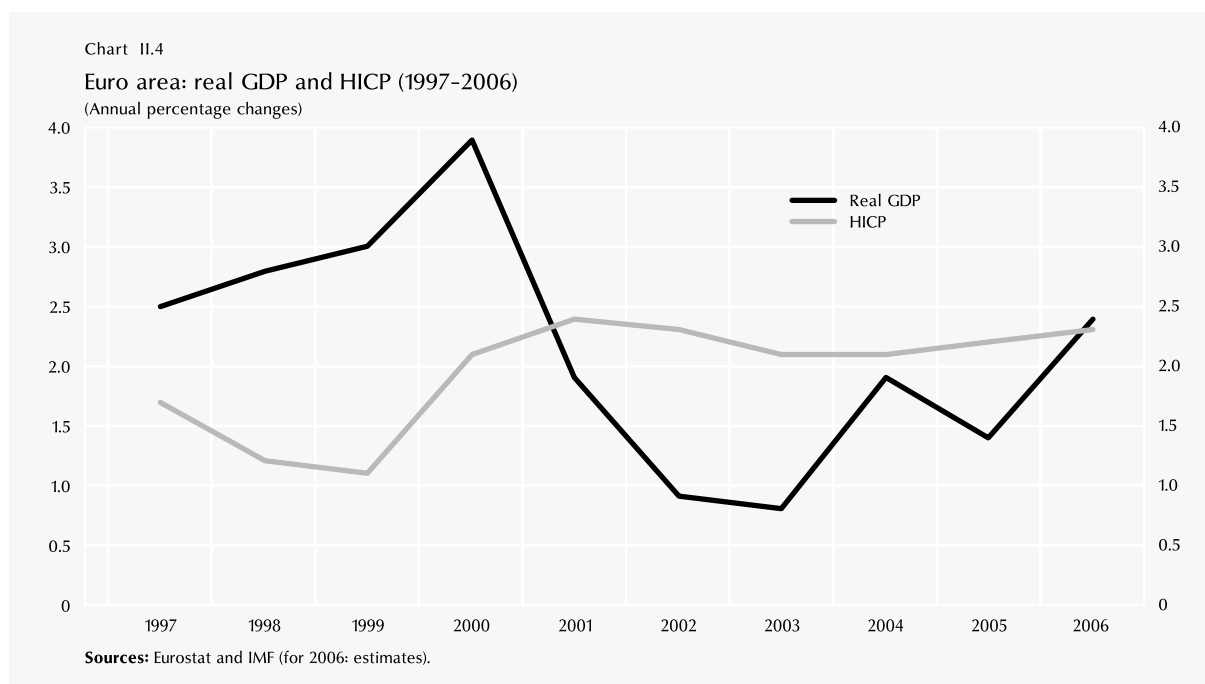
¹² It is estimated that 50% of the increase in net global demand for basic metals over the last four years has been due to greater demand from China.

¹³ The following analysis is based on developments recorded until the end of September 2006 and on forecasts produced by international organisations such as the IMF (*World Economic Outlook*, September 2006), macroeconomic projections by ECB experts (ECB, *Monthly Bulletin*, September 2006) and forecasts by the European Commission (*Spring 2006 Economic Forecasts*, May 2006, and *Interim Forecasts*, September 2006).

¹⁴ At an institutional level, note the decision of the EU Council to admit Slovenia into the euro area from 1 January 2007. The Council's decision was taken on the basis of the Convergence Reports produced by the ECB and the European Commission, in which it was ascertained that Slovenia had met the convergence criteria set by the Maastricht Treaty. The conversion rate of the Slovenian tolar to the euro was set, by a decision of the ECOFIN Council on 11 July 2006, at 239.64 tolar to the euro and corresponds to the Slovenian currency's central rate within the Exchange Rate Mechanism II (ERM II).

¹⁵ Note that, following the exceptional performance in 2002, when the GDP growth rate of the euro area reached 3.8%, the five years which followed were marked by short-lived periods of recovery, with the average annual rate of GDP increase approaching just 1.4%. HICP inflation hovered slightly above 2% for most of this period. Account should, however, be taken of the fact that, from 2001 until autumn 2006, the international price of oil approximately tripled, from \$25 per barrel in 2001 (average annual levels) to approximately \$70 throughout most of 2006.

¹⁶ According to the IMF, average annual inflation in the euro area is forecast to reach 2.3% in 2006 and 2.4% in 2007 (the impact of the three percentage point increase in VAT in Germany on inflation in the euro area is estimated at 0.4 percentage point).



prices and the noticeable drop in inflation in September) are based on the assumption that the rise in oil prices and other raw materials will have only limited second-round effects on wages. In addition, it is forecast that there will be a further steady increase in productivity and thus the increase in unit labour costs will generally be restrained. Finally, the projections for inflation are based on the assumption that there will be no major inflationary pressures from imports (other than imports of commodities).

2.2 Economic activity

Available data for the first six months of 2006 along with conjuncture surveys show that a fairly broad-based upturn in economic activity is in progress in the euro area. The acceleration in the quarter-on-quarter GDP growth rate to 0.8% in the first quarter of 2006, from 0.3% in the fourth quarter of 2005, and further to 0.9% in the second quarter is due to the contribution made both by domestic demand and net exports. Specifically, the growth rate of private consumption in the first

quarter was 0.7%, compared with just 0.1% in the final quarter of 2005, while exports showed a sharp upturn of 3.1%. This rise in private consumption, which has been the weakest part of economic activity in the euro area in recent years, provided a broader base for the upturn and strengthened prospects of maintaining economic growth at approximately its potential rate. In the second quarter of 2006, a further large increase of 2.1% in investment expenditure compared with the previous quarter, following an increase of 0.9% in the first quarter and 0.4% in the fourth quarter of 2005, was the main feature of the increase in GDP. The upturn in economic activity in the euro area is forecast to continue throughout the remainder of 2006 at a somewhat slower pace, approximately equal to the potential GDP growth rate. Available data from conjuncture surveys¹⁷ show that indicators of

¹⁷ E.g. the economic sentiment indicator for the euro area, which is published by the European Commission, reached 109.3 in September (compared with 101.0 in December 2005), and remains significantly higher than its long-term trend.

business and consumer confidence remain at high levels, while, according to a recent forecast from the European Commission which was based on short-term indicators, quarterly GDP growth will fluctuate between 0.6% and 0.7% in the second half of 2006.¹⁸

Annual GDP growth in the euro area is expected to reach 2.4% this year and 2.0% in 2007, according to IMF forecasts (the European Commission's forecast is for 2.5% this year). Similar projections have been issued by ECB staff, according to which GDP growth in the euro area will fluctuate between 2.2% and 2.8% in 2006 and between 1.6% and 2.6% in 2007. This prospect is based both on today's relatively high growth rates in the world economy and in world trade being maintained for the coming two years (see Sections 1.1 and 1.2 of this chapter) and on domestic demand strengthening. According to ECB staff, global demand for euro area products is expected to rise by 8.7% this year and by 6.6% in 2007. As for domestic demand, the gradual increase in employment and the expediting of purchases in Germany in the light of VAT increases next year are expected to benefit private consumption in 2006, while rising oil prices have had a negative effect. In addition, the maintenance of favourable financing conditions and satisfactory business profitability levels, combined with strong international demand, is contributing to a strengthening of business investment.

2.3 Employment and unemployment

Labour market developments in the euro area indicate that the gradual improvement in key indicators throughout most of 2005 accelerated in the first six months of 2006, as the annual growth rate of employment reached 1.0% in the first quarter and 1.2% in the second quarter of the year (the

highest since 2000).¹⁹ The results of recent surveys²⁰ show improved expectations concerning employment in industry, the retail trade and construction. It is expected that the forecast favourable development of economic activity will affect the rate of increase in employment, which is forecast to reach approximately 1.0% for 2006 as a whole. The unemployment rate in the euro area fell by about one percentage point within the last two years, to 7.9% in August 2006. This drop is partly due to the cyclical upturn in economic activity but also reflects the impact of labour market reforms.²¹

2.4 Fiscal developments

The fiscal position of the euro area as a whole is expected to improve slightly in 2006 following a considerable improvement in 2005 (by 0.5 percentage point), which occurred chiefly as a result of the high growth rate of public revenue in a number of Member States. According to IMF forecasts, the general government deficit will reach 2.0% of GDP in the current year, from 2.2% in 2005, and will narrow marginally in 2007 to 1.9% of GDP.

Fiscal policy is expected to be slightly restrictive in 2006, as –according to IMF calculations– the structural fiscal deficit²² in the euro area as a whole will reach 1.7% of potential GDP, from 2.0% in 2005. The gross public debt is forecast to fall to 69.8% of GDP in 2006, from 70.6% in 2005.

¹⁸ See European Commission, *Interim Forecasts*, 6 September 2006.

¹⁹ See Eurostat, press release, 14 September 2006.

²⁰ European Commission, *Business and consumer survey results*, September 2006.

²¹ See ECB, *Monthly Bulletin*, June 2006, and European Commission, *Spring 2006 Economic Forecasts*, May 2006.

²² The “structural deficit” corresponds to the nominal deficit adjusted to accommodate the impact of the economic cycle and temporary factors.

Fiscal developments and prospects in the euro area for 2006 reflect the results of the different performance of individual countries: the fiscal position is forecast to improve in six Member States which show a fiscal deficit (in certain cases the improvement will be only marginal), while in the other Member States the situation is expected to deteriorate or to remain unchanged. In the Member States of the euro area which have been subjected to the Excessive Deficit Procedure (EDP), the IMF forecasts an improvement in the fiscal position in 2006 and a narrowing of the deficit to below 3% of GDP in Germany, France and Greece (to 2.9%, 2.7% and 2.8% respectively),²³ while an improvement is also expected in Portugal and Italy (marginal improvement in the latter case), although the deficit in these two countries will remain wide (4.6% of GDP in 2006 and 3.7% in 2007 in Portugal, 4.0% in 2006 and 4.1% in 2007 in Italy).

On the basis of Article 104(9),²⁴ the Council of Finance Ministers (ECOFIN) recommended, within the framework of the EDP, on 14 March 2006 that Germany take a number of measures to bring an end to its excessive deficit as soon as possible and by the end of 2007 at the latest. The procedure laid down in the above article provides for the production of a report to enable the Commission to evaluate progress made towards eliminating an excessive deficit (it should be remembered that the procedure laid down in Article 104(9) has already been set in motion from 17 February 2005 for Greece's excessive deficit).

As far as the institutional fiscal framework is concerned, the revised Stability and Growth Pact has been under implementation for approximately one year. According to an initial evaluation by ECOFIN,²⁵ based on the assessment by the Commission contained in the report *Public Finances in EMU-2006*, June 2006,²⁶ the evaluation

of the implementation of the revised Pact is positive overall, as fiscal adjustment is again underway in the EU, as reflected in the fiscal results achieved in 2005, according to which the structural fiscal adjustment in the euro area and the EU reached 0.8% of GDP. In addition, "medium-term budgetary objectives (MTO)" have been differentiated for individual Member States in line with the agreed principles of the revised Pact. The Council considers as less positive the fact that the fiscal efforts provided for are not sufficiently ambitious in every case and that in certain cases fiscal adjustment has been scheduled to take place in the long term rather than in the near future. In conclusion, the Council judges that the revised Pact has remained a rules-based system, but has also stimulated a constructive and transparent economic policy dialogue at EU level, allowing the Council to reach unanimous agreement on all recommendations put forward by the Commission. The Council feels that it is essential for certain countries to take advantage of this benign economic environment to pursue and step up fiscal consolidation efforts to reach their medium-term budgetary objectives.²⁷ The need to implement the amended Pact with rigour in order to achieve sustainability for public finances and to strengthen the credibility of common fiscal rules has also been emphasised repeatedly by the ECB.²⁸

²³ According to IMF forecasts, the deficit will remain below 3% of GDP in these three countries in 2007.

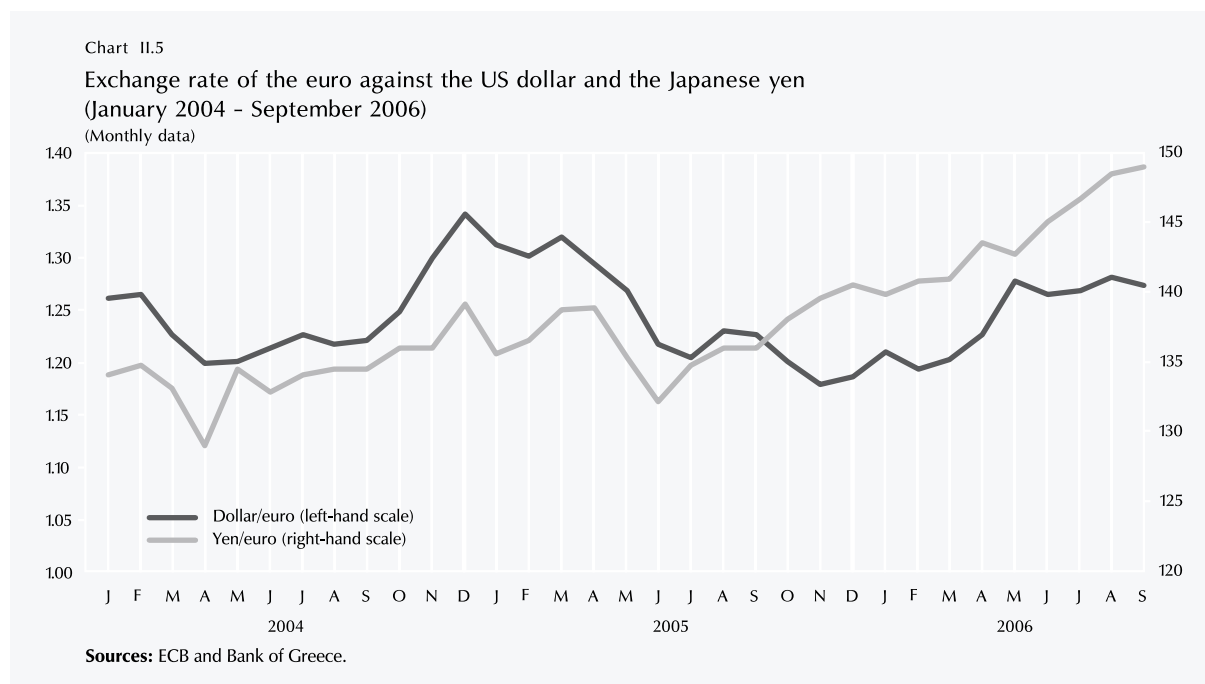
²⁴ According to article 104(9), in the event of non-compliance with the recommendation to correct the excessive deficit, the Council is entitled to impose sanctions on the Member State concerned.

²⁵ Conclusions reached by ECOFIN on 11 July 2006.

²⁶ See the announcement made by the European Commission on 10 June 2006, which was based on the report in question.

²⁷ The conclusions of the ECOFIN Council on 11 July 2006 also state that Member States of the euro area and of the ERM II that have not yet reached their MTO reaffirm their commitment to achieve, as a benchmark, an annual structural adjustment of 0.5% of GDP net of one-off measures.

²⁸ See ECB, *Monthly Bulletin*, June 2006, and the introductory statements made by the President of the ECB J.C. Trichet in the press releases of 6 July and 5 October 2006.



As far as non-euro area EU Member States are concerned, the Council, with its decision of 24 January 2006, ascertained the existence of an excessive deficit in the United Kingdom, recommending that the deficit be eliminated at the latest within the financial year 2006-2007. The European Commission also decided on 21 June 2006 to recommend to the Council that the EDP to which Cyprus was subject be abrogated, as the country's structural deficit had fallen to 2.4% of GDP in 2005 and is forecast to narrow further in 2006 and 2007. In its announcement,²⁹ the Commission noted that, "The Cypriot case shows that budgetary consolidation undertaken with resolve can achieve sustainable results," and encouraged Cyprus to "pursue this route and achieve its objective of having a budgetary position close to balance by the end of the decade." On 11th July 2006, the ECOFIN Council decided to abrogate the EDP against Cyprus.

2.5 The exchange rate of the euro and Exchange Rate Mechanism II³⁰

The broad nominal effective exchange rate of the

euro,³¹ which had risen in total by 17.1% in 2004 compared with 2002 (in average annual terms), started to follow a downward course at the beginning of 2005, which continued almost without interruption until February 2006. Since March 2006, the course of the index has been reversed, and in August it reached a level 1.5% higher than the 2005 average and 3.9% higher than in December 2005.

The real effective exchange rate (based on the CPI) followed a parallel course to that of the nominal exchange rate. After increasing in total by 16.1% in the two years 2003-2004, it dropped slightly by 1.8% (on average) in 2005. The improvement in the international price competitiveness of the euro area continued without inter-

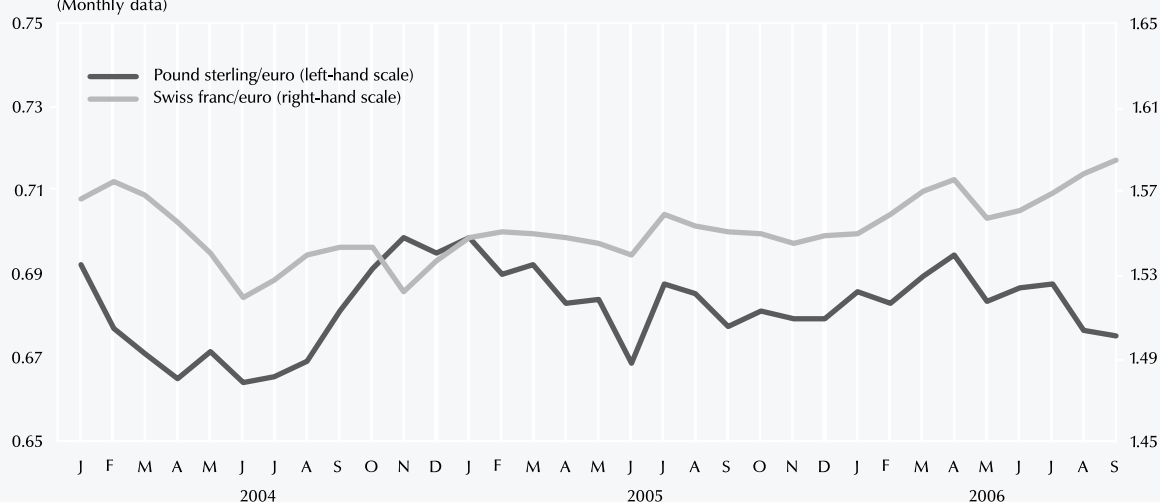
²⁹ Press Release 21 June 2006, "Commission recommends abrogation of excessive deficit procedure against Cyprus".

³⁰ The bilateral and effective rates used in this section are period averages (monthly or yearly).

³¹ Indicator of individual bilateral exchange rate developments based on the external trade of the euro area with 42 trading partners.

Chart II.6

Exchange rate of the euro against the pound sterling and the Swiss franc
(January 2004 – September 2006)
(Monthly data)



Sources: ECB and Bank of Greece.

ruption throughout 2005 and up until February 2006 and, combined with strong external demand, it is estimated that it had a beneficial effect on economic activity, chiefly in 2006. From March onwards, the average monthly real effective exchange rate of the euro rose, (indicating a decline in price competitiveness) and in August it was 0.9% higher than the average figure for 2005 and 3.7% higher than in December 2005.

The major force affecting fluctuations in the value of the euro is its bilateral exchange rate against the US dollar (see Chart II.5). The continuous depreciation of the dollar against the euro in the three-year period 2002-2004, which resulted in the euro exchange rate reaching a record high (\$1.3408) in December 2004, was reversed in 2005. In November 2005 the bilateral exchange rate fell to the lowest level for the year (1.1786), but since then it has been rising. In August 2006, the bilateral dollar/euro exchange rate stood at 1.2811, a level which corresponds to an appreciation of the euro of 3.0% compared with the 2005 average and 8.1% compared with December 2005.

The exchange rate of the yen against the euro has been losing ground continuously since 2000. By 2005 the euro had appreciated by 37.6% against the yen compared with the 2000 level. In August 2006, the yen/euro exchange rate stood at 148.53, a level corresponding to an 8.5% appreciation of the euro compared with the 2005 average and to 5.7% compared with December 2005. The pound sterling rate against the euro continued in 2006 to fluctuate within a narrow band (see Chart II.6), while the rate of the euro against the Chinese yuan followed a similar course to that of the euro against the dollar. In August the euro/yuan exchange rate stood at 10.2141, corresponding to a small appreciation of the euro (of 0.2%) compared with the 2005 average level, though in comparison with December 2005 it corresponds to an appreciation of 6.7%.

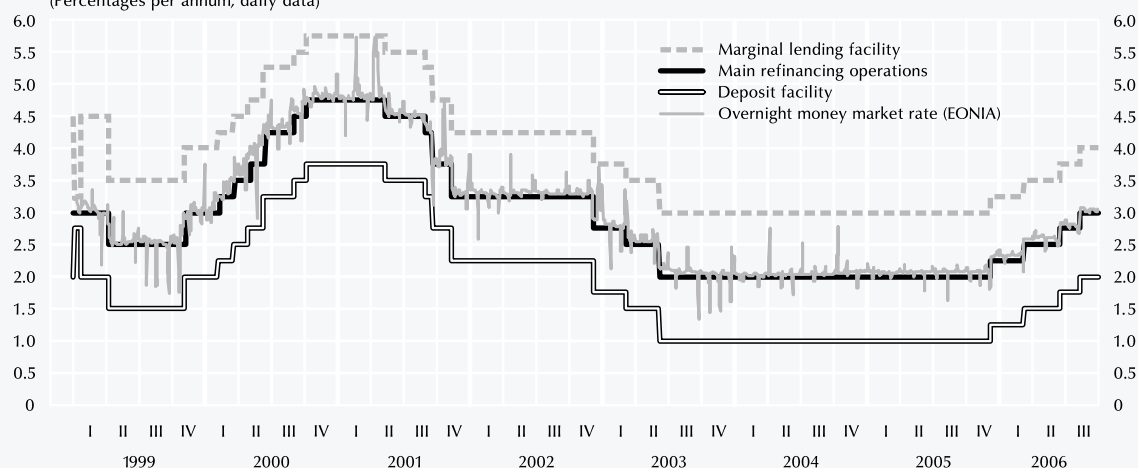
Within the Exchange Rate Mechanism II (ERM II), most currencies have remained close to their central rate in recent months. The Slovak koruna, however, was an exception, demonstrating considerable volatility. Its depreciation against the

Chart II.7

ECB interest rates and the overnight money market rate (EONIA)

(January 1999 – September 2006)

(Percentages per annum, daily data)



Note: On 5 October 2006, the Governing Council of the ECB decided to increase the key interest rates further, by 25 basis points.

Source: ECB.

euro in June was reversed, chiefly after the country's central bank raised its key rate by 50 basis points on 25 July 2006. By the end of August the exchange rate of the Slovakian currency had risen by 2% over its central rate within ERM II.

3. Monetary developments and policy in the euro area

3.1 The single monetary policy of the ECB

As mentioned above (see Section II.1), in certain large industrial economies monetary policy tightening started quite earlier than in the euro area – in the United States, interest rate increases began in July 2004. In the euro area, the ECB Governing Council raised its key interest rates five times since late 2005,³² by 25 basis points each time (see Chart II.7 and Table II.2), against a background of upside risks to price stability, on the one hand as a result of the recovery of economic activity, rises in oil prices until August and potential further rises, and, on the other hand, due to

monetary and credit developments. Thus, the minimum bid rate on the main refinancing operations, which had dropped to the historically low level of 2% on 5 June 2003, now stands at 3.25%. The ECB Governing Council underlined that, if its assumptions and baseline scenario continued to be confirmed, it would remain warranted to further withdraw monetary policy accommodation. The Governing Council continues to monitor closely all economic and monetary developments so as to ensure price stability over the medium and longer term.

From mid-2001 to mid-2003 the ECB key rates declined, as prospects of maintaining price stability seemed more likely because of the weakening economic activity and the appreciation of the euro at the time. Monetary policy also became expansionary in the other developed economies during 2001-2003.

³² On 1 December 2005 and on 2 March, 8 June, 3 August and 5 October 2006.

Table II.2

Changes in key ECB interest rates

(Percentages per annum)

Date of interest rate change ¹	Deposit facility	Main refinancing operations	Marginal lending facility
6 October 2000	3.75	4.75	5.75
11 May 2001	3.50	4.50	5.50
31 August 2001	3.25	4.25	5.25
18 September 2001	2.75	3.75	4.75
9 November 2001	2.25	3.25	4.25
6 December 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 December 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 August 2006	2.00	3.00	4.00
11 October 2006	2.25	3.25	4.25

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.

From June 2003 to November 2005, key interest rates in the euro area remained unchanged at historically low levels, as risks to price stability appeared to be balanced. The effect of labour market conditions on wages and the course of prices of imported manufacturing goods eased inflationary pressures. On the other hand, inflationary pressures were generated by sharp increases in the price of oil and other commodities and the continuing accumulation of excess liquidity, combined with a significant strengthening of credit expansion to the private sector. Starting from late 2005, as already mentioned, key interest rates have been increased repeatedly in order to prevent growing upside risks to price stability from materialising.

With these increases, the ECB sought to keep inflation expectations firmly anchored at levels consistent with price stability. Such anchoring is a prerequisite for monetary policy to make an ongoing contribution towards supporting economic growth and job creation in the euro area. Despite these increases, nominal and real inter-

est rates at all maturities still remain low, lending support to economic activity. Moreover, liquidity remains ample.

The economic analysis underlying the recent interest rate increases showed that the euro area economy should grow at rates close to potential³³ in the second half of 2006 and in 2007 (also see Section II.2). The inflation rate (which was over 2% until August, but then fell to 1.8% in September) may accelerate again until the end of the year and is projected to average above 2% both in 2006 and in 2007, owing to stronger indirect effects of price increases in oil³⁴ and other commodities, as evidenced by a pickup in the growth rate of industrial producer prices (except construction and energy) and consumer prices (excluding energy and unprocessed food), as well as by the survey results regarding pro-

³³ For trends in euro area potential output growth, see ECB, *Monthly Bulletin*, Box 5, July 2005.

³⁴ An increase in the crude oil price has direct, indirect and second round effects on inflation (see Bank of Greece, *Monetary Policy 2004-2005*, February 2005, Box III.1).

ducer prices. In addition, the increase in indirect taxes in Germany, scheduled for 2007,³⁵ is expected to add about 0.5 percentage point to the euro area inflation. However, the growth of unit labour costs remains subdued, reflecting wage moderation in an environment of global competitive pressures.

The decisions to increase interest rates took into account the fact that the inflation projections,³⁶ especially for 2006, were repeatedly revised upwards mainly reflecting the rise in oil prices until August 2006.

The ECB Governing Council has identified upside risks to price stability associated with potential further increases, a stronger pass-through of past oil price rises into consumer prices, additional increases in administered prices or indirect taxes, as well as stronger than expected wage developments due to second-round effects or effects from higher aggregate demand.

It should be noted that (i) second-round effects on labour costs may be caused by increases not only in oil prices, but also in indirect taxes and administered prices and (ii) the pass-through of crude oil price increases into consumer prices (via direct, indirect and second-round effects) is facilitated when economic activity is recovering and demand in product and labour markets is relatively stronger, as is the case in the current conjuncture.

Based on its monetary analysis, the Governing Council underlines that liquidity remains ample, which contributes to increasing upside risks to price stability over the medium to longer term. Although M3 growth slowed down in the June-August 2006 period, possibly reflecting the rise in interest rates, its annual growth rate remains very high, having been accelerating almost continu-

ously for two years (May 2004: 5%, May 2006: 8.8%, August: 8.2%, see Chart II.8). The strong year-on-year dynamics of M3 cannot be attributed to portfolio shifts to more liquid and safer assets amid heightened uncertainty, as was the case in the 2001-2002 period. Rather, the high growth rate of M3 is a source of concern, not only because it adds to an already ample liquidity situation, but also (unlike the 2001-2002 period) because it has been accompanied for several years by a strengthening of credit expansion to the private sector (May 2004: 6%, May 2006: 11.8%, August 2006: 11.9%), especially of housing loans to households and, more recently, loans to enterprises. Such strengthening of credit expansion to the private sector is mainly driven by the low level of interest rates.

It should be pointed out that the bulk of credit to households is used to finance house purchases, thus supporting strong house price dynamics in several euro area countries. Increases in residential property prices contribute, in turn, to higher borrowing, also encouraged by the associated value of collateral offered by households to Monetary Financial Institutions (MFIs). In addition, they lead to expectations of further price increases, thus supporting demand for dwellings in order to make capital gains and, therefore, demand for credit to finance house purchases.³⁷

3.2 The evolution of M3

The annual M3 growth rate accelerated in the first five months of 2006, to 8.8% in May, from 7.3% in December 2005 (see Chart II.8). Subsequently,

³⁵ See Deutsche Bundesbank, *Monthly Report*, May 2006.

³⁶ Macroeconomic projections for the euro area are produced by ECB staff in March and September every year and by Eurosystem staff every June and December.

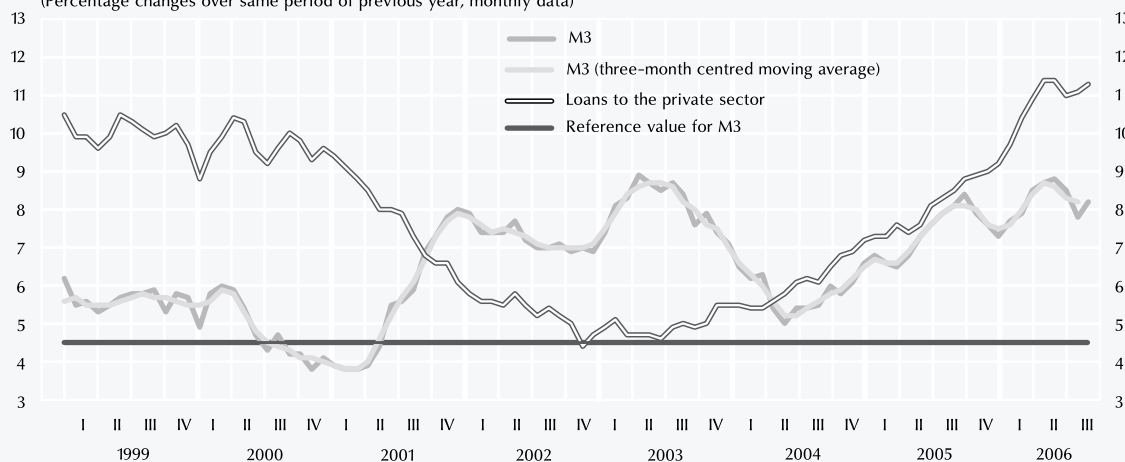
³⁷ See ECB, *Monthly Bulletin*, "Assessing house price developments in the euro area", February 2006.

Chart II.8

Euro area M3¹ and loans to the euro area private sector

(January 1999 – August 2006)

(Percentage changes over same period of previous year, monthly data)

¹ Data adjusted for seasonal and calendar effects.

Source: ECB.

it slowed down to an average of 8.2% for the three months from June to August 2006. M3 growth strengthened for the most part of the period from 2001 to early 2003 (December 2000: 4.1%, April 2003: 8.9%), thus exceeding the reference value (4.5%) for a long period. It then fell to 5% in mid-2004 and has been rising almost continuously since then.

The strengthening of M3 growth from early 2001 to early 2003 can be attributed to portfolio shifts out of riskier and higher-yield assets, such as shares, into more liquid and safer assets such as marketable instruments included in M3, against the background of significant falls in stock market prices and, more generally, heightened uncertainty. By contrast, in periods (such as from early 2003 to mid-2004) when uncertainty receded, portfolio shifts were reversed, thereby contributing to the deceleration of M3. However, from mid-2004 on, the stimulative impact of the prevailing low level of interest rates, which implies a low opportunity cost of holding money,³⁸ remained the predominant factor driving an almost uninter-

rupted acceleration in the M3 rate. Finally, the M3 growth rate declined in June and July 2006 (although it continues to stand at very high levels) reflecting interest rate increases.

Turning to individual components of M3,³⁹ the annual growth rates of M1 and of its sub-components decelerated in the first eight months of 2006 (see Table II.3). However, the M1 growth rate

³⁸ If available funds had not been invested in M3, they would have been placed in alternative assets and their returns would have been based on the yield of such assets. The opportunity cost of money, i.e. the revenue foregone by an economic agent when holding one euro in money, is given from the yield of the alternative asset. In practice, the question is which asset should be taken as alternative to M3: long-term bonds, money market instruments, assets in foreign currency or goods? Thus, to quantify the opportunity cost of holding money, the returns on a wide range of assets are often used. In the estimation of the M3 demand function, the ECB has used, alternatively, the yield of 10-year euro area bonds, the three-month EURIBOR and the inflation rate (considered to represent the return on goods).

³⁹ It should be recalled that M3 = M1 + other short-term deposits + marketable instruments; M1 = currency in circulation + overnight deposits; other short-term deposits = deposits with an agreed maturity of up to two years + deposits redeemable at a notice of up to three months; marketable instruments = repurchase agreements + money market fund shares/units + debt securities with a maturity of up to two years.

Table II.3

Main components of M3 in the euro area

(Annual percentage changes,¹ derived from data adjusted for seasonal and calendar effects; quarterly averages²)

	2005		2006			
	Q3	Q4	Q1	Q2	July	August
M1	11.2	10.9	10.3	9.9	7.4	7.2
Currency in circulation	16.0	14.8	13.4	11.9	11.5	11.4
Overnight deposits	10.4	10.2	9.8	9.5	6.7	6.5
Other short-term deposits (=M2–M1)	5.5	5.9	6.8	8.4	9.2	9.8
Deposits with an agreed maturity of up to two years	4.5	6.5	9.7	15.2	19.0	21.0
Deposits redeemable at notice of up to three months	6.0	5.3	4.6	3.7	2.5	2.2
M2	8.4	8.5	8.6	9.2	8.2	8.4
Marketable instruments (=M3–M2)	5.5	3.7	3.3	5.7	5.3	7.3
M3	8.0	7.8	7.8	8.7	7.8	8.2

1 Annual rates of change in the corresponding index, which is compiled on the basis of outstanding stocks for December 2001 and cumulative monthly flows, adjusted for exchange rate variations, reclassifications etc.

2 The quarterly average is derived from monthly averages (which are calculated as arithmetic means of two successive end-of-month figures) and is not the three-month average of end-of-month annual growth rates (see the Technical Notes in the ECB Monthly Bulletin).

Source: ECB.

remains very high, having accelerated significantly in the past few years, mainly due to the low level of interest rates. The annual growth rate of deposits with an agreed maturity of up to two years also increased significantly in the first eight months of 2006, since the interest rates on these deposits have followed the general upward trend. By contrast, the annual growth rate of overnight deposits and deposits redeemable at a notice of up to three months declined, as interest rates on these deposits did not increase fully in line with the aforesaid interest rates, thus causing a shift of funds out of this category into deposits with an agreed maturity. A substantial rise was seen in the annual growth rate of debt securities with a maturity of up to two years, as investors preferred these securities over longer-term bonds, due to expectations of further interest rate increases. Debt securities with a maturity of up to two years include new dynamically growing structured products, which combine these securities with derivative instruments that involve some exposure to developments in equity markets, while protecting investors from large capital losses.

The pickup in the growth rate of money in the first eight months of 2006, as well as in most of the period since mid-2004, mainly reflects the virtually continuous acceleration of the annual growth rate of credit to the private sector (see Chart II.8 and Table II.4). Credit developments can be attributed to the very low level of interest rates⁴⁰ and – in the first half of 2006 – to the recovery of economic activity. The strengthening of the annual growth of housing loans to households since mid-2003 can also be attributed to strong house market dynamics in several euro area countries. As noted above, credit expansion to households supports demand for dwellings, thus leading to further price increases. An upward effect on M3 is exerted by the increase in the net MFI external assets since early 2006, as expectations of a con-

⁴⁰ According to the Bank Lending Survey for the euro area, conducted by the Eurosystem on a quarterly basis, MFIs have reduced their interest rate margins in the last few years. They have also reported some easing of their lending conditions other than the interest rate, such as collateral requirements, maturity and size of loan, loan covenants, non-interest rate charges and, additionally for housing loans, loan-to-value.

Table II.4

Main counterparts of M3 in the euro area

(Annual percentage changes,¹ derived from data adjusted for seasonal and calendar effects; quarterly averages²)

	2005		2006			
	Q3	Q4	Q1	Q2	July	August
Longer-term financial liabilities³	9.2	8.9	8.8	8.7	8.8	8.4
Credit to general government	1.1	2.5	2.3	0.8	-0.9	-1.7
Loans to general government	-1.2	0.0	0.8	0.3	-0.6	-0.9
Credit to the private sector	8.6	9.4	10.4	11.7	11.8	11.9
Loans to the private sector	8.4	9.0	10.1	11.2	11.1	11.3
– to non-financial corporations ⁴	7.0	7.7	9.2	11.0	11.8	12.0
– to households ⁴	8.5	9.0	9.6	9.8	9.4	9.2

1 Annual rates of change in the corresponding index, which is compiled on the basis of outstanding stocks for December 2001 and cumulative monthly flows, adjusted for exchange rate variations, reclassifications etc.

2 The quarterly average is derived from monthly averages (which are calculated as arithmetic means of two successive end-of-month figures) and is not the three-month average of end-of-month annual growth rates (see the "Technical Notes" in the *ECB Monthly Bulletin*).

3 Including capital and reserves.

4 Data not adjusted for seasonal and calendar effects.

Source: ECB.

tinued strengthening of the euro, along with the narrowing of the short-term interest rate differential between the United States and the euro area, have encouraged portfolio investment inflows into euro area securities. By contrast, the growth rate of MFI longer-term financial liabilities has remained at high levels, exerting a dampening effect on M3 growth in the last few years. The deceleration of credit expansion to the general government sector has also had a downward effect on M3 growth.

3.3 Money market interest rates, bank rates and long-term bond yields

Short-term interest rates (one-, three-, six- and twelve-month) began rising in the last quarter of 2005, amid growing expectations of increases in the key ECB interest rates. The rise in interest rates has continued into 2006 (see Chart II.9).⁴¹ This followed a period when short-term interest rates fell in line with the key ECB interest rates from mid-2001 to mid-2003 and a long period when they remained unchanged at historically

low levels (from June 2003 to the third quarter of 2005).

From late 2005 onwards, market expectations about the future path of short-term interest rates, as implied by the prices of three-month EURIBOR futures contracts, were gradually revised upwards, as an increase in key ECB interest rates became likely. This led to stronger rises at longer maturities and therefore the slope of the money market yield curve, measured as the difference between the twelve- and one-month EURIBOR, has steepened compared with the previous year (see Chart II.9).

The implied volatility of the three-month EURIBOR⁴² has been declining for more than three years now and reached historically low levels in August 2006. This indicates that money market

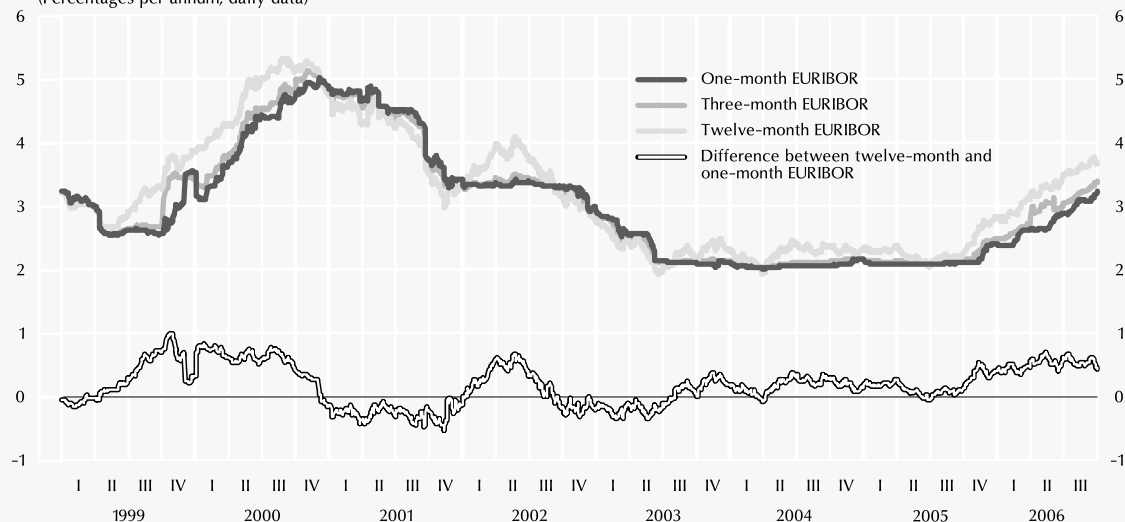
⁴¹ Three-month EURIBOR on 28 September: 3.41%.

⁴² Volatility is extracted from the prices of options on three-month EURIBOR futures. These prices incorporate market expectations about the future level of the three-month EURIBOR.

Chart II.9

Short-term interest rates in the euro area (January 1999 – September 2006)

(Percentages per annum, daily data)



Source: ECB.

uncertainty concerning the path of short-term interest rates in the near future remains very low, which should be partly attributed to the ECB's communication policy.

MFI interest rates on most categories of deposits and loans⁴³ have been rising since late 2005, broadly in line with increases in money market rates and bond yields. Short-term MFI interest rates increased by 10-87 basis points between September 2005 and July 2006,⁴⁴ while the three-month EURIBOR rose by 96 basis points. Long-term MFI interest rates, which follow with some lag the changes in the yields of government bonds of similar maturities, increased by 8-108 basis points, while five-year bond yields increased by 124 basis points.

Despite the continued rise in the cost of bank financing and the cost of market-based debt financing and a small rise in the cost of equity financing, the real cost of financial corporations' external financing⁴⁵ remained relatively low in the first half of 2006. The difference between MFI

lending rates to non-financial corporations and households and government bond yields of comparable maturities also narrowed. The indebtedness of households and non-financial corporations in the euro area increased further (as a per-

⁴³ For example, the following interest rates were offered in July 2006 (the last month for which data are available) in the categories of deposits and loans with the largest volumes of new business: overnight deposits: 0.81% for households, 1.24% for non-financial corporations; current account overdrafts: 9.86% for households, 5.52% for non-financial corporations.

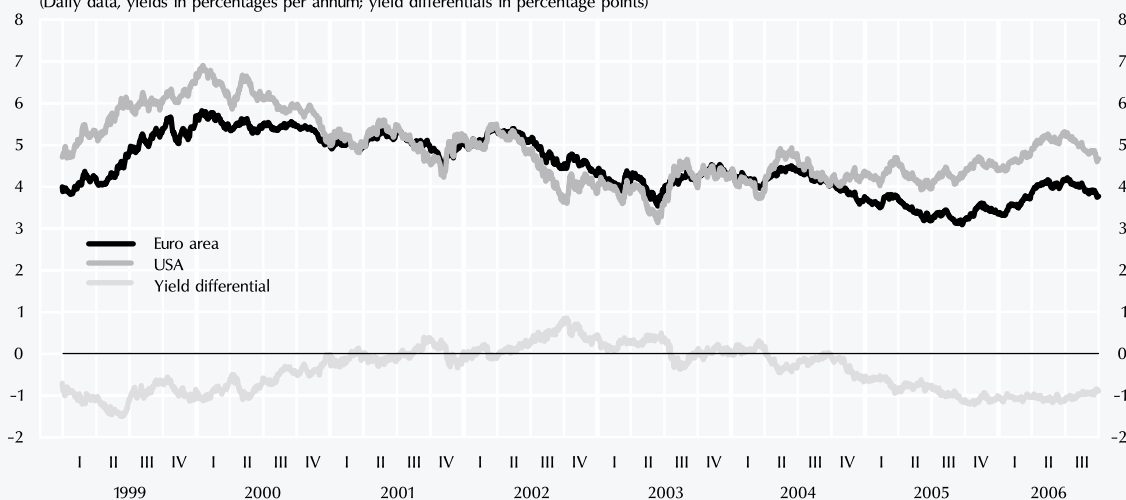
⁴⁴ The interest rates reported in this chapter are those applying to new business rather than to outstanding amounts, which include business agreed in the past.

⁴⁵ The real cost of external financing is calculated as a weighted average of the cost of bank lending, the cost of debt securities and the cost of equity, on a deflated basis, with weights reflecting the respective amounts outstanding. The real cost of bank lending and debt securities is derived from the corresponding interest rates, deflated by inflation expectations published by Consensus Economics Forecasts. The calculation of the cost of equity is based on the fact that the current price of a share is equal to the sum of the present value of all future dividends, which can be expressed in algebraic form assuming that (i) dividends are a constant proportion of earnings and (ii) corporate earnings growth is expected to develop in three stages, so that after 12 years it will approach, on a deflated basis, the trend potential growth of the euro area and will remain unchanged thereafter. Given the assumptions regarding the development of corporate earnings and dividends, the real discount rate can be calculated, which equates the present value of dividends with the current price of equity (on a deflated basis). This rate is a measure of the real cost of equity.

Chart II.10

Ten-year bond yields in the euro area and the United States
(January 1999 – September 2006)

(Daily data, yields in percentages per annum; yield differentials in percentage points)



Source: ECB.

centage of GDP) in the first half of 2006,⁴⁶ although it remains low compared with other industrial economies.

Long-term government bond yields generally followed an upward path in the first half of the year. Although yields fell in the third quarter,⁴⁷ they remained at higher levels than in 2005 (see Chart II.10). The rise in yields in the first half of 2006 may be attributed to the improved outlook for economic activity, which led to an increase in the real interest rate, reinforced (though marginally, given the credibility of the ECB) long-term inflation expectations and related risk premia incorporated in long-term interest rates.⁴⁸ Yields fell in the third quarter of 2006, mainly reflecting assessments of a slowdown in economic activity in the United States.

From the early 1990s until the end of 2005, long-term bond yields followed a downward path globally. Despite increases in the first half of 2006, yields still stand at low levels, since the decline in inflation and the enhanced credibility of monetary policy (compared with the previous decade) con-

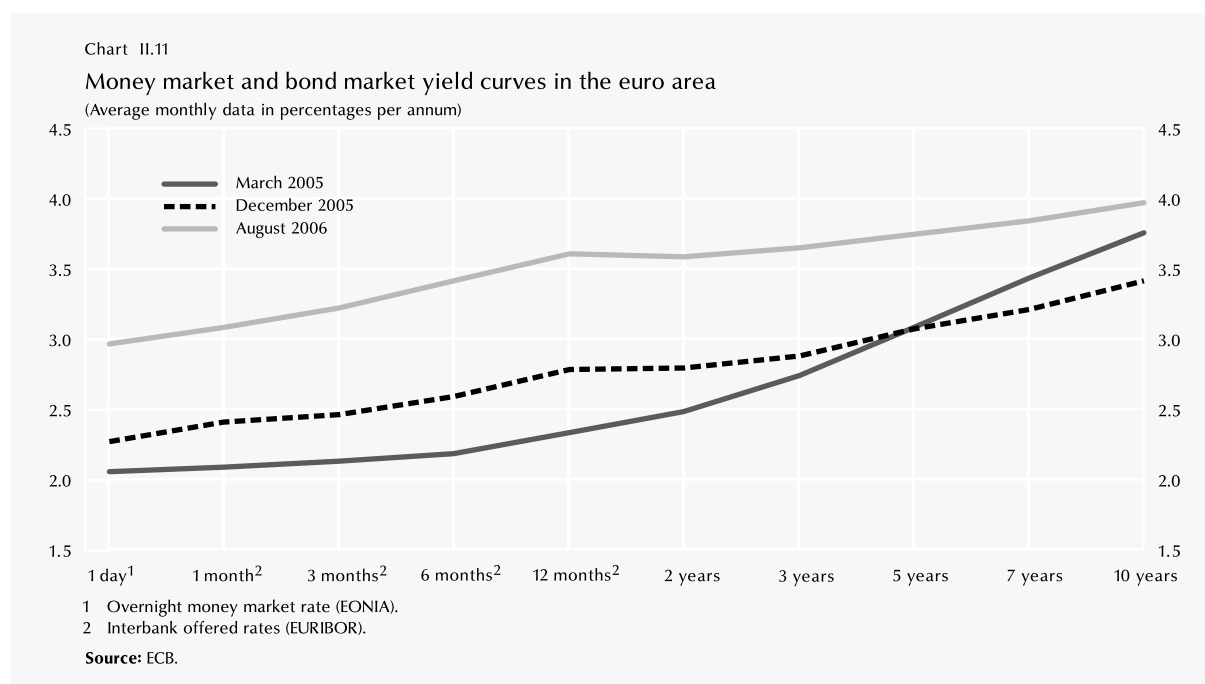
tribute to containing inflation expectations. The rise in oil prices since 2004, which is largely considered to be permanent (short-term fluctuations aside), negatively affects the long-term growth expectations and, hence, the real interest rate. In addition, in the last few years there has been an exceptional pickup in demand for long-term government bonds, owing to changes in the structure of global capital markets, which are not related to the business cycle.⁴⁹ Specifically, certain provisions of the regulatory framework governing pension funds and insurance companies have urged such entities to

⁴⁶ The respective debt-to-GDP ratios rose to 58.5% and 65% respectively. At the end of 2005, i.e. the latest available year, the household (corporate) debt to GDP ratio stood at 57.8% (62.9%) in the euro area, 90.3% (65.5%) in the United States and 96.7% (105%) in the UK. Sources: ECB, US Federal Reserve, Bank of England and UK National Statistics. Data refer to the total debt of households and not only their liabilities to MFIs (for which see Chapter III, sections 2.1 and 2.4).

⁴⁷ This development limits the transmission of the increases in key ECB interest rates to the economy. However, the increase in the household debt-to-GDP ratio acts in the opposite direction, especially to the extent that debt consists of variable-rate loans.

⁴⁸ Ten-year bond yields on 28 September: 3.77%.

⁴⁹ See Bank of Greece, *Monetary Policy* 2005-2006, February 2006, Box II.1.



invest more heavily in long-term government bonds. Dealing with the demographic challenges requires increased savings, thus strengthening demand for long-term financial instruments. Additional factors working in the same direction are the rise in the revenue of oil-producing countries, owing to higher oil prices, and strategic interventions of several Asian central banks in foreign exchange markets in order to contain the appreciation of their currencies vis-à-vis the US dollar.

Corporate bond spreads have narrowed significantly since 2002. Moreover, the implied volatility⁵⁰ of government bond yields has fallen to very low levels since 2003, indicating that investors do not expect any major change from the current low yields. The euro area bond yield curve remains positive (see Chart II.11); however, following several fluctuations in the last few months, the curve has become flatter compared with 2005. This occurred because long-term inflation expectations, which affect long-term interest rates, remain at low levels, consistent with price stability. Given the credibility of the ECB's monetary

policy, the market participants' view is that the ongoing increase in short-term interest rates will ensure that inflation rates above 2% will be temporary, implying that short-term interest rates will return to low levels in the future.

Bond yields in the United States and Japan have also picked up slightly since the beginning of the year. The rise in ten-year bond yields in the United States until end-September 2006 was similar to that in the euro area and, therefore, the yield differential between the United States and the euro area remained around 100 basis points (see Chart II.10).

3.4 Stock market developments

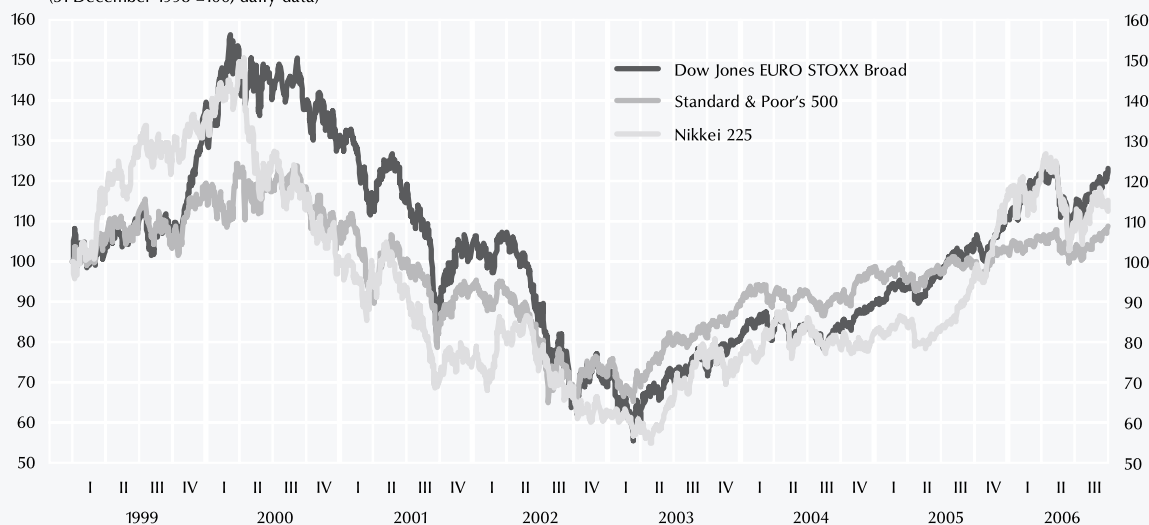
Between mid-2000 and the first quarter of 2003, global share prices dropped significantly, mainly

⁵⁰ The implied bond market volatility is an indicator of uncertainty prevailing among participants in the market. For the euro area, it is measured on the basis of the prices of options on 10-year German Bund futures.

Chart II.12

Stock price indices (January 1999 - September 2006)

(31 December 1998 =100, daily data)



Source: ECB.

reflecting weakened global economic activity and heightened uncertainty associated with the terrorist attacks of 11 September 2001 and other geopolitical factors. In addition, there was a correction in share prices, especially in the technology sector, which had reached very high levels in the late 1990s.

Share prices in developed stock markets increased substantially⁵¹ from the second quarter of 2003 to the third quarter of 2006 (see Chart II.12), reflecting continuous declines in long-term interest rates over most of the period and robust corporate profitability, while uncertainty abated, as evidenced by a drop, on average, in implied

stock market volatility.⁵² The negative effect exerted on share prices by the recent rise in interest rates both in the euro area and the United States seems to have been counterbalanced by favourable data on corporate profits. Between the beginning of the year and 28 September, the Dow Jones EURO STOXX index gained 11.7% and the Standard & Poor's 500 index in the United States gained 7.3%, while the Nikkei 225 index remained unchanged from its end-2005 level.

⁵¹ In Japan, the upward path was reversed in 2006. The Nikkei 225 index fluctuated around the levels reached at end-2005.

⁵² Stock market uncertainty is measured using a method similar to that described in footnote 50 for bond market uncertainty.

III. Monetary and financial developments, capital markets and stability of the financial system in Greece

1. Monetary developments in Greece

1.1 The evolution of monetary aggregates

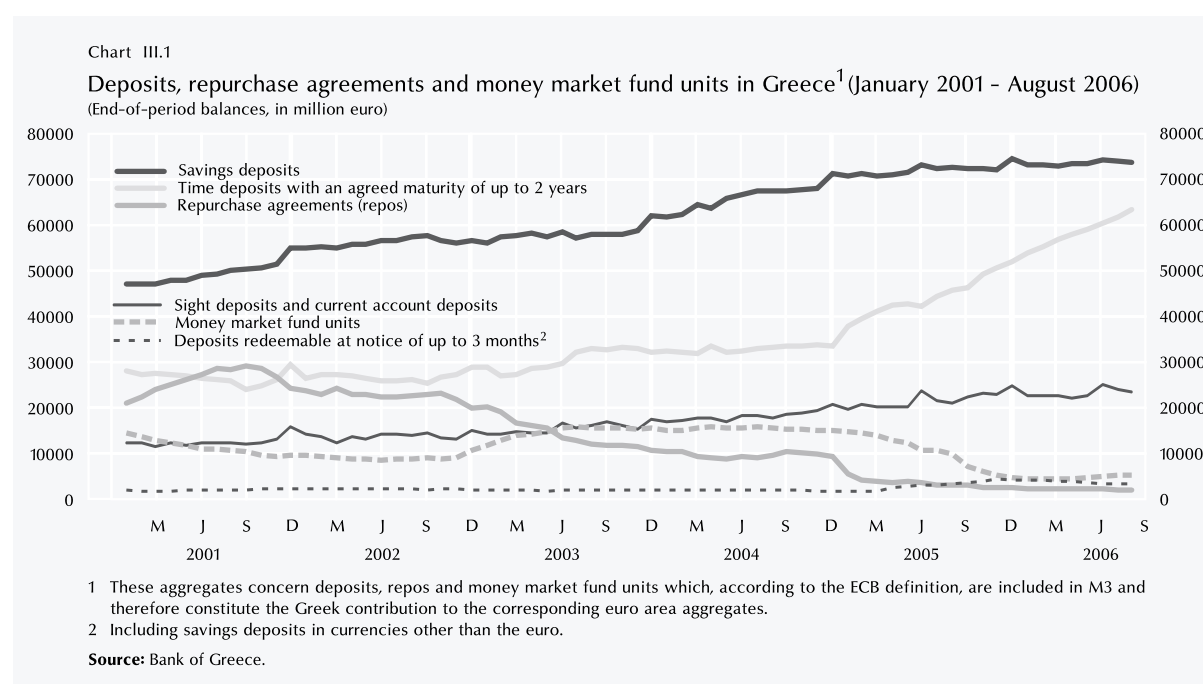
After decelerating in 2005 (particularly during the second half of the year), the annual growth rate of the Greek contribution to the euro area M3 (excluding currency in circulation) picked up gradually from January to August 2006, to stand at 12.1% in August (see Table III.1). This development is associated with portfolio shifts away from assets not included in M3 (mainly bond fund shares/units) to assets included in M3 (mostly deposits with an agreed maturity of up to two years), as well as the acceleration in the annual growth rate of the financing of the economy (mainly general government financing) during the same period. As a result, although the growth rate of the Greek M3 had been lower than that of the euro area since the second half of 2005, it started rising to higher levels from the second quarter of 2006. In general, the rate of change in the Greek M3 showed wider fluctuations than the corresponding euro area rate in the last five years. These fluctuations reflect, on the one hand, the factors determining the development of total liquidity in the euro area (e.g. the decline in interest rates and the uncertainty due to international geopolitical tensions) and, on the other hand, the effects of more specific factors concerning the Greek economy (such as stronger growth compared with the euro area, and the changes in tax rates on repo yields and deposit interest income).

As regards individual M3 components, time deposits rose significantly during the January-August 2006 period (although their annual growth rate fell slightly). The steeper rise in time deposit rates during this period (rates on deposits with an agreed maturity of up to one year rose by 56 basis points, against only 13 basis points for

Table III.1
Greek contribution to the key monetary aggregates of the euro area (2001-2006)
(Not seasonally adjusted data)

	Outstanding balances on 31.8.06 (million euro)	Annual percentage changes ¹									
		2001		2002		2003		2004		2005	
		Q4 ²	Q4 ²	Q4 ²	Q4 ²	Q4 ²	Q4 ²	Q4 ²	Q4 ²	Q1 ²	Q2 ²
1. Overnight deposits	97,035.0	11.1	8.9	6.8	16.8	11.8	10.6	9.3	5.4	4.5	3.9
1.1 Sight deposits and current account deposits	23,419.3	5.3	5.7	17.7	19.1	18.4	21.2	20.2	13.0	10.0	10.6
1.2 Savings deposits	73,615.7	12.5	9.8	4.1	16.1	9.9	7.7	6.3	3.3	2.8	1.8
2. Time deposits with an agreed maturity of up to 2 years	63,314.8	-9.3	10.1	29.3	5.3	31.7	36.0	45.2	41.1	40.6	42.6
3. Deposits redeemable at notice of up to 3 months ⁴	3,381.4	19.7	8.1	1.5	2.8	30.1	67.0	105.2	108.6	47.6	-4.2
4. Total deposits (1+2+3)	163,731.2	4.6	9.2	12.6	13.1	17.4	18.4	20.7	17.5	16.4	16.0
5. Repurchase agreements (repos)	2,045.2	38.3	-19.0	-47.7	-12.6	-57.2	-64.7	-72.8	-51.2	-37.9	-38.9
6. Money market fund units	5,401.6	-38.4	-3.7	68.0	-1.9	-19.6	-34.7	-51.8	-60.4	-52.6	-34.5
7. Bank bonds with a maturity of up to 2 years	553.6	-1.1	-26.2	268.6	-0.3	24.5	-20.6	-42.2	-35.8	-16.6	4.4
8. M3 excluding currency in circulation (4+5+6+7)	171,731.6	4.6	2.2	6.4	9.2	8.5	7.1	6.9	7.6	9.7	12.1

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



savings deposits, see Section 1.2) contributed to a shift in financial savings towards this category from high liquidity deposits, such as savings deposits, and from non-M3 items, as mentioned above. Thus, the share of deposits with an agreed maturity in M3 rose further (by almost five percentage points) during the period under review. Note that the share of deposits with an agreed maturity in M3 had risen (by almost eight percentage points) in 2001-2005. By contrast, there was a slowdown in the growth rate of all the other deposit categories, in particular savings deposits, as well as sight deposits and current accounts, causing a deceleration in the growth rate of deposits included in M3 during the January-August 2006 period. Of the other components of M3, holdings of repos fell further in the same period (see Chart III.1). As mentioned above, the changes in tax rates on repo yields in 2002 and 2005 led to a decline in their share in M3 to 1.7% at the end of 2005 (from 17.7% at the end of 2001, when repo yields were tax-free). Moreover, the rates of change in holdings of money market fund shares/units, although

reduced, remained negative in 2006. These holdings are mostly temporary and are chosen by households and enterprises in times of economic and financial uncertainty. However, since stock market conditions were particularly favourable in the first five months of the year, investors' interest turned towards stock market holdings.

1.2 Deposit interest rates

The level of short-term¹ deposit rates is determined by ECB rates and market expectations of future changes in these rates, which are also influenced by the ECB communication policy, as well as by competition between credit institutions. Deposit rates and repo rates in Greece rose in the January-August 2006 period,² in the wake of ECB

¹ The bulk of deposits by households and enterprises in Greece mature in up to one year (August 2006: 97%).

² The rates on new overnight deposits by households showed a relatively small increase (13 basis points, August 2006: 1.04%, see Chart III.2), while interest rates on deposits with an agreed maturity of up to one year recorded a stronger increase (56 basis points, August 2006: 2.95%), as did the repo rate (56 basis points, August 2006: 2.74%).

Table III.2A
Bank interest rates on new deposits by households in the euro area and Greece
(Percentages per annum)

	December 2005	July 2006	Change July 2006/Dec. 2005 (in percentage points)
Overnight			
Weighted average interest rate in the euro area	0.71	0.81	0.10
Maximum interest rate	1.20	1.69	0.49
Minimum interest rate	0.15	0.13	−0.02
Interest rate in Greece	0.91	1.02	0.11
Interest rate differential between Greece and the euro area	0.20	0.21	0.01
With an agreed maturity of up to one year²			
Weighted average interest rate in the euro area	2.15	2.70	0.55
Maximum interest rate	2.48	3.00	0.52
Minimum interest rate	1.57	1.88	0.31
Interest rate in Greece	2.39	2.84	0.45
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 III.2B
Bank interest rates on new deposits by households in the euro area¹

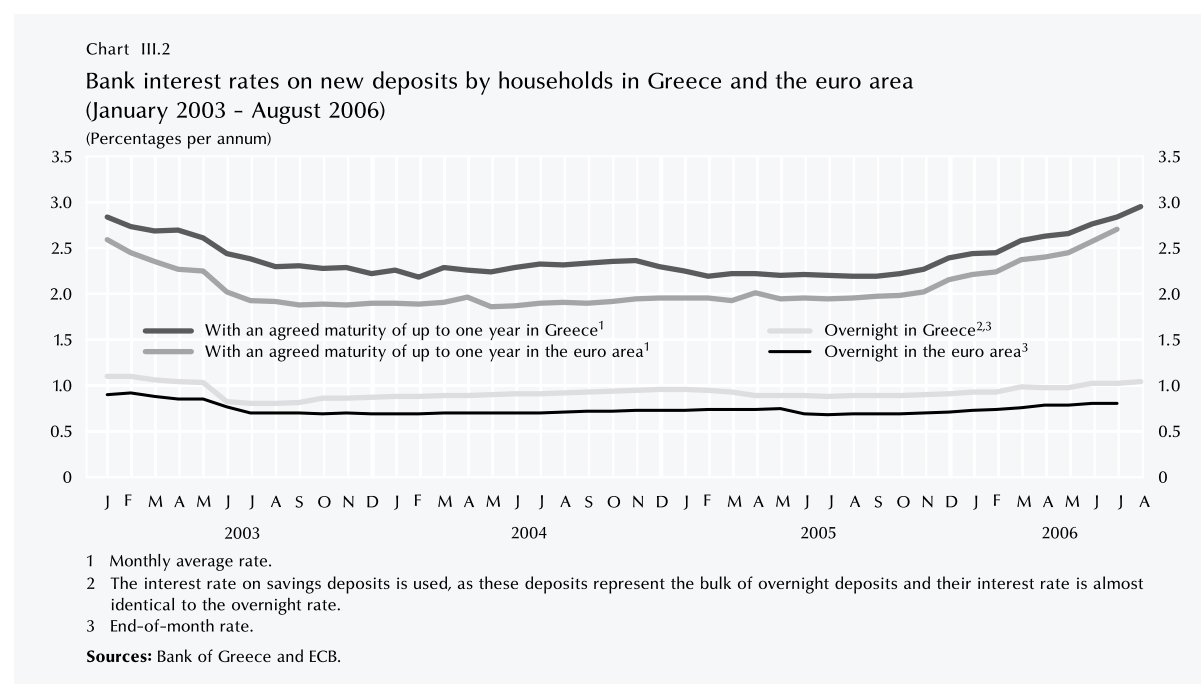
	Overnight ²		With an agreed maturity of up to one year ³	
	December 2005	July 2006	December 2005	July 2006
Belgium	1.01	1.11	2.02	2.79
Germany	1.20	1.36	2.06	2.63
Greece	0.91	1.02	2.39	2.84
Spain	0.41	0.45	2.30	2.84
France	0.16	0.17	2.27	2.72
Ireland	0.57	0.74	1.96	2.54
Italy	0.64	0.78	1.57	1.88
Luxembourg	1.19	1.69	2.09	2.64
Netherlands	0.48	0.51	2.48	3.00
Austria	1.00	1.29	2.19	2.76
Portugal	0.15	0.13	1.98	2.51
Finland	0.44	0.47	2.34	2.93

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.
Sources: ECB and euro area NCBs.

rates. The corresponding euro area rates also rose during the January-July 2006 period,³ with the most significant increase being recorded in deposits with a maturity of up to one year. Thus, Greek overnight rates were 21 basis points higher than the corresponding euro area average in July

(almost the same as in December 2005), while for deposits with an agreed maturity of up to one year the positive differential was contained to 14 basis

3 When this report was going to press, data on euro area bank rates in August 2006 were not available.



points (from 24 basis points in December 2005, see Tables III.2A and B). In general, repo rates in Greece remain close to the euro area average, although in July they stood 16 basis points below the corresponding euro area rate.

As expected, after Greece's entry into the monetary union in 2001, deposit rates generally followed the trend of those in euro area countries. In more detail, interest rates on savings deposits and deposits with an agreed maturity of up to one year decreased from 2001 to mid-2003 by 300 and 232 basis points, respectively (following the course of ECB key interest rates, which dropped by a total of 275 basis points over the same period), while they fluctuated slightly until November 2005. From December 2005, deposit rates started moving upwards (see Chart III.2), as in this month, as already mentioned, monetary policy in the euro area entered a phase of rising interest rates. In general, households' deposit rates in the euro area moved parallel to the corresponding Greek rates, but remained lower. In particular, the average positive differential between

Greek interest rates and the corresponding euro area rates in 2003-2005⁴ was 18 basis points for overnight deposits and 33 basis points for deposits with an agreed maturity of up to one year, while the repo rate in Greece stood at almost the same level as the corresponding euro area rate.

2. The financing of the economy

The annual growth rate of the total financing of the economy by Monetary Financial Institutions (MFIs)⁵ accelerated further during the first eight months of 2006 and rose to 19.6% in August (fourth quarter 2005: 14.0%, see Table III.3),

⁴ The new harmonised methodology of recording bank rates started being applied in euro area countries in 2003.

⁵ The financing of the economy by domestic MFIs comprises the outstanding balance of loans to enterprises, households and general government, as well as total government securities and corporate bonds held by the central bank, credit institutions and money market funds. Note, however, that, in order to calculate the rate of change in total financing, apart from the change in the balances of the above items, account is also taken of write-offs and securitisation of loans by banks during the reference period.

Table III.3
Total financing of the economy by Greek MFIs
(Annual percentage changes)

	2001	2002	2003	2004	2005		2006		
	Q4 ¹	Q4 ¹	Q4 ¹	Q4 ¹	Q4 ¹	December ²	Q1 ¹	Q2 ¹	August ²
1. Total financing by MFIs ^{3,4}	8.9	7.1	4.4	11.0	14.0	17.0	16.6	18.1	19.6
2. Financing of general government	-2.4	-5.2	-15.9	-5.6	-0.7	5.1	4.2	8.0	12.8
3. Financing of enterprises and households ^{3,4}	23.1	18.2	19.1	19.6	20.1	21.8	21.5	21.8	21.8
3.1. Enterprises ³	16.7	11.3	13.7	13.0	12.7	14.7	13.9	15.3	15.9
3.2. Households ⁴	40.0	33.1	28.8	30.2	30.6	31.4	31.6	30.3	29.1
3.2.1 Housing loans ⁴	36.7	35.4	27.8	26.9	31.5	33.5	33.7	32.7	31.5
3.2.2 Consumer loans ⁴	44.3	27.4	25.0	38.4	30.4	28.7	28.7	26.7	24.3

1 The quarterly average is derived from monthly averages (which are calculated as arithmetic means of two successive end-of-month figures) and is not the three-month average of end-of-month annual growth rates (see the 'Technical Notes' in the ECB *Monthly Bulletin*).

2 Annual rate of change at the end of the month.

3 Including corporate bonds held in MFI portfolios. Write-offs of claims are also taken into account since the fourth quarter of 2003, when relevant statistical data were made available.

4 Including securitised loans. Write-offs of claims are also taken into account since the fourth quarter of 2003, when relevant statistical data were made available.

Source: Bank of Greece.

which is significantly higher than the average annual rate in 2001-2005, when it stood at 10.0%. This, as in the preceding five-year period, reflects mainly developments in the rate of change in MFI financing of general government, which rose significantly, after recording negative levels in the fourth quarter of 2005 (-0.7%), and stood at 12.8% in August 2006. The increase in MFI claims on general government reflects a corresponding rise in their holdings of government securities, whose yields followed an upward trend from September 2005,⁶ after a period during which banks reduced their holdings of government securities, in the context of extensive portfolio restructuring. The historically low levels of government bond yields in 2001-2005 and, as a result, the limited expectations of capital gains, induced MFIs to substitute claims on general government with claims on enterprises and households. Thus, MFI (excluding the Bank of Greece) claims on general government were reduced to 16% of their total assets at end-2005, from 26% at end-2000.

The accelerated increase in the total financing of the economy in the first eight months of 2006 was also related, though to a lesser extent, to the evolution of financing of enterprises and households, the annual growth rate of which was 21.8% in August (fourth quarter 2005: 20.1%). This growth rate was slightly higher than the average growth rate of financing of enterprises and households in the preceding five-year period (20.5%), which remained high mainly due to low interest rates, which sustained a robust demand for bank credit in the private sector, mostly by households. Demand for bank credit in the preceding five-year period was also influenced by improved expectations of enterprises and households regarding the future evolution of incomes, by the undertaking by enterprises of investment programmes associated with the 2004 Olympic Games, as well as by

the relatively low household indebtedness as a percentage of GDP. At the same time, the supply of bank credit to the private sector also remained high, owing to the restructuring of bank portfolios, as mentioned before, as well as the release of funds after the gradual harmonisation of the minimum reserve system of the Bank of Greece with that of the Eurosystem. Moreover, banks resorted to new sources of liquidity, e.g. securitisation of claims and issuance of subordinated securities, in order to finance the high credit expansion.

2.1 Bank lending to enterprises and households

The annual rate of increase in bank loans to enterprises picked up in the first eight months of 2006 and stood at 15.9% in August (fourth quarter 2005: 12.7%). According to available data on business confidence and the economic sentiment,⁷ business uncertainty regarding the future development of demand has been reduced and enterprises are more willing to undertake new investment initiatives. This, combined with the sustained relatively favourable financing conditions, as evidenced by low interest rates and the fact that banks (according to the results of the July 2006 Bank Lending Survey⁸) have not tightened their terms of financing,⁹ leads to greater recourse of enterprises to bank credit. Thus, the annual growth rate of bank lending to enterprises in August stood at higher levels than the 2001-2005 average (14.0%).

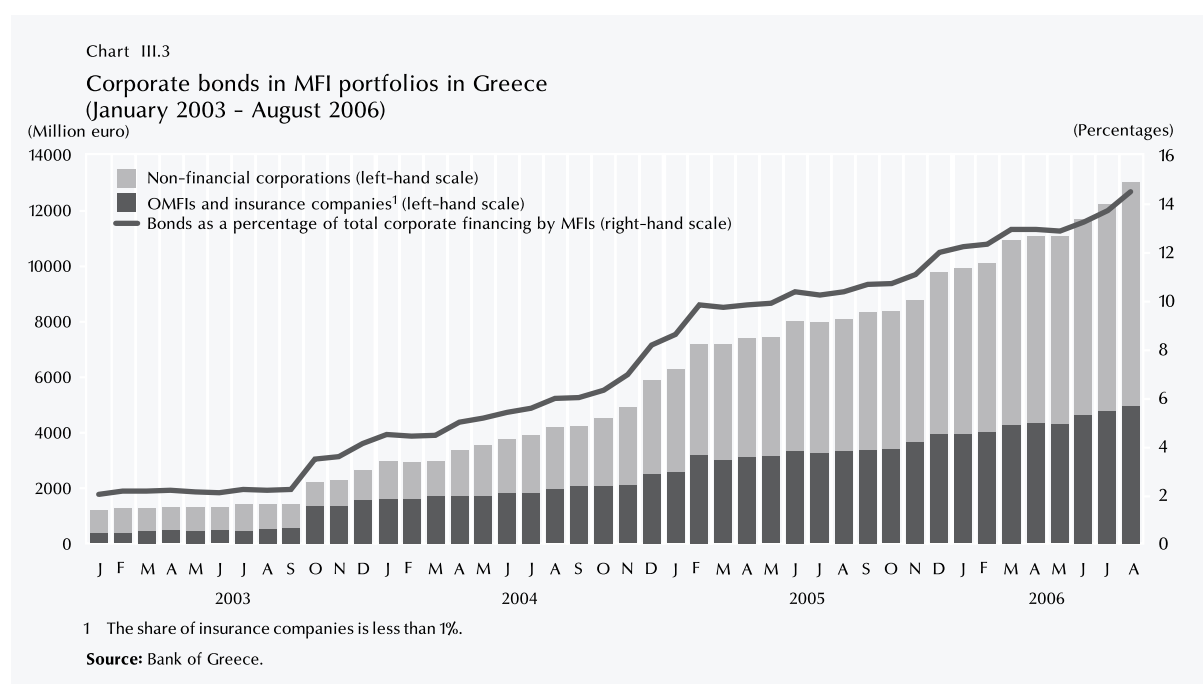
A significant part of total bank lending to enterprises consists of corporate bonds, issued by

⁶ Which came to an end in July 2006, see Section 3 of this Chapter.

⁷ See Chapter IV.

⁸ The Bank Lending Survey is conducted by the Bank of Greece on a quarterly basis, in the context of a wider survey at the Eurosystem level.

⁹ However, some of the banks participating in the survey (67%) reported a tightening of their standards regarding the evaluation of requests for corporate financing.



enterprises mostly because of the tax advantages they offer, and held by MFIs – often replacing existing loans.¹⁰ In particular, during the first eight months of 2006 enterprises raised funds through bond issuance to the net amount of €3,175 million (January-August 2005: €2,169 million). As a result, the share of this form of financing in total bank lending to enterprises rose to 14.5% (December 2005: 12.0%, see Chart III.3). As regards the breakdown of new loans to non-financial corporations, lending on floating rate or an initial rate fixation of up to one year amounts to more than 90% of the total, whereas, regarding the amount of new loans, large loans (over €1 million) still account for more than 60% of the total amount of new loans.

The breakdown of bank *lending* by sector of economic activity¹¹ shows that the annual rate of change in loans to agriculture turned marginally positive during 2006 and stood at 2.6% in August (see Table III.4). This is attributed to the waning influence of one-off write-offs of the Agricultural Bank of Greece (ATE bank) receivables from this

sector which had taken place mainly during 2005.¹² However, even if these write-offs are taken into account, credit expansion to agriculture accelerated (August 2006: 9.3%, fourth quarter 2005: 8.4%).

Improved industrial confidence since mid-2005¹³ is also reflected in the evolution of the rate of change in bank lending to industry. Thus, this rate has turned positive since December 2005 and rose to 5.2% in August 2006. Taking into account

¹⁰ This became a widely used practice after the enactment of Law 3156/2003 in June 2003, which, among other things, provides for the exemption of corporate bond issues from contributions under Law 128/1975 (0.6% of the outstanding balance of the loan), which are levied on bank loans. See *Monetary Policy 2004-2005*, February 2005, Appendix to Chapter IV, pp 109-115.

¹¹ Note that the calculation of the breakdown of lending to enterprises by sector of economic activity does not include write-offs of receivables, as information on the amount of write-offs by sector is not available. However, there is available information regarding the agricultural sector (see next footnote).

¹² These one-off write-offs amount to a total of about €760 million and are associated both with the implementation of Law 3259/2004 (which deals with the settlement of overdue debts and includes special provisions for agriculture) and with ATE bank's efforts to consolidate its portfolio.

¹³ See Chapter IV.

Table III.4 Breakdown of bank loans to enterprises and households in Greece												
	Outstanding balances on 31.8.06 (million euro)	Annual percentage changes										
		2001	2002	2003	2004	2005	2006	December ²	Q1 ¹	Q2 ¹	August ²	
		Q4 ¹	Q4 ¹	Q4 ¹	Q4 ¹	Q4 ¹	Q1 ¹					
A. Enterprises³	76,034	16.7	11.4	11.0	8.6	6.4	8.7	8.8	10.6	9.9		
1. Agriculture	3,204	-2.6	-14.0	3.3	7.8	-12.7	-9.1	-6.6	1.7	2.6		
2. Industry ⁴	16,658	10.2	11.5	10.4	1.1	-0.6	0.5	0.9	4.1	5.2		
3. Trade	20,372	20.3	7.8	4.0	12.7	6.6	6.0	3.3	2.4	1.7		
4. Tourism	4,301	14.2	33.7	24.4	17.6	4.6	3.7	3.3	3.5	4.7		
5. Shipping	6,784	7.8	5.5	2.3	3.0	34.4	37.6	34.2	22.1	18.0		
6. Non-monetary financial institutions	2,330	141.8	72.5	-3.2	9.5	-29.7	-17.0	-0.6	17.9	26.4		
7. Other loans	22,385	24.6	14.3	26.5	11.7	15.7	20.6	20.8	24.6	20.9		
B. Households⁵	73,997	40.0	33.1	28.2	28.0	26.2	27.2	27.5	26.1	26.3		
1. Housing loans	48,138	36.7	35.4	27.1	23.8	28.1	30.4	30.8	29.2	27.2		
2. Consumer loans	23,956	44.3	27.4	24.8	37.9	24.0 ⁶	22.3 ⁶	22.4 ⁶	20.8 ⁶	24.5		
– Credit cards	7,579	62.1	37.1	27.8	23.4	-0.7 ⁶	-2.5 ⁶	-4.5 ⁶	-7.6 ⁶	4.4		
– Other consumer ⁷ loans	16,377	31.8	19.2	21.8	53.1	44.5	42.5	43.9	42.2	36.7		
3. Other loans	1,903	165.5	62.6	135.7	18.8	11.5	13.3	14.2	16.7	28.5		
Total	150,031	23.2	18.3	17.1	16.1	14.9	16.9	17.1	17.6	17.4		

1 The quarterly average is derived from monthly averages (which are calculated as arithmetic means of two successive end-of-month figures) and is not the three-month average of end-of-month annual growth rates (see the “Technical Notes” in the ECB *Monthly Bulletin*).

2 Annual rate of change at the end of the month.

3 Excluding corporate bonds held in MFI portfolios and written-off claims.

4 Comprising manufacturing and mining/quarrying.

5 Excluding securitised housing loans and consumer loans.

6 The slowdown of consumer loan growth is partly associated with the securitisation of loans effected in July 2005.

7 Comprising personal loans and loans against supporting documents.

Source: Bank of Greece.

the corporate bond issues of the industrial sector –which makes extensive use of this alternative source of financing¹⁴– the rate of change in total bank lending to this sector stood at 8.2% in August 2006. By contrast, the growth rate of loans to trade showed a decelerating trend, which started last year and continued into the first eight months of 2006, with the rate falling to 1.7% in August. However, commercial firms too resort to raising funds through corporate bond issues.¹⁵ Thus, taking into account corporate bonds issued by commercial firms, the growth rate of loans to trade stood at 6.6% in August 2006.

Credit expansion to shipping stood at very high levels during 2005, but a partial slowdown was observed in the January-August 2006 period (August 2006: 18.0%, fourth quarter 2005: 34.4%). However, this reflects the evolution of the euro/US dollar exchange rate during the first eight months of 2006,¹⁶ given that over 75% of loans to shipping are denominated in US dollars. Therefore, if the effect of exchange rate movements is not taken into account, the annual growth rate of loans to shipping decelerated only slightly (August 2006: 23.0%, fourth quarter 2005: 26.0%).

The strong pick-up in the rate of change in loans to financial corporations other than banks (August 2006: 26.4%, fourth quarter 2005: –29.7%) is partly attributable to technical reasons, after the unwinding of the influence on this rate from the substitution of loans amounting to €500 million with corporate bond issues in February 2005. However, the growth rate of *total* bank credit to these corporations (loans and bonds) has also been accelerating strongly (August 2006: 39.9%, fourth quarter 2005: 11.7%), as leasing companies, which receive the bulk of credit to non-bank financial corporations, are financed by their parent banking groups in order to further develop their activities. Note, however, that the enactment

of the law governing the new institutional framework for leasing companies¹⁷ in July 2006 is expected to act as a catalyst for the absorption of such companies by their parent banks, as the law allows credit institutions themselves to pursue leasing activities. Insofar as this is done, credit to this sector is expected to decrease substantially, while credit to other sectors will increase correspondingly.

Total MFI credit to households kept rising strongly during the first eight months of 2006, showing only a slight deceleration compared with the end of 2005 (August 2006: 29.1%, fourth quarter 2005: 30.6%). This development reflects a relatively small slowdown in the high growth rates of housing and consumer loans, while the growth rate of other loans to households picked up, although they still represent a very small part of total credit to households.¹⁸ Compared with the average annual growth rate of total bank credit to households in 2001-2005 (32.5%), the growth rate in August 2006 was slightly lower.

As the growth rate of total household borrowing remained high, households' total indebtedness (MFI loans, including securitised loans) rose in August 2006 to 41.2% of GDP (December 2005: 38.0%). If securitised loans are not taken into account, MFI loans to households stood at 38.3% of GDP in August 2006 (December 2005: 36.3%, see Chart III.4). This rate, though lower for the time being than the corresponding euro area rate

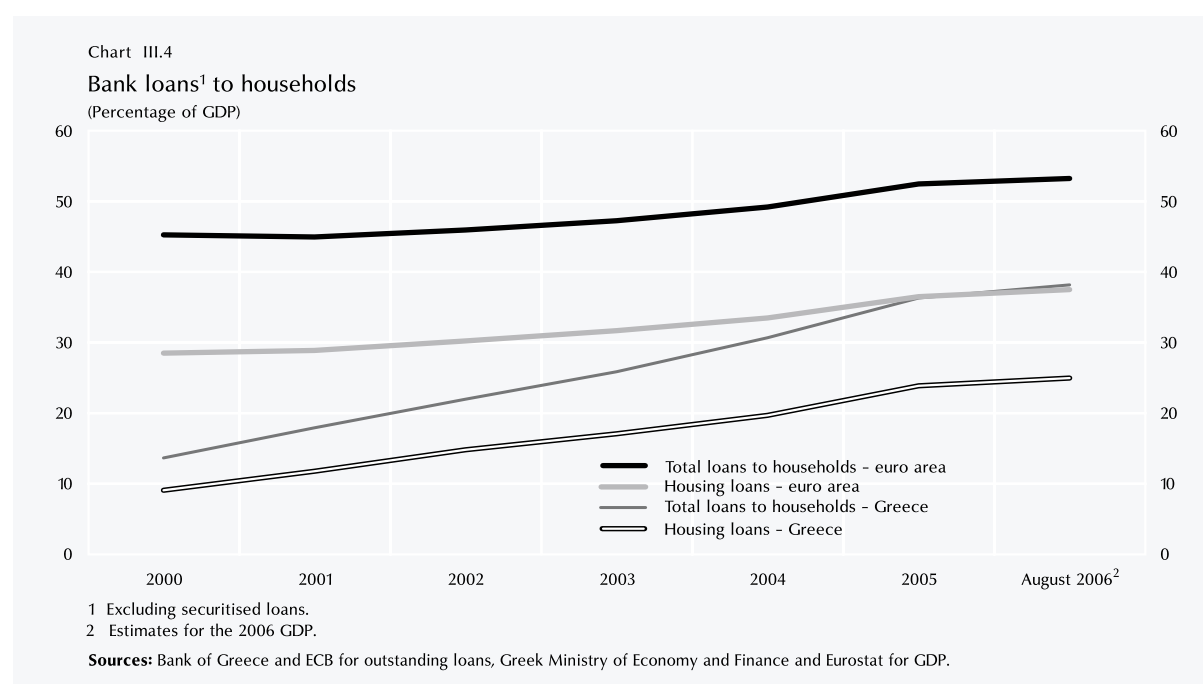
¹⁴ In August 2006 corporate bonds issued by industrial firms represented 20.6% of total corporate bond issues held by MFIs.

¹⁵ Commercial firms had issued 15.4% of the corporate bonds that were held by MFIs in August 2006.

¹⁶ Between end-December and end-August 2006 the euro appreciated by 8.9% against the US dollar.

¹⁷ Law 3483/2006 "Amendment and supplementation of provisions on leasing, provisions regarding public revenue, and other provisions".

¹⁸ In August 2006, other loans to households accounted for 2.4% of total bank credit to households (including securitised loans).



(August 2006: 53.4%, December 2005: 52.4%), is gradually approaching it.¹⁹ In any case, conclusions about the indebtedness of households cannot be drawn solely on the basis of aggregate figures, as the distribution of debt among households should also be taken into account. Indeed, according to a recent sample survey at household level conducted on behalf of the Bank of Greece,²⁰ although most households have no difficulties in servicing their debt, for some households (12% of the households sample that have taken out a loan) debt servicing absorbs over 40% of their monthly income. Moreover, these households have undertaken 30% of total household debt.

Housing credit, in particular, is still strongly affected by the factors that determined its course in the 2001-2005 period. Thus, the fact that, despite the increases in ECB key interest rates, interest rates on housing loans remain relatively low, as well as strong competition between banks in this market, which is manifested in different ways, maintain households' interest in housing loans at high levels. From time to time, the hous-

ing loan market is also influenced by one-off factors associated with the announcement of tax regulations.²¹ The effects of the increased activity in the housing market in the last quarter of 2005, which was affected by the announced adjustments to the objective values of real property and the application of VAT on new residential buildings, are still perceptible in the annual growth rates of housing loans in the first eight months of 2006, which remain high also due to the influence of the aforementioned factors (August 2006: 31.5%, fourth quarter 2005: 31.5%). However, compared with the last quarter of 2005, the amount of total new loans granted was smaller in the January-August 2006 period (average monthly amounts: January-August 2006: €1,241 million, fourth quarter 2005: €1,702 million). As ECB pol-

¹⁹ Given that securitised loans represent a different percentage of GDP in Greece, compared with the euro area, caution should be exercised when comparing the two figures.

²⁰ A description of the survey and analysis of its results is given in the Appendix to Chapter VI of the *Annual Report 2005*, April 2006.

²¹ For example, the announcement of changes in tax exemptions for interest on housing loans is associated with the boom in these loans during the last quarter of 2002.

icy decisions point to rising interest rates in the euro area, households in Greece gradually show less preference for borrowing on floating rate or with an initial rate fixation of up to one year. Therefore, while these loans represented on average 89.1% of new housing loans during 2005, the percentage fell to 75.4% in the first eight months of 2006.

The declining trend in the annual growth rate of consumer loans during 2005 continued into the January-August 2006 period. However, this rate is still high, standing at 24.3% in August (fourth quarter 2005: 30.4%).²² Personal loans followed a particularly dynamic course, as their annual growth rate stood at 40.1% in August 2006 (fourth quarter 2005: 44.4%). Personal loans have developed into the most important individual category of consumer loans, reaching a share of 46.5% (including securitised loans). This is partly related to the extensive supply of bank products which allow the repayment of accumulated debts associated with consumer credit, thus giving borrowers the opportunity to reduce their current debt servicing costs from higher interest rate credit products, such as credit cards. By contrast, the balances of credit card loans, which were the most important consumer loan category until mid-2005, show a declining trend during 2006, which is reflected in their diminishing share in total consumer loans (August 2006: 34.3%, December 2005: 38.7%).

2.2 Bank lending rates

The rise in ECB key interest rates, which started in December 2005 and continued into 2006 during the period under review, as well as market expectations of further increases until the end of the year, had an upward effect on lending rates in Greece and the euro area. During the January-August 2006 period, Greek interest rates rose²³ in almost all loan

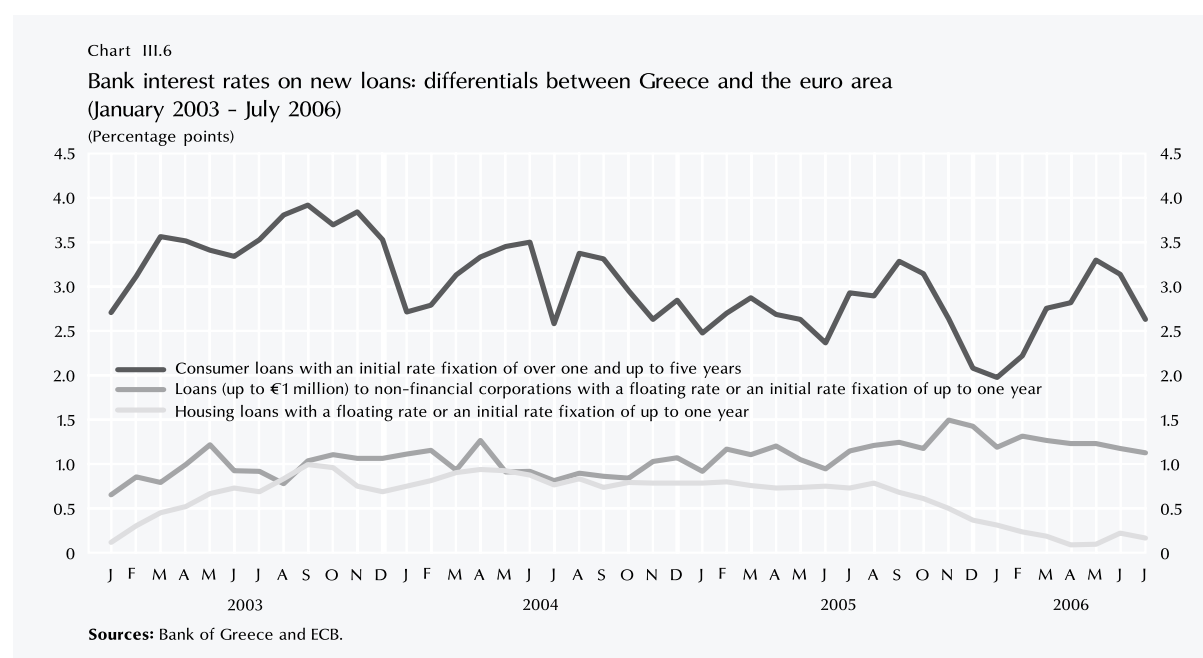
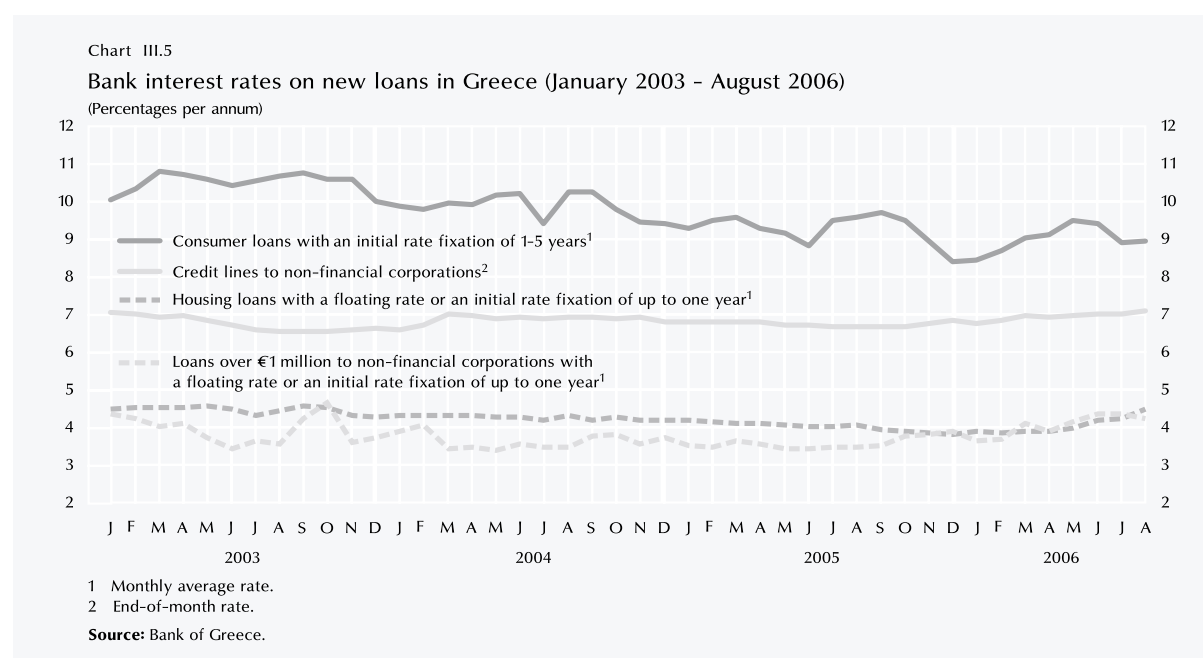
categories (see Chart III.5), while they had fallen significantly in the previous five years. The steepest declines, concerning almost all loan categories, were observed from the beginning of 2001 to mid-2003, when the cycle of decreasing ECB key rates came to an end. During that period, interest rates on corporate loans without a defined maturity recorded the biggest drop (354 basis points, to 6.61% in July 2003). From mid-2003 to November 2005, when ECB key rates remained unchanged, Greek interest rates kept falling (though at a slower pace) in most loan categories.

In the January-July 2006 period the rise in lending rates in the euro area was bigger than in Greece in most loan categories. Therefore, the positive differential between Greek and euro area interest rates decreased in housing loans to households and in corporate loans (see Chart III.6). As regards consumer loans to households, the positive differential widened, with the exception of loans with a floating rate or an initial rate fixation of up to one year, where the differential showed a marked decline. Given that in the 2001-2005 period euro area interest rates fell less than Greek rates, these differentials also declined during that period.

The decrease in the positive differentials between interest rates in Greece and those in the

²² The Bank of Greece, within the framework of its supervisory role and taking into account the high growth rates of consumer loans, has already taken supervisory measures to ensure the stability of the credit system. Thus, among other things, it increased the minimum provisioning ratios for consumer loans (Bank of Greece Governor's Act 2557/26 January 2005) and issued guidelines to banks stipulating that, when evaluating applications for personal loans, attention should be paid to the relation between the amount needed for debt servicing and the applicant's disposable income (Bank of Greece Governor's Act 2565/11 October 2005). See Section 4 of this chapter for an evaluation of the stability of the credit system.

²³ The increase in the average interest rate on loans to households (62 basis points, to 6.78% in August 2006) was higher than that in the average interest rate on corporate loans (43 basis points, to 5.71% in August 2006).



euro area may be attributed to stronger competition between banks in Greece, particularly in housing loans, as well as the increasing integration of financial markets in the euro area.²⁴ However, interest rate differentials are still relatively significant in some loan categories, a fact which is mainly associated with such factors as the higher operating costs of Greek banks (see

²⁴ Characteristically, in loan categories where “customer proximity” is a less decisive factor for the conclusion of a loan, as in the case of large corporate loans (over €1 million), interest rate differences among euro area countries are rather small and the relevant markets are much more integrated. By contrast, in the case of consumer loans, where the above-mentioned factor is a key determinant for the conclusion of a loan, the relevant markets are characterised by a high degree of segmentation and significant interest rate differences across euro area countries. See the ECB study *Differences in MFI interest rates across euro area countries*, September 2006.

Table III.5A
Bank interest rates on new loans in the euro area and Greece
(Percentages per annum)

A. Loans with a floating rate or an initial rate fixation of up to one year¹			
	December 2005	July 2006	Change July 2006/Dec. 2005 (in percentage points)
A.1 Loans up to €1 million to non-financial corporations			
Weighted average interest rate in the euro area	3.99	4.57	0.58
Maximum interest rate	5.73	6.23	0.50
Minimum interest rate	3.53	4.13	0.60
Interest rate in Greece	5.41	5.70	0.29
Interest rate differential between Greece and the euro area	1.42	1.13	-0.29
A.2 Loans of more than €1 million to non-financial corporations			
Weighted average interest rate in the euro area	3.25	3.84	0.59
Maximum interest rate	4.22	4.84	0.62
Minimum interest rate	2.70	3.45	0.75
Interest rate in Greece	3.93	4.40	0.47
Interest rate differential between Greece and the euro area	0.68	0.56	-0.12
A.3 Housing loans			
Weighted average interest rate in the euro area	3.49	4.11	0.62
Maximum interest rate	4.44	4.92	0.48
Minimum interest rate	3.18	3.77	0.59
Interest rate in Greece	3.86	4.28	0.42
Interest rate differential between Greece and the euro area	0.37	0.17	-0.20
A.4 Consumer loans			
Weighted average interest rate in the euro area	6.76	7.34	0.58
Maximum interest rate	10.18	11.28	1.10
Minimum interest rate	3.95	4.62	0.67
Interest rate in Greece	7.78	7.85	0.07
Interest rate differential between Greece and the euro area	1.02	0.51	-0.51
B. Loans with an initial rate fixation of 1-5 years¹			
Consumer loans			
Weighted average interest rate in the euro area	6.36	6.31	-0.05
Maximum interest rate	8.61	10.25	1.64
Minimum interest rate	4.26	4.95	0.69
Interest rate in Greece	8.44	8.94	0.50
Interest rate differential between Greece and the euro area	2.08	2.63	0.55

¹ Monthly average rate.

Sources: ECB and euro area NCBs.

Table III.11), weaker competition in Greece than in the euro area, the lower degree of maturity of certain loan markets in Greece (compared with the corresponding markets in the euro area), the higher borrowing costs – mostly size-related – of Greek banks in the interbank market, as well as the higher non-performing loans to total loans ratio compared with the euro area²⁵ (see also Table III.10), which leads to a higher risk premium incorporated in interest rates. Therefore, as relevant markets become more mature, competition between banks intensifies and Greek banks gain in size, interest rates in Greece will tend to converge towards the corresponding euro area rates.

As regards individual loan categories, the differential in housing loan interest rates between Greece and the euro area has been almost eliminated, as Greek and euro area rates in this category have shown a strong tendency to converge.²⁶ Moreover, interest rates on corporate loans have also converged to a large extent, particularly in the case of loans over €1 million.²⁷ Interest rates on consumer loans, particularly loans with a floating rate or an initial rate fixation of up to one year, showed a convergence towards those in the euro area.²⁸ By contrast, the interest rate differential of consumer loans without a defined maturity rose (by 15 basis points) in the January-July 2006 period and still remains significantly high (July 2006: 355 basis points). This differential is attributed to the fact that loans through credit cards are the most significant²⁹ loan category without a defined maturity in Greece, contrary to other euro area countries. The interest rate on loans through credit cards remains high (August 2006: 14.34%) as, among other things, it reflects the high administrative costs associated with this product. The interest rate differential as regards consumer loans with an initial rate fixation of over one and up to five years rose significantly (by 55 basis

points) against the corresponding euro area rates and stood at 263 basis points in July 2006. It should be noted that consumer loans with longer maturities involve greater risks, which may be limited if banks obtain collateral or guarantees. High interest rates on these loans in Greece indicate their lower level of collateralisation.

For all the above reasons, the spread between the weighted average interest rate on total new bank loans and the corresponding rate on new deposits in Greece is higher than in the euro area, although it fell by 121 basis points during the 2001-2005 period. From January to August 2006 this spread is estimated to have risen by 18 basis points (to 4.65% in August, see Table III.6). In the seven months from January to July 2006 (a period for which there are available data about interest rates in the euro area) the spread increased by 11 basis points in Greece, while the corresponding

²⁵ Non-performing loans as a percentage of total loans of Greek commercial banks stood at 6.4% in June 2006, which is significantly higher than that for average-size banks in the European Union (December 2005: 3.3%).

²⁶ As regards housing loans with a floating rate or an initial rate fixation of up to one year, which are the main category of housing loans in Greece, the interest rate differential fell to 17 basis points in July 2006, as this interest rate rose in Greece less than in the euro area (see Tables III.5A and B). However, housing loans with an initial rate fixation of over one year and up to 5 years recorded the most significant convergence, as the interest rate in this category, in contrast to other interest rates which rose, fell significantly in Greece (to 4.44% in August 2006), urging households to shift their preference towards this loan category, while the differential between this rate and the corresponding euro area rate stood at 13 basis points in July.

²⁷ The interest rate differential as regards corporate loans decreased to 56 basis points for loans over €1 million, to 113 basis points regarding loans up to €1 million and to 167 basis points regarding loans without a defined maturity. Note that corporate loans without a defined maturity are mostly concluded through credit lines.

²⁸ The interest rate differential in this category fell to 51 basis points in July 2006, from 102 basis points in December 2005.

²⁹ In other euro area countries, loans through credit cards are not the most significant loan category (as regards consumer loans without a defined maturity), as the relevant debt is mostly repaid without leaving a balance. An alternative type of borrowing is overdrafts from current accounts, as their interest rates are lower for larger loans, thus making them preferable to consumer loans with a defined maturity. Moreover, in some countries loans through credit cards are granted by non-MFIs and therefore their interest rates are not included in bank rates.

Table III.5B
Bank interest rates on new loans in euro area countries¹

	New loans with a floating rate or an initial rate fixation of up to one year ²								Consumer loans with an initial rate fixation of over one and up to five years ²	
	To non-financial corporations				Housing loans		Consumer loans			
	Loans up to €1 million		Loans over €1 million							
	Dec. 2005	July 2006	Dec. 2005	July 2006	Dec. 2005	July 2006	Dec. 2005	July 2006	Dec. 2005	July 2006
Belgium	4.02	4.42	2.95	3.45	3.18	4.09	5.98	6.94	7.07	7.72
Germany	4.57	5.11	3.46	4.00	4.44	4.92	4.85	5.54	5.64	5.41
Greece	5.41	5.70	3.93	4.40	3.86	4.28	7.78	7.85	8.44	8.94
Spain	3.69	4.36	3.12	3.74	3.29	4.08	8.13	8.48	7.57	8.15
France	3.53	4.25	2.70	3.81	3.37	3.77	4.91	5.88	6.33	6.07
Ireland	4.52	5.29	4.22	4.84	3.47	3.90	4.96	5.89	8.17	8.44
Italy	4.07	4.59	3.25	3.86	3.60	4.30	10.18	11.28	7.87	8.31
Luxembourg	... ³	4.44	... ³	4.00	3.62	3.93	... ³	... ³	5.42	5.63
Netherlands	3.60	4.32	3.63	3.69	3.44	4.09	7.51	7.99	... ³	... ³
Austria	3.66	4.13	3.13	3.57	3.99	4.34	4.94	5.65	4.26	4.97
Portugal	5.73	6.23	3.93	4.60	3.50	3.92	8.02	7.81	8.61	10.25
Finland	3.74	4.32	3.19	3.88	3.25	3.79	3.95	4.62	4.52	4.95

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 includes 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.

Sources: ECB and euro area NCBs.

spread³⁰ for the euro area rose by 24 basis points to 2.70% in July. Therefore, it is obvious that the convergence of Greek interest rates towards the corresponding euro area rates continues and their differential is gradually decreasing.

Additional information on the evolution of bank interest rates 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 in the first eight months of 2006. In particular, a rise was observed in the average interest rate on the most important category of consumer loans (those with a maturity of up to one year),³¹ while the average rate on the most important category

of housing loans (those with an initial maturity of over five years) recorded a smaller increase. The average interest rate on loans to enterprises also rose. This development in the average interest rates on outstanding balances of loans is due to the rise in the key ECB interest rates, which began, as mentioned above, in December 2005 and continued into the period under review. However, it should be noted that this category of interest rates (average interest rates on total outstanding balances of loans) is not influenced solely by interest rates on new loans. Interest

³⁰ According to Bank of Greece calculations. For corresponding ECB calculations, see the recent study *Differences in MFI interest rates across euro area countries*, September 2006.

³¹ The interest rate on the second most important category of consumer loans (those with a maturity of over one and up to five years) remained unchanged.

Table III.6
Average bank interest rates on loans and deposits in Greece¹
(Percentages per annum)

	Average lending rate	Average interest rate on deposits	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	6.04	1.15	4.89
Dec. 2004	6.03	1.19	4.84
Dec. 2005	5.73	1.25	4.47
July 2006	6.14	1.56	4.58
Aug. 2006	6.27	1.62	4.65

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.

rates on older loans also play an important role. In the case of Greece, interest rates on older loans had been very high, compared with those in other euro area countries, particularly for loans granted before the country's entry into the euro area.

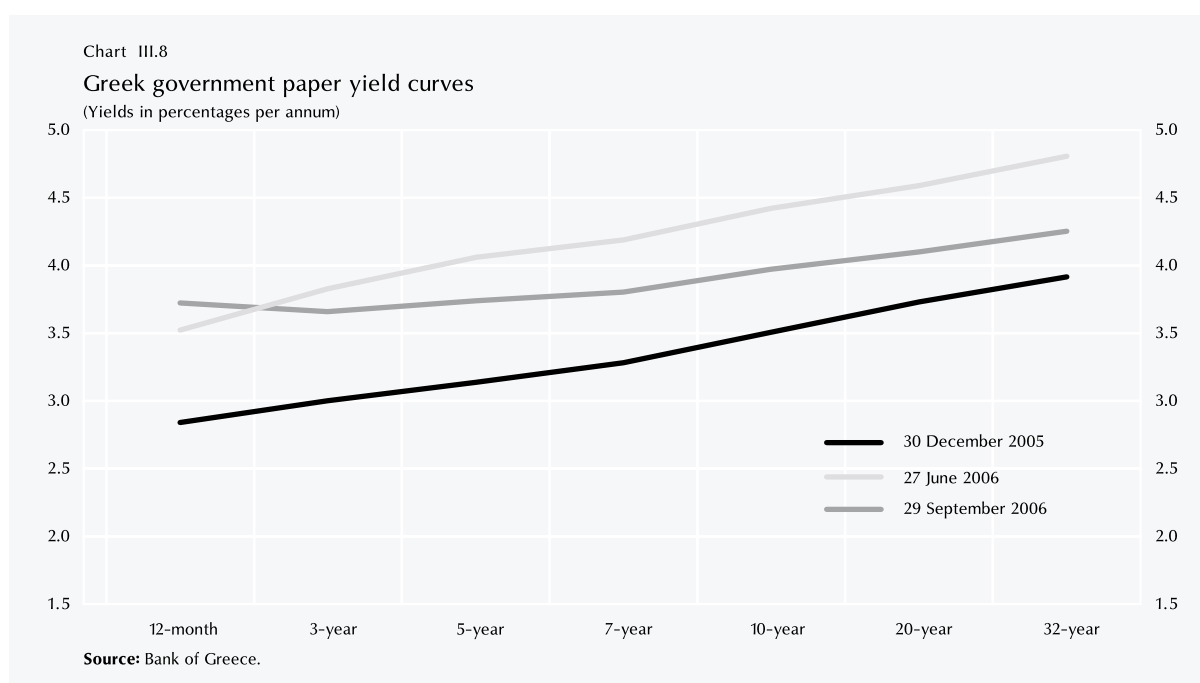
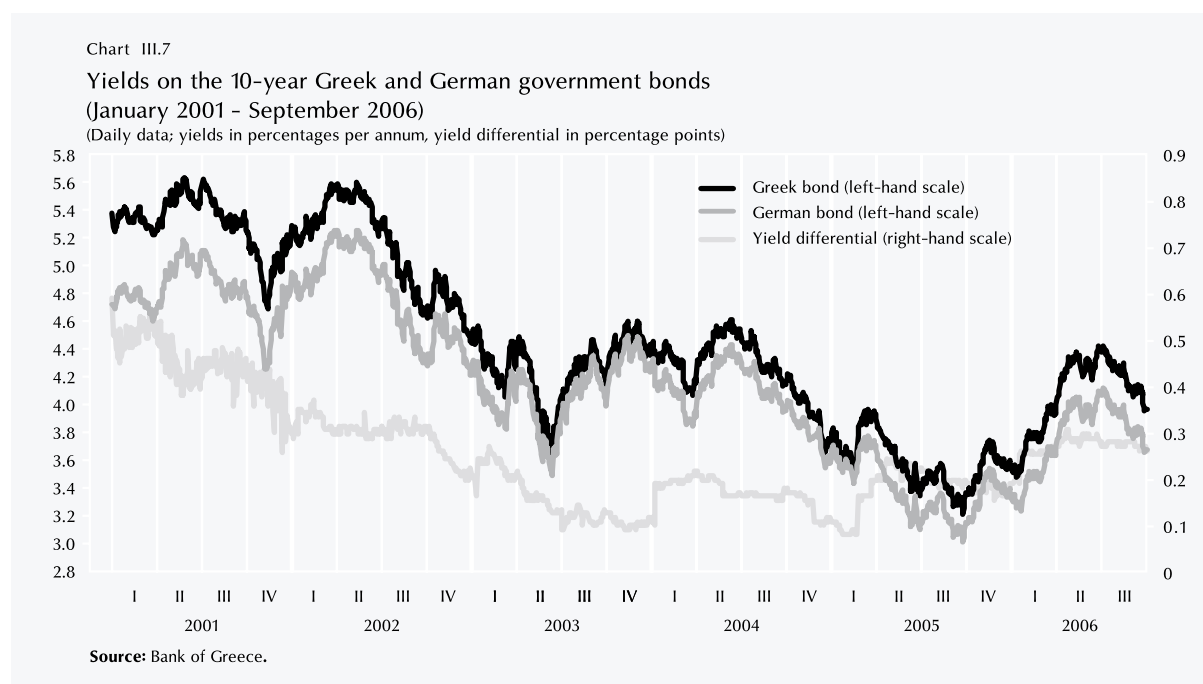
3. Capital markets

3.1 The bond market

The upward course of Greek government bond yields in the secondary market observed since the historical lows recorded in September 2005 continued at a strong pace up to June 2006, while in the July-September quarter bond yields edged down (see Charts III.7 and III.8). At the same time, between January and September 2006 the value of transactions in such securities in the Electronic Secondary Market for Securities (HDAT) decreased slightly compared with the corresponding period of 2005 (see Chart III.9), while standing near the average of the last five years.

This trend of Greek government bond yields followed similar developments in the euro area – and the US – bond markets, which were affected by the announcement of positive macroeconomic data that, combined with the further increase in oil prices, aggravated concerns regarding the emergence of inflationary pressures. In addition, the European Central Bank (ECB) revised its estimates on euro area growth and inflation upwards and repeatedly raised its key interest rates³² in the course of the current year, which in turn affected bond markets as investors estimated that monetary policy stance would become less accommodative. However, these developments were more than offset by the investors' uncertainty regarding the effect on the world economy of the geopolitical instability and the possible slowdown

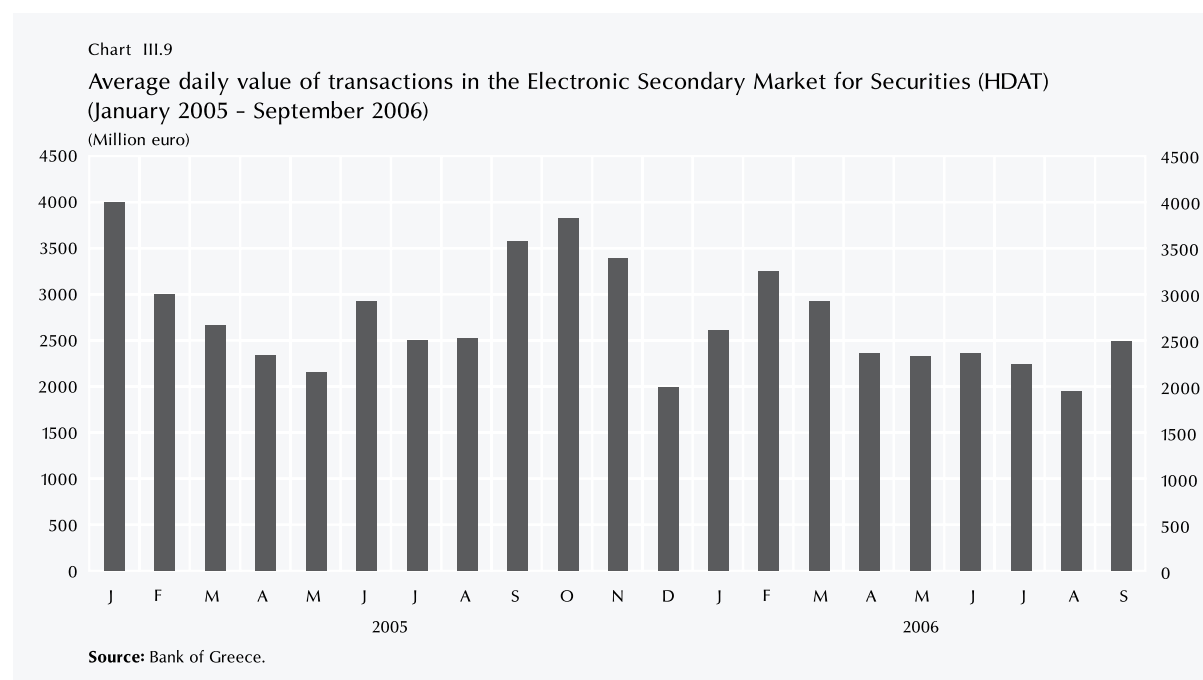
³² It should also be noted that the US Federal Reserve continued to pursue a tight monetary policy in the period under review (January-September 2006), raising its key interest rates four times, while the central bank of Japan announced its intention to discontinue the lax monetary policy stance it has followed in the last few years and, moving in this direction, raised its key interest rate once in this same period.



of US economic growth, due mainly to the announcement of housing market data less favourable than anticipated, which led bond yields to slightly decline in the July-September quarter.

At end-September 2006, the yield on the Greek 10-year government bond stood at 3.97%, i.e. 46

basis points higher than at end-December 2005 and 76 basis points higher than the trough observed in September 2005, but 53 basis points lower than the 2001-2005 average. In the first nine months of the current year this yield ranged more widely than in 2005, between a trough of 3.48% on 9 January 2006 and a peak of 4.42% on



27 June 2006.³³ Also, the yield differential between this bond and the comparable German one broadened in early 2006 – something observed in Italy as well – and then remained at roughly the same levels up to end-September (September 2006: 29 basis points, December 2005: 21 basis points – see Chart III.7).³⁴

Between end-December 2005 and end-September 2006 an increase was also recorded in Greek government bond yields for other maturities as well. Thus, the yield curve shifted upwards (see Chart III.8) while becoming less steep, as evidenced by the yield spread between the 10-year bond and the 12-month Treasury bill, which stood at 25 basis points at end-September 2006 compared with 67 basis points at end-December 2005.³⁵

The average daily value of transactions in the HDAT, which more than doubled in the 2001-2005 period,³⁶ fell to €2.5 billion in the first nine months of 2006, i.e. by 12.3% over the corresponding 2005 period (see Chart III.9), but nevertheless remained close to the last five years' aver-

age. The bulk of transactions regarded 10-year bonds, which accounted for about 72% of the transactions' total value in the period under review. The bid-ask spread declined in September 2006 (to 7.3 basis points) compared with December 2005 (7.9 basis points).³⁷

In the primary market for Greek government securities, the total amount of funds raised in the first nine months of 2006 fell to €26.9 billion, or by 25.1% compared with the corresponding

³³ The spread between the two outermost values for the first nine months of 2006 (94 basis points) was broader than the corresponding one for 2005 as a whole (76 basis points).

³⁴ The widening of the yield differential between the two bonds would be lesser (September 2006: 28 basis points, December 2005: 25 basis points) if they had the same maturity date.

³⁵ The spread between the 32-year bond and the 12-month Treasury bill narrowed by 55 basis points in the same period.

³⁶ The average daily value of transactions in the HDAT amounted to €2.9 billion in 2005 compared with €1.3 billion in 2001. A similar picture (2005: €25.8 billion, 2001: €11.4 billion) was observed in the average daily value of transactions in the Book-Entry Securities System of the Bank of Greece, which declined to €22.6 billion in the January-September 2006 period from €26.7 billion in the corresponding 2005 period.

³⁷ This narrower spread is also linked to the slightly reduced volume of transactions in 32-year bonds.

Table III.7
Greek government paper issuance

Type of security	January - September			
	2005		2006	
	Million euro	Percentage of total	Million euro	Percentage of total
<i>Treasury bills</i>	1,658	4.6	1,700	6.3
<i>Bonds¹</i>	34,253	95.4	25,210	93.7
3-year	6,990	20.4	3,931	15.6
5-year	7,343	21.4	6,828	27.1
7-year	—	—	—	—
10-year	9,184	26.8	7,842	31.1
12-year	3,499	10.2	—	—
20-year	—	—	—	—
23-year	2,213	6.5	2,363	9.4
32-year	5,024	14.7	4,246	16.8
Total	35,911	100.0	26,910	100.0

¹ By initial maturity as regards the reopening of past issues.
Source: Ministry of Economy and Finance.

period of 2005 (see Table III.7). Around 80% of total issuance regarded syndicated issues. Out of all the bond securities issued, maturities of 10 years or more accounted for an amount of €14.5 billion, or 57.3% of total issued bond value (January-September 2005: 58.2%), while the weighted average maturity of all issued Greek government securities stood at 13.1 years³⁸ (2005: 10.5 years). Treasury bill issues in the first nine months of 2006 remained at low levels, slightly higher than in the corresponding period of 2005, accounting for approximately 6.3% (2005: 4.6%) of total issuance value (see Table III.7). Finally, investors continued to be strongly interested in purchasing public debt in the primary market and, as a result, in the case of auctioned issues fund supply considerably outstripped demand.³⁹

3.2. Stock market developments

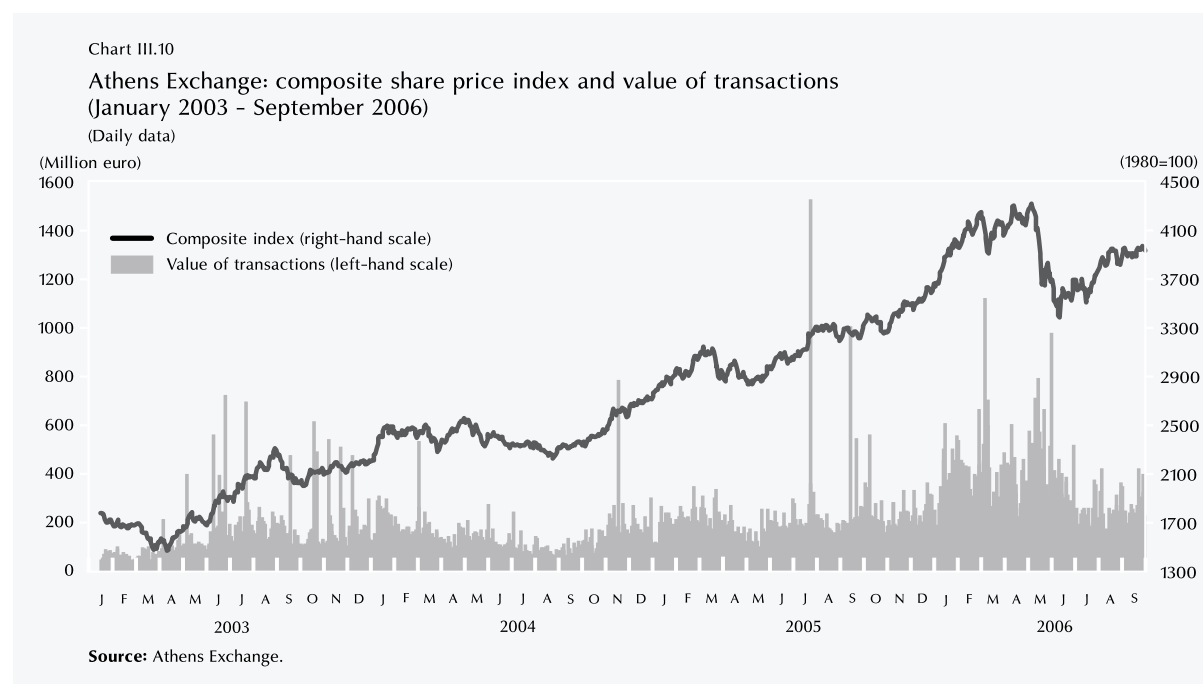
In the period between January and September 2006, the main characteristic of the Athens Exchange (Athex) figures was the wide fluctuation

of share prices and the considerable increase of transactions, as well as of the funds raised by firms (see Chart III.10 and Table III.8).

The upward course recorded in the composite share price index of the Athex in 2005, in line with similar developments in international stock markets, continued at a strong pace during the first ten days of May 2006, when the index peaked at a five-year high. This development is associated with the improved profitability of Athex-listed firms in 2005, with estimates for a further increased profitability in the first two quarters of 2006, following the completion of important business agreements, as well as with the investors' positive estimate regarding the course of the programme for structural reforms in companies in which the state holds a stake (initial public offerings/privatisations).

³⁸ With reference to the first half of 2006.

³⁹ It should be noted that the total supply of funds outstripped demand in the auctions for 3-year and 10-year bonds by 4.5 and 4.6 times respectively, while the average outstripping in the auctions for Treasury bills was around 2.2 times.



Thereafter, from mid-May 2006 the Athex composite index followed a strongly downward path, to stand at end-June at approximately the same level as in early 2006. This development came mainly as a result of the raised key interest rates of the ECB and the US Federal Reserve and the investors' expectations for further increases therein,⁴⁰ while the sales effected by mainly foreign institutional investors – who apparently showed a “herding” behaviour – were particularly strong both in the Greek and in international stock markets. There was also a shift of funds out of stock markets into bond markets due to the investors' reluctance to take up risks. In the next three months, the successful initial public offering of the Postal Savings Bank and the privatisation of Emporiki Bank, the confirmation of the investors' estimates about a considerable improvement in the profitability of Athex-listed firms in the first half of 2006⁴¹ and the fall of long-term interest rates led to a recovery in share prices (see Chart III.10).

In more detail, between end-December 2005 and end-September 2006, the Athex composite index

rose by 7.3%, while its average level was 28% and 57% higher than in the first nine months of 2005 and the 2001-2005 five-year average, respectively.⁴² In the course of the first nine months of 2006, compared with the composite share price index, a considerably higher rise was observed in the indices of prices of medium (28.3%) and low capitalisation (25.1%) shares, while the high capitalisation share price index rose less (6.2%).⁴³

In the January-September 2006 period, the average daily value of transactions (€341 million) was

⁴⁰ Higher interest rates are estimated to have a negative effect on firms' profitability and asset valuation.

⁴¹ The profits (after tax and minority rights) of groups of Athex-listed companies rose by 51% (40% at parent company level) in the first half of 2006 compared with last year's corresponding period, while, excluding financial corporations, this rise comes to 41% (30% at parent company level).

⁴² The highest value of the composite share price index (4,316.98 points) was recorded on 8 May 2006 and the lowest (3,379.28 points) on 14 June 2006.

⁴³ As regards developments in the main foreign stock markets, the Dow Jones EURO STOXX broad index in the euro area rose by 11.8%, the Standard and Poor's 500 in the US by 6.5%, and the Nikkei 225 in Japan only marginally (by 0.1%). However, in euro terms, the Standard and Poor's 500 and the Nikkei 225 indices appear decreased by 0.2% and 6.7% respectively.

Table III.8
Fund-raising through the Athens Exchange
(Million euro)

Business sectors	Number of firms		Funds raised ¹	
	January - September		January - September	
	2005	2006*	2005	2006*
Listed companies	9	8	1,616.1	3,215.6
Newly listed companies	5	1	59.6	86.0
Total	14	9	1,675.7	3,301.6
– Banks ²	2	1	1,349.0	3,000.5
– Investment	1	1	83.2	31.1
– Insurance	2	–	122.0	–
– Industrial	3	1	50.9	19.7
– Construction	–	1	–	14.1
– Commercial	3	–	29.8	–
– Telecommunications	–	1	–	119.9
– Real estate management	1	1	26.4	86.0
– Information technology	2	1	14.4	6.9
– Other	–	2	–	23.4

1 Share capital increases through public offerings and private placements. Subscriptions to the share capital increase are entered on the last day of the public offering period.

2 The funds raised by banks do not include an amount of €611.6 million concerning the sale of existing shares of the Postal Savings Bank.

* Provisional data.

Sources: Athens Exchange and Bank of Greece.

almost double that in the corresponding period of 2005 and more than double than the last five years' average (€150 million). The bulk of transactions (around 90%) related to the large capitalisation market, while almost half of these transactions were conducted in shares of financial corporations. A considerable contribution to this development was the participation of foreign investors in Athex market capitalisation, which remained high, and in fact slightly increased in the period under review, despite the considerable fall of share prices in May.⁴⁴

The total amount of funds raised from the stock market in the first nine months of 2006 (€3,301.6 million) was about twice the one raised in last year's corresponding period (€1,675.7 million, see Table III.8) and almost three times the 2001-2005 average. These funds involved 9 companies (2005: 14

companies), one of which was newly-listed, raising €86.0 million (in the corresponding 2005 period, 5 newly-listed companies raised €59.6 million).⁴⁵

A considerable increase, compared both with 2005 and with the 2001-2005 average, was

⁴⁴ According to Central Depository of Securities data, at end-August 2006 foreign investors accounted for 43.3% of the Athex market capitalisation, compared with 38.0% at the end of 2005. The share of foreign institutional investors was 32.2% (end-2005: 25%). The share of foreign investors (47.4%) was higher in the large capitalisation category. Moreover, compared with end-August 2005, the share of foreign investors in the medium capitalisation category more than doubled (August 2006: 47.0%, August 2005: 20.0%). It should be noted that in early 2001 foreign investors accounted for a share lower than 26% of total capitalisation.

⁴⁵ The increased amount of funds raised in the period under review is due mainly to the funds raised by the National Bank of Greece. Excluding the banking sector, the funds raised were 8% lower than in the corresponding nine months of 2005. In the same period, fund-raising by the non-financial sector more than doubled and stood close to the 2001-2005 average, when 38 firms – 13 newly-listed – raised funds each year.

Table III.9

Coefficients of correlation between the Athex Composite Index and the main European stock market indices

Indices	Period January - September 2006				
	Athex Composite Index	DAX-30	CAC-40	FTSE-100	DJ EURO STOXX
Athex Composite Index	1.00				
DAX-30	0.49	1.00			
CAC-40	0.55	0.95	1.00		
FTSE-100	0.55	0.89	0.91	1.00	
DJ EURO STOXX	0.60	0.97	0.98	0.92	1.00

Indices	Period 2001-2005				
	Athex Composite Index	DAX-30	CAC-40	FTSE-100	DJ EURO STOXX
Athex Composite Index	1.00				
DAX-30	0.38	1.00			
CAC-40	0.39	0.86	1.00		
FTSE-100	0.36	0.76	0.87	1.00	
DJ EURO STOXX	0.43	0.92	0.98	0.88	1.00

Note: For the calculation of the correlation coefficients, use was made of the daily percentage changes in the stock price indices of the Athens Exchange (Athex), the Frankfurt Exchange (DAX-30), the Paris Exchange (CAC-40) the London Exchange (FTSE-100) and the euro area broad Dow Jones STOXX index (DJ EURO STOXX).

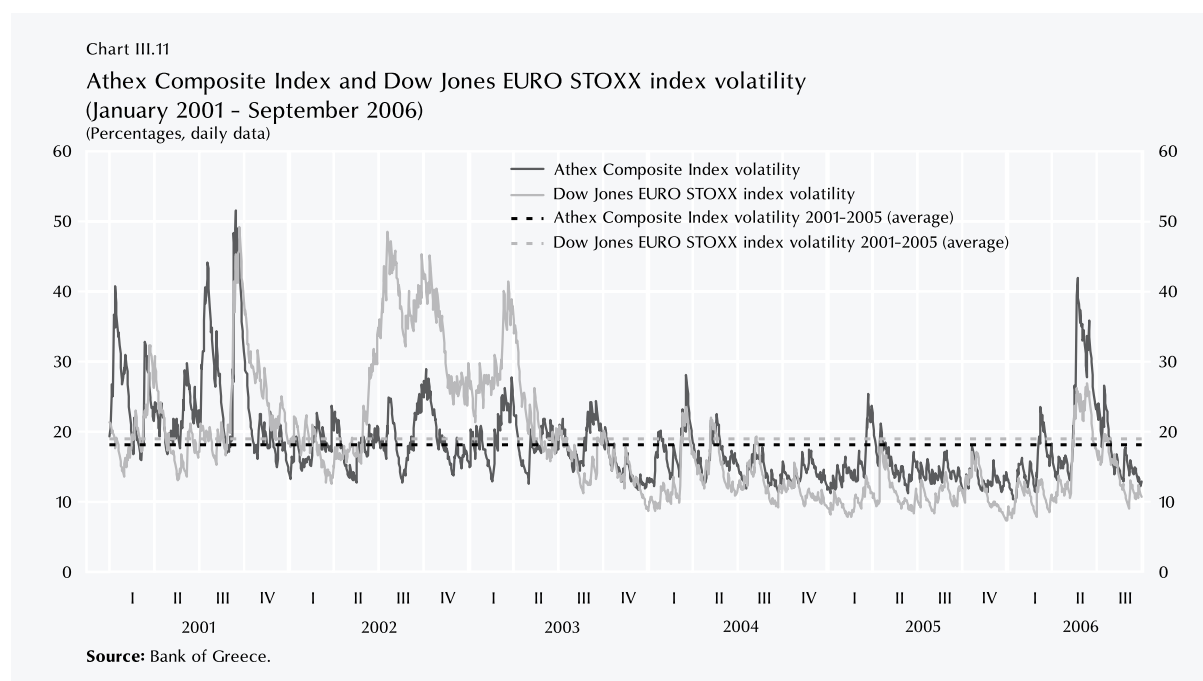
observed in the correlation coefficients of the Athex composite index (see Table III.9) with the Dow Jones EURO STOXX broad index and the share price indices of the major EU stock markets (FTSE-100, DAX-30, CAC-40).⁴⁶ More specifically, as regards the Dow Jones EURO STOXX broad index, its correlation with the Athex composite index rose to 0.60 in the January-September 2006 period, compared with 0.37 in 2005 and 0.43 on average in the last five years. This increase is mainly attributable to the high correlation of the two indices in the May-June 2006 period, when share prices in the domestic and the international stock markets declined considerably. However, despite the rise observed, this coefficient remains considerably lower than the coefficients of correlation among the indices of the major EU stock markets, which range between 0.89 and 0.98 for the January-September 2006 period and between 0.76 and 0.98 for the 2001-2005

period – which indicates the relatively lower integration of the Greek stock market with the major EU stock markets.

From early 2006 and until mid-May, volatility⁴⁷ in both the Athex composite index and the Dow Jones EURO STOXX broad index remained roughly at the same levels as in 2005 (see Chart III.11). Thereafter, and until end-June, as a result of the instability observed in stock markets worldwide, the volatility of both indices doubled compared with the January-April 2006 period and stood at a level higher than the last five years' average. However, in the July-September 2006 quarter, the volatility of the two indices declined again to levels lower than

⁴⁶ The correlation coefficient was calculated using daily percentage changes in prices.

⁴⁷ Volatility was estimated applying a specialised econometric model (GARCH) to daily observations for the period from January 2001 to September 2006.



this average. It should be noted that the volatility of the Athex composite index in the first nine months of the current year remained –as in 2005– higher than that of the Dow Jones EURO STOXX broad index.

The aforementioned difference in the volatility of the two indices reflects the deviation recorded in their development from 1999 onwards. In more detail, the difference between the highest and the lowest values in the 1999-2003 period was larger for the Athex composite index (–77%) than for the Dow Jones EURO STOXX broad index (–64%). Moreover, a considerable differentiation was also observed during the period of increase in both indices (April 2003 to September 2006), in which the Athex composite index rose by 165% while the Dow Jones EURO STOXX broad index by 119%. Owing to this considerably higher increase of the Athex composite index, its price to earnings per share ratio (P/E) at end-September 2006 was higher (15.7) than that of the Dow Jones EURO STOXX broad index (13.3).⁴⁸

This development partly reflects investor expectations of higher profitability for Greek firms than for corresponding European ones, given that at end-September 2006 the earnings yield⁴⁹ and the dividend return for the Athex composite index (6.4% and 2.5% respectively) were lower than the corresponding figures for the Dow Jones EURO STOXX broad index (7.5% and 2.9% respectively).⁵⁰

Finally, in the January-September 2006 period, the banking sector sub-index grew (by 11.3%) faster than the Athex composite index, while the same also holds in this period for the growth rate (104%) of the average daily value of transactions in banking sector shares compared with the corresponding rate for the market as a whole. These developments are due to the business initiatives

⁴⁸ Source: Bloomberg.

⁴⁹ The earnings yield is measured as the ratio of earnings per share to share price.

⁵⁰ Besides, investment in both Greek and European shares appears relatively more attractive than in bonds, the yield of which –albeit considerably increased in 2006– still remains at comparatively lower levels.

undertaken in the banking sector,⁵¹ as well as to the persistence of the Greek commercial banks' profitability rate at high levels, thanks to both their domestic activities and their expansion in markets abroad, mainly in the Balkans.⁵² In more detail, in the first half of 2006, *after tax* profits of Greek Athex-listed commercial banks (banking groups) rose by 38.9% (36.7%) over the same 2005 period, supported by the reduction of the tax rate, while, if the one-off profits from the sale of some banks' participations are also taken into consideration, this rise comes to 63.6% (61.8%). Another significant contribution to these results was the rise in operating income (banks: 24.6%, banking groups: 24.3%),⁵³ which was considerably higher than that in operating costs (banks: 10.8%, banking groups: 15.4%).⁵⁴ This development led to an improved efficiency ratio (i.e. operating costs to operating income), which fell to 47.9% (50.4%) from 53.8% (55.0%) in the corresponding 2005 period. A considerable contribution to the rise in the banks' (groups') operating income were their 20.8% (27.1%) higher net fee income and 12.2% (15.4%) higher net interest income, while the net interest rate margin⁵⁵ decreased slightly at bank level (first half of 2006: 2.7%, first half of 2005: 2.9%), remaining however roughly unchanged (3.0%) at banking group level compared with the corresponding 2005 period.

4. Banking system stability

4.1 Introduction

Since the financial system plays a very important role in the smooth functioning of the economy, ensuring its stability is one of the main objects of supervisory authorities. The analysis that follows focuses on the stability of the banking sector, given banks' key position in the Greek financial system. This includes an assessment of the risks

assumed by banks and their risk management, as well as the profitability and capital adequacy of banks, which are the determinants⁵⁶ of their shock-absorbing capacity. The conclusion of this analysis is that Greek banks' exposure to credit and market risk, despite increasing slightly, is still relatively low, and their profitability and capital adequacy continue to provide a satisfactory buffer for ensuring the stability of the Greek banking system. However, there is a need to monitor and control continuously the risks assumed by banks, as well as the possible impact of these risks on their balance sheet aggregates and capital adequacy ratios (CARs) over the medium and the long term.

4.2 Banking system structural developments

The Greek banking system has followed a positive course for several years, especially after the completion of its liberalisation in the mid-1990s and Greece's entry into the euro area in 2001, which drove down interest rates and reduced foreign exchange risk. Banking activity, notably credit expansion, also benefited from strong economic growth and banks' increased liquidity as a result of a substantial reduction in their compulsory deposits with the Bank of Greece (see Chart III.12). These factors, coupled with progress in IT, which allowed banks to offer new

⁵¹ These business initiatives involve the successful initial public offering of the Postal Savings Bank, the privatisation of Emporiki Bank, the participation of foreign investors in the share capital of Greek commercial banks, and the expansion of Greek banks' activities in foreign markets.

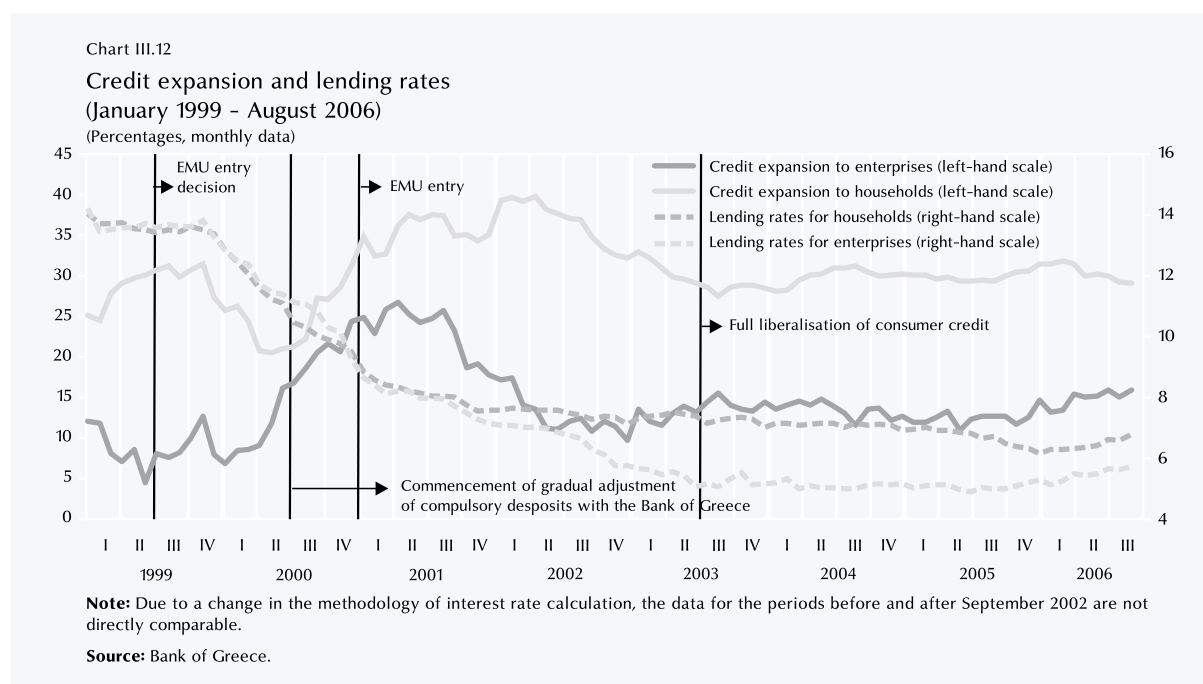
⁵² For more details regarding the expansion of Greek commercial banks in the Balkan markets, see Section 5 in this chapter.

⁵³ Interest income represents more than 60% of total income.

⁵⁴ Personnel outlays represent 60% of total operating costs.

⁵⁵ Calculated as the ratio of net interest income to the average level of assets.

⁵⁶ It should be noted that, according to the ECB, the most important factors that are expected to affect the banking industry in the euro area in the next 5-10 years are the competitive environment, regulatory changes and effective risk management (see ECB, *Financial Stability Review*, June 2006).



products, cut operating costs, develop new risk management methods and internationalise operations, have been and are still contributing to financial deepening, banking system modernisation and a smoother absorption of possible external shocks.

In addition to the aforementioned factors, structural change in the Greek banking system during the last 15 years has also been driven by mergers and acquisitions, flotations and privatisations of state banks,⁵⁷ as well as Greek banks' further cross-border expansion, notably to Southeastern European countries.⁵⁸ Specifically, given the small size of the domestic market and the intensity of competition,⁵⁹ banks' cross-border expansion allows them to take advantage of opportunities in the foreign markets concerned, diversify their income and portfolio and increase their size, which is still relatively small in comparison with EU banks' average size. Against this background, in order to minimise the risks from this expansion, credit institutions must keep their capital adequacy ratios high, increase loan-loss provi-

sioning, further consolidate their portfolios and, in particular, reduce their non-performing loans (NPLs) to total loans ratio,⁶⁰ as well as upgrade their internal control systems.⁶¹

⁵⁷ The most recent examples are the acquisition of Emporiki Bank by the French bank Crédit Agricole, the second flotation of the Agricultural Bank of Greece and the listing of the shares of the Postal Savings Bank on the Athens Exchange.

⁵⁸ It should be pointed out that, by the end of 2005, both the number of branches of Greek banks in these countries and their staff had tripled in comparison with end-2000 and are expected to grow further in 2006, mainly through expansion to the Turkish market. For details on the expansion of Greek commercial banks to the banking markets of Southeastern Europe, see Section 5 of this chapter.

⁵⁹ The degree of concentration in the Greek banking system showed a small decline at the end of 2005 in comparison with the end of 2001, measured on the basis of the assets of either the five largest banks (2001: 67%, 2005: 65.6%) or all the banks operating in the Greek market (Herfindahl-Hirschman index, 2001: 1,113, 2005: 1,096). The Herfindahl-Hirschman index ranges from 0 (perfectly competitive market) to 10,000 (monopolistic market). It should further be noted that competition might have also been strengthened by a narrowing of the market share of state banks and a commensurate widening of the shares of other banks (see H.D. Gibson, "Greek banking profitability: recent developments", Bank of Greece, *Economic Bulletin*, No. 24, January 2005).

⁶⁰ The provisioning coverage of non-performing loans and the non-performing loans to total loans ratio improved in the 2001-2005 period, but the latter is still considerably higher than in the euro area countries.

⁶¹ For internal control and risk management systems, see Bank of Greece Governor's Act 2577/9 March 2006.

4.3 Banking risks

The continuous evolution of banking risks makes risk analysis an integral part of the assessment of the Greek banking system's stability. Specifically, in the current conjuncture, banks' interest rate margin may be affected adversely by strong competition, a possible slowdown in economic activity, a potential reduction in liquidity worldwide if central banks (notably in the EU and the USA) further raise their key interest rates, and the increasing exposure of Greek banks to higher-risk investments.

4.3.1 Credit risk

As for all commercial banks worldwide, credit risk is the major risk facing Greek banks. The magnitude of credit risk is associated on the one hand with banks' credit policy and, on the other hand, with developments in the overall economic environment, notably in interest rates, which affect household and corporate borrowers' financial condition.

The strong credit expansion observed in recent years (see Chart III.12), in particular in retail banking, constitutes a potential risk factor for banks, despite the considerable improvement of their loan book quality and increased provisioning as a result of high profitability, as well as the measures taken by the Bank of Greece.⁶² This type of risk warrants very careful credit rating of household and corporate borrowers by banks.

4.3.1.1 Household loans' credit risk

Loans to households now make up about 50% of total bank lending to the private sector; as a result, recent developments in households' financial condition affect the overall credit risk facing banks more than in the past. Households' indebtedness in Greece rose from 36.3% of GDP in

December 2005 to 38.3% in August 2006 (or 41.2% including securitisation), which is still considerably lower than the corresponding euro area average (53.4%). However, it should be pointed out that households are exposed to increased risk to the extent that they have overestimated their ability to service regularly the loans they have obtained, especially in periods (like the current one) of rising interest rates. In particular with respect to housing loans, taking into account that a large part of them have been obtained at floating rates, a shift to fixed-rate loans has already been observed, as such loans reached 45% of housing loan disbursements in August 2006, from 7% at end-2005. This reflects borrowers' efforts to secure themselves against possible further rises in lending rates. Besides, a sampling survey conducted by the Bank of Greece in 2005 showed that, for 12% of household borrowers, loan servicing costs exceeded 40% of their income and therefore the financial pressure on these households must be strong.⁶³ For this reason, when banks evaluate loan applications, they should ensure that the ratio of total debt servicing costs to income for any given borrower does not exceed a reasonable percentage (30% or 40% of the income).

As it has been pointed out,⁶⁴ credit risk arising from housing loans is also influenced by the loan-to-value ratio and developments in residential property prices, as a potential substantial drop would reduce the value of the underlying collaterals. During 2005, under the pressure of competition, there was an increase in the loan-to-

⁶² These measures (Bank of Greece Governor's Acts 2557/26 January 2005 and 2565/11 October 2005) include an increase in the provisioning ratios for non-performing consumer and housing loans, as well as incentives for further loan write-offs (see *Annual Report 2005*, Chapter X).

⁶³ Furthermore, it should be pointed out that these households account for almost 30% of total household indebtedness.

⁶⁴ See *Annual Report 2005*, Chapter X.5.1.2.

value ratio: in 32% of new housing loans, it exceeded 80%. Hence, the Bank of Greece decided (by Bank of Greece Governor's Act 2564/11 October 2005) that the reduced capital requirement ratio for credit risk (4%) will henceforth apply only to the part of the loan up to 75% of the market value of real estate collateral (which, on the basis of international experience, is considered consistent with reduced capital requirements), the remaining part being subject to the standard 8% capital requirement.

4.3.1.2 Corporate loans' credit risk

The rate of credit expansion to the corporate sector, which is lower than that to households, despite being relatively stable in recent years, has picked up slightly since mid-2005 (see Chart III.12). Specifically, the acceleration of credit expansion to non-financial corporations⁶⁵ has pushed up a little their leverage ratio⁶⁶ (end-2005 data). This does not seem to constitute yet a considerable credit risk-enhancing factor for banks, although the pre-tax profits to total liabilities ratio of enterprises remained below 10% in 2005. Therefore, a potential slowdown of economic growth is expected to affect the ability to repay corporate loans.⁶⁷

The credit registry data compiled by "Tiresias S.A." and associated with banks' credit risk provide a mixed picture. Specifically, in the January-July 2006 period, bankruptcy petitions and the value of court payment orders increased by 35% and 28% respectively, while the value of unpaid cheques dropped by 16%. It should be noted that, except for the rise in bankruptcy petitions, the other two aggregates do not seem to have added to banks' credit risk, as the rate of change in the value of court payment orders remained around the level of 2005, which was the lowest in recent years, while the value of unpaid cheques

fell, after rising in recent years. More encouraging signs are provided by the data on the profitability of Athens Exchange-listed non-financial corporations, as the strong growth rate was maintained in the first half of 2006 both at parent company and group level.⁶⁸

4.3.2 Market risk

In addition to credit risk, which is associated with their core intermediation function, banks also face market risk, i.e. the risk of incurring losses as a result of changes in the prices of (notably financial) assets.⁶⁹ The main type of market risk for banks is interest rate risk. The impact of this risk on banks' net income and equity depends on the shift in the term structure of interest rates and the change in the slope of the relevant curve.

During 2006, this curve steepened until June, but afterwards it shifted downwards and became flatter; as a result, long-term interest rates declined slightly. If this trend continues, banks' profit margins may narrow, as their ability to increase their net interest rate margin⁷⁰ through maturity transformation will be limited, since new long-term loans will be remunerated at lower interest rates. However, this risk is mitigated by the fact that credit expansion remains

⁶⁵ This concerns corporations included in the ICAP database.

⁶⁶ The leverage ratio is calculated as the ratio of a firm's total borrowing to its assets.

⁶⁷ It should be noted that, according to a recent study (see Athanasoglou P., I. Asimakopoulos and K. Siriopoulos, "External financing, growth and capital structure of the firms listed on the Athens Exchange", Bank of Greece, *Economic Bulletin*, No. 26, January 2006) that examines a sample of Athens Exchange-listed non-financial corporations, only a small percentage of Greek firms (actually lower than in the EU) is capable of financing their growth with internal funds, while the majority have to resort to external (mainly short-term) financing. As a result, any slowdown in profit growth will reduce the ability of most firms to self-finance their expansion and may increase banks' credit risk, to the extent that these firms will resort to bank lending in order to finance their requirements.

⁶⁸ See Section 3 of this chapter.

⁶⁹ It should be noted that market risk also has an indirect impact on banks' loan book, as it affects borrowers' credit rating.

⁷⁰ See footnote 55.

relatively high. Consequently, the overall impact of interest rate risk on banks' results currently does not seem to be an important negative factor for the stability of the banking system.

However, it should be pointed out that a further rise in key interest rates in the euro area and the USA may put a strain on liquidity worldwide, which has reached high levels. This may have a lagged downward impact on net interest income, especially for those banks that finance their credit expansion with borrowed funds raised through the money markets and are more sensitive to interest rate changes.⁷¹ For Greek banks, the cost of raising funds is estimated to be 45 basis points (on average) higher than the euro area average, as Greek banks' credit rating is lower.⁷² It should be noted that the loan-to-deposit ratio in the Greek banking system is rising (now close to 100%, from 94.5% in 2005), which points to increased refinancing risk, since, when deposits do not suffice to finance credit expansion, banks have to raise funds from the money market at a higher cost, thus burdening their financial position. It should be noted, however, that for euro area banks this ratio exceeds 120%, implying a higher risk for these banks.⁷³

In addition, banks face the risk arising from changes in the prices of bonds and shares in the capital markets, as these changes affect their banking book and, by implication, banks' income and own funds. During 2006, bonds (which make up about 20% of the Greek banking system's total assets) had a negative impact, as their prices fell from the all-time highs reached in 2005.⁷⁴ Besides, a possible interest rate rise will further affect adversely bond prices, at least over the short term. The impact from changes in shares listed on the Athens Exchange on the stability of the banking system is expected to be weak, since not only the percentage of equities in banks' portfolios is limited (about 3% of their total assets), but also stock

market volatility, despite rising temporarily in 2006, is still rather low in comparison with the average for the last five years, and the profitability of Athens Exchange-listed firms remains strong.⁷⁵ Certainly, a potential drop in share prices and transactions on the Athens Exchange would have a negative impact on banks' income from commissions and financial operations.

Moreover, both Greek banks' investment in foreign hedge funds (which, albeit still low, is rising gradually) and the development of structured products involve increased market risk and require highly-skilled staff and methods for monitoring them.⁷⁶ At the same time, Greek banks' cross-border expansion, mainly to neighbouring countries through subsidiaries, increases their exposure to country risk (including foreign exchange risk)⁷⁷ and warrants the development of appropriate risk monitoring mechanisms and (general and special) provisioning, as country risk is not covered by the International Financial Reporting Standards (IFRS).

4.3.3 Credit and market risk measurement and management

The rise in both credit risk-weighted assets between the end of 2005 and the end of the first

⁷¹ Certainly, the magnitude of this impact also depends on the time of adjustment of banks' lending rates in relation to the time of adjustment of the rates on the borrowed funds with which they are financed.

⁷² Greek banks' credit rating has remained unchanged since 2003, with the exception of two banks (one in 2005 and one in 2006) which were upgraded.

⁷³ See ECB, *Financial Stability Review*, June 2006.

⁷⁴ For developments in the capital markets, see Section 3 of this chapter.

⁷⁵ See the preceding footnote.

⁷⁶ Indicatively, certain banks' investment in hedge funds and structured products has reached 4% of their assets, which calls for careful monitoring. For the increasing importance of these innovative products, see *Annual Report 2005*, Chapter X, Sections 5.3.2 and 5.3.3.

⁷⁷ They are all non-euro area countries.

Table III.10

Non-performing loans as a percentage of total loans and by category, and net non-performing loans¹

(Percentages)

Year	Total loans	Consumer loans	Housing loans	Corporate loans	Net non-performing loans
2001	8.3	8.3	6.6	8.7	4.6
2002	7.4	8.5	6.9	7.4	3.9
2003	7.0	8.0	4.8	7.4	3.5
2004	7.0	7.2	4.6	7.8	3.4
2005	6.3	7.8	3.6	7.1	2.4
2006 (first half)	6.4	8.1	3.9	6.9	2.5

¹ Non-performing loans minus provisions.

Source: Bank of Greece.

half of 2006 (by 9.9%) and in weighted assets as a percentage of banks' assets (June 2006: 63.9%, December 2005: 62%) are indications of Greek banks' increasing exposure to credit risk.

Despite rising marginally (June 2006: 6.4%, December 2005: 6.3%), at end-June 2006 the NPLs ratio was considerably lower than the 2001-2005 average (see Table III.10). Underlying this rise was a deterioration of the corresponding ratio for housing loans (June 2006: 3.9%, December 2005: 3.6%) and consumer loans (June 2006: 8.1%, December 2005: 7.8%), while the ratio for corporate loans improved (June 2006: 6.9%, December 2005: 7.1%). The domestic overall NPLs ratio is relatively high in comparison with medium-sized banks in the euro area, especially taking into account that faster credit expansion has a downward effect on this ratio.⁷⁸ Moreover, the net NPLs⁷⁹ ratio rose marginally in June 2006 (2.5%) in comparison with December 2005 (2.4%), but remains lower than the average (3.5%) for the 2001-2005 period. At the same time, the coverage of NPLs by provisions dropped slightly (June 2006: 60.9%, December 2005: 61.9%).

Capital requirements for market risk make up only a small part of Greek banks' overall capital

requirements (3.1%). However, a possible rise in money and capital market volatility, which has remained low in recent years, and the increasing use of innovative products by Greek banks are considered as factors that may enhance banks' exposure to market risk, warranting systematic monitoring.

Greek banks have stepped up their efforts to improve their credit risk measurement and management systems in the run-up to the implementation of the new supervisory framework ("Basel II") as from 1 January 2007.⁸⁰ For its part, the Bank of Greece carries out preliminary audits in order to verify credit institutions' readiness for the implementation of this framework. Emphasis has been placed on those credit institutions that are expected to apply the advanced methodologies,

⁷⁸ It should be noted, however, that the definition of NPLs used in Greece is more conservative than in the other euro area countries. Nevertheless, it has been observed that certain banks facilitate borrowers facing loan repayment difficulties either by prolonging the loan repayment period or claiming only payment of interest for a specific time period; as a result, the actual NPLs ratio is underestimated.

⁷⁹ NPLs minus provisions.

⁸⁰ For details on the preparation for the implementation of the new supervisory framework and its possible impact, see *Monetary Policy 2005-2006*, February 2006, Chapter III.4.1.3 (Credit risk measurement and management), and *Annual Report 2005*, Chapter X.6.2.

while at the same time banks' readiness to implement the Standardised Approach is assessed. In addition, in order to estimate the impact from worst-case scenarios of adverse developments in credit and market risk factors, the Bank of Greece, in cooperation with Greek commercial banks, has carried out and will continue to carry out stress testing, with a view to ensuring that banks have adequate capital buffers to address such developments. The results of the alternative scenarios examined show that their impact on the CAR would be limited and would not jeopardise the stability of the Greek banking system,⁸¹ as Greek banks' capital base is sufficient to cover unexpected losses. This does not relieve Greek banks of the obligation to adapt their provisioning or reserves for expected losses.

4.4 Banks' profitability and capital adequacy

As already mentioned, banks' shock-absorbing capacity, which is instrumental to safeguarding the stability of the Greek banking system, is inextricably linked with their profitability and capital adequacy.

4.4.1 Profitability

In the first half of 2006, the *pre-tax* profits of Athens Exchange-listed Greek banks grew by 37.4% year-on-year (or 60.7% including one-off profits from the sale of participations). This led to a considerable improvement of return on equity (ROE),⁸² which reached (on an annual basis) 21.7% (first half of 2005: 17.1%),⁸³ i.e. a level higher than for euro area banks (around 20% at end-2005) and, for Greek banks, more than double than the 2001-2005 average (9.7%).

However, this considerable increase in profitability during the reviewed period is not attributable to a widening of the net interest rate margin,⁸⁴ which showed a small contraction (first

half of 2006: 2.7%, first half of 2005: 2.9%), as the hike in net interest income (12.2%)⁸⁵ fell short of the average rise in assets (20.6%). This was a result of increasing competition among domestic credit institutions and the lagged pass-through of the cost from the ECB's interest rate hikes to bank customers. However, this margin was higher than the 2001-2005 average (see Chart III.13).

Underlying the improvement in Greek banks' profitability was primarily a hike in operating income (24.6%), mainly owing to rapid credit expansion, and secondarily a comparatively weaker increase in operating costs (10.8%), which have shown a continuous decline as a percentage of assets in recent years, but remain considerably higher than for euro area banks (see Table III.11).⁸⁶ These developments led to a considerable improvement in the efficiency ratio⁸⁷ (January-June 2006: 47.9%, January-June 2005: 53.8%). It should be noted that in 2001 this ratio was close to 60%, while its average for the 2001-2005 period was 62.1% (see Chart III.13). The remarkable containment of operating costs in recent years was a result of banks' successful efforts to manage more effectively both their human resources and IT systems. However, it is considered that the scope for further cuts in oper-

⁸¹ For the results of stress testing, see *Annual Report 2005*, Box X.2, and F. Kalfaoglou, "Stress testing of the Greek banking system", Bank of Greece, *Economic Bulletin*, No. 27, July 2006.

⁸² ROE is calculated as the ratio of after-tax profits to average own funds.

⁸³ A similar development was observed in return on assets (ROA) (first half of 2006: 1.5%, first half of 2005: 1.1%).

⁸⁴ See footnote 55.

⁸⁵ For more details on developments in bank lending rates, see Section 2.2 of this chapter.

⁸⁶ It should be noted that income was boosted considerably by (in addition to interest income) a 20.8% rise in commission income (these two income categories make up 84% of total income), while 44.5% of the increase in expenses is attributable to administrative and other expenses, as personnel outlays (which account for about 3/5 of expenses) showed a small decline (of 2.5%).

⁸⁷ Measured as the ratio of operating costs to operating income.

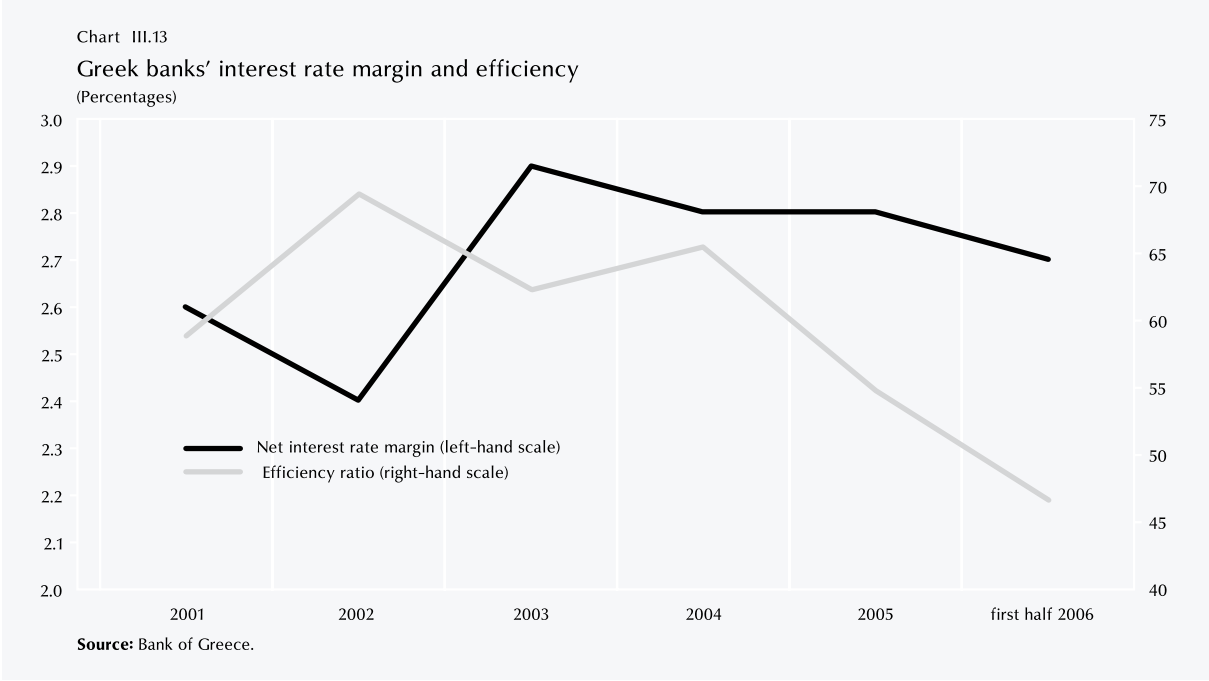


Table III.11
Bank's operating costs as a percentage of their assets

Year	Greece	Euro area
2002	2.6	1.6
2003	2.5	1.5
2004	2.4	1.4
2005	2.2	1.4
2006 (first half)	2.2	...

Sources: Bank of Greece and ECB.

ating costs is limited, which is also observed in the banks of the other euro area countries.⁸⁸

Therefore, the efficiency and profitability of Greek banks in the near future will depend on their income developments to a larger extent than in the past. Since bank profitability is an important determinant of the stability of the banking system, as by strengthening their capital base credit institutions are better-placed to counter the impact from any adverse developments, banks should take advantage of their satisfactory profitability in the current favourable economic conjuncture by increasing

provisioning and strengthening their reserves and capital base.

4.4.2 Capital adequacy

Greek commercial banks' capital adequacy remained satisfactory, despite the negative impact on their total own funds from the adoption of the IFRS.⁸⁹ Underlying the maintenance of a high CAR were capital increases by certain credit institutions and the gradual widening of the share of

⁸⁸ See footnote 73.

⁸⁹ For this impact, see *Annual Report 2005*, Box X.3.

supplementary and hybrid capital in Greek banks' total regulatory capital. The latter was approved by the Bank of Greece with a view to ensuring a level playing field with European banks.

In particular, in the first half of 2006, Greek banks' CAR came to 12.3%, i.e. it was lower than the 2001-2005 average (13.1%), but clearly higher than the regulatory minimum (8%). This decline is accounted for by a 9.9% increase in credit risk-weighted assets in the first half of 2006, mainly as a result of strong credit expansion, the assumption of higher risks by banks, as well as a comparatively larger rise (of 10.3%) in market risk-weighted assets than in regulatory capital (1.9%). During the same period, Tier I capital reached 8.2%, which is satisfactory, albeit lower than the 2001-2005 average (10.5%).⁹⁰

Regarding the impact on capital adequacy from the implementation of the provisions of the new Basel framework ("Basel II"), as incorporated into Community Directives 2006/48 and 2006/49, it should be pointed out that, to the extent that non-performing loans (which will be weighted with higher ratios) will not decline further and the average quality of the performing loan book will not improve, banks' total capital requirements are expected to rise, also because capital requirements for operational risk⁹¹ will apply for the first time, which will not be fully offset by the decrease in capital requirements for credit risk. Since in other EU countries a decline in total capital requirements is expected, the implementation of the new framework should worsen the relative competitive position of certain Greek banks. At the institutional level, the transposition of the said Directives to Greek law is in progress and the Bank of Greece is assessing banks' readiness for their implementation. Moreover, the Bank of Greece cooperates with the supervisory authorities of countries where

Greek credit institutions are active, in order to ensure effective supervision at group level. Finally, in cooperation with the Hellenic Bank Association, the Bank of Greece promotes the recognition of credit rating companies (which are necessary under the new framework), in line with the principles of the Committee of European Banking Supervisors (CEBS) for ensuring a level playing field and uniform treatment of these companies.

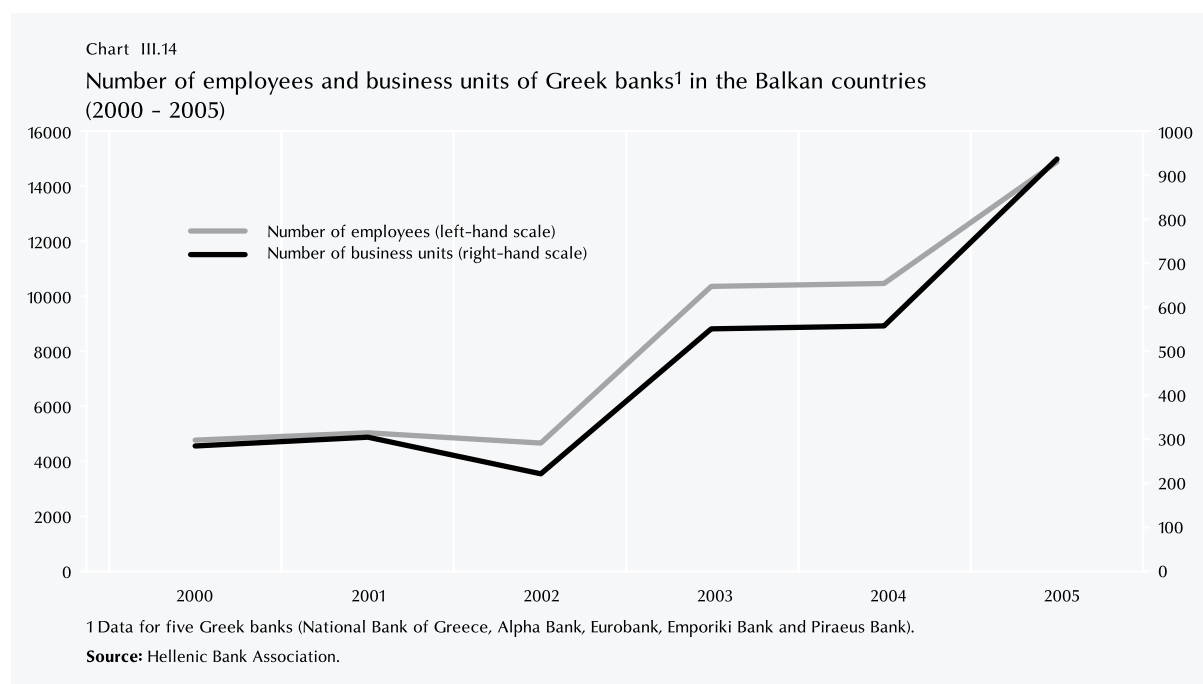
5. The expansion of Greek banks in South Eastern Europe

The activity of Greek banks in the countries of South Eastern (SE) Europe has increased since 1993 and has become particularly important for the economies of both Greece and the host countries (Albania, Bulgaria, the FYROM, Romania, Serbia-Montenegro). The reform policies adopted by the governments of these countries in the second half of the 1990s, combined with the strengthening of macroeconomic and political stability, have allowed the banking sector to grow considerably, mainly after 2000.⁹² Most credit institutions in the countries of the region were privatised and restructured through a substantial contribution by credit institutions based in countries such as Austria, Italy and Greece, with which significant trade transactions have developed.

⁹⁰ At group level, the CAR reached 12.3% in the first half of 2006, compared with 13.2% in 2005, while the Tier I ratio was 10.2% in the first half of 2006, compared with 10.8% in 2005.

⁹¹ The increasing reliance on advanced IT systems and the development of complex financial products have enhanced the importance of operational risk for Greek banks.

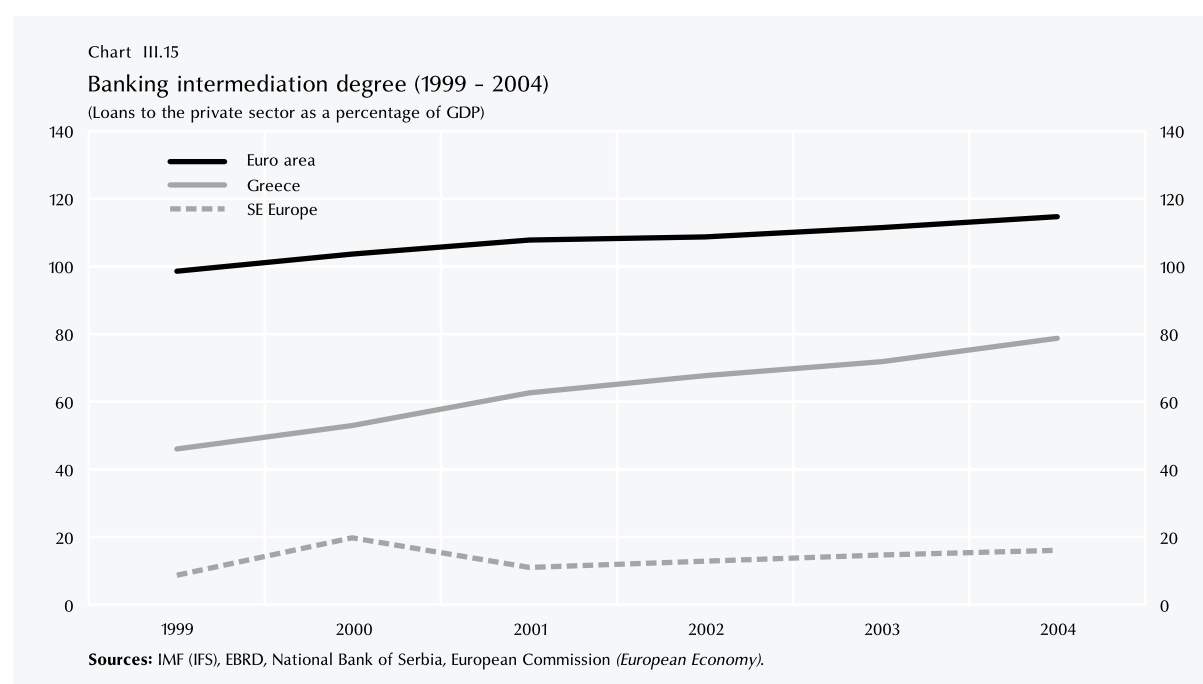
⁹² On the basis of the banking reform and interest rate liberalisation index compiled by the European Bank for Reconstruction and Development (EBRD), the countries of SE Europe were upgraded in 2005 compared with the previous years. Albania, Bosnia-Herzegovina, Serbia-Montenegro and the FYROM were rated with 3-, while Romania with 3 and Bulgaria with 4-. This index takes values from 1 to 4+, depending on the country's progress towards adopting open economy characteristics.



Greek banks have chosen to expand in the countries of SE Europe mainly through the establishment of subsidiary banks, by acquiring existing credit institutions and utilising and modernising their already existing networks, as well as through the establishment of branches. The choice between establishing a subsidiary or a branch depends on numerous factors. Unlike bank branches, which constitute integral parts of the parent bank, a subsidiary bank lends from its own funds (and not those of the parent bank) and is subject to the supervision rules applicable in the host country. Typically having at its disposal a broader network of branches, the subsidiary bank is in a position to engage in retail banking. Penetration through acquisition of an existing bank also offers the comparative advantage of benefiting from the available information on the conditions prevailing in the local market, while the acquired bank benefits from the foreign investors' know-how regarding the offer of innovative financial products. Moreover, in acquisition cases, the subsidiary bank may preserve its local brand name, provided it is of the required reliability level.

At the end of 2005, Greek banks had set up 18 subsidiary banks and 6 branch networks in the aforementioned countries, or a total of roughly 1,000 business units staffed with approximately 15,000 employees.⁹³ The numbers of employees and business units have tripled since the end of 2000, although the expansion of Greek banks in the region appears particularly strong after 2002 (see Chart III.14). Other factors contributing to this development – in addition to reforms policy and politico-economic stability – have been Greece's broadened trade with these countries, as well as the increased credibility of the Greek credit system following the country's entry into the euro area. Another positive factor was the Greek banks' utilisation of their comparative advantage (vis-à-vis the "domestic" ones) in the fields of know-how and customer service.

⁹³ It should be noted that the direct investment of the Greek banking sector in the Balkan banking markets approached €400 million in 2005, compared with approximately €50 million at the end of 2004.



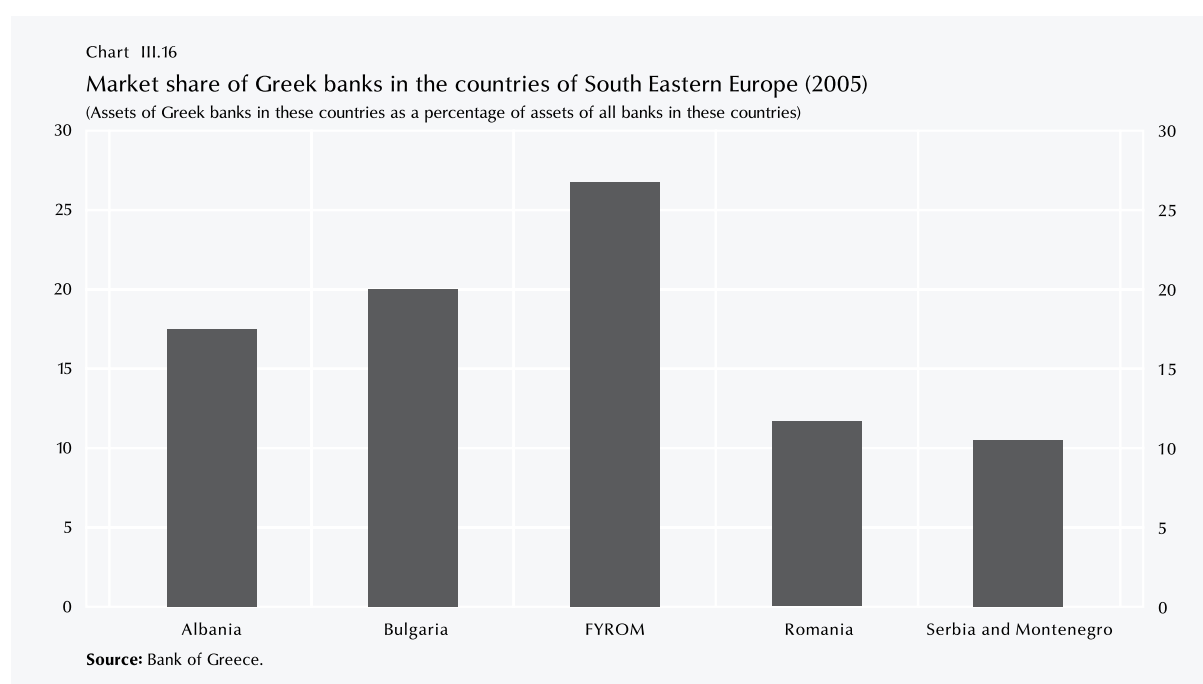
The degree of penetration by Greek banks varies across the aforementioned countries. Particular emphasis has been placed on the banking markets of Bulgaria (361 business units at the end of 2005) and Romania (263 business units), i.e. of EU acceding countries with the higher income *per capita* among the countries of the region. Considerable penetration was also observed in the Serbian banking market, where the number of business units reached 286 (compared with only 29 in 2004), while this year Greek banks have focused on the Turkish market, with two important agreements for the acquisition of banks involving funds amounting to €2.5 billion.

A major factor facilitating the expansion of Greek banks is the low degree of bank intermediation (measured as the ratio of loans to the private sector to GDP) observed in these countries. Despite its steady – albeit slow – rise in recent years, bank intermediation in the countries of SE Europe at the end of 2004 remained considerably lower than in Greece and the euro

area (see Chart III.15).⁹⁴ This low level implies that there is room for further growth of banking operations and generally of the banking sector in these countries. As the level of bank intermediation in the Greek banking market gradually rises, the possibility of banks retaining in the future their current high rates of increase in income is estimated to diminish considerably if there is no transfer of funds from developed markets to less developed ones (this transfer is considered propitious for maintaining satisfactory profitability levels in the medium term). Furthermore, given the relatively small size of the Greek banking market, this expansion offers Greek banks the opportunity to grow and diversify their income sources.

In addition, the rising level of economic integration between Greece and the SE European coun-

⁹⁴ It should be noted that the levels of bank intermediation vary considerably across these countries, with the higher ones observed in Bulgaria (23.2%), Serbia-Montenegro (22.4%) and the FYROM (17.7%), and the lower ones in Romania (10%) and Albania (6.2%).



tries favours the expansion of Greek banks. The immediate geographic adjacency (that has allowed Greek banks to better familiarise themselves with the local conditions), the establishment of a macroeconomic stability climate in these countries and the achieved high rates of growth have offered significant opportunities for Greek firms to invest in the region and for Greek banks to cover the financing needs of these firms. Thus, the provision of financial services related to international trade constitutes a major driving force of the presence of Greek banks in this region. Hence, to the extent that these economies will continue to grow and increasingly get connected with the Greek one, the comparative advantage of Greek banks for further engagement in this region will build up.

Finally, the abolition of regulatory provisions aimed at sheltering the domestic banking system, the 'opening' to foreign investors through the establishment of a regulatory framework that favours the entry and operation of foreign banks (including tax treatment), as well as the improved

supervisory environment have strengthened the presence of foreign banks.

Greek banks currently have a significant market share in these countries – larger in the FYROM (26% of total assets), Bulgaria (20%) and Albania (17%) and smaller in Romania (12%) and Serbia-Montenegro (11%), according to end-2005 data (see Chart III.16).⁹⁵

The expansion of Greek banks has contributed to the considerable improvement of their financial results. Their gross income from activities in the SE European countries as a percentage of total income came close to 10% at the end of 2005, from 7.5% a year before. Respectively, their pre-

⁹⁵ As regards loans to the private sector and customer deposits, according to end-2005 data of the Bank of Greece and the central banks of the SE European countries, the market share of Greek banks varies across these countries. In more detail, with respect to loans the larger share is observed in Albania (35%), and then in the FYROM (26%), Bulgaria (24%), Romania (13%) and Serbia-Montenegro (12%), while with respect to deposits the larger share is observed in the FYROM (32%), and then in Bulgaria (19%), Albania (16%) and Romania and Serbia-Montenegro (9% in each).

tax profits from such activities rose by approximately 50% between 2004 and 2005, although as a percentage of total profits they stood at 5.1% at the end of 2005 from 5.8% a year before, due to the increased costs of their expansion in the region and the comparatively higher growth of

their profits in the Greek market. This year, the profitability of Greek banks attributable to their expansion in this region improved further and in the first half of 2006 their corresponding pre-tax profits accounted for more than 5.5% of their total profits.

IV. Macroeconomic developments and prospects in Greece

1. Inflation: developments, determinants and prospects

1.1 Summary of developments

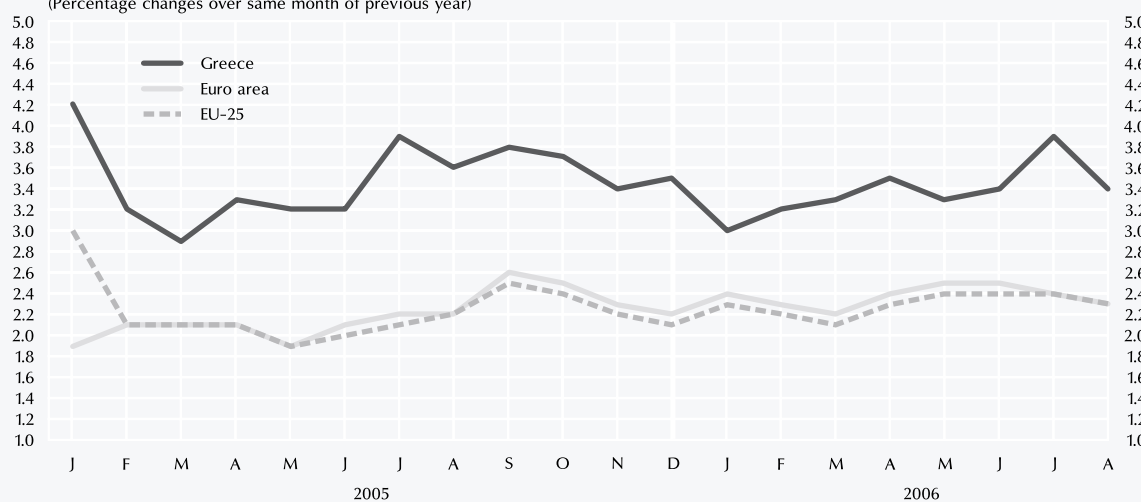
In the first nine months of 2006, inflation in Greece stood close to the average annual rate of the previous year and to that of the whole 2001-2005 period (3.5%). The annual inflation rate on the basis of the Harmonised Index of Consumer Prices (HICP – see Chart IV.1) is estimated to have reached 3.4% in the third quarter, compared with 3.5% in the last quarter of 2005. Core inflation, as measured on the basis of the HICP excluding energy and unprocessed food, is estimated to have come to 2.8% in the third quarter, compared with 3.0% in the fourth quarter of 2005 (see Chart IV.2), remaining lower than the average level for the period 2001-2005 (which for core inflation was also 3.5%). For 2006 as a whole, it is estimated that the average HICP inflation rate will be 3.3%, almost as high as in 2005 (3.5%). Core inflation is expected to fall to 2.8% (on an average annual basis), from 3.2% in 2005.

Average annual inflation this year stands at almost the same level as in 2005, chiefly because the unwinding (from April onwards) of the effect of last year's increase in indirect tax rates (VAT and the special consumption tax on alcoholic beverages and tobacco) offsets the impact of the estimated considerably faster rise in unit labour costs in 2006 compared with 2005. At the same time (as it will be explained below), due to the significant increase in crude oil prices (up until August) and the much faster rise in prices for other commodities on the world market, the impact of imported inflation on consumer prices has increased in comparison with 2005, but remains relatively small. By contrast, this impact

Chart IV.1

Harmonised index of consumer prices in Greece, the euro area and the European Union
(January 2005 – August 2006)

(Percentage changes over same month of previous year)

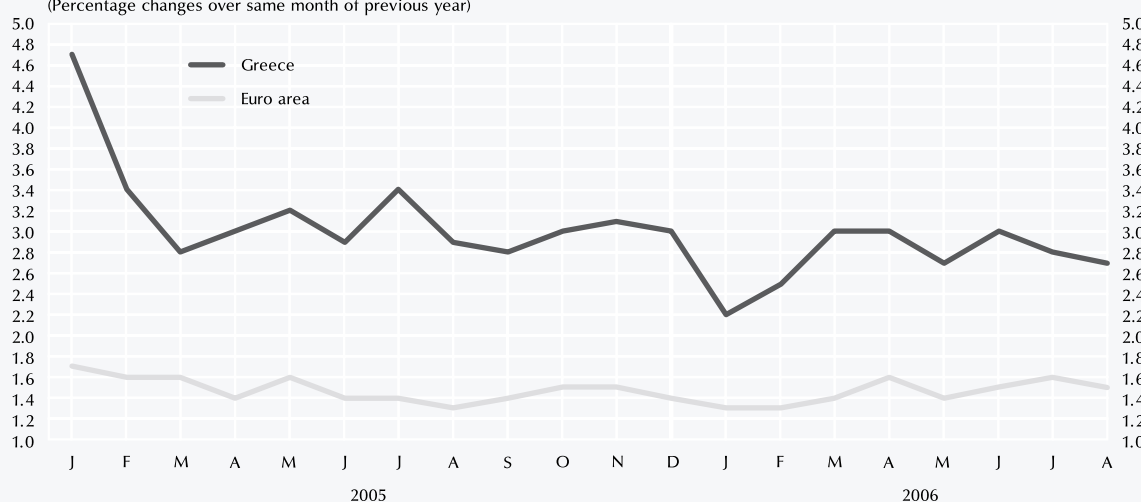


Sources: NSSG and Eurostat. In September euro area inflation fell to 1.8% (provisional estimates).

Chart IV.2

Core inflation in Greece and the euro area on the basis of the HICP excluding energy and unprocessed food
(January 2005 – August 2006)

(Percentage changes over same month of previous year)



Sources: NSSG and Eurostat.

is much more significant with regard to producer prices. In addition, inflationary pressures from the demand side remain virtually unchanged compared with 2005.

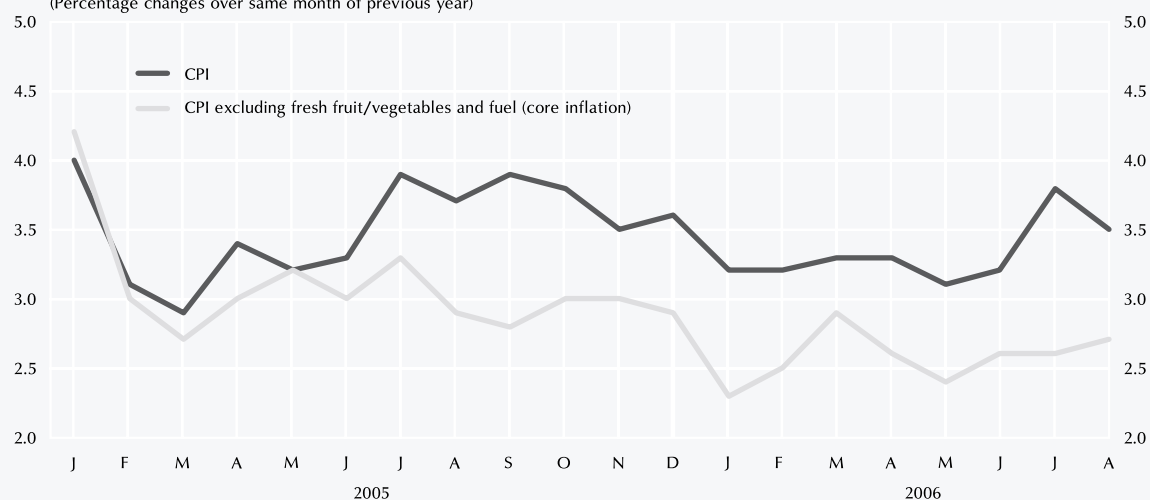
In the euro area, HICP inflation increased slightly in the current year (see Table IV.1),

while core inflation declined slightly – but less than in Greece. Thus, in the first eight months of the year, the differential of Greek inflation over the corresponding figure in the euro area as a whole narrowed to one percentage point, from 1.3 percentage points in both 2005 and – on average – in the period 2001-2005. The differ-

Chart IV.3

Consumer price index and core inflation in Greece (January 2005 – August 2006)

(Percentage changes over same month of previous year)



Source: Calculations based on NSSG data.

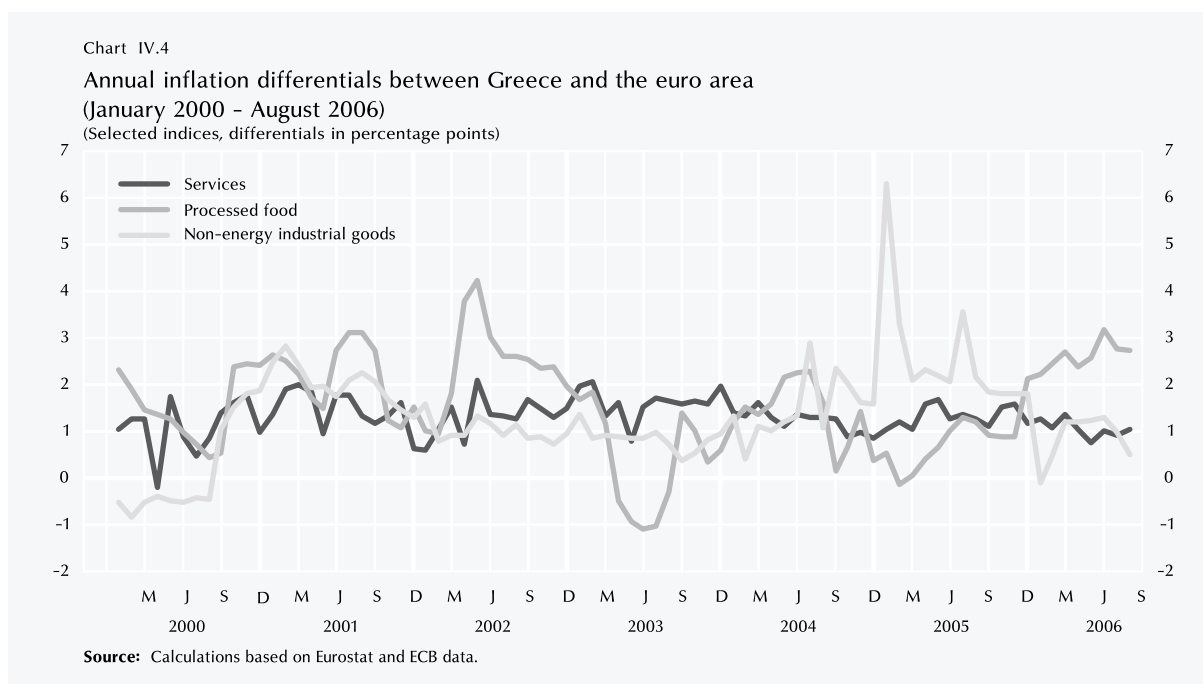
Table IV.1

Harmonised index of consumer prices: Greece and the EU (2004-2006)

(Annual percentage changes)

Country	2004 (year average)	2005 (year average)	August 2005	August 2006
Austria	2.0	2.1	1.9	2.1
Belgium	1.9	2.5	2.9	2.4
Cyprus	1.9	2.0	1.5	2.7
Czech Republic	2.6	1.6	1.4	2.6
Denmark	0.9	1.7	2.4	1.9
Estonia	3.0	4.1	4.2	5.0
Finland	0.1	0.8	1.0	1.3
France	2.3	1.9	2.0	2.1
Germany	1.8	1.9	1.9	1.8
Greece	3.0	3.5	3.6	3.4
Hungary	6.8	3.5	3.5	4.7
Ireland	2.3	2.2	2.1	3.2
Italy	2.3	2.2	2.1	2.3
Latvia	6.2	6.9	6.3	6.8
Lithuania	1.2	2.7	2.3	4.3
Luxembourg	3.2	3.8	4.3	3.1
Malta	2.7	2.5	2.5	3.0
Netherlands	1.4	1.5	1.6	1.9
Poland	3.6	2.2	1.8	1.7
Portugal	2.5	2.1	2.5	2.0
Slovakia	7.5	2.8	2.1	5.0
Slovenia	3.6	2.5	1.8	3.1
Spain	3.1	3.4	3.3	3.8
Sweden	1.0	0.8	1.1	1.6
United Kingdom	1.3	2.1	2.4	2.5
EU-15	2.0	2.1	2.3	2.3
EU-25	2.1	2.2	2.2	2.3
Euro area	2.1	2.2	2.2	2.3

Source: Eurostat.



ential of core inflation fell to 1.3 percentage points from 1.7 percentage points in 2005¹ and 1.3 percentage points on average in the period 2001-2005. During this same five-year period, the differential of the average annual increase in unit labour costs between Greece and the euro area as a whole was even wider (two percentage points) and in 2006 it rose to 2.9 percentage points (see also Table IV.3 below). Of course, the level of prices in Greece is lower than the euro area average but is gradually converging with the latter. To the extent that this price convergence process relates also to *non-internationally tradable* goods and services, the inflation differential does not necessarily imply an equivalent decline in international competitiveness.² Nevertheless, the decline in price competitiveness is derived from calculations which take into account the development both of consumer prices and unit labour costs in manufacturing in Greece and in the 27 countries which are Greece's major trading partners, in combination 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 Chart IV.23 and

¹ As far as the prices of the individual groups of goods and services which comprise the core inflation "basket" are concerned, in the first eight months of 2006 (compared with the corresponding period in 2005) the positive inflation differential for industrial goods excluding food and energy narrowed, while it widened for processed food. As for the two groups of goods which are not included in the "basket", the positive differential in the growth rate of energy prices was reduced. In addition, although it narrowed, the differential of the rate of change in unprocessed food prices remained negative. See Table IV.2 and Chart IV.4.

² It should be recalled that, according to the "Balassa-Samuelson effect" analysis, the higher rate of inflation in the less developed countries does not necessarily imply a worsening of international competitiveness to the extent that it concerns goods which are not internationally tradable. This occurs when nominal wages in the economy rise in line with the higher rate of increase in productivity in the internationally tradable goods sector, resulting in a rise in the general level of prices due to an increase in the prices of internationally non-tradable goods, as productivity remains stable in that sector. However, in Greece the internationally tradable goods sector does not play a decisive role in determining pay rises, while wage bargaining in the broader public sector plays a more important role. Also, a wider range of products are internationally tradable in Greece than in many other countries, due to the importance of tourism. Finally, certain services traditionally considered as internationally non-tradable are now provided by sectors which have been deregulated and are affected by international competition; further, the prices of these services enter into the production costs of other, internationally tradable products. For older estimates by international organisations (which, for the most part, did not take these factors into account), see Bank of Greece, *Monetary Policy- Interim Report 2003*, October 2003, pp 47-50.

Table IV.2

Contribution to the inflation differential between Greece and the euro area (2001-2006)

(Percentage points)

	2001	2002	2003	2004	2005	2006 (Jan.-Aug.)
Differential of average annual rates of HICP change	1.4	1.6	1.3	0.9	1.3	1.0
Core inflation	1.55	1.18	0.94	1.16	1.40	1.01
of which:						
Services	0.56	0.50	0.60	0.48	0.51	0.40
Processed food	0.36	0.36	0.04	0.20	0.10	0.36
Non-energy industrial goods	0.63	0.32	0.30	0.48	0.79	0.25
Unprocessed food	0.10	0.39	0.36	-0.36	-0.30	-0.13
Energy	-0.25	0.03	0.00	0.10	0.20	0.16

Source: Calculations based on Eurostat and ECB data.

Table IV.13) that the real effective exchange rate (REER) based on consumer prices (i.e. the relative consumer prices expressed in a common currency) has cumulatively risen in the last six years (2000 to 2006) by approximately 14%, while the REER on the basis of labour costs (i.e. the relative unit labour costs in manufacturing expressed in a common currency) rose in total by 34%. In the same six-year period, the nominal euro exchange rate (weighted on the basis of Greece's external trade) rose cumulatively by almost 9% (appreciation of the euro).³

1.2 Determinants of inflation in 2006

As already noted, the gradual elimination (from April 2006 onwards) of the impact of last year's changes in indirect taxation on the annual rate of increase in consumer prices played a part in determining inflation levels this year. It has been calculated⁴ that the rise in indirect taxation, after having been fully implemented, contributed 0.75 percentage point to the annual growth rate of the CPI (based on data for December 2005), while its impact on average

annual inflation in 2005 was in the order of 0.6 percentage point.

As for imported inflation, the international price of crude oil rose significantly this year until August, but at a lower annual rate than in 2005 (see Charts IV.5 and IV.6), and afterwards began to fall.⁵ By contrast, there is a sharp acceleration in the growth rate of the prices of other raw materials and commodities (reflecting, *inter alia*,

³ For 2006, the average annual appreciation is estimated at 0.1% (based on the technical assumption that the effective exchange rate will remain at the September level until the end of the year).

⁴ See Bank of Greece, *Annual Report 2005*, April 2006, pp 150-51.

⁵ The dollar price of Brent crude oil rose significantly during the first eight months of the current year (by 29.4%), but the average year-on-year rate of increase remained lower than the very high rates recorded last year: 28.7% in the period January-August 2006, compared with 46.2% for 2005 as a whole. In euro terms, the price of crude oil rose by 19.8% between December 2005 and August 2006, but at an average year-on-year rate of 31.4% for the eight-month period (compared with 46.2% for 2005 as a whole – see ECB, *Monthly Bulletin*, Statistical Appendix, Tables 5.1.2 and 8.2). According to the most recent projections-assumptions of the ECB staff (September 2006), the average annual increase in the dollar price of Brent crude oil will be 30.5% for 2006 as a whole. However, if account is taken of the fall in the price of crude oil in September, the average annual increase in the dollar Brent price will be in the order of 20%.

the large increase in world demand – see also Chapter II.1).⁶ On the other hand, certain factors contribute to a relative restraint in imported inflation: (a) the appreciation of the euro against the dollar and other currencies during the current year,⁷ (b) the low growth rate of prices of imported final products from euro area countries and (c) the import of low-cost final products (e.g. clothing and footwear, consumer durables and household goods) from the emerging economies of Asia. As shown by the available import price indicators (see Chart IV.8), average annual growth rates are picking up (with the exception of fuel), but remain low (except for intermediate goods, the growth rate of which is relatively high).⁸ Of course, the increase in the price of oil until August, which had a direct inflationary effect on the general price level in the same period due to the increase in fuel prices included in the consumer “basket”, continues to exert an indirect lagged effect on production costs.⁹ This indirect effect partly explains the significant acceleration recorded this year in the rate of increase in producer prices of consumer goods for the domestic market (wholesale prices): the average annual rate of increase reached 7.7% in the eight months January-August, from 1.3% in the corresponding period of 2005.¹⁰

The fact that the prices of fresh fruit and vegetables show a small increase this year compared with a large fall in 2005 had an inflationary effect (see Chart IV.9).¹¹ (It should be recalled that the large fall in the prices of fresh fruit and vegetables in the two-year period 2004-2005 followed a large rise in the preceding two-year period.)

The factors referred to above are both extraordinary and exogenous. More generally, however, it should be recalled that, as noted above, the

6 In the first eight months of 2006 the dollar prices of non-energy raw materials rose at an average annual rate of 22.8% (compared with 9.4% for 2005 as a whole). According to the most recent projections-assumptions of the ECB staff (September 2006), the dollar prices of non-oil commodities will rise this year by 26.2%, compared with just 6.1% in 2005

7 The euro appreciated by 7.4% against the dollar between December 2005 and September 2006, while in the period January-August 2006 it depreciated at an average year-on-year rate of 1.5%. On the technical assumption that the exchange rate in the remaining months of the year stays at the level of approximately 1.27, it can be calculated that for 2006 as a whole the euro will show an average annual appreciation of 0.6% against the dollar (2005: 0%). In addition, the nominal exchange rate of the euro against other currencies, weighted on the basis of Greece's external trade (see Chart IV.7), rose by 1.3% between December 2005 and September 2006, but in the period January-September 2006 it fell at an average annual rate of 0.2%. If the assumption is made that the effective exchange rate will stay at the September level for the remaining months of the year, it is estimated that the rate will show an average year-on-year increase of 0.1% this year, compared with an average annual fall of 0.7% in 2005.

8 The Import Price Index in Industry (compiled by the NSSG) shows an average annual increase of 6.7% in the seven-month period January-July 2006 (compared with 8.6% in the corresponding period of 2005). Excluding energy prices, the increase is limited to 2.4%, but is significantly higher than in the corresponding period of 2005 (1.2%). The evolution of imported consumer goods prices is similar (2.2% compared with 1.2%), while the rate of increase in the prices of imported intermediate goods does not simply show an acceleration but has reached a relatively high level (4.2% compared with 3.2%). According to the above index, the prices of imported raw materials for energy production (crude oil and natural gas) rose at a high average annual rate of 25.2% in the first seven months of 2006, though this rate was much lower than in the corresponding period of 2005 (60.4%), while the prices of imported final fuel products (i.e. gasoline, as well as heating oil, diesel and heavy oil) increased at an average annual rate of 20.1% (compared with 21.3% in the corresponding period in 2005). Moreover, at a wholesale level on 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 22.5% in the first eight months of 2006 (compared with an increase of 22.4% in the corresponding period in 2005). Finally, retail fuel prices included in the CPI rose in the first eight months of the year at an average annual rate of 16.7% (compared with 17.6% in the corresponding period in 2005). It should be recalled that Article 10 of Law 3483/2006 (which was passed in July) provides for a gradual rise during the four years up to and including 2009 in the Special Consumption Tax on fuels. As emphasised in a statement by the Ministry of Economy and Finance (23 June 2006), the Special Consumption Tax rates in Greece until June were on average 20% lower than the lowest rates of fuel tax that will be in force anywhere else in the European Union from 2010. The increase was imposed as part of the country's efforts to meet its obligation to the European Union to bring taxes imposed on fuel up to the minimum permitted level of fuel tax which will apply in the European Union from 2010 onwards. The tax increases will be imposed gradually until 2009, so as to minimise the effect on inflation. This year, for example, the Special Consumption Tax on unleaded gasoline (higher than 96.5 octanes) was raised by 5.7% on 1 July 2006 (i.e. by two euro cents a litre including VAT).

9 The effects of the rising price of oil on the general price level and on economic activity of course also depend on whether the increase is temporary or permanent.

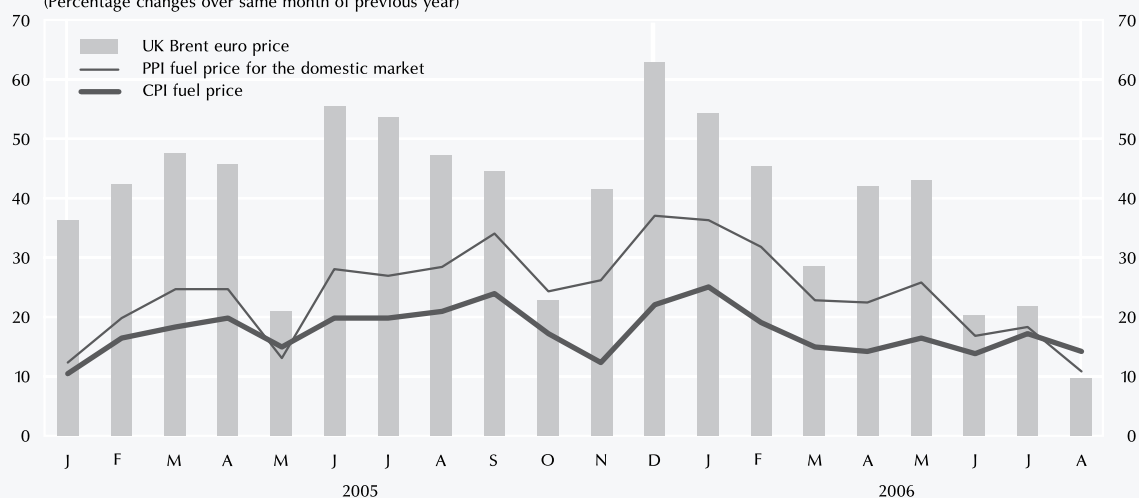
10 This acceleration was limited exclusively to consumer non-durables (from 1.2% to 7.9%), which account for 95% of total consumer goods and 25% of total goods included in the CPI for the domestic market. Approximately 1/3 of non-durables are processed food, beverages and tobacco, which are characterised by a high level of concentration, at least at the supplier level. By contrast, the prices of consumer durables showed a small slowdown (from 4.2% to 3.6%).

11 The prices of fresh fruit and vegetables rose in the first eight months of the year at an average annual rate of just 0.4%, compared with a reduction of 10.7% in the corresponding period of 2005.

Chart IV.5

Evolution of CPI/PPI fuel prices and of the euro price of Brent crude oil (January 2005 - August 2006)

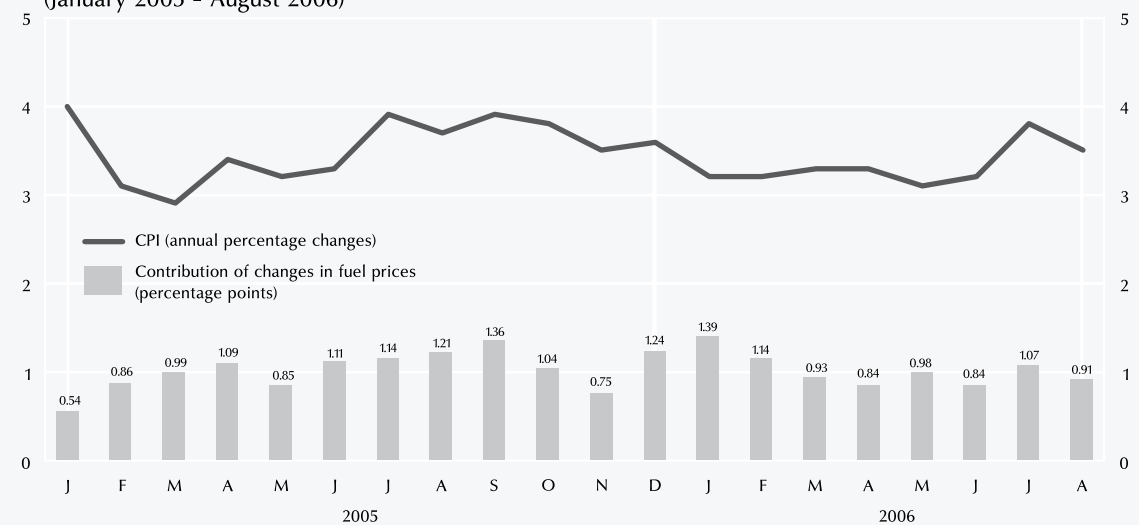
(Percentage changes over same month of previous year)



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

Chart IV.6

Inflationary contribution of changes in fuel prices (January 2005 - August 2006)



Source: Calculations based on NSSG data.

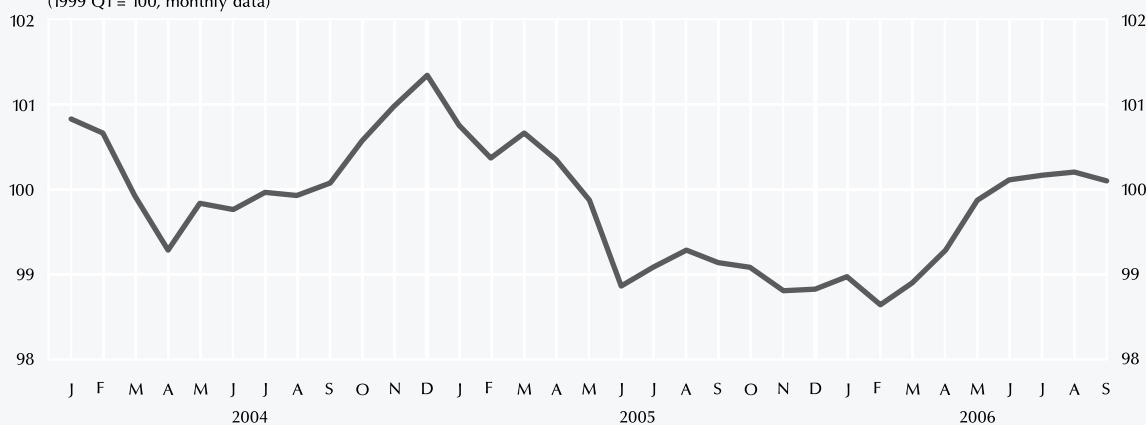
positive differential of inflation in Greece over that in the euro area as a whole is due in part to the convergence of prices and incomes in Greece towards the euro area average. Apart from this factor, however, the persistence of core inflation at relatively high levels (in the

order of 2.5-3.0%) and its positive differential over inflation in the euro area are due to macro-economic factors associated with demand and with production costs (and to the interaction between the two). They are also a result of inadequate competitive conditions in certain mar-

Chart IV.7

Revised effective exchange rate index, weighted on the basis of Greece's external trade
(January 2004 – September 2006)

(1999 Q1 = 100, monthly data)



Note: The revised effective exchange rate index includes Greece's 27 main trading partners (among them, the other 11 countries of the euro area) and 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.

kets which do not operate efficiently. Depending on the particular case, production cost developments, excess demand, price inelasticity of demand (for some articles), the fact that a number of companies take advantage of their dominant market position and that certain enterprises collude can all have an undesirable effect on prices.

In the current year, the rate of increase in unit labour costs is estimated to accelerate significantly, both in the economy as a whole (to 3.8%, from 2.2% in 2005) and in the business sector¹² (to 4.5% from 2.3%),¹³ chiefly reflecting a corresponding acceleration in the growth rate of average nominal pre-tax earnings (to 6.1% from 4.6% in 2005). The rate of increase in productivity (GDP per employee) is expected to accelerate only slightly (to a little above 2%).¹⁴ Of course, it should be taken into account that the rate of increase in unit labour costs in the business sector will, on an annual basis, probably be lower than is forecast, insofar as it will be 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 time (these provisions came into force on 1 October 2005).¹⁵

¹² It includes public and private enterprises and banks.

¹³ It should be recalled that, for these estimates, (nominal) unit labour costs are defined as the ratio of total compensation of employees to real GDP or –expressed in a mathematically equivalent form– as the ratio of compensation per employee to productivity (measured as GDP per salaried employee). In the National Accounts they are defined differently, namely as the ratio of compensation per employee to productivity (measured as GDP per employed person in general, including the self-employed). The reasons for which the Bank of Greece –in its calculation of the change in unit labour costs– prefers to take into account the change in productivity on the basis of the change in the ratio of GDP to the number of employees have been presented in previous reports (see *Monetary Policy 2002-2003*, March 2003, Box 2, pp 47-48, and *Annual Report 2002*, April 2003, Box IV. 2, pp 151-53). It should also be noted that, since 1977, the Bank of Greece has published its own estimates concerning the increase in average earnings in the economy as a whole, which are not always the same as those produced by the National Accounts Department of the NSSG.

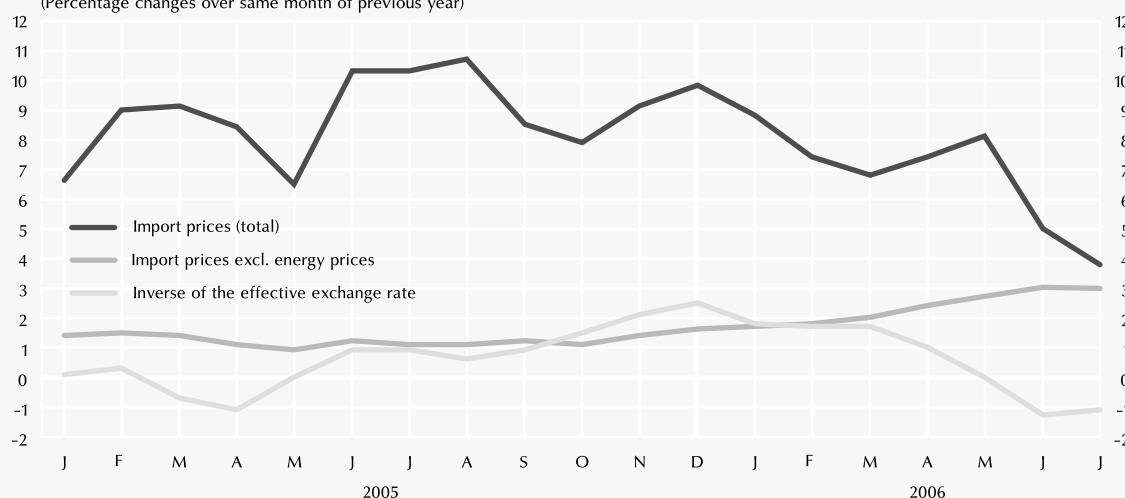
¹⁴ Short-term analysis of factors which affect the growth rate of productivity is not easy. Over the long term, however, the growth rate of productivity is influenced by the capital-labour ratio and by total factor productivity, which in turn is affected by technological progress, improved organisation, and upgrading of human capital. See also *Annual Report 2004*, April 2005, pp 71-79.

¹⁵ As there are insufficient data concerning the allocation of overtime, it is not easy to calculate this effect.

Chart IV.8

Import price index in industry and the inverse of the effective exchange rate of the euro, weighted on the basis of Greece's external trade (January 2005 – July 2006)

(Percentage changes over same month of previous year)



Sources: NSSG and Bank of Greece.

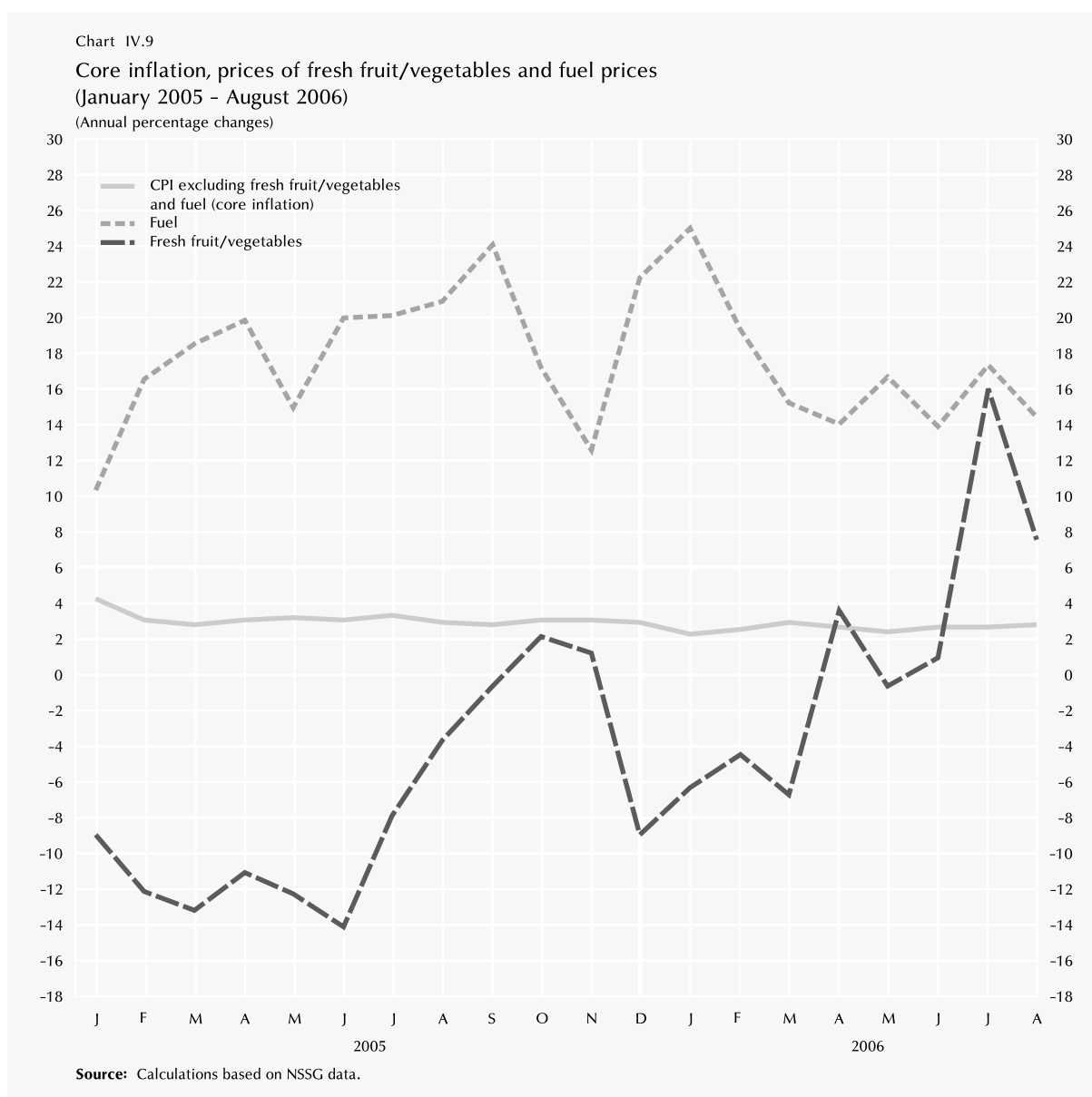
More specifically (see also Table IV.3), gross outlays for wages and salaries in central government are expected –taking account of the 2006 Budget forecasts and developments in the first eight months of the year– to increase this year by approximately 6%¹⁶ (compared with 3.1% in 2005). In the non-bank private sector, according to the National General Collective Labour Agreement (3 April 2006), minimum wages for unskilled workers were raised 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. These arrangements mean that the average annual increase in minimum wages (i.e. the annual income of unskilled workers) will stand at 6.2% in 2006 (compared with 4.9% in 2005) and 5.4% in 2007.¹⁷ The increase in contractual earnings at branch level should be similar, while average gross earnings in the non-bank private sector (including the effect of “seniority”) are estimated to show an average annual increase of 6.5%-7%. In public utilities,¹⁸ it is estimated –based on the two-year collective agreements already signed– that the average

annual increase in contractual earnings this year is in the order of 5.5% (in the order of 7% for

16 According to the State Budget for 2006, the total increase in central government personnel outlays excluding pensions is expected to reach 6.3%, while, including pensions, it should come to 6.1%. It is estimated that the increase in the number of civil servants will be limited (in the order of 0.2%). As usual, the expected percentage increase in outlays per employee (6.1%) includes all kinds of increase in compensation of central government employees in addition to the increase in their regular salaries. According to government announcements (1 February 2006) and the relevant legislative provision (Article 11 of Law 3453/2006), the basic salary payable to government functionaries and civil servants, to the employees of Local Authorities and other legal persons in public law as well as to the officers of the Armed Forces and the Security Forces was increased by 3% as from 1 January 2006. However, total regular salaries (including benefits which will remain unchanged) increased by 2.1-2.4%. In addition to these percentages, in calculating wage increases for central government personnel account should also be taken of changes in seniority benefits (due to advancement, etc.) and of the award, from September 2006, of the second instalment of the new “special conditions allowance” payable to the uniformed members of the Armed Forces and the Security Forces (payment of the first instalment began in September 2005).

17 Including the “carry-over effect” from the previous year.

18 I.e. 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).



gross earnings).¹⁹ Finally, collective bargaining in banks is still going on.

It should be noted that in the euro area as a whole it is estimated that average earnings (to be precise: compensation per employee includes employers' social security contributions) will increase this year by 2.1% (compared with 1.8% in 2005) and that unit labour costs will increase by 0.9% (compared with 1.1% in 2005).²⁰ As unit labour costs are a key element of nominal production costs, their

¹⁹ The circular (15 February 2006) on "Implementation Instructions for Law 3429/2005" stated that, in the enterprises covered by Chapter A of the 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 ascertained that the collective agreements that had been signed were in line with this aim. It should be noted that the percentage increases referred to in the text have been calculated also taking into account the collective agreements signed by companies which are not covered by Chapter A of Law 3429/2005.

²⁰ See European Commission, *Spring 2006 Economic Forecasts*, 8 May 2006 (for 2006) and ECB, *Monthly Bulletin*, Sept. 2006, Table 5.1.4 in the "Euro Area Statistics" Section (for data concerning 2005).

Table IV.3

Employees' earnings, productivity and labour costs (2001-2006)

(Annual percentage changes)

	2001	2002	2003	2004	2005	2006 (estimate)
Greece						
Average gross earnings (nominal):						
– whole economy	4.7	6.6	5.6	7.2	4.6	6.1
– central government ¹	5.5	7.3	5.9	9.7	3.1	6.1
– public utilities	7.0	10.6	10.9	9.9	7.6	7.0
– banks	6.4	2.9 ⁴	3.1 ⁴	8.0	1.5 ⁴	...
– non-bank private sector	5.3	6.5	5.8	5.8	5.6	6.8
Minimum earnings	3.5	5.4	5.1	4.8	4.9	6.2
Net² income of an employee with average earnings						
(nominal)	3.4	6.3 ⁵	6.3 ⁷	5.3	3.8	5.7
(real)	0.0	2.6 ⁵	2.7 ⁷	2.3	0.3	2.3
Total compensation of employees (including employers' social security and other contributions)	8.3	9.1⁶	8.3⁷	8.9	5.9	7.8
Compensation per employee	4.8	5.9⁶	5.5⁷	7.6	4.1	6.1
GDP⁸	4.6	3.8	4.8	4.7	3.7	3.8
Output per person-hour in manufacturing	–0.6	0.6	1.2	1.2	–0.4	3.4
Unit labour costs:						
– whole economy	3.5	5.1 ⁶	3.5 ⁷	4.1	2.2	3.8
– business sector ³	4.4	4.5 ⁶	3.9 ⁷	2.7	2.3	4.5
– manufacturing	6.1	5.3 ⁶	4.7 ⁷	4.5	6.0	3.3
Euro area						
Compensation per employee	2.7	2.5	2.4	2.2	1.8	2.1
Unit labour costs (whole economy)	2.3	2.3	2.0	0.9	1.1	0.9

1 Compensation per employee.

2 Gross earnings less employees' social security contributions less income tax.

3 It comprises private and public enterprises and banks.

4 The relatively low growth rate of average earnings in banks mainly reflects changes stemming from staff restructuring.

5 Including the abolition (as from 1 January 2002) of stamp duties (0.6% of gross earnings) paid by employees.

6 Including the abolition (as from 1 January 2002) of stamp duties (0.6% of earnings) paid by business sector employers.

7 Taking into account the increase (of 0.1% of gross earnings) in both employees' and employers' contribution to the Workers' Fund.

8 NSSG for the years 2001-2005 (March 2006). Estimates by the Bank of Greece and the Ministry of Economy and Finance for 2006.

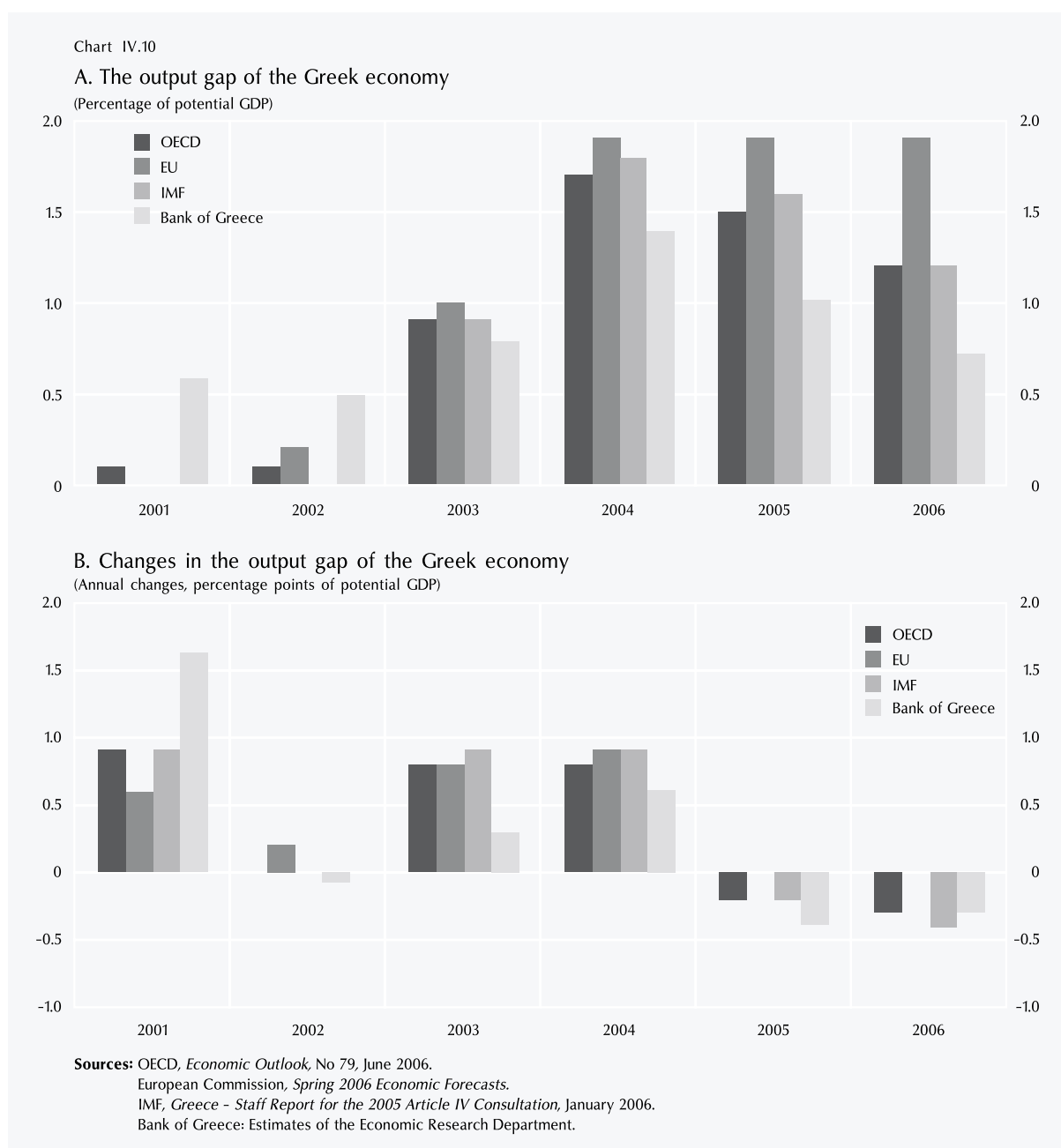
Sources: NSSG (GDP 2001-2005), Bank of Greece estimates-forecasts (for GDP in 2006 and for the other annual aggregates in 2001-2006). For the euro area: ECB, *Monthly Bulletin*, and European Commission, *Spring 2006 Economic Forecasts*.

more rapid growth in Greece compared with the euro area over a number of years (in the five years 2001-2005, the average annual rates of increase were 3.7% and 1.7% respectively – see Table IV.3) is one of the reasons behind the positive inflation differential and the loss of price competitiveness.

Turning to profit margins in the current year, the data available (end-June results of non-financial corporations listed on the Athens Exchange)

indicate a significant increase in the first half of the year, as profits (after tax and minority rights) rose at an annual rate in the order of 30-40%,²¹ while turnover increased by 15-20%. However, these data are not necessarily representative of all companies or of profits for the whole year; thus, they are not enough for drawing reliable general conclusions.

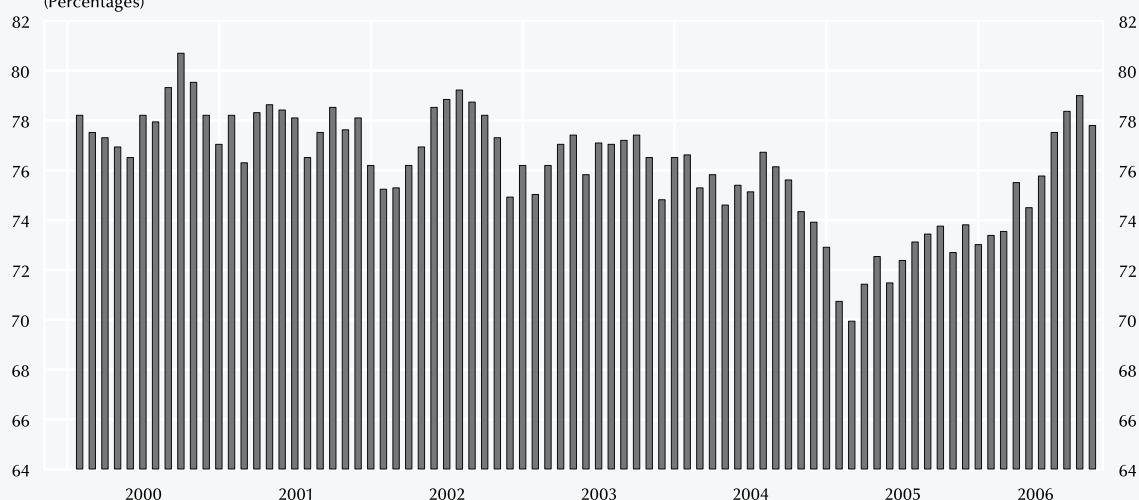
²¹ See also Chapter III.3.2. If financial corporations are also included, the increase in profits is even greater.



More generally, however, the strength of demand-side inflationary pressures does not appear to have changed in comparison with the situation in 2005. The data available for private consumption indicate that its growth rate remains high (see Section 2 of this chapter). In addition, the “output gap”²² of the Greek economy, which has been positive in recent years (i.e. the level of current production exceeds the

²² 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 is estimated by various alternative methods. Estimates of potential output and the “output gap” are surrounded by a high degree of uncertainty. (For estimates of the potential output, see also ECB, *Monthly Bulletin*, July 2005, Box 5.) These considerations must be kept in mind when the conclusions of the relevant 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.11
Industrial capacity utilisation rate (manufacturing)
(January 2000 – September 2006)
(Percentages)



Source: Foundation for Economic and Industrial Research (IOBE).

potential level), remains unchanged or is narrowing only slightly this year according to the most recent estimates (see Chart IV.10).²³ Therefore, excess demand continues to play a part in keeping inflation at a high level. However, the fiscal policy pursued, which aims to reduce the general government deficit to below 3% of GDP this year (from 4.5% in 2005), contributes to holding back inflationary pressures to the extent that the deficit reduction affects demand. The effect of monetary conditions is similar, since they are becoming less relaxed, as the real effective exchange rate (on the basis of the HICP – see Chart IV.23) in the first six months of 2006 remained at approximately the same level as in the corresponding period in 2005, while real interest rates on the money market still remain negative, although less so than they were in the corresponding period²⁴ last year (see the Monetary Conditions Index in Chart IV.12).

Finally, certain structural changes in retail trade (entry of new department store chains and increasing numbers of so-called “discount” stores

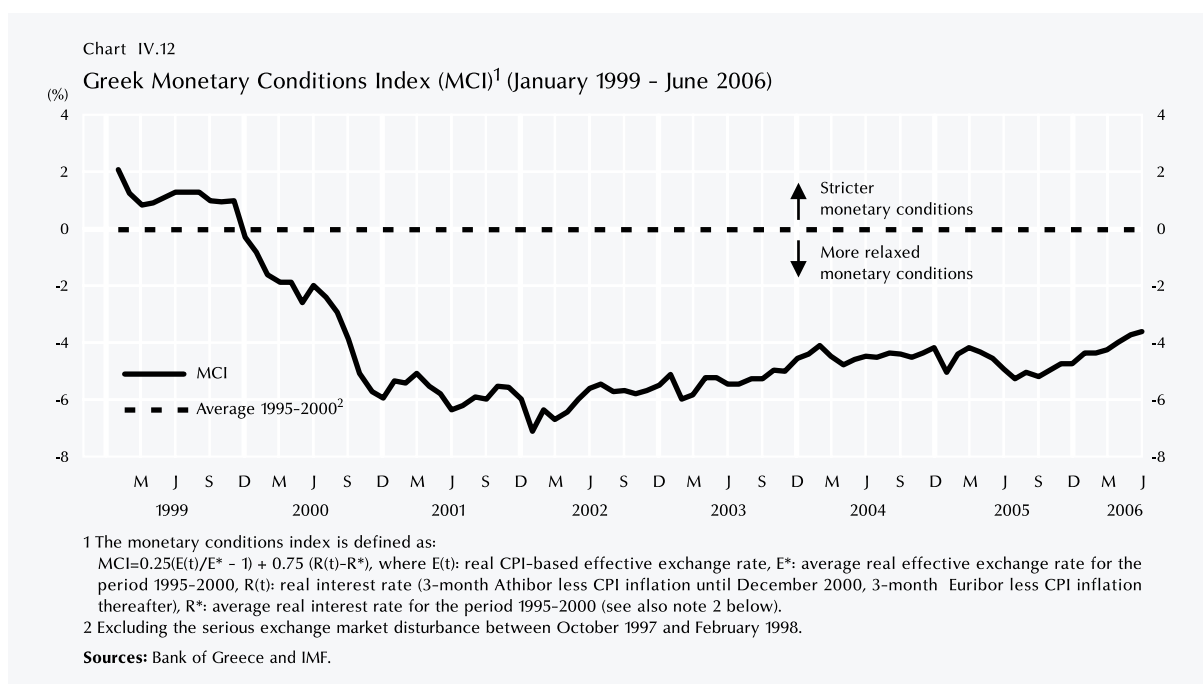
in the supermarket sector) are strengthening competition, leading to a fall in the prices of certain goods and eventually holding back the rise in the general level of consumer prices.

1.3 Inflation prospects for the year as a whole

The developments, estimates and assumptions referred to above – concerning on the one hand

²³ According to the European Commission (*Spring 2006 Economic Forecasts*, May 2006), the output gap has remained at 1.9 in 2004, 2005 and in the current year. According to the OECD (*Economic Outlook*, June 2006), it narrowed to 1.2 this year from 1.5 in 2005. Finally, according to earlier forecasts by the IMF (*Greece: 2005 Article IV Consultation – Staff Report*, January 2006), it narrowed to 1.2 this year, from 1.6 in 2005. However, it should be noted that estimates of stability or a slight narrowing in the positive output gap of the Greek economy this year do not fit in with two other associated indications: (a) in industry (from which only 11% of GDP is derived), the capacity utilisation rate has increased markedly this year (to 76.1 on average for the first nine months of 2006, from 72.1 in the corresponding period of 2005 – see Chart IV.11) and (b) the unemployment rate has declined, while the employment rate has increased, indicating an increase in the rate of labour force utilisation (see Section 3 of this chapter and Chart IV.22).

²⁴ The nominal three-month Euribor in the money market increased in the last quarter of 2005, while the rate of increase in the CPI in Greece (used to calculate the real interest rate) remains essentially unchanged.



international oil prices and the prices of other raw materials, the euro exchange rate and the prices of fresh fruit and vegetables and, on the other, unit labour costs, profit margins and demand (in conjunction with the productive capacity of the economy) – make it possible to formulate estimates about the development of inflation for the year as a whole.²⁵ Account has also been taken of the more effective surveillance of the market by the Ministry of Development.

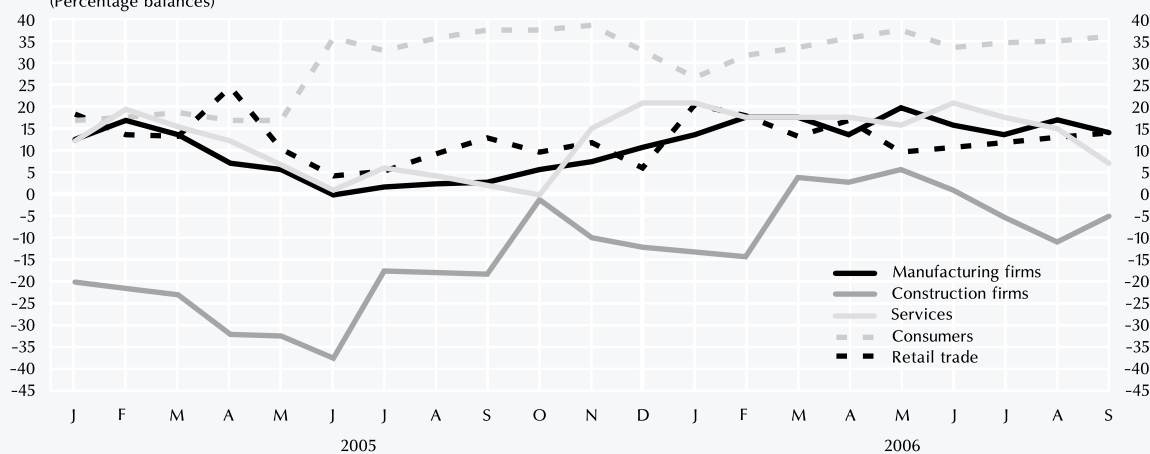
As already reported, it is estimated that the average annual increase in the HICP will reach 3.3% (almost the same as in 2005), while core inflation will drop slightly to 2.8% (from 3.2%) in 2005. Of course, these forecasts contain an element of uncertainty, to the extent that they depend on developments during the remaining months of 2006, on oil prices (which fell in September), on the prices of raw materials and commodities on the world market, on the dollar exchange rate against the euro and on the prices of fresh fruit and vegetables.

2. Economic activity: developments and prospects

As a result of a number of favourable factors (such as the country's entry into the stable macroeconomic environment of EMU and the consequent fall of real interest rates, which remained low in the period that followed) and extraordinary events (such as the Olympic Games and the considerable increase in revenue from shipping in 2004), the

²⁵ In addition, account has been taken of business firms' own forecasts concerning the prices of the goods or services they supply and of consumers' inflation expectations. Surveys carried out by the IOBE in the first nine months of the current year indicate that in the third quarter there was a fall (compared with the second quarter of the year) in the percentage of firms in the services industry, manufacturing and residential construction sectors which expected that during the coming 3–4 months the prices of the products or services they offer would increase (to be precise: the above increase regards the positive balance between the percentage of firms which expect an increase in their prices and the percentage of those which expect a reduction, see Chart IV.13). As for retail trade, the percentage remained essentially unchanged. Concerning consumers' inflation expectations, the percentage of those who expect inflation to increase in the coming twelve months (as recorded in a survey carried out on behalf of the European Commission) indicates that expectations did not change substantially in the third quarter in comparison with the second.

Chart IV.13

Inflation expectations¹ of consumers and business firms (January 2005 – September 2006)
(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.

Sources: IOBE and European Commission, *Business and consumer survey results*.

Greek economy enjoyed continuous and steady growth over the past five years. Economic activity grew at rates markedly higher than those achieved in the second half of the 1990s (the annual growth rate during 2001-2005 was 4.4% compared with 3.5% during 1996-2000).

In 2005, GDP growth fell to 3.7% (according to the NSSG) from the particularly high rates of 4.8% in 2003 and 4.7% in 2004, which were directly related to the preparation and conduct of the Olympic Games. As from the beginning of 2006, the Greek economy showed signs of a new gradual pickup, which stemmed mainly from the increase in investment, the fact that private consumption growth rates remained at the high levels of recent years and the significant acceleration in the growth of goods exports. According to the latest NSSG estimates, in the first half of 2006 the economy grew at an annual rate of 4.1%, against 3.6% in the corresponding 2005 period (see Table IV.4).

The gradual recovery of the Greek economy is rather uniformly confirmed not only by the avail-

able direct indicators of activity but also by the results of surveys that were based on assessments and forecasts of businesses from various economic sectors and of consumers. Furthermore, the coincident indicator of economic activity, which is compiled by the Bank of Greece and summarises information contained in a set of key short-term indicators of economic activity, has been gradually rising since end-2005, and its annual rate of increase was about 3.8% in the first seven months of 2006 (see Chart IV.14). Moreover, the economic sentiment indicator for Greece²⁶ (compiled by the European Commission on the basis of business survey results) has been moving parallel to the coincident indicator for the past one-and-a-half year and has been on the rise, practically without interruptions since July 2005.²⁷

²⁶ It has been found that the economic sentiment indicator for Greece has a satisfactory correlation with GDP.

²⁷ Moreover, the leading OECD indicator of economic activity is consistent with the other indicators and points to a recovery of industrial activity, based on its values for the first seven months of 2006.

Table IV.4

Demand and gross domestic product (2004-2006)

(At constant market prices of year 1995, annual percentage changes)

	2004	2005	2006 (first half)
Private consumption	4.7	3.7	3.8
Government consumption	2.8	3.1	2.4
Gross fixed capital formation	5.7	-1.4	10.2
Housing	-0.6	-1.4	...
Other constructions	6.0	-6.1	...
Equipment	8.0	0.5	...
Other	7.0	14.5	...
Stocks and statistical discrepancy (<i>percentage of GDP</i>)	0.4	0.3	...
Domestic final demand	4.7	2.3	...
Exports of goods and services	11.5	3.0	2.2
Exports of goods	-2.5	8.2	...
Exports of services	21.8	-0.1	...
Imports of goods and services	9.3	-1.2	6.4
Imports of goods	9.0	-0.1	...
Imports of services	11.0	-7.6	...
Gross domestic product at market prices	4.7	3.7	4.1

Note: Detailed data on GDP revision for the period 2000 onwards were not available on the date this report was printed and thus they have not been taken into account.

Sources: NSSG/National Accounts Directorate (March 2006) for 2004 and 2005. For 2006, provisional data for the first half of the year. For Bank of Greece estimates for 2006, see the main text.

The smooth recovery of GDP growth to higher levels than originally anticipated in 2005 (the first year after the Olympic Games) and the increase in employment are, at first sight, positive elements as regards the growth prospects of the Greek economy. The latter's performance, however, should be attributed to some extent to two facts: (a) fiscal adjustment is partly based on the increase in extraordinary non-tax revenue that does not exert a direct influence on economic activity²⁸ and (b) the large expansion of consumer and housing credit has substantially supported private consumption and economic activity. Nevertheless, it should also be borne in mind that the satisfactory GDP growth rates were achieved amid geopolitical uncertainty and rising energy prices, which erode household income and may have an adverse impact on business confidence.

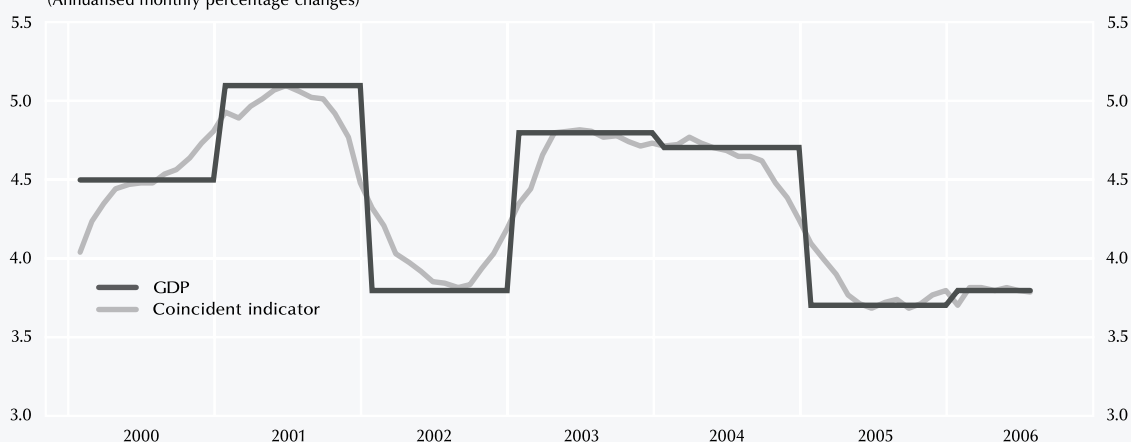
The Greek economy is still in a process of real convergence, in an environment of intensifying global competition. The investment-to-GDP ratio exceeds the corresponding euro area average, but national savings are insufficient. This inequilibrium between savings and investment is reflected in the current account deficit, which has reached high levels over recent years (see Section 5 of this chapter). Furthermore, per capita GDP in purchasing power standards still lags behind the EU-15 average (according to Eurostat estimates). It is of course expected that the gap will narrow significantly on the basis of the revised national accounts for the years from 2000 onwards (details for which were not available when this report was going to press).

²⁸ See Section 4 of this Chapter.

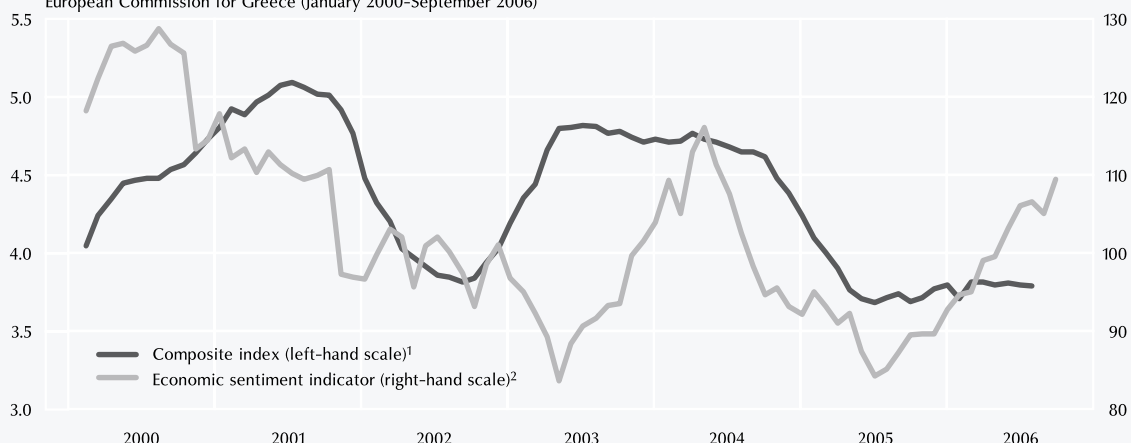
Chart IV.14

Economic activity indicators

A. The coincident indicator of economic activity compiled by the Bank of Greece (January 2000–July 2006)
(Annualised monthly percentage changes)



B. The coincident indicator of economic activity compiled by the Bank of Greece and the economic sentiment indicator compiled by the European Commission for Greece (January 2000–September 2006)



1 Annualised monthly percentage changes.

2 Monthly data.

Sources: Bank of Greece (coincident indicator and 2006 GDP), NSSG (2000–2005 GDP) and European Commission (economic sentiment indicator).

The Bank of Greece had estimated – in its earlier Reports of February and April this year – that GDP growth in 2006 will be in the area of 3.5%. More recent developments indicate that GDP growth will eventually be slightly higher, to around 3.8%. It is estimated that in the second half of 2006 the economy's growth rate might slow down a little, reflecting a possible limited deceleration (over the same period) of global economic growth, hence of international trade, as monetary policy assumes a more restrictive

stance and the prices of energy and raw materials remain at historically high levels (although oil prices fell in September). At the same time, the anticipated increase in the growth rate of goods and services imports is expected to check GDP growth.

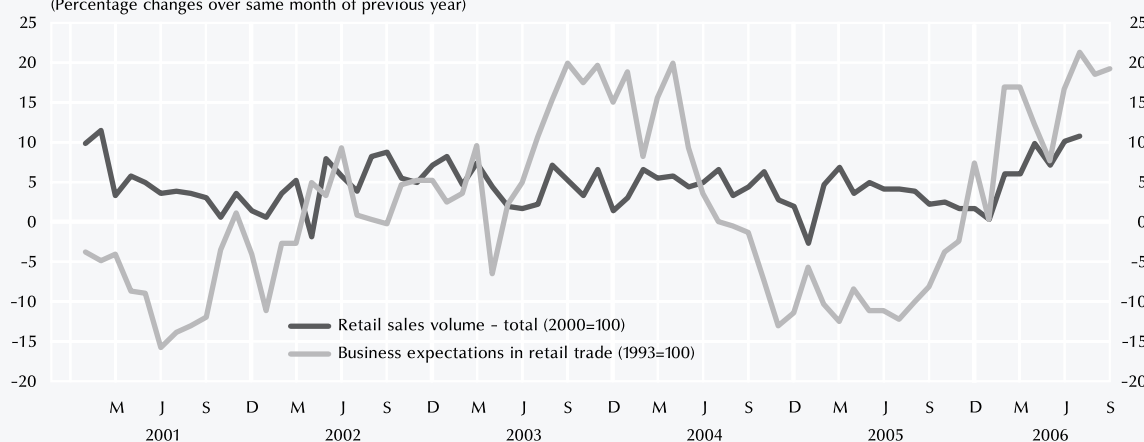
As evidenced by national accounts analysis, domestic demand was the main driver of the 4.4% GDP growth (average annual rate) recorded during 2001–2005. The contribution of

Chart IV.15

Consumer demand (January 2001 – September 2006)

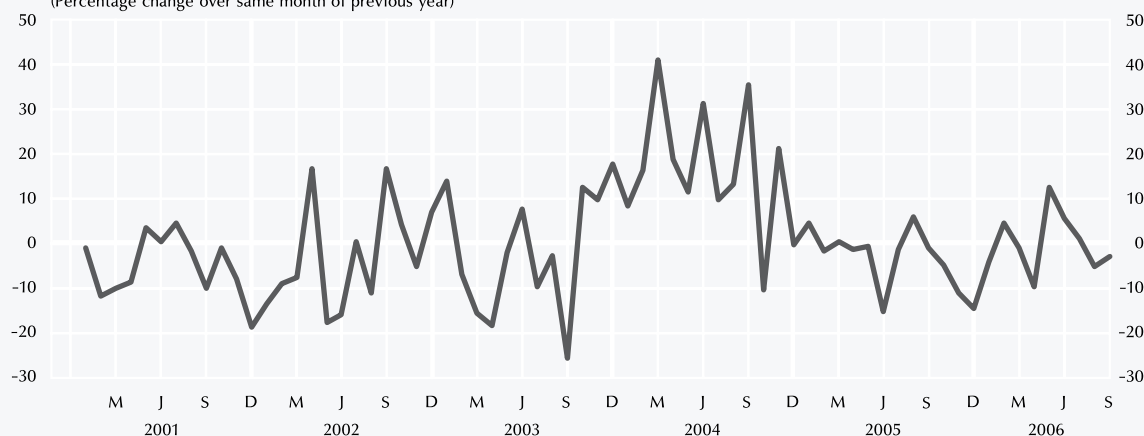
A. Retail sales volume and retail trade business expectations

(Percentage changes over same month of previous year)



B. New passenger car registrations

(Percentage change over same month of previous year)



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.

domestic demand was 4.6 percentage points, whereas, the external sector had a negative contribution (0.2 percentage point – see Table V.1 in Chapter V).

Household consumption expenditure contributed 2.8 percentage points to the average annual GDP growth rate during 2001-2005. Private consumption continued to increase at a high rate in 2006 and remains the demand component with the largest contribution to GDP growth.

According to the most recent NSSG national accounts estimates, during the first half of 2006 the annual growth rate of private consumption remained at 3.8% (same as in the corresponding 2005 period). Moreover, short-term indicators and survey results that provide information on the current and future behaviour of consumers and retail trade business firms paint an even brighter picture for private consumption growth (see Charts IV.5 and IV.6). Retail sales volume (turnover at constant prices, which includes only consumer goods, excluding the sale of cars and

Table IV.5

Indicators of consumer demand (2004-2006)

(Annual percentage changes)

	2004	2005	2006 (available period)
Volume of retail sales ¹	4.5	3.0	7.2 (Jan.-July)
Food-beverages-tobacco ²	7.1	5.6	10.1 (» »)
Clothing-footwear	1.4	1.3	-2.7 (» »)
Furniture-electrical appliances-household equipment	3.9	0.6	13.0 (» »)
Books-stationery-other	4.7	-1.1	2.6 (» »)
Revenue from VAT (constant prices)	8.3	-0.8	10.6 (» »)
Retail trade business expectations index	2.8	-7.7	14.3 (Jan.-Sept.)
New passenger car registrations	15.7	-3.0	0.0 (» »)
Piraeus Port Authority (OLP) passengers	-4.9	4.1	5.8 (Jan.-July)
Tax revenue from mobile telephony (monthly flat fees)	13.0	10.8	12.5 (Jan.-Aug.)
Outstanding balance of total consumer credit extended by banks ³	37.9 (Dec.)	28.7 (Dec.)	24.3 (Aug.)

1 Revised retail sales volume index (based on the NSSG's new sample for the year 2000).

2 Comprising big food stores and specialised food-beverages-tobacco stores.

3 The rates of change take into account securitised loans and loan write-offs.

Sources: NSSG (retail sales, cars), Bank of Greece (VAT revenue and consumer credit), IOBE (expectations), OLP, Ministry of Economy and Finance (tax revenue from mobile telephony).

liquid fuels)²⁹ rose impressively at an average annual rate of 7.2% in the first seven months of 2006, compared with an increase of 3.5% in the corresponding 2005 period and 3% for the entire 2005.³⁰ Also, the annual growth rate of the composite index of employment in retail trade, which had slowed to 0.5% in the first quarter of 2006, gathered pace in the second quarter and reached 2.5% (compared with an average annual growth of 2.2% in 2005).

The expansion of consumer credit strongly supports the increase in private consumption³¹ and has not yet been notably affected by the small rise in consumer loan rates in the first eight months of the year (see Chapter II.2.2). In particular, the outstanding balance of consumer loans kept on growing at a high annual rate (24.3% in August compared with 28.7% in December 2005³²). At the same time, the real disposable income of the private sector is estimated to grow in 2006 at a rate higher than in 2005, but lower than that of

private consumption growth, leading to a further decline in the savings ratio. The rise in real disposable income reflects *inter alia* the faster than in 2005 increase in employees' average pre-tax earnings and the continuing increase in employment (see Sections 1 and 3 of this chapter). Moreover, the very low growth rate of direct tax receipts from both natural and legal persons has a

29 According to statistical research, the evolution of retail sales volume is consistent with that of private consumption of goods (on a national accounts basis).

30 Other indicators are of less importance. The number of new passenger car registrations remained unchanged (on an annual basis) in the period January-September 2006, having been reduced by 1.4% in the corresponding 2005 period and by 3% in 2005 as a whole. The consumer confidence indicator (compiled by the European Commission) suggests a strengthening of consumer confidence from June onwards. Moreover, according to the Foundation for Economic and Industrial Research (IOBE) survey, the retail trade business expectations index increased by 14.3% in the nine-month period January-September 2006, compared with a 10.1% reduction in the corresponding 2005 period.

31 According to some simplified and approximative calculations, 56% of the increase in private consumption in 2005 reflected credit expansion. The corresponding percentage for the second quarter of the current year is 53%.

32 See Chapter III.2.1.

Table IV.6

Retail trade turnover index (2006)

(Percentage changes over corresponding period of previous year)

Components	Jan.-July
1. Big food stores	15.1
2. Department stores	20.1
3. Food-beverages-tobacco	2.1
4. Pharmaceuticals-cosmetics	4.3
5. Clothing-footwear	-0.8
6. Furniture-electrical appliances-household equipment	13.0
7. Books-stationery-other	4.5
8. Retail sales not in stores	1.8
Retail trade turnover index	9.3

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

favourable effect on the disposable nominal income of the private sector as a whole.³³

Despite the relatively moderate growth of the private sector's real disposable income, private consumption maintained its high growth rate in 2006, mainly because consumer expectations about their future income remain positive. In more detail, Greece's entry into the stable macroeconomic environment of the euro area and the ensuing large drop of interest rates (which continued in the period that followed, driving real interest rates to particularly low levels), coupled with the liberalisation of the banking system, strengthened household expectations about future income flows and ultimately encouraged their recourse to borrowing. Thus, during the past years, the consumption pattern in Greece started to change gradually: it is now less dependent on the relatively volatile current disposable income and more on household wealth (see Table IV.7 for the continuing increase in dwelling prices) and borrowing. Easier access to consumer credit for a growing number of households has allowed the lengthening of the time horizon for decisions on

consumption. Thus, consumption is less affected by short-term and cyclical fluctuations of current disposable income or by exogenous shocks and records a relatively stable growth rate over the past years, which in turn contributes to the relative stability of GDP growth (given the large share of private consumption in total GDP).

The rise in consumption was also the result of a gradual increase in *per capita* income, which supported consumer demand for goods and services that are typical to more developed societies, such as recreation, education, telecommunications and healthcare.³⁴ The demand for services was met by domestic production sectors, increasing both their share in total value added and employment in these sectors. It should also be stressed that the steady growth of population (mainly owing to the large inflow of economic immigrants, i.e. persons with relatively low income but, in principle, a strong propensity to consume)³⁵ has had a positive contribution to private consumption's achieving and maintaining a high growth rate over the past years. The effect of economic immigrants on consumption is estimated to have more than offset the effect from the worsening age structure of the "native" population.

³³ See Section 4 of this chapter. Although personal income tax receipts increased by 10.6% (i.e. more than pre-tax income at current prices, suggesting, *inter alia*, an increase in the tax burden of employees) in the first half of the year, revenue from other categories of direct taxes (corporate income tax, taxes on inheritance, gifts and parental donations, settlement of pending tax cases) was reduced; thus total income from direct taxes increased by 1% only, which implies that the tax burden of the private sector decreased and disposable income rose more than pre-tax income.

³⁴ The percentage share of these categories in the consumption pattern of an average household remained essentially stable between 1999 and 2004, as evidenced by the Household Budget Surveys compiled by the NSSG (see *Annual Report 2005*, April 2006, p. 107).

³⁵ Of course, immigrants whose families remain at their country of origin possibly have a high saving ratio and send remittances to their countries. Alternatively or additionally, however, they may as well make large purchases, in value terms, mainly of consumer durables, which they also send to their countries: in this case, private consumption increases.

Table IV.7
Dwelling price index

Period	Urban areas-total			Athens			Other urban areas		
	Index		Percentage changes	Index		Percentage changes	Index		Percentage changes
	1997=100	Over previous period	Over corresponding period of previous year	1997=100	Over previous period	Over corresponding period of previous year	1993 Q4=100	Over previous period	Over corresponding period of previous year
1994	76.1	...	...	73.4	9.5	9.5	106.0	...	...
1995	82.6	8.5	8.5	80.1	9.2	9.2	114.3	7.8	7.8
1996	91.2	10.5	10.5	88.9	11.0	11.0	125.7	10.0	10.0
1997	100.0	9.7	9.7	100.0	12.5	12.5	134.7	7.1	7.1
1998	114.4	14.4	14.4	115.5	15.5	15.5	152.6	13.3	13.3
1999	124.5	8.9	8.9	129.6	12.2	12.2	161.5	5.8	5.8
2000	137.7	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	...	...	...	...	...	...	269.3	13.4	13.4
2000 I	132.1	2.5	9.7	141.6	4.1	14.3	166.1	0.8	5.2
II	135.7	2.8	9.8	146.5	3.5	14.4	169.6	2.1	5.3
III	138.8	2.2	10.8	150.4	2.7	15.3	172.6	1.8	6.4
IV	144.2	3.9	11.9	158.0	5.0	16.2	177.1	2.6	7.5
2001 I	150.5	4.4	14.0	165.7	4.9	17.0	184.0	3.9	10.8
II	156.1	3.7	15.0	174.2	5.1	18.9	188.0	2.2	10.8
III	159.5	2.2	15.0	178.7	2.6	18.8	191.3	1.8	10.9
IV	164.0	2.8	13.7	183.0	2.4	15.8	197.5	3.2	11.5
2002 I	171.5	4.6	14.0	193.6	5.8	16.8	204.0	3.3	10.8
II	180.3	5.1	15.5	208.0	7.4	19.4	208.9	2.4	11.2
III	180.7	0.2	13.3	205.4	-1.3	14.9	213.3	2.1	11.5
IV	184.9	2.3	12.7	208.2	1.4	13.8	220.5	3.4	11.6
2003 I	188.6	2.0	10.0	214.6	3.1	10.8	222.5	0.9	9.1
II	187.5	-0.6	4.0	210.6	-1.8	1.3	224.4	0.8	7.4
III	189.0	0.8	4.6	210.6	0.0	2.6	228.1	1.7	7.0
IV	190.9	1.0	3.3	211.5	0.4	1.6	232.1	1.7	5.3
2004 I	190.6	-0.2	1.0	209.7	-0.9	-2.3	233.6	0.6	5.0
II	191.6	0.5	2.2	209.4	-0.2	-0.6	236.5	1.2	5.4
III	193.3	0.9	2.3	211.1	0.8	0.2	238.8	1.0	4.7
IV	198.0	2.4	3.7	219.4	3.9	3.7	240.9	0.9	3.8
2005 I	205.2	3.6	7.7	223.7	2.0	6.6	254.1	5.5	8.8
II	211.6	3.1	10.5	228.9	2.3	9.3	264.1	3.9	11.7
III	...	...	...	...	...	...	274.5	4.0	15.0
IV	...	...	...	...	...	...	284.5	3.6	18.1
2006 I	...	...	...	...	...	...	292.3	2.7	15.0
II	...	...	...	...	...	...	298.0	1.9	12.8
2004 Dec.	...	...	...	221.2	1.0	4.0	...	...	...
2005 Jan.	...	...	...	223.6	1.1	5.1	...	...	...
Feb.	...	...	...	223.5	-0.1	7.9	...	...	...
March ..	...	...	...	224.0	0.2	6.9	...	...	...
Apr.	...	...	...	226.4	1.1	8.8	...	...	...
May	...	...	...	229.1	1.2	8.3	...	...	...
June	...	...	...	231.3	1.0	10.9	...	...	...

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.

Sources: For the other urban areas: Bank of Greece (quarterly data). For Athens: calculations based on data from "Danos and Associates" (1993-97) and "Property Ltd" (monthly data for 1997-05). For the total of urban areas: weighted index based on the housing stock in Athens and other urban areas.

In the first half of 2006 the annual growth rate of public consumption at constant prices was 2.4% compared with 3.5% in the corresponding 2005 period.³⁶ Besides, fiscal data on the first eight months of 2006³⁷ do not point to a noticeable decrease in public consumption growth (3.1% in 2005).

The high growth rate of the Greek economy and the projects associated with the preparation for the Olympic Games helped maintain the growth rate of gross fixed capital formation at high levels in the period 2001-2004 (7.9% on average at constant prices), improving the medium-term potential growth rate. Thus, the share of investment in GDP exceeded 25% in 2004, a very high percentage in terms of both the Greek track record and the corresponding European averages. In 2005 gross fixed capital formation fell by 1.4%, mainly due to the drastic cut in public investment in line with the fiscal consolidation programme adopted by the government and the completion of the works for the Olympic Games. In the period 2001-2005, investment contributed 1.5 percentage points to the average annual GDP growth rate (business investment: 1.2 percentage points, residential investment: 0.2 percentage point and public investment: 0.1 percentage point – see Table V.1 below).

The outlook for 2006 is favourable and, according to all available indications and data (see Table IV.8), a marked recovery of fixed capital formation is expected, owing on the one hand to the acceleration of the growth rate of business investment and on the other hand to the recovery of residential and public investment. In more detail, according to the latest available national accounts estimates, the annual growth rate of total gross fixed capital formation picked up to 10.2% in the first half of 2006, having been negative (–2.4%) in the corresponding 2005 period.

Business investment, which had grown by a mere 1.5% in 2005, is estimated to increase by about 5% this year. In this respect, it should be noted that the financial position of business firms is generally good and the profitability level of certain dynamic firms is satisfactory.³⁸ Furthermore, financing conditions are favourable, since short-term and medium-term real interest rates remain at extremely low levels: although monetary policy is expected to tighten further during this year, it is estimated that the direct impact on investment initiatives will be marginal. Besides, according to IOBE business surveys, confidence indicators in industry, construction, retail trade and services for the nine-month period from January to September 2006 are much higher than in the corresponding 2005 period.³⁹ Moreover, according to the most recent IOBE survey on investment activity (first half of 2006), the responses of industrial firms are rather optimistic (but, as usual, should be interpreted with caution, as they are radically revised from one year-half to another⁴⁰). Thus, for industry as a whole, business firms expect a 14.8% increase in current investment expenditure for this year against an estimated decrease of 9.6% for 2005. Private industrial firms expect an 8.5% rise in current investment expenditure for 2006 against an expected fall of 11.7% for 2005.⁴¹

It is estimated that investment activity could be positively affected by the brighter outlook for domestic and international demand, as regards

³⁶ During 2001-2005 public consumption contributed 0.3 percentage point to the average annual growth rate of GDP.

³⁷ See also Section 4 of this chapter.

³⁸ See Chapter III.3.2.

³⁹ However, it has been found that these indicators have little correlation with the evolution of investment (on a national accounts basis).

⁴⁰ The forecasts of these surveys are based on intentions and not actual investments, thus they do not always come true. In any event, they should be assessed with caution.

⁴¹ One year earlier, the survey for the first half of 2005 expected a smaller decrease in current investment expenditure for 2005 (of 8.5% in total industry and 8.4% in private industrial firms).

Table IV.8

Indicators of investment demand (2004-2006)

(Annual percentage changes)¹

	2004	2005	2006 (available period)
Capital goods output	-0.5	-5.1	3.4 (Jan.-Iouλ.)
Investment expenditure (at current prices) of private industrial firms ²	-20.9 ³	-11.7 ⁴	8.5 ⁴
Capacity utilisation rate in the capital goods industry	(78.6)	(71.7)	76.2 (Jan.-Sept.)
Outstanding balance of loans to non-financial corporations with a maturity of over one year ⁵	18.9 (Dec.)	18.0 (Dec.)	14.7 (Aug.)
Disbursements out of the Public Investment Programme	11.7	-21.0	10.3 (Jan.-Sept.)
Volume of private construction activity (on the basis of permits issued)	-3.4	35.2	6.0 (Jan.-July)
Cement production	-2.3	2.4	6.3 (Jan.-July)
Construction business expectations index	-28.9	-22.9	46.9 (Jan.-Sept.)
Outstanding balance of total bank credit to housing ⁶	27.3 (Dec.)	33.5 (Dec.)	31.5 (Aug.)

¹ Excluding the capacity utilisation rate.² Estimates of firms participating in the IOBE investment survey.³ Estimate of the March-April 2005 survey.⁴ Estimate or forecast of the March-April 2006 survey.⁵ Adjusted for the amount of loan write-offs.⁶ Taking into account securitised loans and loan write-offs.

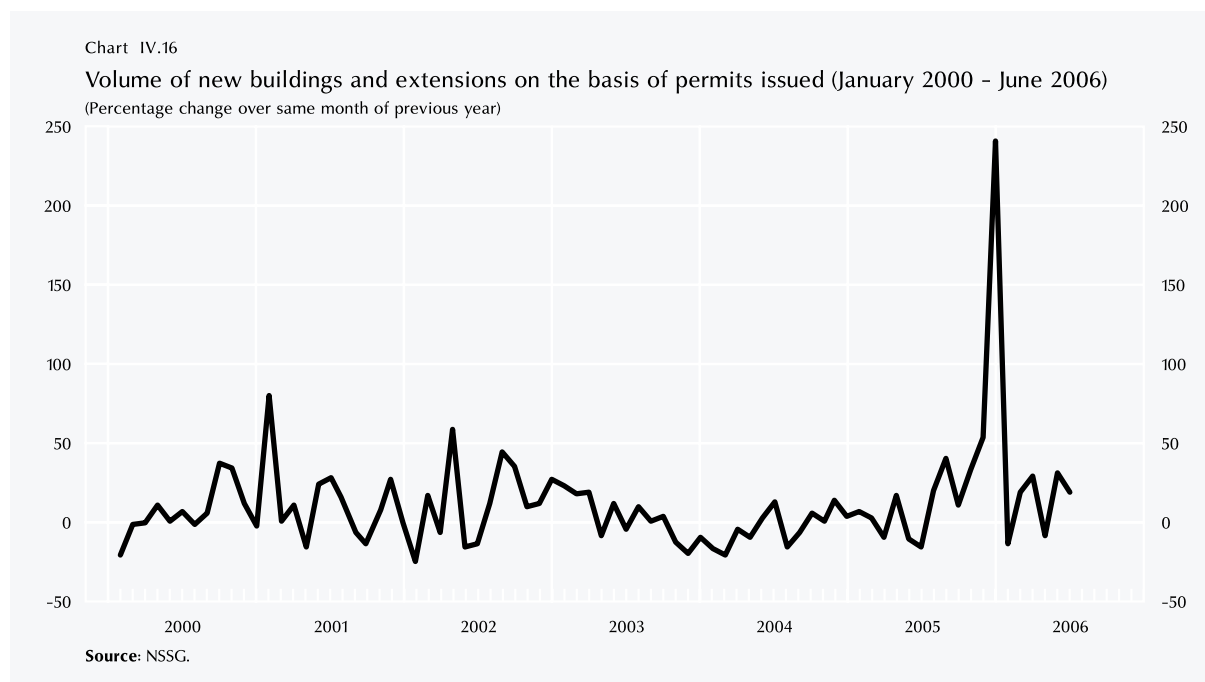
Sources: NSSG (capital goods output, volume of private construction activity, cement production), IOBE (investment expenditure, capacity utilisation rate, business expectations index), Bank of Greece (loans to non-financial corporations, disbursements out of the public investment programme, housing loans).

the products of specific sectors, despite the loss of price competitiveness. According to the new indicators compiled by the NSSG, new orders in industry increased at an average annual rate of 14.3% during the first seven months of 2006, having decreased by 4.5% in the corresponding 2005 period and 1.3% for 2005 as a whole. In more detail, the sharpest rise (19.6%) relates to new orders from the external market for industrial products (first seven months of 2005: +6.6%, average increase for 2005: 8.3%), as corroborated by the development of goods exports (see Section 5 in this chapter). At the same time, new orders from the domestic market for industrial products also recovered, to 11.8% (first seven months of 2005: -10.2%, average change for 2005: -6.0%). Moreover, the law on development (3299/2004), the framework law on public-private partnerships

(3389/2005)⁴² and the effort to simplify bureaucratic procedures have had a positive impact on investment activity.

Nonetheless, in the overall assessment of business investment activity in 2006, account should also be taken of: (i) the — limited so far — phenomenon of some firms relocating to neighbouring countries

⁴² According to data from the Ministry of Economy and Finance, 1,590 investment plans with a total budget of €2,498 million were submitted under Law 3299/2004 until 22 September 2006. This amount equals about 9% of business investment, at current prices, in 2005. (It should be noted that applications have reached the number of 2,812, with the proposed investment totalling €6,274 million.). As far as the public-private partnerships are concerned, the competent inter-ministerial Committee approved (up to the beginning of September) proposals for plans with a total budget of €772 million: this amount equals approximately 12% of general government investment in 2005 at current prices. Total approvals (€3,095 million) correspond to 7.2% of total fixed capital formation in 2005 at current prices.



with lower labour costs and a more favourable tax regime and (ii) the very low level of foreign direct investment in Greece (in spite of a considerable increase in the first seven months of 2006), which is a chronic problem for the Greek economy (see Box IV.1). Finally, it should be noted that, as regards investment by public enterprises (included in business investment), the implementation of investment plans (by companies for which information is available) was not particularly satisfactory in the first eight months of 2006 (even though the investment plans for 2006 slightly exceed actual investment in 2005).

Public investment is expected to recover in 2006 and grow at a rate higher than 5%, following its drastic cut (13.6% at constant prices) in 2005. According to data from the General Accounting Office, expenditure under the Public Investment Budget (PIB) increased by 11.5% in the first eight months of 2006 compared with a budgeted annual increase of 11.7%.⁴³ This increase, however, is partly a result of the low expenditure recorded in the corresponding 2005 period.

Residential investment, which fell slightly in 2004 and 2005, is estimated to grow by 5% this year. An important indication in this direction is the volume of private construction activity, on the basis of permits issued, which made an impressive recovery towards the end of 2005. The average growth rate for 2005 was 35.2%, compared with a 3.4% decrease in 2004. The increase in the volume of private construction activity can be attributed to the pre-announcement of changes in the objective value of property and the application of VAT to new construction as from 1 January 2006. In the first seven months of 2006, the growth rate of private construction volume on the basis of permits issued, which is a leading indicator of construction activity, remained high (6.0% against a mere 2.1% in the corresponding 2005 period, see Chart IV.16). Of course, the outcome as regards resi-

⁴³ According to the corresponding Bank of Greece data, disbursements under the PIB increased by 10.3% at current prices in the first nine months of 2006, whilst in the corresponding 2005 period they decreased by 31.6%.

dential investment will depend, *inter alia*, on the time lag between the issue of the permit and the implementation of the project. More specifically, the fact that the growth rate of the outstanding balance of housing loans has remained at very high levels (above 30%) throughout the eight-month period January-October 2006 (31.5% in August against 33.5% in December 2005)⁴⁴ favours, in principle, investment activity (even though housing loans also finance the purchase of already existing – old or new – dwellings). On the other hand, the sharp increase in the prices of construction materials is expected to have an adverse impact.⁴⁵

Excluding 2001 and 2005, the contribution of the real external balance to GDP growth was negative throughout the period 2001-2005 (see Table V.1). Its positive contribution in 2001 and 2005 came as a result of the reduction, in absolute terms, of imports in these years and not of a notable increase in goods and services exports. Moreover, the large increase (21.8%) in services exports in 2004, which contributed significantly to GDP growth, was mainly the result of an increase in transport receipts owing to the sharp growth of world trade and freight rates.

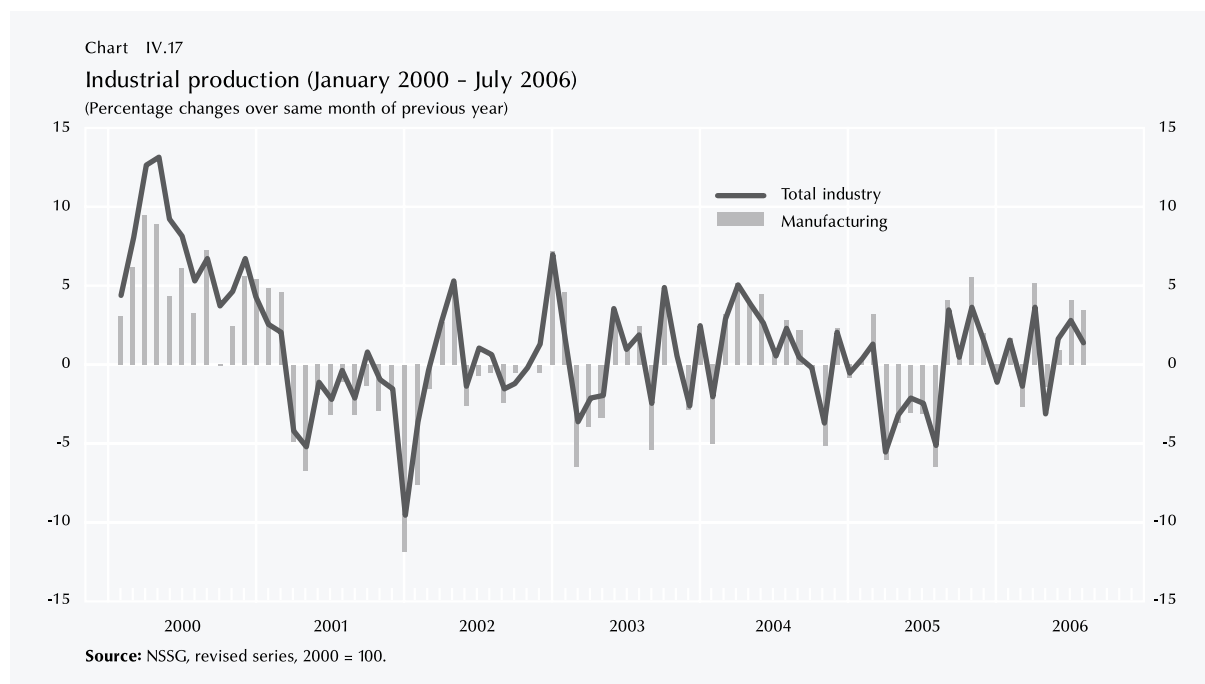
The growth rate of goods exports on a national accounts basis gathered pace considerably in 2005, overshooting the corresponding growth of global demand. According to the most recent NSSG and Bank of Greece data (for the first seven months), goods exports continued their upward course in 2006 (see Section 5 of this chapter). On the other hand, services exports remained unchanged in 2005 (on a national accounts basis), having increased sharply in 2004 (21.8%). As regards 2006, available indications from Bank of Greece data do not suggest a notable rise in services exports, since the increase in travel receipts seems to be offset by

the small decrease or no change in receipts from transport and “other” services (see Section 5 of this chapter). According to NSSG national accounts estimates, goods and services exports recorded a limited year-on-year increase of 2.2% in the first half of 2006. Overall, the increase in the volume of goods and services exports on a national accounts basis is not expected to exceed 5% for 2006 as a whole. Imports of goods and services, which declined by 1.2% in 2005, are projected to recover and grow at rates higher than those of domestic demand. According to NSSG national accounts estimates, total goods and services imports at constant prices grew by 6.4% year-on-year during the first half of 2006 (having declined by 1.8% in the corresponding 2005 period).

On the supply side, the tertiary sector (services) has supported the growth of the Greek economy in recent years and gradually increased its share in total value added. In the period 2001-2005, this sector expanded further (from 70.6% of total gross value added in 2001 to 74% in 2005). At the same time, the share of the agricultural sector decreased (from 7.1% in 2001 to 5.2% in 2005), same as the share of the secondary sector (from 22.3% in 2001 to 20.8% in 2005). The increase in the output of services contributed decisively (by 3.4 percentage points) to the 4% average annual increase of total gross value added (at constant prices) during 2001-2005. The activity of various branches (telecommunications, financial services, real estate management, and trade) grew considerably over the

⁴⁴ See Chapter III.2.1.

⁴⁵ The NSSG composite material costs index rose by 5.8% between August 2005 and August 2006, but for certain materials the increase was higher (electrical materials: 14.2%, plumbing-heating materials: 11.8%, metal materials of basic processing: 6.7%, artificial stone materials: 9.8%, marble products: 8.4%). These increases partly incorporate indirect effects of the rise in oil prices.



same period and growth is continuing in the first months of 2006.⁴⁶

Industrial and manufacturing output remained subdued throughout the period 2001-2005. Based on the latest available NSSG data, however, total industrial and manufacturing output showed signs of recovery in 2006. In the January-July 2006 period (see Chart IV.17) industrial production grew at an average annual rate of 0.9% (having fallen by 0.9% last year), while manufacturing production increased by 1.6% (after last year's 0.8% reduction). In more detail, the production of energy, intermediate and capital goods increased, while the production of consumer durables and non-durables fell. It is worth noting that, according to a new NSSG indicator, the Greek industry turnover rose significantly at current prices (17.5%) during the first seven months of 2006. Indeed, this increase was much higher in the external market than in the domestic one (29.7% against 14.0%). Finally, relevant IOBE and Purchasing Managers' Index surveys give some useful indi-

cations on industrial activity.⁴⁷ According to the IOBE business survey (see Chart IV.18), the average annual increase of the index of business expectations in industry was 10.8% during January-September 2006, which implies a more favourable development of manufacturing production. The latter, which has begun from the second half of 2005, reflects the significant improvement of the business climate over the same period, which is also evident from the increase in the "months of secured production" (to 4.9 in September 2006 from an average of 4.5 in 2005) and the sustained increase in the industrial capacity utilisation rate from January this year onwards. A similar image as regards developments in manufacturing is drawn by the

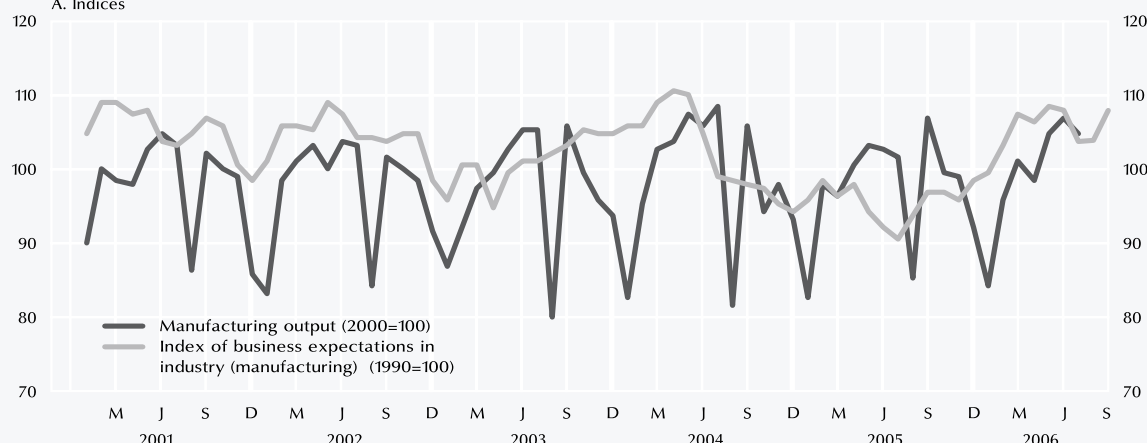
⁴⁶ According to the financial statements for the first half of 2006, bank profits rose considerably compared with the corresponding 2005 period, having increased sharply in 2005 as well (see Chapter III.3.2). In telecommunications, OTE group's turnover rose by 5.5% and the parent company's by 2.6% in the first half of 2006. Moreover, public revenue from mobile telephony rose by 12.7% in the same period. Developments in retail trade have already been mentioned above.

⁴⁷ It has been found that the indicators that stem from these surveys have a satisfactory correlation with the industrial output index.

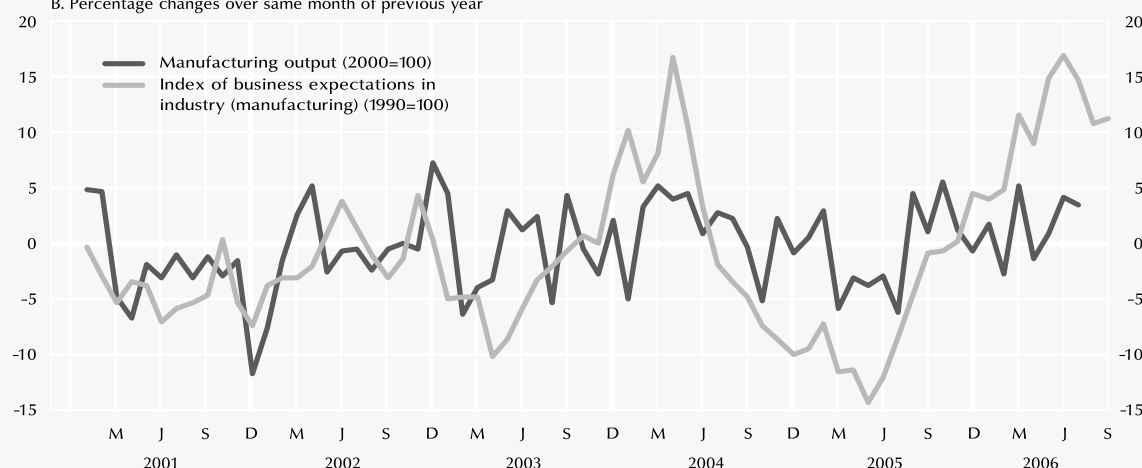
Chart IV.18

Output and business expectations in manufacturing (January 2001 – September 2006)

A. Indices



B. Percentage changes over same month of previous year



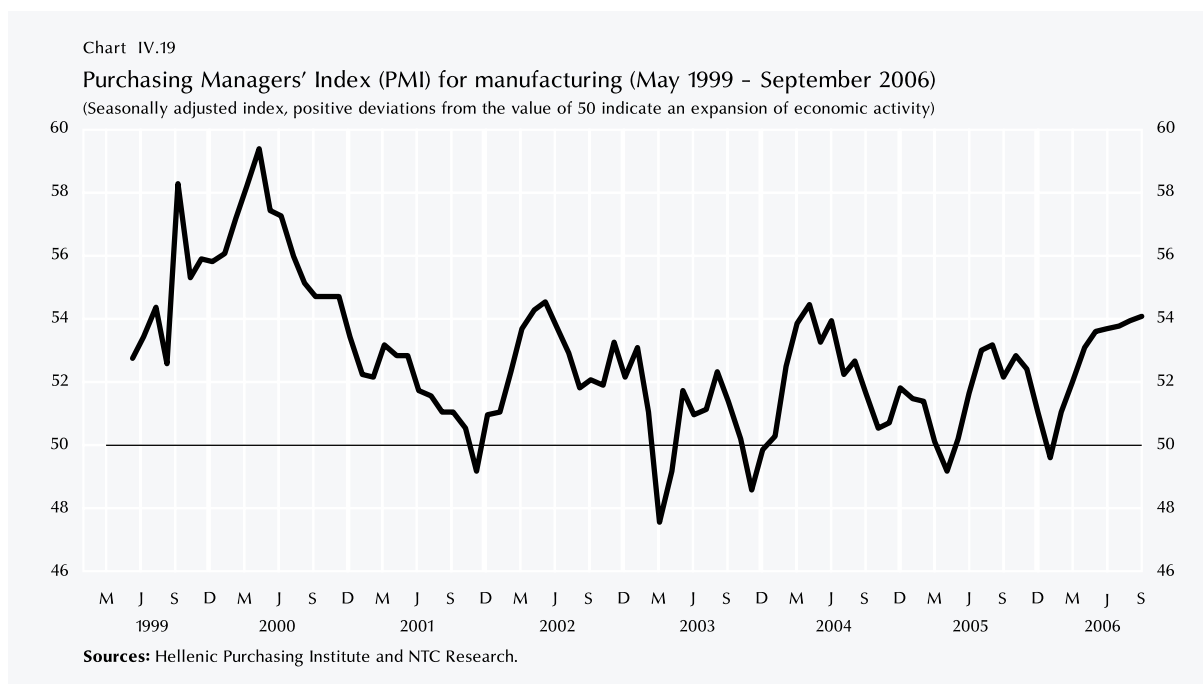
Sources: NSSG (output) and IOBE (expectations). The index of business expectations is based on business firms' estimates of total demand and stocks, and on output forecasts for the next 3–4 months.

Purchasing Managers' Index (PMI – see Chart IV.19), which from February 2006 until September 2006 was clearly above the threshold value (50) that denotes an expansion of manufacturing activity. The PMI recorded a two-year peak in September (54.2) and this is mainly attributed to the stronger increase in production and new orders. As already mentioned, the OECD leading indicator of economic activity is consistent with the other indicators and, based on its values for the period January–July 2006, points to a recovery of industrial activity.

3. Employment and unemployment: developments and prospects

It is estimated that the rise in economic activity in 2006 has been accompanied by an increase in employment and a reduction in the number of the employed in year-on-year terms.⁴⁸ Labour

⁴⁸ This estimate is based on Labour Force Survey (LFS) data, the results of the NSSG survey conducted among retail trade firms in the first half of 2006, Manpower Employment Organisation (OAE) data (January–August 2006) the results of smaller scale business surveys carried out by the IOBE and the results of the PMI survey (January–September 2006).



Force Survey (LFS) data for the first half of 2006 show that the total number of persons employed grew by 1.7% (see Chart IV.20). Average weekly hours worked in the non-agricultural sector decreased marginally by 0.4% in year-on-year terms, mainly due to the fall in hours worked in construction and in spite of the increase in average weekly hours worked in hotels and restaurants, transport and communications and real estate management. At the same time, a significant rise was recorded in part-time employment as a percentage of total employment (from 4.8% in the first half of 2005 to 5.8% in the first half of 2006), as a large share (18%) of new jobs were part-time ones.⁴⁹

The increase in employment stemmed exclusively from the services sector. According to LFS data, in the first half of 2006 employment in transport and communications increased considerably (7%).⁵⁰ In the same period, employment in the financial sector also increased, as evidenced both by LFS data (for the financial sector as a whole) and by banks' published income statements. The year-

on-year growth rate of employment in retail trade, albeit low in the first quarter (0.5%), rose to 1.5% on average for the first half of 2006, according to data from the relevant NSSG survey.⁵¹ Moreover, the total number of persons employed in public administration-defence-compulsory social security, education and health-social care recorded an annual increase of 6.3% in the first half of the year.

Available indications as regards changes in employment in manufacturing are contradictory, thus it is difficult to draw safe conclusions. LFS data show a reduction in the number of persons employed (–2.8%) in this sector⁵² in the first

⁴⁹ The share of part-time employees in the total number of employees, despite its increase, is still much lower in Greece than in EU-15.

⁵⁰ This sector accounts for about 6.5% of total employment.

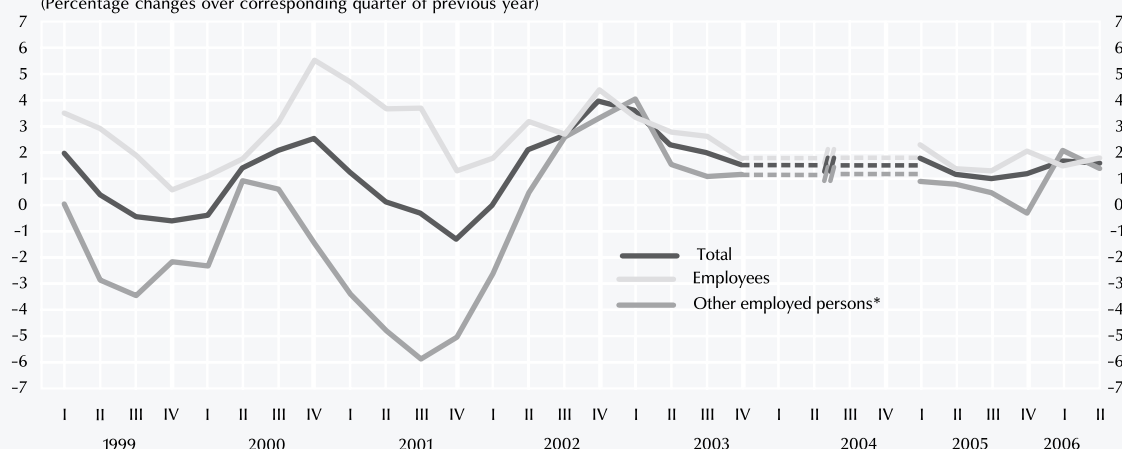
⁵¹ These data, collected on a sample based on a companies' register dating back to 2000, may underestimate changes in employment, since they do not include new business firms.

⁵² The year-on-year rate of decrease of employees in manufacturing was 5.5% in the first quarter and 1% in the second quarter of 2006.

Chart IV.20

Employment (1999 – 2006)

(Percentage changes over corresponding quarter of previous year)



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

Source: NSSG, Labour Force Surveys. 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.

quarter of 2006 compared with the corresponding 2005 period and a marginal increase (0.5%) in the second quarter of 2006 over the corresponding quarter of the year before. (Average weekly hours worked rose by 1.6% in the first quarter and fell by 0.6% in the second quarter year-on-year.) Data from the employment sub-index of the PMI, however, show that dependent employment increased almost throughout the January–September 2006 period.

In the *construction* sector, employment in the first half of 2006 was, according to LFS data, lower than in the first half of 2005.

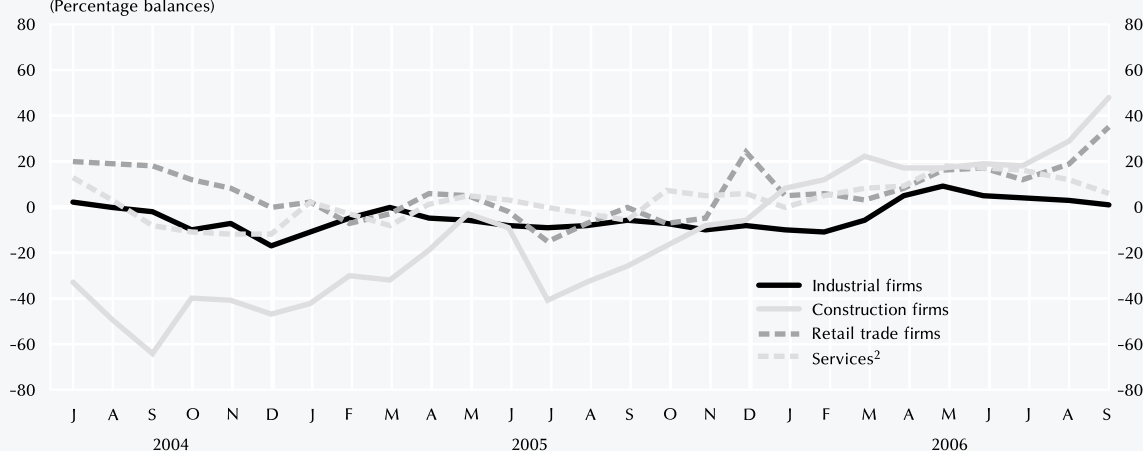
Finally, in the *primary* sector, employment *decreased* at a year-on-year rate of 1.6% in the first half of 2006.

As regards short-term prospects in the labour market, business expectations in all sectors in September were positive and significantly improved compared with those of September 2005 (see Chart IV.21 and Table IV.9).

According to LFS data for the first half of 2006 and OAED data for the number of the registered unemployed in the period January–September 2006, the number of unemployed was substantially lower than in 2005. According to the LFS definition and data, the number of unemployed in the first half of the year was approximately 450,000, i.e. about 34,000 less than in the corresponding 2005 period. The unemployment rate was 8.8% in the second quarter of 2006, down from 9.6% in the corresponding 2005 period (the average unemployment rate in the first half of 2006 was 9.2%, down from 10.0% in the first half of 2005 – see Chart IV.22). The number of the unemployed is generally affected by changes in the number of both employed and economically inactive persons. In particular, some persons that are economically inactive decide to enter the labour market as employees to take up or to seek employment (in the latter case they are registered as unemployed). Moreover, other persons withdraw from the labour market because they are retiring or they are discouraged (in case they do not succeed in finding a job). According to LFS

Chart IV.21

Business and consumer expectations¹ for employment
(July 2004 – September 2006)
(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.

Table IV.9

Business expectations for employment

(Weighted percentage balances)

	September 2006	Average (Jan. 1998-Sept. 2006)	Maximum (Jan. 1998-Sept. 2006)	Minimum (Jan. 1998-Sept. 2006)
Industry	1	-2	14 (May 2002)	-17 (Dec. 2004)
Construction	48	20	60 (March 2000)	-64 (Sept. 2004)
Services	6	3	38 (Q1 2000)	-37 (Q2 2001)
Retail trade	35	12	56 (Nov. 1998)	-15 (July 2005)

Source: IOBE business surveys.

data, the drop in the number of the unemployed in the first half of 2006 against the corresponding 2005 period was accompanied by a considerable increase in employment and a marginal increase in the number of economically inactive persons (by 0.1% or approximately 6,000 persons).

Despite the reduction of the overall unemployment rate, long-term unemployment as a percentage of total unemployment remains considerably high (55.5% in the first half of 2006, while in 2005 it was 54.2% on average compared with 41.6% in EU-15). It should be noted that in May special provisions in support of the employees

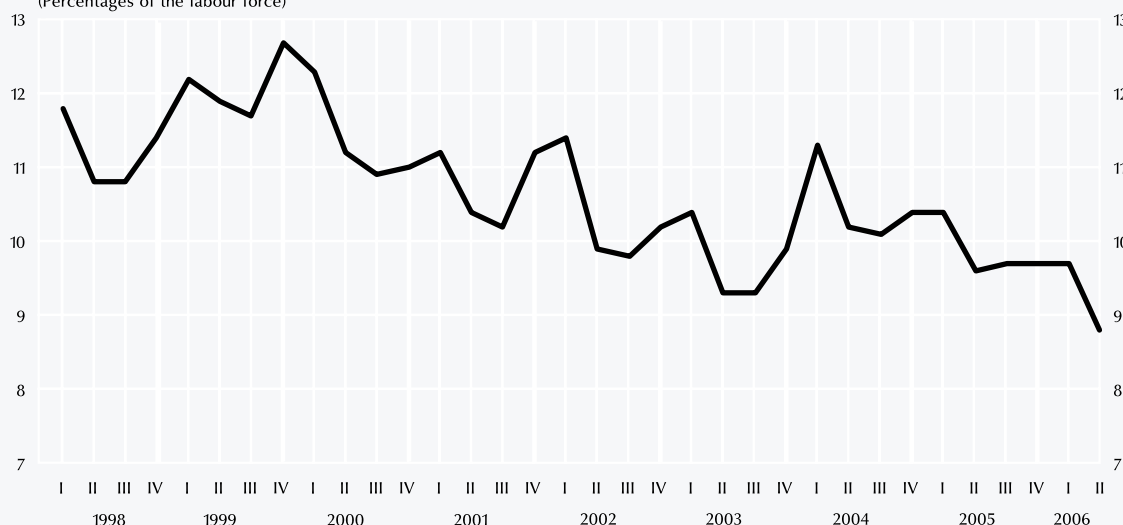
who are laid off by textile firms were voted (Law 3460/2006, Article 13), while a gradual increase (in 2007 and 2008) of the unemployment benefit has been recently announced.⁵³ According to research carried out by international organisations, income measures in support of the unemployed should be applied in conjunction with active labour market policies.⁵⁴ In more detail,

⁵³ See the Press Release of the Ministry of Employment and Social Protection dated 13 September 2006. It was also announced that a Social Solidarity Fund will be established to support those who face difficulties in reentering the labour market (mainly unemployed from declining sectors of economic activity).

⁵⁴ OECD (2006), *Employment Outlook*, Paris.

Chart IV.22

Total unemployment rate (1998 - 2006)
(Percentages of the labour force)



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

the effectiveness of measures aimed at helping the unemployed to reenter the labour market depends on the terms that govern the continuation of unemployment benefits (active job search and participation in programmes of life-long learning).

Recent developments in the labour market are a continuation of the medium-term trends which, in the last five years, have led to a rise in employment and a slight fall in the unemployment rate. In recent years, both the overall change in dependent employment and developments in employment at branch level have shown stronger correlation with changes in economic activity than during the period from 1995 until the beginning of 2000, possibly because business firms now consider the increase in demand as being of a more permanent nature. Besides, especially after 2003, the increase in activity in labour-intensive branches of the services sector has contributed to GDP growth more than in the past. Finally, the closer correlation between the change in GDP and that in employment may be

also explained by the fact that, as evidenced by IOBE surveys,⁵⁵ in the late 1990s the need to restructure and rationalise the operation of firms was the main reason why many of these firms proceeded with staff reductions.

The rise in employment over the last years pushed up the employment rate⁵⁶ to 60.7% in the first half of 2006 from 56.3% in the first half of 2001, while the unemployment rate fell from 10.8% to 9.2% over the same period. These developments are undoubtedly positive, but the current employment and unemployment rates still differ significantly from those of the EU-15. In 2005 the average employment rate was 65.2% in the EU-15 and 60.1% in Greece, while the unemployment rate was 8.2% against 9.9% in Greece. What is more, comparisons of unemployment rates by sex and

⁵⁵ See Politis, T. (2000) "Survey on employment and the labour market 1999", *Oikonomika Themata*, No. 8a, and Tsakanikas, A. and Staggel, E. (2005), "Survey on employment and the labour market 2004", *Oikonomika Themata*, No. 15.

⁵⁶ I.e. the ratio of the employed aged 15-64 to the total population of the same age.

age group paint an even gloomier picture for women and young people in Greece. The persistence of low employment rates and high unemployment rates points clearly to a structural problem, which should thus be addressed with structural policy measures.

4. Fiscal developments

4.1 Fiscal developments in the January-August 2006 period based on administrative data

The relaxation of Greece's fiscal policy after joining EMU led to the initiation of the excessive deficit procedure in May 2004 and a relevant ECOFIN Council decision on 5 July 2004. Following the subsequent revisions of the deficit,⁵⁷ on 17 February 2005 the ECOFIN decided that the procedure had reached the stage of Article 104(9) of the Maastricht Treaty and called upon Greece to take additional measures. At the same time, the deadline to bring the general government deficit (on a national accounts basis) to below 3% of GDP was extended until the end of 2006.

Therefore, the fiscal policy stance has changed since 2005 and continuous efforts are being made to contain the deficit; these efforts have brought the general government deficit to 4.5% of GDP in 2005, from 6.9% in 2004. (It should be noted that the Draft 2007 Budget submitted to Parliament on 2 October 2006 includes revised data on the deficit, which ultimately came to 7.4% of GDP in 2004 and 5.1% of GDP in 2005. The relevant detailed data were not available when this report was going to press) The target for 2006 is to reduce the general government deficit to 2.6% of GDP and put an end to the Excessive Deficit Procedure.

Against this backdrop, the state budget deficit (on an administrative basis) narrowed to 3.0% of GDP

in the January-August 2006 period, from 4.5% of GDP in the same period a year earlier. It should be recalled that the target for the current year's state budget deficit is 4.4% of GDP.⁵⁸ A significant improvement was also observed in the state budget primary surplus, which rose from 0.3% of GDP in January-August 2005 to 1.2% of GDP in the same period of 2006 (see Table IV.10). The reduction in the state budget deficit stemmed mainly from the ordinary budget –due to significantly higher revenue and lower interest payments– and, to a lesser extent, from the public investment budget.

A substantial contribution to the reduction of the ordinary budget deficit, which fell to 2.1% of GDP in the January-August 2006 period from 3.3% over the same period of 2005, was made by *revenue*,⁵⁹ which rose by 8.8%,⁶⁰ compared with a budgeted annual increase of 8.9% (see Table IV.10). According to available *detailed* data on the *first half* of the year, the high growth rate of revenue is attributable to the increase in indirect tax revenue (12.2%), as well as in non-tax revenue (52.8%).⁶¹ By contrast, direct tax revenue increased by a mere 1.0% over the same period, mainly due to the 10.6% rise in receipts from personal income tax, while revenue from almost all other direct tax categories fell. The decline in direct tax receipts is partly associated with a reduction in the tax rates

⁵⁷ Greece was obliged to notify by 5 November 2004 to the European Commission specific measures aimed at bringing the excessive deficit below the reference value (3.0% of GDP) by the end of 2005. Due to the deficit adjustment, the Commission judged that these measures were insufficient, albeit in the right direction.

⁵⁸ This target is compatible with that for the general government deficit on a national accounts basis (2.6% of GDP).

⁵⁹ Including extraordinary non-tax revenue of €482 million, resulting from the decrease in the share capital of the Postal Savings Bank (€299.3 million) and the Agricultural Bank (€33 million) and the settlement of revenue (€149.7 million) of the National Telecommunications and Post Commission (EETT) from fines and licences.

⁶⁰ If extraordinary revenue is not taken into account, the rise in the eight-month period is limited to 7.1%.

⁶¹ Including the extraordinary revenue mentioned above.

Table IV.10
State budget results
(Million euro)

	January-August			Percentage changes		Annual data			Percentage changes		
	2004		2005	2006	2005/04	2006*/05	2003	2004	2005	2004/03	2005/04
	2004	2005	2006	2005/04	2006*/05	2003	2004	2005	Budget for 2006	Budget for 2006/05	Budget for 2006/05
I. Revenue¹	29,189	29,970	33,490	2.7	11.7	41,704	44,949	47,525	52,240	7.8	5.7
1. Ordinary budget (of which extraordinary revenue)	27,538	28,685	31,200	4.2	8.8	39,881	42,055	44,760	48,750	5.5	6.4
2. Public investment budget	1,651	1,285	2,290	-22.2	78.2	1,823	2,894	2,765	3,490	58.7	-4.5
— Own revenue	...	...	...	—	—	77	83	...	90	7.8	26.2
— Revenue from the EU	...	...	...	—	—	1,746	2,811	...	3,400	61.0	...
II. Expenditure¹	38,046	38,089	39,284	0.1	3.1	51,551	57,810	58,800	60,790	12.1	1.7
1. Ordinary budget	32,558	34,589	35,381	6.2	2.3	43,116	48,288 ⁴	51,282 ⁵	52,390	12.0	6.2
— Interest payments ²	7,483	8,711	8,122	16.4	-6.8	9,416	9,464	9,774	9,600	0.5	3.3
— Ordinary budget primary expenditure (of which tax refunds)	25,075	25,878	27,259	3.2	5.3	33,700	38,824 ⁴	41,508 ⁵	42,790	15.2	6.9
2. Public investment budget	1,671	1,629	1,479	-2.5	-9.2	2,799	2,799	2,554	2,200	...	...
III. State budget (SB) results	-8,857	-8,119	-5,794	-36.2	11.5	8,435	9,522	7,518	8,400	12.9	-21.0
III/GDP (%)	-5.3	-4.5	-3.0			-6.3	-7.6	-6.2	-4.4		
1. Ordinary budget	-5,020	-5,904	-4,181			-3,235	-6,233	-6,522	-3,640		
2. Public investment budget	-3,837	-2,215	-1,613			-6,612	-6,628	-4,753	-4,910		
IV. SB primary surplus	-1,374	592	2,328			-431	-3,397	-1,501	1,050		
IV/GDP(%)	-0.8	0.3	1.2			-0.3	-2.0	-0.8	0.5		
Amortisation payments ²	14,301	18,530	16,202	29.6	-12.6	21,615	20,356	20,738	18,136	-5.8	1.9
Ministry of National Defence programmes for the procurement of military equipment ²	459	566	647	23.3	14.3	987	1,792	1,400	1,500	81.6	-21.9
GDP (current prices)	168,417	181,088	194,458			155,543	168,417	181,088	194,458	8.3	7.5

1 For comparability purposes, tax refunds are included in expenditure and have not been deducted from revenue, a practice followed by the Ministry of Economy and Finance in the last few years.

2 For the year 2002 including interest and amortisation payments taken over by the Ministry of National Defence. From 2003 onwards, such payments are recorded in the off-budget item "Ministry of National Defence programmes for the procurement of military equipment".

3 Comprising €149.7 million from EETT revenue settlement, €299.3 million (not included in the 2006 budget) from the capital decrease of the Postal Savings Bank and €33 million from the capital decrease of the Agricultural Bank.

4 Including a grant of €220 million to OTE's personnel insurance fund (TAP-OTE).

5 Including a grant of €330 million to TAP-OTE and the repayment of Greek government debt to the Agricultural Bank, amounting to €345 million. These expenses were not included in the Ministry of Economy and Finance estimates for 2005, which were published in the Introductory Report on the 2006 Budget.

* Provisional data.

Source: Ministry of Economy and Finance.

on corporate income and inheritance, gifts and parental donations, as well as with the declining yield of arrangements for the settlement of pending tax cases and the collection of tax arrears (Law 3259/2004).

The increase in indirect tax revenue (in the first half of the year) was observed chiefly in the following categories:

(a) VAT (14.7%), owing to: (i) the one percentage point increase in tax rates in April 2005, (ii) the intensification of tax audits and (iii) the high international fuel prices (revenue from VAT on fuel rose by 27.6% in the first half of the year). It should be noted that, over the same period, receipts from the special consumption tax on fuel, which is set per unit of volume and is not affected by price changes, increased by 4.6% only. Thus, total revenue from the two types of fuel tax (VAT and the special consumption tax) increased by 12.6% in the first half of the year.

(b) Receipts from the tax on stock exchange transactions (64.4%), due to the rise in prices and transactions in the Stock Exchange during the first half of 2006.

(c) Revenue from car registration fees (43.3%), due to the collection of certain revenue in January 2006, instead of December 2005 (in the February-June period, receipts from car registration fees increased by 0.6% compared with the corresponding figure of 2005) and

(d) Receipts from real estate transfer tax (27.6%), due to the recovery of the real estate market in the second quarter of 2006.

Revenue from other indirect tax categories recorded either low growth rates or a decrease. In the remainder of 2006, the growth rate of rev-

enue is expected to slow down because, first, one year has elapsed since the tax measures of 1 April 2005⁶² and, second, revenue had improved significantly since September 2005 ("base-effect"). By contrast, a positive influence on revenue for the remainder of the year will be exerted by the 5.7% increase, from 1 July, in the special consumption tax on fuel,⁶³ as well as by the measures of 27 July 2006 (increase in the "minimum special consumption tax" on cigarettes and mobile telephony flat fees).

Ordinary budget expenditure (including tax refunds) increased by 2.3% in the first eight months of 2006, compared with 2.3% in the same period of 2005,⁶⁴ reaching €35,381 million (2005: €34,589 million). The moderate increase in expenditure, which is almost equal to the budget forecast, is attributed solely to the 6.8% decrease in interest payments. By contrast, despite the 9.2% decline in tax refunds, primary expenditure rose by 5.3% over the same period, compared with a budgeted increase of 3.1% (see Table IV.10).

According to provisional data,⁶⁵ the increase in primary expenditure is mainly attributable to:

⁶² Tax rates increased on 1 April, but the first increased revenue was yielded by enterprises to tax offices from May up to and including July 2005 (for enterprises that pay the VAT every three months).

⁶³ This adjustment was made because Greece is committed to the European Union to increase by 20% the special consumption tax rates on fuel by 2009.

⁶⁴ It should be noted that the 2005 expenditure, on an administrative basis, includes a €330 million grant to OTE's personnel insurance fund (TAP-OTE), and the repayment of a €345 million debt of the Greek State to the Agricultural Bank. These expenses are not included in the Ministry of Economy and Finance estimates for 2005, as published in the Introductory Report on the 2006 Budget. By contrast, 2005 expenditure does not include: (i) grants of approximately €1.8 billion, paid by the ordinary budget to public hospitals, because they concerned repayment of prior obligations to their suppliers, and (ii) payments of approximately €1.0 billion for capital injection to the Agricultural Bank.

⁶⁵ These data are published monthly by the General Accounting Office (Budget Implementation Bulletin), but the categories are not directly comparable with the corresponding ones of the Budget.

Table IV.11

Net borrowing requirement of central government on a cash basis^{1,2,3}

(Million euro)

	Years		January-September		
	2004	2005	2004	2005	2006*
Central government	15,605	14,424	10,770	10,694	7,844
– State budget	15,377	14,793	11,922	12,107	9,255
(Ordinary budget) ⁴	8,841	10,033 ⁶	7,764	9,761	7,186 ⁷
(Public investment budget)	6,536	4,760	4,158	2,346	2,069
– OPEKEPE ⁵	228	–369	–1,152	–1,413	–1,411
Percentage of GDP	9.3	8.0	6.4	5.9	4.0

1 This table includes the borrowing requirement of central government on a cash basis. The borrowing requirement of public entities is calculated by the NSSG on the basis of detailed data collected directly from these entities through a special quarterly survey regarding their financial results (revenue-expenditure) and their financial position (borrowing, investment in securities, deposits etc.).

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) as from 3 September 2001.

6 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 €1,090 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.

7 Including €149.7 million from EETT revenue settlement, €299.3 million from the capital decrease of the Postal Savings Bank, €33 million from the capital decrease of the Agricultural Bank, €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.

(a) the 5.7% rise in personnel outlays (excluding health care expenditure), mainly due to increased payments for civil servants' pensions (9.2%), while total personnel outlays rose by 4.7%,

(b) the 7.3% rise in expenditure for restitution of revenue to third parties and

(c) the 9.5% rise in outlays for government grants.

By contrast, almost all other primary expenditure components declined due to the efforts to contain them.

Interest payments decreased by 6.8% in the first eight months of the year, compared with the 1.8% budgeted decrease on an annual basis. Since these payments are not evenly distributed over

the year, it is estimated that this decrease is temporary and interest payments will stand close to the budget forecast at the end of the year. It should be noted that interest payments continue their slightly downward course this year because the average interest rate on new government loans (3.8%) remains at present lower than the average rate for the total debt, which stood at about 4.7% by the end of 2005.

The *public investment budget deficit* declined to €1,613 million or 0.9% of GDP in the first eight months of the year, compared with €2,215 million over the same period of 2005 and €3,837 million in 2004 (see Table IV.10). For the remainder of the year, the deficit is expected to widen given that, according to the 2006 budget, the (annual) public investment budget deficit is estimated to come to €4,910 million or 2.5% of GDP.

Table IV.12

Financial and other extraordinary transactions under the ordinary budget on a cash basis

(Million euro)

	January-September	
	2005	2006
I. Receipts from:		
1. EETT revenue settlement	–	149.7
2. the capital decrease of the Postal Savings Bank	–	299.3
3. the capital decrease of the Agricultural Bank	–	33.0
4. privatisations	1,916.0	1,321.2
II. Payments of:		
1. hospital debts	2,200.0	–
2. government debt to the Agricultural Bank	402.1	–
3. government debt to the Farmers' Insurance Fund (OGA)	–	422.9
4. capital injection to the Agricultural Bank	1,028.5	–
III. Total (I-II)	–1,714.6	1,380.3
% of GDP	–0.9	0.7

Sources: General Accounting Office and Bank of Greece.

The containment of the public investment budget deficit in the first eight months of the year is mainly attributed to receipts from various EU funds, which increased by 78.2% over the corresponding period of 2005. By contrast, public investment budget expenditure increased by 11.5%, close to the budget forecast of 11.7%.

4.2 Fiscal developments in the January-September 2006 period based on cash data

In the January-September 2006 period the central government cash deficit, which is also affected by a series of transactions not counted in with regard to data on an administrative basis, dropped to 4.0% of GDP, compared with 5.9% in the corresponding period of 2005 (see Table IV.11). This improvement is mainly due to extraordinary factors, some of which boosted receipts in the January-September 2006 period, while others had pushed up payments in the corresponding period of 2005. When adjusted for the sake of comparability

between the two periods, the deficit stands at 4.7% in 2006, compared with 5.0% in 2005, and the deficit decrease is limited to 0.3% of GDP. All the extraordinary factors that affected negatively the cash result of the two nine-month periods are detailed in Table IV.12.

It should be noted that, except for revenue of €149.7 million from the EETT, all data shown in Table IV.12 concern either financial transactions or transactions among general government sectors. These do not affect the 2005 or 2006 deficit, as recorded in accordance with the definitions and conventions of the European System of Accounts (ESA 1995), but do affect public debt. Ordinary budget cash revenue in the nine-month period, including extraordinary revenue of €482.0 million,⁶⁶ increased by 8.2%. This increase is similar to the rise in revenue on an administrative

⁶⁶ See footnote 59. Ordinary budget extraordinary revenue does not include receipts from privatisations.

basis (8.8%) and is due to the reasons stated above, which also favoured revenue on an administrative basis.

Ordinary budget cash expenditure in the nine-month period declined by 1.5% compared with the corresponding period of 2005. However, in 2005 cash expenditure was burdened by extraordinary payments⁶⁷ of €2,601.1 million, while in 2006 such payments amounted to €422.9 million only (see Table IV.12). If these extraordinary payments are not taken into account, expenditure in the nine-month period increased by 4.3% compared with the corresponding period of 2005.

5. Balance of payments

5.1 Current account

5.1.1 Overall trends

According to Bank of Greece balance-of-payments data, the current account deficit stood at 7.3% of GDP on average in 2001-2005.⁶⁸ The persistently high current account deficit is attributable to a number of factors:

(a) Loss of international price competitiveness of the Greek economy, mainly reflecting Greece's positive unit labour cost differential vis-à-vis its competitor countries, not least in a period of a global rise in exports from low-cost emerging markets. Specifically, between 2000 and 2006 the real effective exchange rate (real EER) based on consumer prices (i.e. relative consumer prices expressed in a common currency) recorded a cumulative rise of around 14%, while the real EER based on unit labour costs (i.e. relative unit labour costs expressed in a common currency) rose cumulatively by 34% (see Table IV.13 and Chart IV.23).

(b) The low level of structural competitiveness, mainly owing to structural weaknesses of the economy that are also reflected in the composition of external trade in goods. Still, Greek exports to emerging economies have been growing at a relatively rapid pace since 2000. Also, although the share of medium- and high-technology products in total exports has increased considerably, it remains relatively small,⁶⁹ since the economy has not yet sufficiently developed the production of skill- and technology-intensive goods.

(c) A shortfall of savings relative to investment spending,⁷⁰ which is a result of both a decrease in saving and a significant increase in investment. The decline in savings is associated with the substantial fall in interest rates following entry into the euro area, the resulting surge in household borrowing and changes in consumption patterns, as well as the sizeable fiscal deficits.⁷¹ Furthermore, as stressed in earlier reports, high current account deficits can be justified for an economy in a process of catching-up, to the extent that such deficits correspond to spending for productive investment.⁷²

⁶⁷ Excluding the capital injection to the Agricultural Bank, which is not recorded in the ordinary budget account, but in another government account with the Bank of Greece.

⁶⁸ Over the same period the combined current account and capital account deficit – which corresponds to Greece's net external borrowing – averaged 6.1% of GDP.

⁶⁹ See Bank of Greece, *Annual Report 2005*, April 2006, Box IX.2, pp 290-91, and Panhellenic Exporters Association, Export Research Centre (KEEM), *New developments in export activity* (in Greek), July 2006.

⁷⁰ Saving stood at 14.7% of GDP and investment at 24.2% on average in 2001-2006.

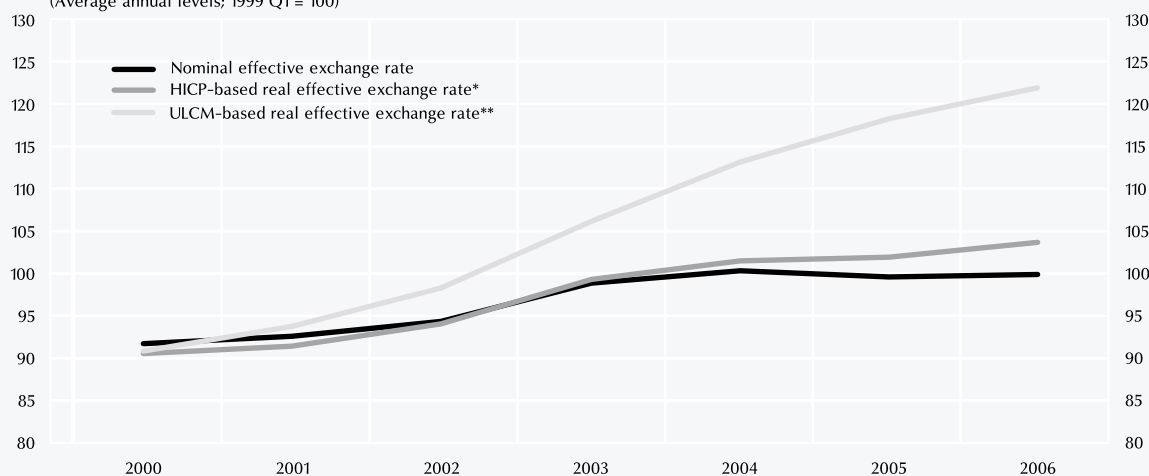
⁷¹ See also European Commission, Directorate-General for Economic and Financial Affairs, *Public Finances in EMU 2006*, 13 June 2006.

⁷² See also M. Bussière, M. Fratzscher and G.J. Müller, "Current account dynamics in OECD and EU acceding countries – an intertemporal approach", ECB Working Paper No. 311, February 2004.

Chart IV.23

Greece: revised effective exchange rate indices (2000-2006)

(Average annual levels; 1999 Q1 = 100)



* Real effective exchange rate on the basis of relative consumer prices (according to the Harmonised CPI).

** Real effective exchange rate on the basis of relative unit labour costs in manufacturing (ULCM).

Source: Bank of Greece calculations. For 2006: provisional data and estimates.

Table IV.13

Greece: revised nominal and real effective exchange rate indices (EER)¹

(Average annual levels)

	Nominal EER		Real EER on the basis of relative consumer prices		Real EER on the basis of relative unit labour costs in manufacturing	
	Index: 1999 Q1=100	Percentage change	Index: 1999 Q1=100	Percentage change	Index: 1999 Q1=100	Percentage change
2001	92.6	1.0	91.4	1.0	93.7	3.2
2002	94.3	1.9	94.0	2.9	98.2	4.7
2003	98.8	4.7	99.3	5.6	106.1	8.0
2004	100.3	1.5	101.4	2.1	113.1	6.6
2005	99.6	-0.7	101.8	0.4	118.2	4.5
2006 ²	99.7	0.1	103.4	1.6	121.9	3.2
Cumulative percentage change in 2001-2006		8.8		14.3		34.3

1 The revised indices are based on the structure of Greece's trade in manufacturing products (categories SITC 5-8) with its 27 main trading partners in 1999-2001.

2 Provisional data and estimates.

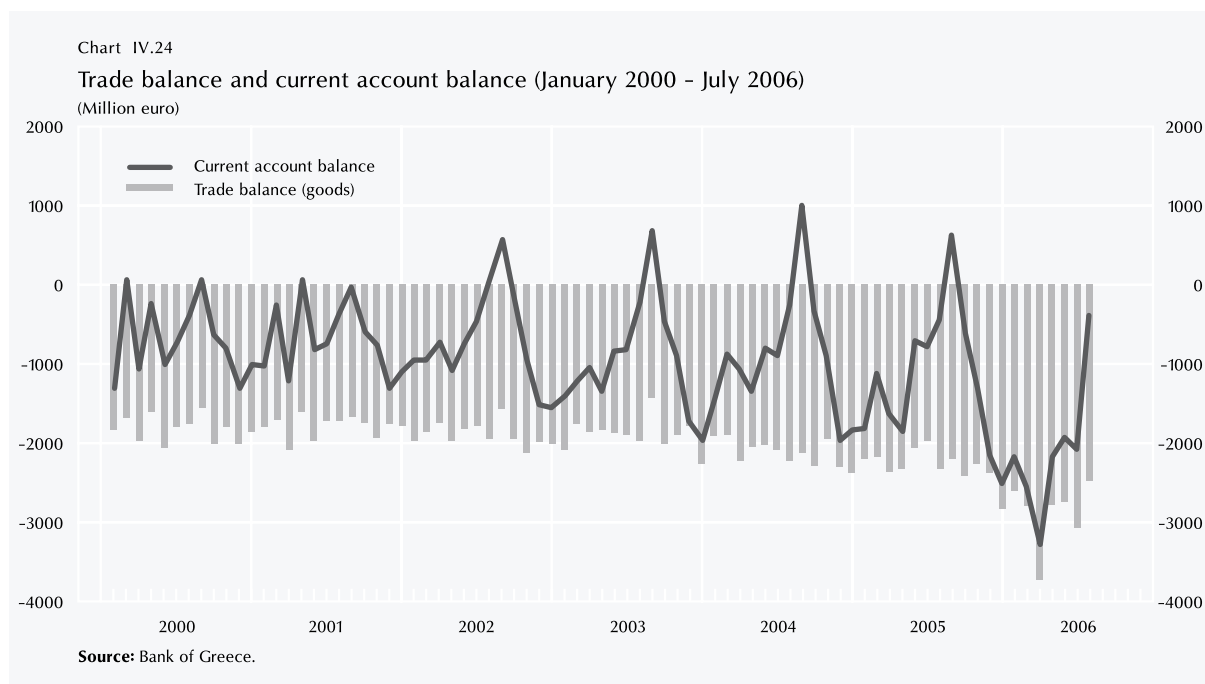
Sources: Exchange rates: ECB, euro reference exchange rates.

CPI: Harmonised CPI where available, ECB.

Unit labour costs in manufacturing: for Greece: Bank of Greece estimates, for the other countries: ECB.

In addition to the direct risks it implies to the country's growth prospects, the considerable widening of the current account deficit over the last years also gives rise to indirect risks related to

the significant increase in public and private gross external debt, which stood at 122.3% of GDP at end-2005. Even though there is no problem in the financing of the external debt, because of Greece's



participation in the euro area, the servicing of this debt absorbs income, which has adverse repercussions on growth and employment.

Over the last few years, the level of the current account deficit has been affected by additional important factors. The trade balance has been burdened by the surge in oil prices, as well as by increased outflows associated with the purchase of ships. The income account has been burdened by a continued rise in outflows for the payment of interest, dividends and profits, due to an increase in public debt and in Greek shares held by foreign institutional investors. Finally, regarding the services balance, transport receipts benefited from the steep rise in freights in the context of strong growth of world trade volumes, especially in 2004. When conditions in the freight market stabilised, transport receipts did not register further increases and broadly remained at the high levels of 2004. Moreover, the expected gains from the 2004 Olympic Games did not fully materialise as far as the services balance is concerned. However, available data on tourist

arrivals and receipts from travel services in 2006 are reassuring.⁷³

These factors have contributed —as explained in more detail below— to a significant increase in the current account deficit (see Chart IV.24), which is projected to come close to 11% of GDP this year, from 7.9% in 2005. Given that current and capital transfers surpluses are expected to decline over the medium term, reflecting lower Structural Fund or CAP support —in an enlarged EU of 25 and soon 27 Member States— it becomes clear that struc-

⁷³ In addition, it should be noted that certain current account aggregates have been affected by the methodological changes over the last years in harmonisation with international balance of payments compilation practices (specifically the guidelines of the International Monetary Fund as set forth in the *Balance of Payments Manual*, 5th edition). This harmonisation started in 1999 and was completed in 2005 and 2006 with the distinction between current and capital transfers, the recording of interest payments related to bonds on an accruals basis rather than on a cash basis, the more accurate recording of relevant data and the inclusion of reinvested profits from direct investment. (Travel services data were revised earlier, in 2002, on the basis of the border survey). As a result of these changes and revisions, data on the level of the current account deficit are fully comparable across periods from January 2003 onwards.

tural adjustments are necessary on the supply side of the Greek economy that will enable it to respond to the conditions in the international environment by offering more competitive goods and services.

5.1.2 Developments in 2006

In January-July 2006 the current account deficit increased by €6,296 million compared with the same period in 2005 and stood at €14,664 million. This is a result of, mainly, a widening of the trade deficit (by €4,796 million) and, to a lesser extent, an increase in the income account deficit (by €967 million) and a fall in the services and current transfers surpluses (by €342 million and €211 million respectively).

5.1.2.1 Trade balance

The widening of the trade deficit including oil and ships in January-July 2006, compared with the same period in 2005, is almost equally due to a higher deficit excluding oil and ships (by €1,633 million), a rise in the net oil import bill (by €1,632 million) and an increase in net outflows for imports of ships (by €1,510 million). Export receipts *excluding oil and ships* rose considerably by €778 million or 13.4%, but the increase in the respective import bill (€2,084 million or 11.6%) was higher in absolute terms.⁷⁴ According to detailed Bank of Greece data for January-July 2006, both the import bill and export receipts recorded an increase which was broadly based across product categories (see Table IV.14).⁷⁵ Regarding the geographical breakdown of external trade, the latest detailed NSSG data for the January-July period point to a drop in the share of both exports and imports to and from the EU-25. By contrast, a considerable rise was recorded in the share of exports to the ten new members of the EU-25 (as well as a slight increase in the share of imports from the said countries). The shares of imports from North

Africa and the Middle East and from the Commonwealth of Independent States rose significantly, mainly reflecting the impact of higher crude oil prices (see Table IV.15).

5.1.2.2 Services balance

The services surplus fell by €342 million mainly on account of a drop in net transport receipts by €557 million, as well as of an increase in net payments for “other services” (by €304 million). By contrast, net travel receipts rose by €519 million as gross travel receipts (i.e. travel spending by non-residents in Greece) increased by €432 million or 8.2% and gross travel payments (i.e. travel spending abroad by residents of Greece) fell by €87 million or 6.2%. Regarding transport services, the rise in gross transport payments was the main cause underlying the drop in net transport receipts, as gross transport (mainly shipping) receipts fell only marginally.⁷⁶

5.1.2.3 Income account

The income account deficit grew by €967 million in January-July 2006, as a result of increased net

⁷⁴ According to provisional NSSG data for January-July 2006, in value terms total exports increased by 20.4% and non-oil exports by 14.1%, total imports grew by 16.6% or by 13.9% excluding ships and 8.4% excluding oil and ships. It should be recalled that discrepancies between Bank of Greece balance of payments data and NSSG trade statistics are due to several reasons, most importantly the fact that the former relate to receipts and payments effected 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.

⁷⁵ Noteworthy exceptions to these upward trends were, on the exports side, “other manufacturing sectors”, where lower receipts reflected declining exports of textiles and, on the imports side, “consumer durables”, where payments dropped.

⁷⁶ It should be noted that most transport services transactions are denominated in US dollars. In dollar terms, the decline in gross receipts would be 3.6% (0.7% in euro terms), while the increase in gross payments would be 6.7% (9.7% in euro terms). In other words, the strengthening of the US dollar against the euro in January-July 2006 compared with the same period in 2005 implies a smaller percentage decline in receipts in euro terms (this decline was due to a fall in freights from the high levels of 2005) and a larger percentage rise in payments.

Table IV.14

Breakdown of Greece's external trade by product category (excluding oil and ships)

(January – July)

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	18.7	20.1	19.2	8.3	8.3
Chemicals, plastics	13.2	13.6	13.4	4.2	11.7
Metallurgy ¹	9.6	13.8	17.0	45.1	40.0
Machinery, appliances	6.0	6.4	5.9	7.6	5.4
Means of transport excl. ships	1.1	1.7	2.1	60.3	39.1
Other manufacturing branches ¹	20.4	19.3	15.9	-4.4	-6.4
Unclassified goods ²	31.0	25.2	26.6	-18.0	19.7
Total (excl. oil and ships)	100.0	100.0	100.0	1.0	13.4

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	14.2	13.6	13.4	-5.9	10.0
Chemicals, plastics	14.9	16.4	15.1	8.7	2.8
Metallurgy ¹	9.5	10.5	10.9	8.5	15.9
Machinery, appliances	21.0	18.1	17.5	-15.1	7.3
Consumer durables	3.5	3.1	2.5	-11.3	-10.9
Capital goods	13.4	11.3	10.9	-16.7	7.1
Computers	2.0	1.5	2.0	-28.8	48.5
Fixed-voice and mobile telephony	2.1	2.2	2.1	1.9	7.0
Means of transport excl. ships	14.7	14.7	16.7	-1.8	27.0
Passenger cars	7.5	7.3	7.7	-3.9	18.7
Other manufacturing branches ¹	21.3	22.4	21.6	3.3	7.6
Other goods	0.3	0.2	0.1	-48.1	-26.3
Unclassified goods ²	4.0	4.1	4.7	1.5	28.2
Total (excl. oil and ships)	100.0	100.0	100.0	-1.6	11.6

¹ Including raw materials used.² Products for which no code number has been reported.

* Provisional data.

Source: Bank of Greece.

payments for interest, dividends and profit. These in turn stemmed mainly from a rise in net interest payments, reflecting a continued increase in non-residents' holdings of government bonds.

5.1.2.4 Current transfers balance

In January-July 2006 the current transfers surplus decreased slightly compared with the same

period in 2005, owing to a drop in net current transfers to general government (mainly from the EU)⁷⁷ which more than offset a rise in net current transfers to the remaining sectors other than gen-

⁷⁷ Current EU transfers mainly include receipts from the Guarantee Section of the European Agricultural Guidance and Guarantee Fund –EAGGF– in the context of the Common Agricultural Policy, receipts from the European Social Fund and Greece's contributions to the Community Budget.

Table IV.15

Breakdown of Greece's external trade by geographical area*

(January – July)

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)	52.1	54.7	53.2	16.7	16.8
European Union (15)	48.8	47.5	44.7	8.1	13.3
Euro area	39.0	38.2	37.5	8.8	18.0
OECD countries ¹	12.7	13.6	12.9	18.3	14.6
USA	4.9	5.5	4.4	24.1	-2.5
Balkan countries ²	16.7	14.9	15.5	-0.7	25.4
Commonwealth of Independent States	2.7	2.4	2.4	-2.6	21.8
North Africa & Middle East countries ³	6.5	7.2	9.5	22.1	59.0
China & Southeastern Asia ⁴	1.7	2.4	2.0	56.3	0.2
Other countries	7.6	4.9	4.5	-27.9	10.4
Total	100.0	100.0	100.0	11.1	20.2
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)	56.7	56.3	53.9	0.4	11.7
European Union (15)	55.9	54.0	51.4	-2.3	11.0
Euro area	49.4	48.2	45.7	-1.2	10.6
OECD countries ¹	16.9	14.0	13.7	-16.1	13.8
USA	5.1	4.6	1.8	-8.5	-55.3
Balkan countries ²	2.8	3.3	3.4	18.3	18.3
Commonwealth of Independent States	5.4	8.3	9.0	54.5	26.7
North Africa & Middle East countries ³	8.0	8.9	11.3	12.6	48.0
China & Southeastern Asia ⁴	5.2	5.5	5.1	5.7	8.4
Other countries	4.9	3.7	3.7	-23.3	15.8
Total	100.0	100.0	100.0	1.2	16.6

¹ The OECD Member States 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.

eral government. Specifically, in the period under review a fall was recorded in payments to the Community budget,⁷⁸ but also in receipts from the Guarantee Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) under the CAP. It should be noted that the latter are not distributed evenly over the year,

because (i) they depend on the seasonality of pro-

⁷⁸ Regular contributions to the Community budget are more or less evenly distributed over the year. However, Greece's payments to the EU, as recorded in the balance of payments, include various other items such as extraordinary contributions, refunds, provisional transfers to EU accounts held with central banks etc., which may show an occasional increase on a monthly or annual basis (as was the case in 2005).

duction and marketing of the various products and (ii) there are no specific deadlines for submitting the formal request to receive funds for some product categories.

5.2 Capital transfers balance

The increase in the capital transfers surplus in January-July 2006 reflects a rise in capital transfers to general government from the EU⁷⁹ to €2,050 million from €1,085 million over the same period in 2005 and stems mainly from the higher rate of absorption of Structural Fund resources under CSF III. Specifically, from the start of implementation of CSF III in 2001 until end-July 2006, disbursements were €11.3 billion, against total support of €22.7 billion, implying a rate of absorption close to 50% on a cash basis.⁸⁰ Although the average annual rate of absorption was significantly higher in 2004-2005 than in 2001-2003, the fact that the overall rate of absorption for the past six years as a whole is not higher reflects a number of weaknesses which have been identified during this period (e.g. weaknesses regarding the regulatory framework governing the commissioning of projects and management and control systems) and are being dealt with.⁸¹ In order to boost the rate of absorption, measures are being taken to speed up the implementation of operational programmes, while proposals on the reallocation of CSF III resources are being submitted to the European Commission.

According to the above, it is expected that inflows under CSF III will rise in 2006. As regards inflows from the EAGGF Guarantee Section to Greece in the context of the revised CAP (which for Greece is effective from this year), these are expected to remain in 2006 broadly at the same levels as in previous years (around €2.7 billion).⁸² Taking also into account Greece's pay-

ments to the Community Budget, net EU transfers are projected to come close to €4.2 billion in 2006, from €3.8 billion in 2005 (on a cash basis, as recorded in the balance of payments compiled by the Bank of Greece). This amount corresponds to about 2.2% of GDP.

Beyond 2006, Greece is expected to receive €20.1 billion from the Structural Funds and the Cohesion Fund for the implementation of the National Strategic Reference Framework (CSF IV, 2007-2013). At the same time, the CAP is expected to remain more or less unchanged until 2013. Taking also into account Greece's future payments to the Community Budget, net EU transfers should be at €3.5 billion per annum, which corresponds to around 1.8% of GDP. The compilation of the 2007-2013 National Strategic Reference Framework is expected to be concluded by the end of this year, at both national and community level, so that its implementation can start as from 1 January 2007.

5.3 Combined current account and capital account (old methodology)

The combined current account and capital account (old methodology) showed a deficit of €12,661

⁷⁹ 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.

⁸⁰ This figure includes CSF III amounts collected in advance in 2001. At end-July 2006, the absorption rates on a cash basis for the individual Structural Funds were as follows: European Regional Development Fund (ERDF) 49%, European Social Fund (ESF) 52%, Guidance Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) 51%, Financial Instrument for Fisheries Guidance (FIFG) 50%. At end-August 2006, public spending (Community and national) corresponding to contracts signed was close to 71% of total public spending budgeted under CSF III.

⁸¹ See speech by the Minister of Economy and Finance (CSF III 9th Monitoring Committee, 20 June 2006).

⁸² On CAP revision see Bank of Greece, *Annual Report 2005* (pp. 301-302) and *Annual Report 2004* (pp 258-259).

million in January-July 2006, compared with €7,343 million over the same period in 2005. This deficit also reflects the size of the financing required from the viewpoint of the financial account.

5.4 Financial account

In January-July 2006, net financial inflows to the Greek economy were higher than in 2005. Specifically, financial investment, i.e. the sum of direct, portfolio and “other” investment,⁸³ showed a net inflow of €12,987 million, compared with €7,273 million in 2005. This development was driven by “other” investment, while the other two components played a secondary role. In particular, direct investment (see Box IV.1) showed a net inflow of €970 million (compared with a net inflow of a mere €15 million in the corresponding period in 2005). More specifically, direct investment inflow stood at €1,464 million, while the corresponding outflow was €495 million.⁸⁴ Over the same

period, portfolio investment recorded a net inflow of €2,542 million, since the inflow of non-residents’ investment in Greece – mainly in Greek government bonds (€6,734 million) and shares (€4,211 million) – more than offset redemptions of short-term Greek government securities, and the outflow of residents’ investment in foreign bonds, Treasury bills and shares. (It should be noted that purchases of Greek government bonds by non-residents fell

⁸³ Financial investment can also be calculated by deducting changes in reserve assets from the financial account balance.

⁸⁴ In January-July 2006, the most important direct investment flows concerned, on the side of inflows, the acquisition of Q-Telecommunications S.A. by US-based Apax and Texas Pacific in January (€298 million), the participation of Sara Lee corporation in the capital increase of its subsidiary Sara Lee Hellas in March (€114 million) and the acquisition of 31.5% of Marfin Financial Group’s capital by Dubai Financial in May (€392 million) and, on the side of outflows, the acquisition of an additional 20% of the capital of Turkey-based Intelteck by Intralot (€69 million), National Bank’s participation in the capital increase of Romania-based Banca Romanesca in January (€63 million) and the completion of the acquisition of EFG Eurobank S.A. Polska in Poland by Eurobank-Ergasias S.A. in March (€77 million).

BOX IV.1

Foreign direct investment

Comparative data for Greece and the other EU-25 countries – why Greece lags behind

Inward Foreign Direct Investment (FDI)¹ seems to constitute an important factor for economic growth, especially for small open economies like Greece. In the long run, FDI creates prospects for increased sustainable growth, mainly through the qualitative improvement of the production base. This could occur through better managerial practices, as well as the introduction of new ideas and technologies. Apart from a pure level effect, these benefits are also subject to spillovers to the domestic firms. These prospects are reinforced, *inter alia*, by the fact that FDI increases the opportunity to attract and employ skilled labour. Moreover, FDI can increase both the domestic as well as the international competitiveness of the host market. As new and innov-

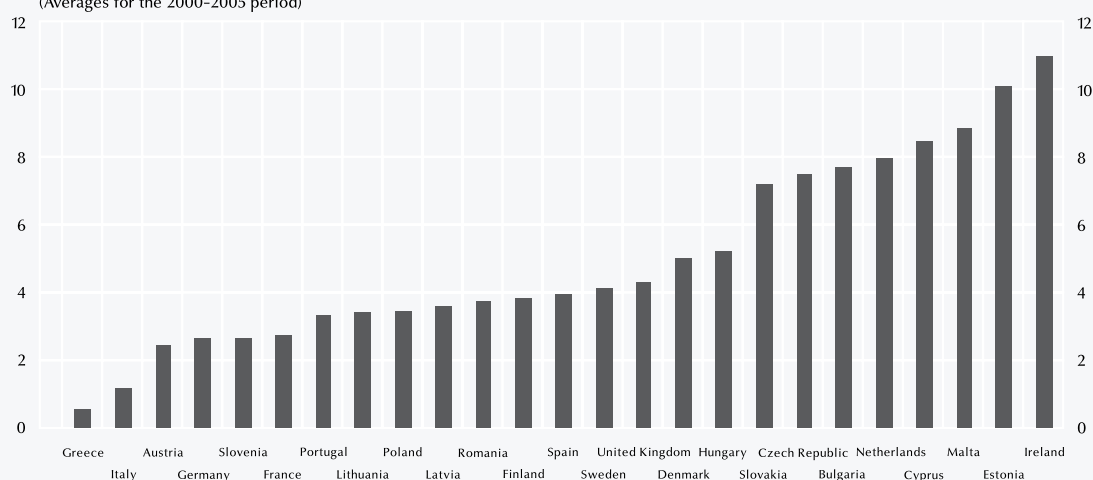
ative firms gain access, they can contribute to lower domestic prices as well as increase host market exports. There are also direct gains as FDI helps to finance current account deficits, thus reducing the need for foreign borrowing.

For Greece, the degree of inward FDI is particularly low, especially when compared with the other EU Member States. The data presented in Charts A and B show the inward flows and stocks of FDI as percentages →

¹ Foreign direct investment (FDI) is the category of international investment made by an entity resident in one economy (direct investor) to acquire a lasting interest in an enterprise operating in another economy (direct investment enterprise). The lasting interest is deemed to exist if the direct investor acquires at least 10% of the equity capital of the direct investment enterprise.

Chart A

FDI inflows as a percentage of GDP in the EU-25
(Averages for the 2000–2005 period)

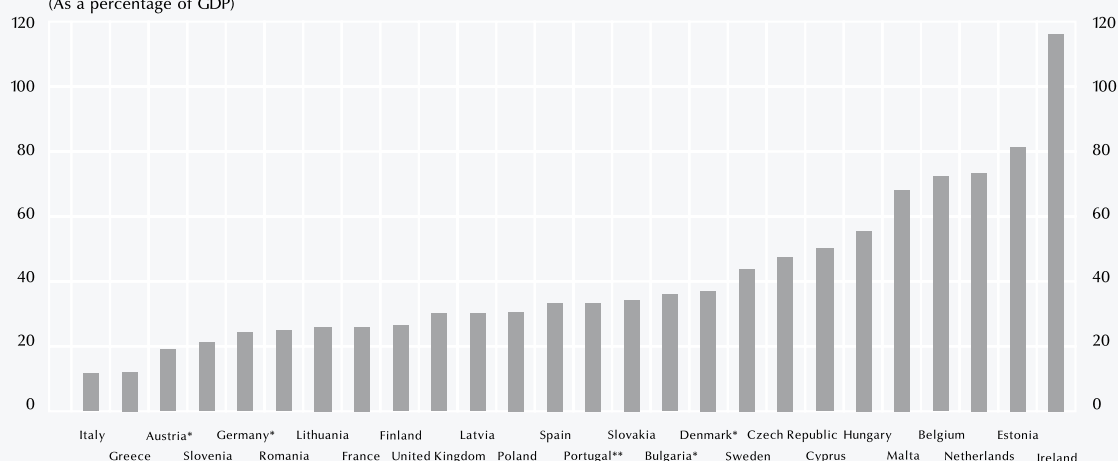


Note: For Bulgaria and Romania the data refer to the period 2000–2004.

Sources: World Bank (World Development Indicators) and Eurostat.

Chart B

Inward FDI stock in 2004 in the EU-25
(As a percentage of GDP)



* Data for 2003.

** Data for 2002.

Sources: Eurostat, Bank of Greece, National Bank of Belgium and Sveriges Riksbank.

→ of GDP. Greece runs last among the EU-25 and ranks even below the acceding countries.² The small amount of inflows that does exist represents mainly isolated mergers and acquisitions (M&As), while the inflows for greenfield investment are very limited. Although the European economic integration can, through macroeconomic stability, contribute towards attracting FDI, Greece — unlike other Member States — has not been able to take advantage of this factor. The

limited inward FDI is also shown in the “Inward FDI Performance Index” compiled by UNCTAD,³ which ranks Greece as 129th among 140 countries for the period 2002–2004. →

² Based on preliminary data for 2005, the FDI stock as a percentage of GDP amounts to 14%, which does not change Greece’s ranking.

³ United Nations Conference on Trade and Development.

Table A: Indicators of openness of the economy in the EU-25

Exports of goods and services as a percentage of GDP (2004)		Imports and exports of goods and services as a percentage of GDP (2004)	
Ireland	80.23	Estonia	164.52
Estonia	78.42	Malta	159.16
Slovakia	76.80	Slovakia	156.29
Malta	75.88	Ireland	144.91
Czech Republic	71.75	Czech Republic	143.84
Netherlands	65.45	Hungary	132.26
Hungary	64.28	Bulgaria	127.13
Slovenia	59.94	Netherlands	125.49
Bulgaria	58.43	Slovenia	120.48
Lithuania	54.34	Lithuania	115.60
Austria	50.99	Latvia	103.70
Sweden	46.28	Austria	97.14
Latvia	43.94	Sweden	84.53
Denmark	43.47	Romania	83.53
Poland	39.00	Denmark	81.83
Germany	37.99	Poland	79.96
Finland	37.14	Germany	71.05
Romania	37.07	Portugal	69.09
Portugal	30.72	Finland	68.66
Italy	26.64	Spain	55.02
France	25.97	United Kingdom	52.74
Spain	25.70	Italy	52.47
United Kingdom	24.70	France	51.70
Greece	20.91	Greece	50.38
Cyprus	...	Cyprus	...

Source: World Bank (World Development Indicators).

→ FDI can generally be divided into “horizontal” and “vertical”. Horizontal FDI is market oriented and aims at selling products locally in the host country, acting thus as a, at least partial, substitute for international trade. Vertical FDI is production oriented and driven by cost minimising objectives. It involves the outsourcing of a part of the production process to the host country and exporting it back to the home market. In this case vertical FDI acts as a complement to international trade. Inward FDI can also act as a platform for exports to third countries.⁴ Hence, it is clear that FDI is closely related with trade and it is not surprising in this respect that the structural problems associated with a low degree of inward FDI coincide in part with those responsible for the low level of trade (see Table A).⁵

Among the fundamental determinants of inward FDI are the host country’s geographical location, its pro-

duction costs and the size of the economy. The fact that Greece is relatively isolated, in geographical terms, from the EU and that it has a small domestic economy constitutes an important hindrance in attracting FDI. In addition, as we can see from Table B, Greece cannot attract FDI that aims at low-cost production or taking advantage of low taxes.⁶ Other structural determinants of FDI are the direct and indirect →

⁴ See Brainard (1997), Carr *et al.* (2001), Bloningen *et al.* (2003), Ekholm *et al.* (forthcoming), Baltagi *et al.* (forthcoming), Baldwin *et al.* (2003).

⁵ See ECB (2005) and (2006).

⁶ From Table B we can see that Greece has relatively high hourly labour costs, compared with the new and the prospective members of the EU, although they are lower compared with ‘older’ members. The problem is that, unlike its EU counterparts, the Greek economy still relies heavily on low value added goods that are produced cheaper in other low-cost countries.

→ costs of trade and investment in general, as well as the level of human capital and skills in the labour force.⁷ On a more general note: the structural determinants that seem to be the culprits of low inward FDI are highly connected with the ones responsible for the low competitiveness of the Greek economy as a whole.⁸ They include: (a) regulatory work that impedes competition and the flexibility of labour and product markets. (b) the high costs of doing business due to bureaucratic hindrances to starting firms and the relatively high taxation. (c) the inadequacy of infrastructure, particularly in the context of new technology and (d) the weakness/inability of the education system to link itself with the production process, creating hence an imbalance between labour demand and supply in abilities. More specifically the structural determinants include:

- *The institutional framework governing the labour and product markets:* Despite the progress made, there are still significant structural inefficiencies in the functioning of the labour and product markets. Greece's regulatory framework encourages the creation and perpetuation of non-competitive markets and does not provide the necessary control mechanisms to ensure that markets function well. This constitutes an important deterrent for inward FDI. International experience shows that the presence of severe restrictions to market functioning can significantly increase the cost to firms and acts thereby as a disincentive for investment. These institutional problems, in conjunction with a shortage of skilled labour, are also a deterrent when it comes to the development of new industries, especially in high technology. Moreover, the institutional rigidities of the labour market, the large size of the public sector and the operational framework for public enterprises (at least until the implementation of the new Law 3429/2005) curtails the flexibility needed for employment to increase adequately as an industry develops (See Table B).
- *The high cost of doing business in Greece:* This is to a large extent not due to corporate taxation and labour costs (See Table B, col. 1 and 2).⁹ It is rather due to the fact that, despite the recent progress, bureaucratic obstacles remain significant, making it

costlier to start a new business, for which Greece still lacks a "land use zone designation" scheme. The complex and often overlapping responsibilities of government departments involved, as well as the multitude of applicable laws and provisions, lead to a large increase of the required time for starting up and effectively operating a business in an internationally competitive manner. Bureaucratic obstacles and poor organisation, apart from resulting in direct and indirect costs to enterprises, also contribute in creating and maintaining markets characterised by lack of competition. As shown in Table B (columns 3 and 4), Greece has a low ranking on the ease of doing business and has a high score in terms of number of procedures required for starting a business. At the same time, bureaucracy reinforces distrust of the institutional framework that governs the business environment in Greece.

- *Linking the education system with the labour market:* The education system has not sufficiently responded to the requirements of a modern economy, a fact that leads to the limited supply of skilled labour, properly qualified to meet the needs of both enterprises and the society. As a result, young people aged 15-24 face unemployment rates (26% in 2005) that are the highest in the EU-15 and the third highest in the EU-25. Mismatches between the skills provided by the education and training systems and the needs of the labour market, apart from contributing to the persistence of a high unemployment rate with the resulting social cost, are also a major obstacle to attracting FDI, due to the relative lack of applied knowledge in the workforce.¹⁰ These problems imply the need for a qualitative improvement in the skills and knowledge of the workforce. →

⁷ Direct and indirect costs of trade or investment may include transportation costs, which are more relevant for trade, and the costs of administrative procedures.

⁸ See also the reports from the OECD (2005) and the IMF (2006) for Greece.

⁹ According to Table B, the marginal tax rate for companies in Greece was 35% for 2004. The rate however declined to 32% in 2005, 29% in 2006 and is expected to be reduced to 27% in 2007.

¹⁰ This situation reflects the limited cooperation between the education system and the labour market.

Table B: Direct and indirect costs associated with business start-ups in the EU-25

Highest marginal corporate tax rate (%), 2004	Hourly labour costs in industry and services (excluding public administration), 2004 (in euro)	Ease of doing business (overall world ranking, 2006)	Number of start-up procedures to register a business (2006)	Difficulty of hiring index (0-100), 2006
Cyprus 10	Denmark 30.7	United Kingdom 6	Denmark 3	United Kingdom 14
Ireland 12.5	Sweden 30.43	Denmark 7	Sweden 3	Denmark 17
Latvia 15	Belgium 29.96	Ireland 10	Finland 3	Belgium 20
Lithuania 15	France 28.2	Sweden 13	Belgium 4	Czech Republic 28
Hungary 16	Netherlands 27.44	Finland 14	Ireland 4	Ireland 33
Poland 19	Finland 26.83	Lithuania 16	Romania 5	Poland 33
Bulgaria 19.5	Germany* 26.22	Estonia 17	Latvia 5	Hungary 34
Germany 25	Austria 25.3	Belgium 20	Estonia 6	Austria 37
Portugal 25	United Kingdom 24.71	Germany 21	United Kingdom 6	Slovakia 39
Romania 25	Italy 21.39	Netherlands 22	Hungary 6	Netherlands 42
Slovakia 25	Spain 14.75	Latvia 24	Netherlands 6	Sweden 43
Slovenia 25	Greece* 13.37	Austria 30	France 7	Germany 44
Sweden 28	Cyprus 11.1	France 35	Lithuania 7	Bulgaria 47
Czech Republic 28	Slovenia* 10.54	Slovakia 36	Portugal 8	Lithuania 48
Finland 29	Portugal 9.56	Spain 39	Austria 9	Finland 48
Denmark 30	Malta* 7.77	Portugal 40	Germany 9	Portugal 51
United Kingdom 30	Czech Republic 5.85	Romania 49	Italy 9	Romania 51
Belgium 33	Hungary 5.54	Czech Republic 52	Slovakia 9	Italy 54
Italy 33	Poland 4.74	Bulgaria 54	Slovenia 9	France 56
France 33.3	Slovakia 4.41	Slovenia 61	Bulgaria 9	Slovenia 57
Austria 34	Estonia 4.24	Hungary 61	Spain 10	Estonia 58
Netherlands 34.5	Lithuania 3.22	Poland 75	Poland 10	Greece 58
Greece 35	Latvia* 2.37	Italy 82	Czech Republic 10	Latvia 59
Estonia 35	Romania 1.76	Greece 109	Greece 15	Spain 63
Spain 35	Bulgaria 1.45	Cyprus ...	Cyprus ...	Cyprus ...
Malta 35	Ireland ...	Malta ...	Malta ...	Malta ...

* Data up to 2003.

Sources: World Bank (World Development Indicators); World Bank and the International Finance Corporation, *Doing Business in 2007*.►• *Inadequate infrastructures in new technologies:*

Despite the progress made, infrastructures in new technologies (broadband networks – ADSL, telecommunications etc.) are still significantly lagging behind the other EU-25 countries. At the same time, the substantial gap in terms of both human and physical resources active in research and development (R&D) discourages the diffusion of new technologies and restricts the investment potential in high-technology industries. The data in Table C indicate Greece's technological gap compared with the other EU-25 countries.

As shown by the above points, and given the small size of the domestic market, Greece has a limited potential for horizontal inward FDI. Therefore, the aim should be to attract export-oriented FDI. Owing to the relatively high production costs, these investments should be focused on high- value added industries, which largely coincide with high- or at least medium-technology industries. Greece's geographical location, although disadvantageous compared with other EU Member States when it comes to the EU market, can become a comparative advantage if it acts as an entrance gate to the Balkans, the ►

Table C: Technology – indicators of use and expenditure in the EU-25

Broadband users (2004) ¹		Internet users (2004) ¹		Researchers employed in R&D (2004) ²		R&D expenditure as a percentage of GDP (2003)	
Netherlands	189.45	Sweden	756	Finland*	7,992	Sweden	3.98
Denmark	168.56	Malta	750	Sweden	5,416	Finland	3.49
Belgium	155.43	Denmark	696	Denmark	5,016	Denmark**	2.53
Sweden	152.58	Finland	629	Belgium	3,478	Germany	2.50
Finland	149.18	United Kingdom	628	Germany	3,261	Belgium	2.33
France	108.15	Netherlands	614	France*	3,213	Austria	2.22
Estonia	102.76	Italy	501	Austria**	2,968	France	2.19
United Kingdom	102.51	Germany	500	Ireland	2,674	United Kingdom	1.89
Austria	101.27	Estonia	497	Slovenia	2,543	Netherlands**	1.80
Germany	83.68	Austria	477	Estonia	2,523	Slovenia**	1.53
Portugal	81.74	Slovenia	476	Netherlands	2,482	Czech Republic	1.27
Italy	81.66	Czech Republic	470	Spain*	2,195	Italy**	1.16
Spain	80.88	Slovakia	423	Lithuania	2,136	Ireland**	1.11
Slovenia	59.10	France	414	Slovakia	1,984	Spain	1.11
Malta**	44.50	Belgium	403	Portugal*	1,949	Hungary	0.95
Lithuania	37.56	Cyprus	361	Czech Republic	1,594	Portugal**	0.93
Hungary	36.19	Latvia	350	Poland	1,581	Estonia	0.83
Ireland	33.95	Spain	336	Hungary	1,472	Lithuania	0.69
Poland	32.67	Bulgaria	283	Latvia	1,434	Greece***	0.65
Latvia	16.86	Lithuania	282	Greece	1,413	Slovakia	0.59
Czech Republic	16.46	Portugal	281	Bulgaria	1,263	Poland	0.56
Cyprus*	12.29	Hungary	267	Italy*	1,213	Bulgaria	0.50
Slovakia	11.63	Ireland	265	Romania	976	Romania	0.40
Bulgaria*	5.56	Poland	236	Malta	694	Latvia	0.38
Greece	4.65	Romania	208	Cyprus*	563	Cyprus***	0.27
Romania**	0.72	Greece	177	United Kingdom	. . .	Malta	0.27

1 Per 1,000 inhabitants.

2 Per million inhabitants.

* Data until 2003.

** Data until 2002.

*** Data until 2001.

Source: World Bank (World Development Indicators).

➔ Middle East and North Africa. It could also function as a gate of access to Europe by companies from large developing economies. To this end, measures are required in order to simplify administrative procedures, foster research and development on new technologies and improve the education system, *inter alia*, by linking it more closely to the labour market. Such measures should contribute to the qualitative improvement and development of the Greek economy and –for this reason– to the broader social acceptance of FDI. The data in Tables B and C indicate that, although the Greek economy has achieved high

growth rates and macroeconomic stability, there are still structural weaknesses that keep inward FDI subdued at very low levels. These weaknesses are reflected in the large current account deficits and the high servicing cost of external borrowing and ultimately have a negative impact on growth.

Useful studies on foreign direct investment

Baldwin, R., Forslid, R., Martin, P., Ottaviano, G., Robert-Nicoud, F. (2003), *Economic Geography and Public Policy*, Princeton University Press. ➔

- Baltagi, B. H., Egger, P., Pfaffermayr, M., "Estimating Models of Complex FDI: Are There Third-Country Effects?", *Journal of Econometrics*, forthcoming.
- Bloningen, B. A., Davies, R. B., Head, K. (2003), "Estimating the Knowledge-Capital Model of the Multinational Enterprise: Comment", *The American Economic Review*, 93, No. 3, 980-94.
- Brainard, L. S. (1997), "An Empirical Assessment of the Proximity-Concentration Trade-off Between Multinational Sales and Trade", *The American Economic Review*, 87, No. 4, 520-44.
- Carr, D. L., Markusen, J. R., Maskus, K. E. (2001), "Estimating the Knowledge-Capital Model of the Multinational Enterprise", *The American Economic Review*, 91, No. 3, 693-708.
- Ekholm, K., Forslid, R., Markusen J. R., "Export-Platform Foreign Direct Investment", *Journal of the European Economic Association*, forthcoming.
- ECB (2005), "Competitiveness and the export performance of the euro area", Occasional Paper Series No. 30.
- ECB (2006), "Competitiveness and the export performance of the euro area", *Monthly Bulletin*, July.
- IMF (2006), *Greece: Selected Issues*, Country Report No. 06/5.
- OECD (2005), *Economic Survey of Greece*.
- Yi, K.-M. (2003), "Can vertical specialization explain the growth of world trade?" *Journal of Political Economy*, Vol. 111(1), 52-102.

considerably in the first months of the year, with the exception of May, which can be partly attributed to the pick-up in global stock markets in the first four months of the year.) In "other" investment, the net inflow of €9,476 million reflects the fact that the inflow of €13,547 million for non-residents' investment in deposits and repos in Greece far exceeded the outflow of €4,071 million for residents' similar investment abroad.

Finally, Greece's reserve assets increased by €239 million in January-July 2006, to stand at €2.2 billion at end-July 2006.⁸⁵

⁸⁵ It should be recalled that following Greece's entry into the euro area in January 2001, reserve assets, as defined by the European Central Bank, comprise monetary gold, the reserve position in the IMF, special drawing rights and Bank of Greece's claims in foreign currency on non-euro area residents. Excluded are euro-denominated claims on non-euro area residents, claims (in foreign currency and in euro) on euro area residents, and the Bank of Greece's share in the capital and reserves of the ECB.

V. The current situation and the outlook for the Greek economy

1. The current situation of the economy

As mentioned in earlier chapters, the strong rise in domestic demand and the improvement in external demand are estimated to have maintained the growth of the Greek economy at a high level in 2006. At the same time though, the increase in domestic demand, which cannot be met by domestic production, has caused goods imports to increase and, in conjunction with the rise in the value of crude oil imports (due to the surge in crude oil prices in the world market up to August), accounts for the widening of the current account deficit to alarmingly high levels and for the persistence of inflation at roughly the same, rather high, level of 2005.

In addition, as shown by National Account figures for 2001 onwards — i.e. after Greece adopted the euro — GDP growth has reflected, by almost two-thirds, the rise in private consumption and, to a lesser extent, the rise in business investment (see Table V.1). Considering, however, that investment has grown faster than GDP, the investment-to-GDP ratio is now higher than it was prior to 2001. If the Greek economy's structural weaknesses are taken into account, the fact that economic growth has mainly been driven by the rise in consumption has negative implications in terms of inflation, competitiveness and the external debt, and therefore for the country's medium- and long-term growth prospects.

With regard to the situation of public finances, the general government deficit, after having been considerably reduced in 2005, is projected to fall even lower this year, to 2.6% of GDP, according to the Updated Stability and Growth Programme (USGP) 2005-2008. However, the public debt-to-GDP ratio, though forecast to recede slightly further, will remain particularly high.

Table V.1
Contribution of demand components to GDP growth (2001-2005)
(Contribution in percentage points, annual changes in percentages)

	2001		2002		2003		2004		2005		Average contribution	Average change ¹
	Contribution	Change	Contribution	Change	Contribution	Change	Contribution	Change	Contribution	Change		
GDP	5.1	5.1	3.8	3.8	4.8	4.8	4.7	4.7	3.7	3.7	4.4	4.4
Domestic demand	3.9	3.1	5.0	5.0	6.2	5.5	5.2	4.7	2.6	2.3	4.6	4.1
Change in stocks – statistical discrepancy	-0.5	...	0.4	...	-0.1	...	0.0	...	0.0	...	0.0	...
External sector (net exports)	1.7	...	-1.6	...	-1.3	...	-0.5	...	1.1	...	-0.2	...
Exports	-0.2	-1.0	-1.9	-7.7	0.2	1.0	2.5	11.5	0.7	3.0	0.2	1.3
Imports	1.9	-5.2	0.3	-0.8	-1.5	4.8	-3.0	9.3	0.4	-1.2	-0.4	1.4
Domestic demand	3.9	3.1	5.0	5.0	6.2	5.5	5.2	4.7	2.6	2.3	4.6	4.1
Consumption	2.3	2.7	3.6	4.3	2.7	3.2	3.7	4.4	3.0	3.6	3.1	3.6
Private	2.5	3.5	2.5	3.6	3.0	4.5	3.3	4.7	2.5	3.7	2.8	4.0
Public	-0.2	-1.0	1.1	7.5	-0.3	-2.1	0.4	2.8	0.5	3.1	0.3	2.1
Investment	1.6	6.5	1.4	5.7	3.4	13.7	1.5	5.7	-0.4	-1.4	1.5	6.0
Public	0.1	2.4	0.0	-1.1	0.6	16.4	0.3	7.7	-0.6	-13.6	0.1	2.3
Residential	0.2	4.8	0.4	8.8	0.4	7.3	0.0	-0.6	-0.1	-1.4	0.2	3.8
Business	1.2	8.2	1.0	6.5	2.4	15.1	1.2	7.0	0.3	1.5	1.2	7.7

¹ Arithmetic average.

Note: The detailed data on GDP revision for the period 2000 onwards were not available when this report was going to press and thus they have not been taken into account.

Sources: Ministry of Economy and Finance and NSSG.

As repeatedly stressed in previous Bank of Greece reports, sustaining strong growth requires fiscal consolidation, the achievement of price stability and the transformation of the Greek economy – mainly through structural reforms – into one that is export- and business investment-led.

1.1 Economic activity and demand

The growth rate of GDP (at constant prices) is expected to edge up to 3.8% in 2006, from 3.7% in 2005.¹ This high growth is estimated to have been driven mainly by the strong growth of domestic demand, but also by the quicker growth of goods exports. In contrast, services exports (at constant prices) are expected to pick up only slightly, as the increase in travel receipts apparently seems to have been offset by the small drop or no change of receipts from transport (mainly shipping) and “other” services. Furthermore, it is estimated that goods imports meet a substantial part of the increase in domestic demand (which mainly concerns goods not produced domestically, such as various consumer durables, but also capital goods). Thus, the deficit of the real external balance on goods and services (on a national accounts basis)² has widened considerably. Private consumption is estimated to be rising sharply, boosted by the increase in households’ real disposable income, the ongoing rapid expansion of consumer credit and the cumulative rise in the market prices of household assets over recent years, and the growth of employment. Total investment is projected to increase markedly in 2006, after decreasing slightly in 2005, due, for one, to the pick-up of business investment growth and, secondly, to the recovery of both residential investment, after the small declines of 2004 and 2005, and public investment, after the substantial cut-backs of 2005.

In general terms, demand components continue to evolve in line with the 2001-2005 trends (see

Table V.1). The high average annual growth rate of 4.4% during that period was mainly driven by buoyant domestic demand (increasing at an average annual rate of 4.1%), whereas the average annual growth of goods and services exports was markedly lower (1.3%).³ Specifically, while goods exports remained broadly unchanged from 2000 to 2005 (average annual growth rate of 0.1%) mainly on account of the Greek economy’s low structural competitiveness, services exports increased year-on-year by 1.9% on average, thanks mainly to the dynamic merchant marine sector.

1.2 Current account deficit

The current account deficit is projected to widen by some three percentage points to 11% of GDP in 2006 (after widening by 1.5 percentage points in 2005). The impact from the surge in oil prices through August, the substantial rise in the volume of goods and services imports (including ships) and the higher interest payments on debt held by non-residents were the main factors that offset the favourable impact from the pick-up in goods exports growth. The widening of the current account deficit, which stood at high levels (7.3% of GDP on average) over the period 2001-2005,

¹ The revised estimate of GDP growth for 2006 (3.8%) coincides with the initial forecast made in the 2006 Budget and the Updated Stability and Growth Programme 2005-2008 (December 2005), but is slightly higher than previous projections by the Bank of Greece (*Monetary Policy 2005-2006*, February 2006, and *Annual Report 2005*, April 2006) and various international organisations and analysts. This difference is due to the stronger than expected growth of domestic demand, which in turn however led to a wider than anticipated current account deficit.

² In other words, the negative balance between goods and services exports and goods and services imports, at constant prices.

³ Goods and services imports grew at an average annual rate of 1.4% over the same period. It should be recalled that: (a) GDP is calculated by adding up domestic demand (private and public consumption and investment) and goods and services exports, and then subtracting goods and services imports. Therefore, an increase in imports negatively impacts GDP. In absolute terms, goods and services imports at constant prices have exceeded exports by a substantial 35-50% for the past six years.

led to a sizeable increase in Greece's negative international investment position,⁴ from €59 billion (47.5% of GDP) at end-2000 to €148 billion (82% of GDP) in 2005. This development principally reflects the increase in the public debt held by non-residents and, to a lesser extent, the rise in deposits in Greece by non-residents (mainly credit institutions from other euro area countries in the context of the TARGET system), the increase in non-residents' holdings of Greek shares and, last, the growth of the stock of foreign direct investment. As a result of the increase in the net liabilities of residents vis-à-vis non-residents, net interest payments on the public and private external debt reached the equivalent of 2.4% of GDP in 2005 and are expected to come close to 3% in 2006.

1.3 Inflation, international competitiveness and the purchasing power of income

Average annual inflation based on the HICP is expected to come to 3.3% in 2006, i.e. almost as high as in 2005, as the waning impact from the increase in indirect taxes in April 2005 is offset mainly by the impact of the international oil price surge through August and by the considerably faster – relative to 2005 – rise in unit labour costs.⁵ Core inflation, as measured on the basis of the HICP excluding energy and unprocessed food, is expected to recede to 2.8% from 3.2% last year, exclusively as a result of the waning impact of last year's indirect tax increase mentioned above.⁶

During the period 2001-2005, average annual inflation in Greece was 1.3 percentage points higher than in the euro area and remained relatively high. Over the same period, the differential between the average annual growth rates of unit labour costs in Greece and the euro area as a whole was even wider (two percentage points – see Table IV.3 in Chapter IV). True, the *level* of

prices in Greece is lower than the euro area average, with which, however, it is gradually converging. Insofar as this price convergence process also involves *non-internationally tradable* goods and services, the inflation differential does not necessarily imply an equivalent deterioration in international competitiveness.⁷ Nevertheless, the decline in price competitiveness is also confirmed by the fact that the real effective exchange rate (REER) relative to the 27 countries which are Greece's major trading partners, based on consumer prices (i.e. the relative consumer prices expressed in a common currency), has risen by nearly 14% in total from 2000 to 2006, while the REER on the basis of labour costs (i.e. the relative unit labour costs in manufacturing expressed in a common currency) rose in total by 34%. In the same six-year period, the nominal euro exchange rate (weighted on the basis of Greece's external trade) rose cumulatively by almost 9% (appreciation of the euro).⁸

Therefore, the fact that price stability has not yet been achieved and that inflation in Greece remains higher than in the euro area adversely impacts Greece's international competitiveness and ultimately hurts its economic growth and employment prospects. It goes without saying that this also entails a higher cost of living for con-

⁴ A country's international investment position is the net balance between external financial assets and the respective liabilities of residents vis-à-vis non-residents. For instance, Greek residents' direct investment abroad, bonds issued abroad and held by residents, as well as the deposits abroad of Greek credit institutions are residents' assets vis-à-vis non-residents. Non-residents' direct investment in Greece, their holdings of Greek government bonds and their deposits in Greece are liabilities of residents vis-à-vis non-residents (see Bank of Greece, *Annual Report 2000*, April 2001, Box VIII.1, pp 194-196).

⁵ Average annual inflation based on the CPI is expected to edge down to 3.3% in 2006 from 3.5% in 2005.

⁶ Core inflation (as measured by the annual CPI change excluding fuel and fresh fruit and vegetables) will fall to 2.6%, from 3.1% in 2005.

⁷ See also Chapter IV.1.1, footnote 2, p. 88.

⁸ See Table IV.13 and Chart IV.23 in Chapter IV.

Table V.2

General government deficit and debt (2001-2005)

(Percentage of GDP)

	2001	2002	2003	2004	2005	Weighted five-year average
General government deficit/surplus ¹	-4.9	-4.9	-5.8	-6.9	-4.5	-5.4
Primary deficit/surplus	2.2	1.1	-0.3	-1.5	0.5	0.3
Cyclically adjusted deficit/surplus	-4.3	-5.0	-5.7	-7.3	-4.9	-5.5
Cyclically adjusted primary deficit/surplus	2.8	1.1	-0.3	-1.9	0.1	0.2
Public debt	114.1	110.7	107.8	108.5	107.5	109.5

1 The deficit is defined in compliance with the Council Regulation on the Excessive Deficit Procedure.

Note: The Draft Budget for 2007 submitted to Parliament on 2 October 2006 includes revised deficit data for 2004 and 2005, which were not available when this report was going to press.

Sources: National Statistical Service of Greece (notification of data to Eurostat on 31 March 2006) and Bank of Greece estimates.

sumers in Greece, as it erodes their purchasing power. This holds, in particular, for the economically weaker and those whose nominal income is practically fixed.

1.4 Fiscal developments

Data on an administrative basis for the first eight months of 2006 indicate the existence of certain pressures that are likely to lead to an overshooting of the annual budget projections for ordinary budget primary expenditure. These pressures must be held in check if the annual deficit objective is to be attained without having to cut back on public investment. Specifically, according to the USGP projections for 2006, (a) the general government deficit will be further reduced –by 1.9 percentage points from last year– to 2.6% of GDP (compared with an average deficit of 5.4% during the period 2001-2005 – see Table V.2) and (b) the general government debt will fall to 104.3% of GDP (from 107.5% in 2005 and 109.5% on average during the period 2001-2005 – see Tables V.2 and V.3). (It should be pointed out that according to *revised* data contained in the Draft Budget for 2007, submitted to Parliament on 2 October 2006, the deficit had finally amounted to 7.4% of GDP in 2004 and to 5.1% in 2005. Also, according to the Draft Budget, the

general government debt is estimated to fall this year to 104.8% of GDP. These estimates were not available in detail when the present report was going to press.)

In spite of the sizeable fiscal deficit reduction (for the second year running) anticipated in the USGP for 2006, fiscal imbalances remain exceptionally large, considering that (a) the achieved fiscal adjustment has been partly supported by temporary measures, (b) the public debt-to-GDP ratio is projected to fall only slightly to 104.8% by the end of 2006 (according to the Draft Budget for 2007) and (c) the consequences of population ageing, if not addressed in time by policy measures, will lead in the long run to a very large increase in public expenditure and a worsening of Greece's fiscal position. It should be noted that the structural fiscal adjustment achieved so far, albeit non-negligible, remains insufficient. The cyclically adjusted general government *deficit* averaged 5.5% of GDP during the period 2001-2005 (4.9% in 2005 – see Table V.2) and –if the USGP projections for the “nominal” deficit prove to be correct– will fall to 3.0% this year. In addition, the cyclically adjusted general government *primary surplus* averaged a mere 0.2% of GDP during the period 2001-2005 (0.1% in 2005) and –if the USGP projections for the “nominal” primary sur-

plus are confirmed— will increase this year to 1.7% of GDP.

2. Challenges for economic policy

2.1 Monetary policy and the achievement of price stability

Since Greece adopted the euro in 2001, the Bank of Greece no longer conducts monetary policy at the national level, given that the single monetary policy is conducted by the European Central Bank (ECB). The credibility of the single monetary policy has contributed to an important decrease in inflation, inflation expectations and interest rates in Greece, thereby radically improving the macro-economic environment. Indeed, inflation was particularly high in the 25-year period 1972-1996 (average annual CPI increase of 16.3%), before receding considerably in the run-up to euro area membership (average annual HICP increase of 3.7% from 1997 to 2000). Since then (2001-2006), inflation has stood at 3.5% on average. Nonetheless, price stability, defined as a rate of inflation of below but close to 2%, has not been attained and inflation in Greece remains well above the euro area average.

Regarding monetary policy, the ECB Governing Council has already raised its key interest rates five times since December 2005 and continues to monitor economic and monetary developments closely so as to avert any upside risks to price stability over the medium to longer term. With the key ECB interest rates at still low levels (both in nominal and in real terms), money and credit growth dynamic, and liquidity ample in the euro area, the ECB's monetary policy continues to be accommodative. However, if the ECB's assumptions and baseline scenario continue to be confirmed, it will remain warranted to further with-

draw monetary accommodation. Indeed, acting in a timely manner to contain inflationary pressures is essential to ensuring that inflation expectations are kept solidly anchored at levels consistent with price stability. Such an anchoring of inflation expectations is a prerequisite for the single monetary policy to make an ongoing contribution towards supporting sustainable economic growth and job creation in the euro area. It is well known that the single monetary policy is geared towards achieving price stability in the euro area as a *whole*. Yet, the recent increases in the ECB key interest rates are also consistent with the goal of disinflation in Greece, where —as mentioned above— monetary conditions are more relaxed than in the euro area as a whole. In this sense, the increases in the ECB interest rates which started in December 2005 can be expected to contribute to the reduction of inflation in Greece in the future. However, given the size of the inflation differential vis-à-vis the euro area as a whole, achieving price stability in Greece will require the contribution of other policies, namely fiscal policy, wage and unit labour cost growth at levels compatible with price stability, and structural reforms which improve productivity, increase labour and product market flexibility and strengthen competition. In a more flexible economy, monetary policy will gain in effectiveness, as a result of its increased ability to offset possible shocks and ensure price stability more quickly and with smaller fluctuations in output and employment.

2.2 Structural weaknesses of the Greek economy and the current account deficit

The current account deficit reflects the major weaknesses of the Greek economy. The widening of the deficit and its persistence at high levels in recent years are attributable to a loss in price competitiveness and to the weak structural competitiveness of the Greek economy, the latter of

which is also mirrored in the composition of external trade in goods. Despite the relatively brisk rise in Greek exports to emerging markets since 2000 and the considerable increase in the share of medium- and high-technology products in total exports, the Greek economy has not yet sufficiently developed the production of skilled labour- and high-technology-intensive goods (see Chapter IV.5.1.1). The high level of the current account deficit is also attributable to Greece's growth rate being higher than that of the European Union or of the euro area as a whole for a number of years. If the current account deficit is seen as the difference between total investment and total savings, it becomes clear that it remains large also due to the relatively high level of investment, primarily business investment, and – at the same time – to the shortfall in savings owing to the fiscal deficits and to household consumption behaviour. Membership in the monetary union has of course enabled Greece to finance its large current account deficits easily and on much more favourable terms than would have been possible prior to the adoption of the euro.⁹ Nonetheless, the persistence of high current account deficits would undermine the long-term growth prospects of the Greek economy. *Insofar* as they are due to high levels of private consumption and residential investment, current account deficits lead to an increase of the external debt without concurrently strengthening the productive and export potential and, consequently, without improving the economy's ability to service the debt. On the other hand, *insofar* as the deficits reflect an increase in public and business investment, they can be expected to help strengthen potential output in the medium term.

Consumption-led growth, as opposed to investment-led growth which enhances the productive capacity, holds long-term risks for the Greek economy. Household indebtedness (to Monetary

Financial Institutions) remains considerably below the euro area average (38.3% of GDP in Greece in August 2006 – or 41.2% of GDP, including securitised loans – compared with 53.4% in the euro area), but has climbed sharply in recent years (from 13.7% of GDP in 2000). Against this background and as households reach their desired level of borrowing, credit expansion to households will inevitably slow down in the medium term, which would actually be a welcome development. A sharper slowdown may occur if interest rates continue to rise or if real estate market conditions change. The strong increase in the prices of dwellings in urban areas – by some 30% in real terms over the five years to 2005, following a similar increase during the previous five-year period – may have led to an overvaluation of dwellings: therefore, a halt in the rise of dwelling prices cannot be ruled out.¹⁰

As already mentioned, sustainable strong growth will require a transformation of the Greek economy, so that its future growth is export- and business investment-led. This, in turn, will hinge upon continuous fiscal adjustment and wage increases consistent with price stability, if macroeconomic stability is to be attained, as well as upon structural reforms across a wider range of sectors so as *inter alia* to attract foreign direct investment (see Box IV.1), encourage the creation of large export-oriented enterprises capable of coping with international competition and, more generally, enhance the economy's productivity and flexibility. The need for progress in this direction is all the more pressing in view of (i) globalisation, which, while

⁹ Under the drachma regime, the large deficits would have fuelled devaluation expectations and worsened the terms of foreign borrowing.

¹⁰ In any case, prices of dwellings in urban areas have not fallen during the past 12 years, for which data are available. The demand for dwellings will also depend on when the market becomes saturated, for instance, if the stock of dwellings were to increase to such an extent that the yields of these assets would decrease.

Table V.3

Decomposition of changes in the general government debt-to-GDP ratio¹ (1990-2005)

(Percentage points of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997 ²	1998 ²	1999 ²	2000 ³	2001	2002 ⁴	2003 ⁴	2004 ⁴	2005 ^{4,5}
General government debt ratio	79.6	82.2	87.8	110.1	107.9	108.7	111.3	114.0	112.4	112.3	113.3	114.1	110.7	107.8	108.5	107.5
Changes in the debt ratio	10.6	2.6	5.6	22.3	-2.2	0.8	2.6	2.7	-1.6	-0.1	1.0	0.8	-3.4	-2.9	0.7	-1.0
– Effect of primary balance	6.5	3.0	2.1	2.2	-2.7	-2.6	-4.6	-4.0	-5.0	-4.9	...	-2.2	-1.1	0.3	1.5	-0.5
– Effect of GDP changes and interest rate changes	-4.0	-7.8	-1.7	-0.4	-1.1	0.3	1.5	-0.8	-0.3	1.2	...	-0.6	-2.4	-3.3	-3.0	-2.7
– Stock-flow adjustment ²	8.1	7.4	5.2	20.5	1.6	3.1	5.7	7.5	3.7	3.6	...	3.6	0.1	0.1	2.2	2.2

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

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

where D_t = general government debt

PB_t = primary balance

Y_t = GDP at current prices

g_t = nominal GDP growth rate

i_t = average nominal interest rate on government debt

SF_t = stock-flow adjustment

2 Data on debt and the primary surplus are Eurostat estimates.

3 Because GDP data at current prices since 2000 were revised in March 2006, the 2000 GDP is not comparable with that of 1999 at current prices. **The most recent revision of GDP and deficit data (see notes in Tables V.1 and V.2) has not been taken into account.**

4 According to data submitted to Eurostat in March 2006 in the context of the Excessive Deficit Procedure.

5 Provisional data.

6 The 'stock-flow adjustment' includes expenditure or assumption of liabilities which do not affect the deficit but increase debt, as well as revenue (e.g. privatisation proceeds) which does not affect the deficit but reduces debt.

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

opening up new opportunities, entails an intensification of international competition, and (ii) population ageing, the implications of which, if not addressed in a timely manner, will put considerable pressure on public finances and adversely affect the productive capacity of the economy.

2.3 Fiscal adjustment and consolidation

As mentioned previously, the updated Stability and Growth Programme 2005-2008 projects that Greece's fiscal deficit will drop to 2.6% of GDP in 2006, in line with the government's commitment to end the excessive deficit situation and in accordance with the ECOFIN Council decision of 17 February 2005. The Programme also anticipates a further decrease in the fiscal deficit to 1.7% of GDP by 2008. It is positive that these targets have been set; these targets are also compatible with what the Bank of Greece has said on the matter. However, it should be stressed that, as mentioned previously, the deficit reduction for 2006 is partly due to one-off measures that do not imply a permanent improvement in the budgetary position and that the structural fiscal adjustment achieved, albeit not negligible, remains insufficient. Also, a permanent further improvement in Greece's fiscal position as well as sizeable primary surpluses will remain warranted after the abrogation of the Excessive Deficit Procedure in order to reduce public debt (see Table V.3¹¹) to below 60% of GDP by 2015, when the additional expenditure for pensions and healthcare associated with population ageing will start to put a greater strain on public finances.

The magnitude of the ageing problem and the urgent need for timely policy responses are best illustrated by recently published calculations¹² about how certain fiscal aggregates might evolve *in the absence of timely structural interventions to counter the effects of population ageing*. Specifically,

according to projections *based on a no-action assumption*, total age-related public expenditure would increase from 18.9% of GDP in 2005 to 32.4% in 2050¹³; the general government debt ratio would climb to 450%, the general government deficit ratio to 35%, and government interest payments would represent 22.5% of GDP. Such a scenario, if it were to come true, would seriously undermine Greece's sovereign creditworthiness. It is, however, probable that structural interventions will be made in time to deal with such eventualities. As pointed out by the authors of the study, "the scenario is not a prediction [...], but a simulation that highlights the importance of age-related spending trends as a factor in the evolution of sovereign creditworthiness".

In order to improve the efficiency of the public sector and generate sizeable primary surpluses, extensive measures will need to be taken on both the revenue and the expenditure side of general government finances. The intense tax competition within the European Union and the low competitiveness of the Greek economy leave little room for increasing revenue by imposing new taxes or raising the rates of existing ones. Besides, measures to lower corporate tax rates are already being implemented, while gradual cuts in personal income tax rates as of 2007 have been announced. However, revenue can be increased by continuing the effort to curb tax evasion. It

¹¹ This table shows that 2004 and 2005 saw an increase in the "deficit-debt adjustment", i.e. in expenditures or incurrence of liabilities that are not recorded in the deficit, but inflate the debt.

¹² Standard & Poor's, *Global Graying Country Report: Hellenic Republic (Greece)*, 12 June 2006 (a country-specific analysis in the context of a broader report entitled *Global Graying: Aging Societies and Sovereign Ratings*, 27 June 2006).

¹³ The Standard & Poor report drew on relevant European Commission and OECD projections (see Bank of Greece, *Annual Report 2005*, April 2006, pp. 72-73) with two basic differences: the expenditure on education was *not included*, whereas the expenditure for the long-term care of the elderly was. The three other expenditure components covered by the projections were: pensions, healthcare and unemployment benefits.

should be recalled that, according to the most recent relevant study available for Greece,¹⁴ tax evasion (“taxes not paid”) is estimated to have amounted to nearly 15% of GDP in 1997 or 64% of that year’s ordinary budget tax revenues, and today is estimated to be much larger. A substantial curbing of tax evasion and the collection of even just a part of the evaded tax would suffice to create sizeable primary surpluses and substantially reduce public debt. Measures such as the electronic crosschecking of tax data (already implemented by the Ministry of Finance), the introduction of VAT on real estate transactions (which is expected to contribute to the reduction of the extensive tax evasion in the construction sector) and the lowering of income tax rates (which will also help create the necessary preconditions for curbing tax evasion) must be combined with the maintenance of a stable tax environment, with a view to fostering “taxpayer ethics”.

Achieving sizeable primary surpluses and improving public sector services will crucially depend on the ability to effectively contain the general government’s primary expenditures. As pointed out in previous Bank of Greece reports,¹⁵ priority should be given to containing certain categories of expenditure, which are either very high or growing at a much faster pace than total expenditure. These categories include: (a) Central government personnel outlays, which could be lowered by the reducing the ratio of new hirings to retirements, in combination with a better utilisation of existing human resources through personnel reassignments. It should be noted that during the 15 years to 2005 the number of tenured and non-tenured personnel in central government rose by a cumulative 19.7%.¹⁶ (b) Subsidies to cover the deficits of public entities and, to a lesser extent, public enterprises. This item is projected to decrease with the implementation of Law 3429/2005 on public enterprises. (c) Government guarantees on

public enterprise borrowing. (d) Restitution of revenue collected on behalf of third parties (mainly local authorities): reassessing and redefining the financial relations between local authorities and central government could contribute to the effective control of this item. With regard to the institutional framework for the control of expenditures, the General Directorate of Fiscal Audits, set up in a recently enacted law, will have extensive expenditure control powers at all levels of general government and in public enterprises and is thus expected to contribute to the efficient management of financial resources.

2.4 Structural reforms

In spite of the important progress achieved in the past 15 years in addressing structural weaknesses, the markets for labour, goods and services are still hampered by structural rigidities that reduce the production potential and international competitiveness of the Greek economy, as confirmed by the international comparisons of structural competitiveness. Improving the economy’s structural competitiveness will require a further substantial reduction in labour and product market rigidities, an improvement in the business environment, the tax system and public sector efficiency, as well as a reduction of the administrative burden (red tape). It will also require a further upgrading of human capital, especially considering the adverse impact that the huge supply of unskilled labour in South Eastern Asia is beginning to have on certain industries or enter-

¹⁴ N. Tatsos, “*Underground Economy and Tax Evasion in Greece*,” Foundation for Economic and Industrial Research (IOBE) and Papazisis Publishers, Athens, 2001 (in Greek). (See Bank of Greece, *Annual Report 2005*, April 2006, p. 75).

¹⁵ See Bank of Greece, *Annual Report 2005*, April 2006, pp. 75-77.

¹⁶ From 303,683 on 31 October 1990 to 363,529 on 30 June 2005, including Security Forces staff. Hospital staff (97,525 individuals on 30 June 2005) has been excluded for comparability purposes. The relevant data were drawn from the introductory reports on the budgets for 1991 and 2006.

prises in the Greek economy and, consequently, on the employment conditions of the domestic unskilled workforce.

In order to address the structural weaknesses of the economy, the measures that have been taken or announced since April 2006 mainly concern public administration and the functioning of the wider public sector, fiscal management, the framework for supporting private investment, the institutional framework for the operation of private enterprises, technological modernisation and the energy policy.

More specifically, a public consultation was launched in April on the Operational Programme “Strengthening administrative capacity”. A law was passed on 3 October on the “Setting up an Auditing System with a view to ensuring the sound fiscal management of the state budget and the agencies outside the state budget”, which, *inter alia*, provides for the establishment (as previously mentioned) of a General Directorate of Fiscal Audits within the Ministry of Economy and Finance. This General Directorate will be staffed by highly-qualified and experienced Fiscal Auditors and will be entrusted with the task of auditing public expenditure. In September, the government also announced that a National Committee against Tax Evasion, which will include representatives from the social partners, would be set up by the end of the following month. In addition, a system to enhance the transparency of public works and procurements tendering is in the process of being designed and will contribute to the fight against corruption.

In the area of privatisations, the latest major developments were the acquisition of the Commercial Bank of Greece by Crédit Agricole, and the sale to private investors of 34.8% of the capital of the Postal Savings Bank and 7.2% of the capital of the

Agricultural Bank. These moves are expected to enhance both competition within the banking sector and the banking system’s efficiency. In September, the government decided to begin its search, amongst internationally recognised telecommunications organisations, for a strategic partner for the Hellenic Telecommunications Organisation (OTE), who would also acquire participation in the company’s management. The listing of the Public Gas Corporation (DEPA) on the Athens Exchange has also been decided. Last, the implementation of the new institutional framework for public enterprises and organisations (DEKO) (Law 3429/2005) is progressing, while the provisions of Law 3389/2005 on public-private partnerships (PPP) are beginning to be implemented.¹⁷

In early August the government set up an Committee of Experts on social security, whose task will be to update earlier studies and data on the social security system, conduct new studies where necessary, evaluate all the parameters of the system and submit a report (within roughly one year), thereby providing an input to the ongoing debate with the political parties and the social partners.

Turning to the environment of operation of private enterprises, a draft bill amending the basic law governing the establishment and operation of Sociétés Anonymes (SA) was put up for public consultation in July. The main purpose of this amendment will be to reduce the regulatory burden on the setting-up and operation of SAs and to protect the interests of minority shareholders. Meanwhile, a preliminary draft for a law reform-

¹⁷ Proposals for PPP projects with a total budget of €772 million had already been approved by early September. These contracts mainly involved school infrastructure, university buildings, court-houses and fire stations.

ing bankruptcy provisions has already been prepared and will soon be submitted to public consultation. The objective, in this case, is to rationalise existing legislation, and ultimately to give insolvent enterprises a second chance. In late August, the European Commission approved the new Regional Aid Map, drafted by the Ministry of Economy and Finance two months earlier, which defines the framework for support to private investment over the new EU programming period 2007-2013. The Ministry of the Environment, Physical Planning and Public Works has recently completed the studies for a National Land Use Plan and five Special Land Use Plans (for renewable energy sources, tourism, industry, mountain areas and coastal areas) designed to support economic development and protect the environment. Public consultation with all of the concerned parties will begin soon.

In terms of technological modernisation, the implementation of a “Plan for the Development of Broadband Connectivity by 2008” was announced, in the broader context of the new National Digital Strategy.

Finally, with regard to energy policy, of particular importance was the signing on 4 September 2006 of a Joint Declaration by Russia, Bulgaria and Greece, which, among other things, aims at speeding up the implementation of the Burgas-Alexandroupolis oil pipeline project.

All of the above are steps in the right direction; however, there still remains a number of serious structural problems and weaknesses which must be addressed. Pointed out in previous reports by the Bank of Greece as well as by the European Commission, the OECD and the IMF, these problems are, of course, also recorded in last year’s National Reform Programme for Growth and Jobs 2005-2008, which determines guidelines for

action. Some of the more pressing challenges involve strengthening the forces of competition, achieving a more effective functioning of the product and labour markets and of the public sector, reforming the pension system, upgrading the education system and promoting Research and Development (R&D), cutting down on bureaucracy and modernising public administration, and dealing with corruption.

Concerning corruption, it should be pointed out that the governance indicators constructed by the World Bank include one that specifically measures the “control of corruption”, which can receive a rating of –2.5 (indicating poor governance in terms of corruption control) to +2.5 (denoting good governance in this respect). According to the World Bank’s latest study for 2005, Greece obtained a control of corruption rating of +0.40. This score places Greece ahead of three countries within the EU-25 (Latvia, Lithuania and Poland), close to three others (Italy, Slovakia and the Czech Republic) but behind the remaining eighteen. In relation to the entire sample of 213 countries covered by the study, Greece ranks in the third quartile of the distribution (starting from the bottom), meaning that it outperforms 50% of the countries surveyed but lags behind the top 25%.¹⁸ It should be noted that, in order to deal effectively with corruption, it is essential to eliminate the conditions that favour it; *inter alia*, this implies an increase in transparency (for instance, in citizens’ and businesses’ transactions with the public administration and, more specifically, in public procurement procedures, the enforcement of tax and town planning legislation, supervision of markets by the respective authorities, etc.), the

¹⁸ See World Bank: (a) *A Decade of Measuring the Quality of Governance*, 15 September 2006, and (b) D. Kaufmann *et al.*, *Governance Matters V: Aggregate and Individual Governance Indicators for 1996-2005*, September 2006, Table C6 of Appendix C.

promotion of rule-based rather than discretionary decision-making, and the strengthening of control mechanisms and supervision. Obviously, reforms in other sectors – for example, improving the efficiency of public administration and healthcare and social security systems, ensuring a simpler and fairer tax system, streamlining the regulatory framework governing business activity and ensuring a level playing field – can also help eliminate conditions that foster corruption.¹⁹

3. Banking system stability

The banking services market presents particular interest. The Greek banking system has followed a positive course for several years, especially after the completion of its liberalisation in the mid-1990s and Greece's entry into the euro area in 2001. These factors, coupled with progress in IT, the curtailment of operating costs, the development of new risk management methods and the internationalisation of operations, have been and are still contributing to financial deepening, banking system modernisation and a smoother absorption of possible external shocks. Furthermore, structural change in the Greek banking system during the last 15 years has also been driven by mergers and acquisitions, flotations and privatisations of state banks, as well as Greek banks' further cross-border expansion, notably to Southeastern European countries. Given the small size of the domestic market and stronger competition, Greek banks seek to take advantage of growth opportunities in the foreign markets concerned, diversify their income and portfolio and increase their size, which is still relatively small in comparison with EU banks' average size.

Ensuring the stability of the banking sector is one of the main objects of the Bank of Greece as the

competent supervisory authority, given banks' key position in the Greek financial system, the stability of which plays a very important role in the smooth functioning of the economy. The conclusion of the analysis in Chapter III.4 is that Greek banks' exposure to credit and market risk, despite increasing slightly this year, is still relatively low, and their profitability and capital adequacy – which are determinants of their shock-absorbing capacity – continue to provide a satisfactory buffer for ensuring the stability of the Greek banking system. However, there is a need to monitor and control continuously the risks assumed by banks, as well as the possible impact of these risks on their balance sheet aggregates and capital adequacy ratios over the medium and the long term. Furthermore, in order to, *inter alia*, minimise the risks from Greek banks' cross-border expansion, mainly to Southeastern European countries, domestic credit institutions must keep their capital adequacy ratios high, increase loan-loss provisioning, further consolidate their portfolios and, in particular, reduce their non-performing loans (NPLs) to total loans ratio, which remains relatively higher than in the euro area.

An important issue (which is of public concern and is discussed in Chapter III, notably Sections 2.2 and 4) is the fact that the positive spread between the average weighted interest rate of total new bank loans and the corresponding interest rate on new bank deposits in Greece (4.58 percentage points in July and 4.65 percentage points in August this year, according to Bank of Greece calculations) is higher than in the euro

¹⁹ On the policy directions needed to address corruption, see also (a) Ministry of Economy and Finance, *National Reform Programme for Growth and Jobs 2005-2008*, 15 October 2005, pp 8-9, 21 and 34, (b) OECD, *Economic Surveys-Greece*, September 2005, pp 15, 17, 29, 36, 89, and (c) IMF, *Greece: 2005 Article IV Consultation – Staff Report*, Jan. 2006, pp 8 and 14.

area (2.70 percentage points in July). However, from December 1998 (before Greece's euro area entry) to August 2006 there was some progress, as this spread narrowed by 344 basis points in Greece (103 basis points from December 2000). Moreover, during the same period, Greek interest rates converged with euro area interest rates; as a result, the positive spread has gradually shrank.

The fact that the spread between bank lending and deposit rates in Greece remains larger than in the euro area is connected with such factors as Greek banks' higher operating costs, weaker competition in Greece than in the euro area, lower maturity of certain lending markets in Greece (in comparison with the corresponding markets in the euro area), higher cost of interbank market borrowing for Greek banks (mainly owing to their size) and higher NPLs to total loans ratio than in the euro area (as a result of which the risk premium included in lending rates is higher).

The narrowing of the spread between bank lending and deposit rates is a long procedure and will be continued as both the NPLs to total loans ratio and operating costs as a percentage of assets decrease, markets mature, competition strengthens, Greek banks grow and the financial markets become more integrated – especially the retail banking market, which lags behind in terms of integration. Characteristically, for certain categories of consumer loans, the interest rate differential between Greece and the euro area remains wide, reflecting either banks' high administrative costs (e.g. for loans through credit cards) or the relatively lower backing by collaterals (e.g. for consumer loans with an interest rate fixation of over one and up to five years). By contrast, for housing loans the interest rate differential between Greece and the euro area tends to be eliminated. Furthermore, interest rates on corpo-

rate loans (notably loans of over one million euro) have largely converged.

4. Macroeconomic performance, poverty and inequality, and the outlook for the convergence of living standards

The overall satisfactory macroeconomic performance in the 13 years since 1994 (a period marked by an uninterrupted increase in GDP) has contributed to a rise in living standards. Indeed, throughout this long period, annual GDP growth at constant prices averaged 3.6%, population growth 0.5% and employment growth 1.1%, raising the average annual increase in *per capita* GDP to 3.1% and that of productivity (GDP per employed person) to 2.5%. During the same period, real average gross (pre-tax) earnings are estimated to have increased at an average annual rate of 2.5%, i.e. by as much as GDP per employed person, and the real take-home pay of an average employee²⁰ at an average annual rate of approximately 2%. The improvement in living standards is therefore clear, whichever indicator is used. Over the 13 years under review, real *per capita* GDP has risen by a cumulative 50%, real average gross earnings as well as GDP per employed person by 38% and the real take-home of an average employee by 27%. At the same time, there has been considerable progress in terms of real convergence.

Nonetheless, the standard of living in Greece – based on *per capita* GDP in purchasing power standards – remains below the EU-15 average. True, it is expected that this shortfall will be substantially reduced on the basis of the revised

²⁰ Take-home pay figures are obtained by subtracting employees' social security contributions and income tax from gross earnings.

national accounts for the years from 2000. However, the main poverty and inequality indicators exceed the respective EU-15 average figures, indicating that the benefits of economic growth are not sufficiently diffused. As shown by the main indicators²¹ drawn from Eurostat and NSSG surveys, income inequality decreased only slightly between 1994 and 2003 (the last available year). Furthermore, during the period 1994-2004, the at-risk-of-poverty rate ("poverty risk") in Greece remained broadly unchanged, ranging between 20% and 23% (21% in 2004, the latest available year).²² This means that some 2 million people live below the poverty line, according to the Eurostat definition, i.e. that their disposable income is less than 60% of the median disposable income for the entire population. Another important finding is that 32% of the poor are employed, 8% are unemployed seeking work, 27% are retired, while the remaining 33% are economically inactive (neither employed, nor pensioners, nor unemployed seeking work), three quarters of whom are women.²³

As implied by these figures, poverty and social inequality are partly due to labour market rigidities and segmentation, as well as to shortcomings in the education and training systems, which either lead to higher unemployment or discourage labour force participation, by obstructing the access of youth and women to the labour market as well as the creation of new jobs that could absorb displaced workers. These problems also reflect the weaknesses in the social security system, as well as budgetary constraints, i.e. factors which explain why a large share of the poor in Greece are small pensioners and elderly persons. Meanwhile, insofar as social benefits to the family are inadequate and the inequalities in the education system persist, individual occupational and financial prospects may be largely predetermined and the risk of falling below the poverty line or

finding oneself at the lower end of the income distribution may be increased.

The foregoing analysis also has a number of policy implications. Reducing poverty among pensioners will require pressing ahead with fiscal consolidation, for one, so that more resources from the state budget can be allocated to economic support schemes, and reforming the pension system, so that the social security funds can improve the distribution of the pensions they provide. Reducing poverty among the unemployed will require structural reforms in the labour market geared towards ensuring that employment growth is more in line with output growth, increasing labour mobility and achieving a more rapid absorption – through job creation in new dynamic sectors and firms – of unemployment induced by the restructuring of production (mainly on account of globalisation).²⁴ Finally, reducing the number of poor persons who are economically inactive requires reforms (in the labour market, the education and training systems and in social policy) that favour the increase in participation rates, especially among women and youth.

* * *

In conclusion, efforts towards fiscal consolidation and the achievement of price stability must con-

²¹ The indicators used were the Gini coefficient and the S80/S20 ratio. See the relevant NSSG press releases (January 2006) and Bank of Greece, *Monetary Policy 2005-2006*, February 2006, Box IV.2, p. 106.

²² The "poverty risk" was 23% in 1994 and 22% in 1995, and then ranged between 20% and 21% during the period 1996-2004. The figure for 2004 (21%) falls to 17% when income or consumption estimates take into account owner-occupied houses, producer-consumed goods and goods and services provided to households by third parties for free. The data for 2004 were drawn from the Household Budget Survey (HBS) conducted from February 2004 to January 2005 (NSSG, Press Releases dated 21 November 2005 and 20 March 2006).

²³ See *Monetary Policy 2005-2006*, February 2006, Box IV.2, pp 104-106.

²⁴ See Bank of Greece, *Annual Report 2005*, April 2006, Chapter II.9.3.1, pp 79-81.

tinue in a decisive manner, so as to ensure macroeconomic stability. The structural reforms aimed at increasing productivity and competitiveness must be stepped up, so that the robust growth rates recorded in recent years can be sustained and Greece's living standards can effectively converge on the EU-15 average. In addition, it should

be taken into account that euro area participation contributes to macroeconomic stability, but is not sufficient for achieving it without the backing of national economic policies. At the same time, macroeconomic stability and flexibility are essential if Greece is to reap the full benefits of euro area participation.

Monetary policy measures of the Eurosystem

12 January and 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 and 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%, 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%, both with effect from 11 October 2006.

Glossary

Community Support Framework (CSF): compiled by the Commission of the European Communities in co-operation with the Member State and approved by the Commission. It includes the country's growth strategy, activity priorities and financing resources (participation of the Community, national public expenditure, participation of the private sector).

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 12 countries: 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 Member States.

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.

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 which together form the money-issuing sector of the *euro area*. These include the *ECB*, *euro area* national central banks, as well as resident credit institutions and money market mutual funds.

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*.

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Table 1
Consumer price index: general index and basic sub-indices

Period	General index		Goods		Services		CPI excluding fresh fruit/vegetables and fuel		CPI excluding food and fuel	
	(2005=100)	Percentage change over previous year	(2005=100)	Percentage change over previous year	(2005=100)	Percentage change over previous year	(2005=100)	Percentage change over previous year	(2005=100)	Percentage change over previous year
2002	90.7	3.6	91.7	3.2	89.1	4.3	91.0	3.6	91.1	3.6
2003	93.9	3.5	94.5	3.1	92.9	4.2	94.0	3.2	93.9	3.1
2004	96.6	2.9	96.7	2.3	96.4	3.8	97.0	3.3	96.9	3.2
2005	100.0	3.5	100.0	3.4	100.0	3.7	100.0	3.1	100.0	3.2
2005 I	98.5	3.3	98.3	3.1	98.7	3.6	98.6	3.3	98.5	3.5
II	100.4	3.3	100.8	3.0	99.8	3.8	100.2	3.0	100.3	3.1
III	99.6	3.9	99.1	4.0	100.3	3.6	99.7	3.0	99.6	3.1
IV	101.6	3.7	101.8	3.6	101.2	3.7	101.5	3.0	101.6	3.0
2006 I	101.7	3.3	101.5	3.3	101.8	3.2	101.1	2.5	100.8	2.3
II	103.6	3.2	104.4	3.6	102.5	2.7	102.8	2.5	102.6	2.3
2004 Jan.	94.7	2.9	94.4	2.3	95.1	3.9	95.1	3.2	95.0	3.2
Feb.	94.4	2.5	93.9	1.5	95.1	4.0	94.5	3.1	94.0	3.1
March	96.7	2.7	97.6	1.8	95.4	4.2	96.7	3.4	96.6	3.3
Apr.	97.0	2.9	97.7	2.3	96.0	3.9	97.0	3.2	97.0	3.2
May	97.4	2.9	98.4	2.4	96.0	3.8	97.3	3.3	97.2	3.2
June	97.1	2.8	97.7	2.1	96.4	3.9	97.6	3.5	97.5	3.3
July	95.4	2.9	94.6	2.2	96.5	4.0	96.4	3.8	96.1	3.8
Aug.	95.1	2.7	94.1	1.9	96.6	4.0	96.0	3.2	95.6	3.1
Sept.	97.0	2.8	96.9	2.2	97.2	3.7	98.1	3.3	98.1	3.2
Oct.	97.8	3.2	98.2	3.1	97.2	3.5	98.3	3.0	98.4	3.0
Nov.	97.9	3.1	98.2	2.8	97.4	3.6	98.4	3.1	98.5	2.9
Dec.	98.3	3.1	98.2	2.8	98.3	3.5	98.9	2.9	99.0	2.8
2005 Jan.	98.5	4.0	98.4	4.3	98.6	3.7	99.1	4.2	99.2	4.5
Feb.	97.3	3.1	96.5	2.8	98.5	3.6	97.3	3.0	97.0	3.2
March	99.5	2.9	100.0	2.4	98.8	3.6	99.3	2.7	99.4	2.9
Apr.	100.3	3.4	100.7	3.1	99.6	3.8	100.0	3.0	100.0	3.1
May	100.6	3.2	101.1	2.7	99.9	4.0	100.3	3.2	100.4	3.3
June	100.4	3.3	100.7	3.1	99.9	3.7	100.4	3.0	100.5	3.0
July	99.1	3.9	98.5	4.1	100.1	3.7	99.6	3.3	99.5	3.5
Aug.	98.7	3.7	97.7	3.8	100.2	3.6	98.7	2.9	98.4	3.0
Sept.	100.9	3.9	101.0	4.2	100.7	3.6	100.9	2.8	100.9	2.9
Oct.	101.5	3.8	102.0	3.8	100.9	3.9	101.2	3.0	101.4	3.1
Nov.	101.3	3.5	101.5	3.4	101.0	3.7	101.4	3.0	101.5	3.0
Dec.	101.8	3.6	101.9	3.7	101.7	3.5	101.8	2.9	101.9	2.9
2006 Jan.	101.7	3.2	101.6	3.3	101.8	3.2	101.3	2.3	101.3	2.0
Feb.	100.5	3.2	99.7	3.3	101.7	3.2	99.7	2.5	99.2	2.3
March	102.8	3.3	103.3	3.3	102.1	3.3	102.2	2.9	102.0	2.6
Apr.	103.6	3.3	104.3	3.6	102.5	2.9	102.5	2.6	102.3	2.3
May	103.7	3.1	104.7	3.6	102.4	2.6	102.8	2.4	102.6	2.1
June	103.6	3.2	104.3	3.6	102.7	2.7	103.1	2.6	102.8	2.3
July	103.0	3.8	103.1	4.6	102.8	2.7	102.2	2.6	101.8	2.3
Aug.	102.2	3.5	101.5	3.9	103.1	2.9	101.4	2.7	100.8	2.4

Source: Calculations based on NSSG data.

Table 2

Harmonised index of consumer prices: general index and basic sub-indices

Period	HICP (general index)		Unprocessed food		Processed food		Non-energy industrial goods	
	(2005=100)	Percentage change over previous year	(2005=100)	Percentage change over previous year	(2005=100)	Percentage change over previous year	(2005=100)	Percentage change over previous year
2002	90.7	3.9	98.3	6.9	89.5	5.5	93.5	2.5
2003	93.8	3.4	104.6	6.4	92.8	3.6	95.0	1.6
2004	96.6	3.0	101.5	-2.9	97.2	4.8	97.3	2.3
2005	100.0	3.5	100.0	-1.5	100.0	2.8	100.0	2.8
2005 I	98.4	3.4	103.4	-4.0	98.2	2.5	98.3	4.2
II	100.5	3.2	102.3	-2.7	99.6	2.3	101.2	2.5
III	99.5	3.8	95.1	0.1	100.8	3.0	98.3	2.5
IV	101.6	3.6	99.1	1.0	101.4	3.5	102.3	2.1
2006 I	101.5	3.2	103.3	-0.1	102.6	4.5	99.0	0.8
II	103.9	3.4	102.7	-0.6	104.5	1.9	103.1	4.1
2004 Jan.	94.7	3.1	104.8	4.1	94.9	4.5	93.9	1.9
Feb.	94.1	2.6	109.1	4.5	95.7	4.7	90.9	1.3
March	96.7	2.9	109.3	2.4	96.7	5.4	98.0	1.9
Apr.	97.1	3.1	106.6	-2.1	96.9	5.4	98.2	2.0
May	97.5	3.1	106.7	-5.8	97.6	6.1	98.9	2.0
June	97.3	3.0	102.4	-7.3	97.7	6.2	99.1	2.3
July	95.4	3.1	94.2	-9.5	97.8	6.1	94.9	3.6
Aug.	95.1	2.8	95.3	-6.1	97.9	5.2	93.2	2.0
Sept.	97.2	2.9	95.4	-5.9	97.9	3.5	99.4	3.3
Oct.	97.9	3.3	96.4	-4.0	97.9	3.5	100.2	2.9
Nov.	98.0	3.2	96.8	-4.4	98.0	3.7	100.2	2.6
Dec.	98.5	3.1	101.4	-1.0	98.0	3.7	100.2	2.4
2005 Jan.	98.7	4.2	101.6	-3.0	98.1	3.4	100.3	6.9
Feb.	97.0	3.1	104.1	-4.6	98.1	2.5	94.0	3.5
March	99.5	2.8	104.5	-4.4	98.3	1.7	100.4	2.4
Apr.	100.3	3.3	103.8	-2.6	98.9	2.1	100.8	2.6
May	100.7	3.2	104.0	-2.5	99.7	2.1	101.4	2.5
June	100.4	3.2	99.2	-3.1	100.2	2.5	101.4	2.3
July	99.1	3.9	93.1	-1.2	100.6	2.9	98.2	3.5
Aug.	98.6	3.6	95.5	0.2	100.7	2.9	95.1	2.1
Sept.	100.9	3.8	96.6	1.3	101.0	3.2	101.4	2.0
Oct.	101.5	3.7	98.7	2.4	101.1	3.2	102.3	2.0
Nov.	101.3	3.4	98.8	2.1	101.4	3.5	102.3	2.1
Dec.	101.9	3.5	99.9	-1.5	101.8	3.8	102.4	2.1
2006 Jan.	101.7	3.0	101.2	-0.4	102.1	4.1	100.4	0.1
Feb.	100.1	3.1	104.5	0.3	102.4	4.4	94.7	0.7
March	102.8	3.3	104.2	-0.2	103.2	4.9	102.1	1.6
Apr.	103.8	3.5	105.4	1.5	103.4	4.5	102.6	1.8
May	104.0	3.3	103.3	-0.7	104.5	4.9	103.3	1.9
June	103.9	3.4	99.5	0.3	105.6	5.4	103.4	1.9
July	103.0	3.9	98.0	5.2	105.7	5.0	99.8	1.6
Aug.	102.0	3.4	98.4	3.0	105.7	5.0	96.2	1.1

Source: Calculations based on NSSG data.

Table 2 (continued)

Harmonised index of consumer prices: general index and basic sub-indices

Period	Energy		Services		HICP excluding unprocessed food and energy	
	(2005=100)	Percentage change over previous year	(2005=100)	Percentage change over previous year	(2005=100)	Percentage change over previous year
2002	79.8	-0.3	89.3	4.5	90.9	3.9
2003	82.8	3.7	93.0	4.1	93.7	3.1
2004	88.0	6.4	96.5	3.8	96.9	3.4
2005	100.0	13.6	100.0	3.6	100.0	3.2
2005 I	92.3	11.2	98.7	3.6	98.4	3.6
II	100.0	13.5	99.9	3.8	100.3	3.1
III	103.6	16.5	100.3	3.5	99.6	3.1
IV	104.2	13.1	101.2	3.6	101.6	3.0
2006 I	106.0	14.8	101.8	3.2	100.9	2.5
II	112.9	6.5	102.8	1.0	103.2	2.3
2004 Jan.	82.3	-1.4	95.4	3.9	94.8	3.3
Feb.	81.9	-5.5	95.1	3.9	93.6	3.1
March	84.8	-2.9	95.4	4.1	96.6	3.5
Apr.	86.9	7.0	96.2	3.8	97.1	3.4
May	89.5	12.4	96.0	3.7	97.3	3.5
June	88.0	9.8	96.5	4.0	97.7	3.7
July	88.4	8.4	96.6	4.0	96.2	4.2
Aug.	89.2	7.8	96.8	4.0	95.7	3.5
Sept.	89.0	7.5	97.3	3.8	98.1	3.6
Oct.	94.1	13.3	97.2	3.5	98.4	3.3
Nov.	93.7	12.7	97.3	3.6	98.5	3.2
Dec.	88.4	8.9	98.6	3.6	99.1	3.1
2005 Jan.	88.8	7.9	98.7	3.5	99.2	4.7
Feb.	91.8	12.1	98.5	3.6	96.8	3.4
March	96.2	13.4	98.8	3.6	99.3	2.8
Apr.	99.7	14.7	99.8	3.7	100.0	3.0
May	99.2	10.8	100.0	4.1	100.4	3.2
June	101.0	14.9	99.9	3.6	100.5	2.9
July	101.7	15.0	100.1	3.6	99.5	3.4
Aug.	103.3	15.8	100.2	3.5	98.4	2.9
Sept.	105.7	18.8	100.6	3.4	100.9	2.8
Oct.	106.9	13.6	100.8	3.7	101.4	3.0
Nov.	102.5	9.3	100.9	3.7	101.5	3.1
Dec.	103.1	16.6	101.8	3.3	102.0	3.0
2006 Jan.	105.4	18.6	101.9	3.2	101.4	2.2
Feb.	105.1	14.4	101.5	3.1	99.2	2.5
March	107.5	11.8	102.0	3.3	102.2	3.0
Apr.	112.0	12.3	103.0	3.3	103.0	3.0
May	113.4	14.3	102.6	2.6	103.2	2.7
June	113.2	12.0	102.9	3.0	103.5	3.0
July	116.7	14.8	103.1	3.0	102.3	2.8
Aug.	116.0	12.3	103.2	3.0	101.1	2.7

Source: Calculations based on NSSG data.

Table 3

Industrial producer price index (PPI) for the domestic market: general index and basic sub-indices

Period	PPI – domestic market (General index)		Energy (total)		Fuels		General index excl. energy	
	(2000=100)	Percentage change over previous year	(2000=100)	Percentage change over previous year	(2000=100)	Percentage change over previous year	(2000=100)	Percentage change over previous year
2002	106.0	2.3	99.2	2.1	93.3	-0.4	107.6	2.3
2003	108.5	2.3	101.0	1.8	91.6	-1.8	110.2	2.5
2004	112.3	3.5	105.0	4.0	95.6	4.3	115.4	4.7
2005	118.9	5.9	118.9	13.2	119.5	25.1	118.9	3.0
2005 I	114.8	4.6	110.1	9.9	103.0	19.0	116.9	2.6
II	117.8	4.9	116.8	11.6	116.1	21.9	118.2	2.3
III	120.5	6.3	124.0	15.8	129.6	29.8	118.9	2.6
IV	122.6	7.7	124.7	15.3	129.4	28.7	121.7	4.7
2006 I	125.5	9.2	127.0	15.4	133.9	30.0	124.8	6.8
II	127.9	8.6	130.8	12.0	141.1	21.6	126.7	7.2
2004 Jan.	109.3	1.2	99.9	-3.0	86.2	-14.4	113.3	4.0
Feb.	109.5	0.7	99.2	-5.6	84.5	-20.6	114.0	4.3
March ..	110.6	1.8	101.4	-2.1	89.1	-12.4	114.6	4.5
Apr.	111.9	3.9	103.4	4.3	92.9	6.4	115.5	5.2
May	112.9	5.1	106.4	8.7	99.0	18.5	115.7	5.3
June ...	112.2	4.2	104.1	5.1	93.9	8.3	115.6	5.4
July	112.8	4.3	105.9	5.3	97.5	6.5	115.7	5.3
Aug. ...	113.4	4.5	107.5	6.9	100.7	10.0	116.0	5.1
Sept. ...	113.7	4.4	107.9	7.3	101.5	16.3	116.2	4.8
Oct.	114.9	5.2	111.8	10.3	109.5	22.3	116.3	4.7
Nov. ...	114.0	4.1	108.2	7.1	99.7	12.5	116.5	4.4
Dec. ...	112.6	3.0	104.5	4.6	92.2	9.0	116.0	3.9
2005 Jan.	113.6	3.9	107.0	7.1	96.9	12.5	116.4	2.7
Feb.	114.5	4.6	109.1	10.0	101.2	19.8	116.9	2.5
March ..	116.4	5.3	114.2	12.6	110.9	24.6	117.4	2.5
Apr.	117.6	5.1	116.6	12.8	115.9	24.9	118.1	2.2
May	117.1	3.7	114.7	7.8	112.0	13.2	118.1	2.1
June ...	118.6	5.7	118.9	14.3	120.3	28.0	118.5	2.4
July	119.2	5.6	120.6	13.9	123.8	26.9	118.5	2.4
Aug. ...	120.2	6.0	123.5	14.9	129.2	28.3	118.8	2.5
Sept. ...	122.0	7.3	127.9	18.6	136.0	34.0	119.5	2.8
Oct.	123.0	7.0	128.0	14.5	136.1	24.3	120.9	4.0
Nov. ...	122.0	7.0	122.9	13.6	125.7	26.1	121.6	4.3
Dec. ...	122.8	9.1	123.2	17.9	126.3	36.9	122.6	5.7
2006 Jan.	124.9	9.9	126.0	17.8	132.0	36.2	124.4	6.9
Feb.	125.4	9.5	126.8	16.2	133.6	32.0	124.9	6.8
March ..	126.1	8.3	128.2	12.3	136.1	22.7	125.2	6.6
Apr.	127.8	8.6	131.1	12.4	142.0	22.5	126.3	7.0
May	128.0	9.3	130.8	14.0	141.0	25.9	126.8	7.3
June ...	128.0	8.0	130.5	9.7	140.4	16.7	127.0	7.2
July	129.1	8.3	133.4	10.6	146.3	18.2	127.2	7.3
Aug. ...	129.5	7.7	133.6	8.2	143.2	10.9	127.7	7.4

Source: Calculations based on NSSG data.

Table 4

Industrial producer price index (PPI) for the external market and wholesale price index (imported products)

Period	PPI – external market				Import price index		Import price index excl. energy	
	General index		General index excl. energy					
	(2000=100)	Percentage change over previous year	(2000=100)	Percentage change over previous year	(2000=100)	Percentage change over previous year	(2000=100)	Percentage change over previous year
2002	101.8	1.1	105.1	1.6	103.4	0.3	103.8	0.4
2003	101.5	-0.3	104.4	-0.6	104.1	0.7	104.4	0.6
2004	106.6	5.0	106.3	1.8	107.4	3.1	105.2	0.8
2005	110.6	3.7	106.6	0.3	116.9	8.8	106.5	1.2
2005 I	107.2	2.7	105.9	0.0	112.8	8.2	106.0	1.4
II	109.4	2.3	106.3	-0.6	115.2	8.4	106.3	1.1
III	112.6	4.5	106.9	0.4	119.3	9.8	106.7	1.1
IV	113.1	5.4	107.4	1.3	120.1	8.9	107.2	1.4
2006 I	114.7	7.0	108.7	2.7	121.4	7.7	107.9	1.8
II	115.9	5.9	109.3	2.9	123.1	6.8	109.2	2.7
2004 Jan.	104.2	2.4	105.6	2.3	104.1	0.0	104.3	-0.1
Feb.	103.9	1.3	105.8	2.5	103.7	-0.7	104.5	0.0
March ..	105.2	3.0	106.3	2.6	104.8	0.4	104.7	0.3
Apr.	106.6	6.8	107.0	3.4	105.6	1.5	105.1	0.8
May	107.8	8.9	107.0	3.7	106.9	2.9	105.3	1.1
June ...	106.6	6.7	106.7	3.2	106.4	2.5	105.2	1.0
July	107.3	6.0	106.6	2.3	107.7	3.6	105.3	1.0
Aug. ...	107.8	5.7	106.4	2.0	108.5	4.2	105.4	1.0
Sept. ...	108.1	6.4	106.5	1.2	109.7	5.3	105.6	1.0
Oct.	108.8	5.8	106.3	0.0	111.1	6.6	105.8	1.3
Nov. ...	107.4	4.1	106.1	-0.5	110.3	5.8	105.8	1.2
Dec. ...	105.7	3.1	105.7	-0.8	109.4	5.1	105.6	1.1
2005 Jan.	106.2	2.0	105.7	0.1	111.0	6.6	105.8	1.4
Feb.	106.9	2.9	106.0	0.2	113.1	9.0	106.1	1.5
March ..	108.5	3.1	105.9	-0.3	114.3	9.1	106.1	1.4
Apr.	109.1	2.4	106.0	-0.9	114.4	8.4	106.2	1.1
May	109.1	1.2	106.3	-0.6	113.9	6.5	106.3	0.9
June ...	110.1	3.3	106.5	-0.2	117.4	10.3	106.5	1.2
July	111.5	3.9	106.8	0.2	118.8	10.3	106.5	1.1
Aug. ...	112.5	4.4	106.9	0.5	120.1	10.7	106.6	1.1
Sept. ...	113.8	5.2	107.1	0.6	119.0	8.5	106.9	1.2
Oct.	113.6	4.4	107.1	0.8	119.9	7.9	107.0	1.1
Nov. ...	113.1	5.3	107.5	1.3	120.3	9.1	107.2	1.4
Dec. ...	112.6	6.5	107.7	1.9	120.1	9.8	107.2	1.6
2006 Jan.	114.2	7.5	108.3	2.5	120.8	8.8	107.6	1.7
Feb.	114.6	7.2	108.8	2.7	121.4	7.4	108.0	1.8
March ..	115.4	6.4	109.1	3.0	122.1	6.8	108.2	2.0
Apr.	116.0	6.3	109.3	3.1	122.9	7.4	108.8	2.4
May	115.8	6.2	109.3	2.8	123.1	8.1	109.2	2.7
June ...	115.8	5.2	109.3	2.7	123.3	5.0	109.7	3.0
July	116.3	4.3	109.3	2.4	123.3	3.8	109.8	3.0
Aug. ...	117.3	4.2	110.1	3.0	...	...	...	...

Source: Calculations based on NSSG data.

Table 5

Gross value added at basic prices and gross domestic product at market prices

	Annual percentage changes (at constant prices of year 1995)			
	2002	2003	2004	2005
Primary sector (agriculture)	-1.8	-3.5	0.7	-2.1
Secondary sector	2.2	6.3	0.0	1.2
Mining and quarrying, manufacturing, energy	3.1	3.6	-1.4	4.7
Constructions	0.7	10.9	2.1	-4.2
Tertiary sector	4.9	4.5	5.1	3.8
Trade, hotels–restaurants, transport–communications	4.2	5.8	6.2	0.7
Financial intermediaries, real estate management and other activities	2.2	3.5	2.3	5.4
Other services	8.6	3.6	6.2	6.8
Gross value added at basic prices	3.8	4.3	3.7	2.9
Private consumption	3.6	4.5	4.7	3.7
Public consumption	7.5	-2.1	2.8	3.1
Gross fixed capital formation	5.7	13.7	5.7	-1.4
Housing	8.8	7.3	-0.6	-1.4
Other constructions	0.7	13.2	6.0	-6.1
Equipment	6.9	18.3	8.0	0.5
Other	21.0	3.4	7.0	14.5
Change in stocks and statistical discrepancy (as a percentage of GDP)	0.5	0.4	0.4	0.3
Domestic final demand	5.0	5.5	4.7	2.3
Exports of goods and services	-7.7	1.0	11.5	3.0
Exports of goods	-7.1	4.2	-2.5	8.2
Exports of services	-8.1	-1.3	21.8	-0.1
Final demand	2.7	4.8	5.8	2.4
Imports of goods and services	-0.8	4.8	9.3	-1.2
Imports of goods	3.7	7.7	9.0	-0.1
Imports of services	-18.7	-10.0	11.0	-7.6
GDP at market prices	3.8	4.8	4.7	3.7

Source: NSSG/National Accounts, March 2006. Revised data for 2002-2005.

Table 6
Employed persons of 15 years and over, by branch of economic activity
(Thousands)

	Q2 2006	
	Total employed persons	Salaried employees
Total	4,452.8	2,834.1
Agriculture, animal breeding, hunting and forestry	523.0	33.7
Fishing	13.1	2.7
Mining and quarrying	18.2	17.0
Manufacturing	563.2	409.1
Electricity, gas, steam and water supply	40.9	40.9
Constructions	358.5	239.7
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	789.3	412.5
Hotels and restaurants	300.9	169.9
Transport, storage and communication	281.7	203.5
Financial intermediation	115.8	103.2
Real estate, renting and business activities	284.1	152.3
Public administration and defence, compulsory social security	380.9	380.6
Education	331.1	300.7
Health and social work	227.8	191.7
Other community, social and personal service activities	150.4	108.7
Private households with employed persons	73.4	67.2
Extra-territorial organisations and bodies	0.6	0.6

Source: NSSG, Labour Force Survey.

Table 7
Balance of payments
(Million euro)

	January–July			July		
	2004	2005	2006	2004	2005	2006
I CURRENT ACCOUNT BALANCE (I.A+I.B+I.C+I.D)	-6,692.5	-8,368.5	-14,664.2	-254.3	-435.9	-387.3
I.A TRADE BALANCE (I.A.1-I.A.2)	-14,391.9	-15,434.7	-20,210.6	-2,223.1	-2,330.1	-2,482.8
Oil trade balance	-2,396.0	-3,250.6	-4,882.8	-336.5	-529.7	-547.5
Non-oil trade balance	-11,995.9	-12,184.1	-15,327.8	-1,886.6	-1,800.4	-1,935.3
Ship balance	330.6	-327.9	-1,838.1	103.0	14.2	-114.7
Trade balance excl. oil and ships	-12,326.5	-11,856.2	-13,489.7	-1,989.6	-1,814.6	-1,820.6
I.A.1 Exports of goods	7,154.5	7,832.2	9,434.6	1,097.2	1,252.4	1,398.6
Fuel	802.6	1,078.1	1,880.0	128.1	248.4	276.9
Ships (receipts)	622.1	964.4	987.0	121.1	138.2	144.1
Other goods	5,729.8	5,789.7	6,567.6	848.0	865.8	977.6
I.A.2 Imports of goods	21,546.4	23,266.9	29,645.2	3,320.3	3,582.5	3,881.4
Fuel	3,198.6	4,328.7	6,762.8	464.6	778.1	824.4
Ships (payments)	86.0	965.3	2,825.1	18.1	124.0	258.8
Other goods	18,261.8	17,972.9	20,057.3	2,837.6	2,680.4	2,798.2
I.B SERVICES BALANCE (I.B.1-I.B.2)	7,789.2	8,354.6	8,012.1	2,128.8	2,366.0	2,706.9
I.B.1 Receipts	14,175.1	15,063.1	15,395.4	3,129.6	3,425.4	3,787.8
Travel	4,815.0	5,290.5	5,722.6	1,710.0	1,997.0	2,330.4
Transport	7,659.6	8,247.9	8,193.2	1,146.4	1,173.0	1,200.1
Other services	1,700.4	1,524.6	1,479.6	273.2	255.4	257.2
I.B.2 Payments	6,385.8	6,708.5	7,383.3	1,000.9	1,059.3	1,080.9
Travel	1,210.5	1,407.7	1,320.8	180.0	250.0	210.8
Transport	3,297.3	3,485.4	3,987.9	501.5	510.8	549.1
Other services	1,878.1	1,815.4	2,074.5	319.4	298.5	321.0
I.C INCOME BALANCE (I.C.1-I.C.2)	-2,632.4	-3,327.4	-4,294.2	-542.7	-793.4	-756.7
I.C.1 Receipts	1,581.5	1,854.6	1,942.4	229.2	255.7	335.0
Wages, salaries	168.7	160.6	181.3	26.7	25.2	25.7
Interest, dividends, profits	1,412.8	1,694.0	1,761.1	202.5	230.5	309.3
I.C.2 Payments	4,213.9	5,182.0	6,236.7	771.9	1,049.1	1,091.7
Wages, salaries	104.1	121.3	160.6	16.1	20.9	21.5
Interest, dividends, profits	4,109.8	5,060.7	6,076.0	755.9	1,028.2	1,070.2
I.D CURRENT TRANSFERS BALANCE (I.D.1-I.D.2)	2,542.6	2,039.1	1,828.4	382.7	321.5	145.3
I.D.1 Receipts	4,075.4	4,422.5	3,868.8	567.7	546.7	388.8
General government (mainly transfers from the EU)	2,665.8	3,174.4	2,482.0	335.0	311.3	171.1
Other sectors (emigrants' remittances etc.)	1,409.5	1,248.2	1,386.8	232.7	235.5	217.7
I.D.2 Payments	1,532.8	2,383.4	2,040.4	184.9	225.2	243.5
General government (mainly payments to the EU)	1,249.9	1,920.4	1,569.9	148.5	145.4	171.2
Other sectors	282.9	463.0	470.5	36.5	79.8	72.3
II CAPITAL TRANSFERS BALANCE (II.1-II.2)	1,338.7	1,025.4	2,002.9	267.1	-21.9	494.6
II.1 Receipts	1,486.1	1,190.2	2,159.3	334.5	38.1	520.2
General government (mainly transfers from the EU)	1,400.1	1,084.7	2,050.2	321.7	21.6	503.1
Other sectors	86.0	105.5	109.1	12.8	16.5	17.1
II.2 Payments	147.5	164.7	156.4	67.4	60.0	25.7
General government (mainly payments to the EU)	61.9	11.6	18.2	51.5	1.8	6.4
Other sectors	85.6	153.2	138.2	15.9	58.2	19.3
III CURRENT ACCOUNT AND CAPITAL TRANSFERS BALANCE (I+II)	-5,353.8	-7,343.0	-12,661.3	12.8	-457.8	107.3
IV FINANCIAL ACCOUNT BALANCE (IV.A+IV.B+IV.C+IV.D)	5,498.4	7,371.4	12,747.9	20.3	265.3	-499.0
IV.A DIRECT INVESTMENT¹	589.4	15.0	969.5	111.0	-129.7	-40.4
By residents abroad	-510.4	-791.3	-494.5	-117.8	-228.9	-152.9
By non-residents in Greece	1,099.7	806.3	1,463.9	228.8	99.2	112.6
IV.B PORTFOLIO INVESTMENT¹	6,845.7	8,149.4	2,541.7	1,274.8	3,210.4	427.8
Assets	-6,820.8	-10,854.1	-6,197.2	-559.9	176.6	-1,024.6
Liabilities	13,666.5	19,003.5	8,738.9	1,834.8	3,033.8	1,452.4
IV.C OTHER INVESTMENT¹	-3,067.6	-891.0	9,475.7	-1,229.6	-2,735.4	-910.4
Assets	-7,561.2	-13,583.5	-4,070.8	-897.6	-2,515.4	-4,370.0
Liabilities	4,493.6	12,692.6	13,546.5	-332.0	-220.0	3,459.6
(General government loans)	-372.14	688.3	-148.2	-58.54	306.7	218.4
IV.D CHANGE IN RESERVE ASSETS²	1,131.0	98.0	-239.0	-136.0	-80.0	24.0
V ERRORS AND OMISSIONS	-144.6	-28.4	-86.5	-33.1	192.5	391.6
RESERVE ASSETS³				3,474.0	1,896.0	2,184.0

1 (+) net inflow, (-) net outflow.

2 (+) decrease, (-) increase.

3 Following Greece's entry into the euro area in January 2001, reserve assets, as defined by the European Central Bank, comprise monetary gold, the "reserve position" in the IMF, "Special Drawing Rights", and Bank of Greece's claims in foreign currency on non-euro area residents. Excluded are euro-denominated claims on non-euro area residents, claims (in foreign currency and in euro) on euro area residents, and the Bank of Greece share in the capital and reserves of the ECB.

Source: Bank of Greece.

Table 8

Monetary aggregates of the euro area^{1,2}

(Outstanding balances in billion euro, not seasonally adjusted)

End of period	Currency in circulation (1)	Overnight deposits (2)	M1 (3)=(1)+(2)	Deposits with agreed maturity up to two years (4)	Deposits redeemable at notice up to three months (5)	M2 (6)=(3)+(4)+(5)	Repurchase agreements (7)	Money market fund shares/units (8)	Money market paper and debt securities up to two years (9)	M3 ³ (10)=(6)+(7)+(8)+(9)
2001	239.7	2,039.2	2,279.0	1,088.8	1,316.6	4,684.4	218.5	398.0	145.9	5,446.8
2002	341.2	2,158.3	2,499.4	1,075.7	1,406.3	4,981.4	226.9	470.5	127.6	5,806.4
2003	397.9	2,329.2	2,727.1	1,039.2	1,529.6	5,295.8	208.7	581.5	92.7	6,178.7
2004	468.4	2,480.5	2,948.9	1,040.5	1,642.9	5,632.3	228.8	604.9	102.3	6,568.2
2005	532.8	2,946.8	3,479.6	1,123.7	1,550.0	6,153.3	221.9	615.8	129.8	7,120.8
2004 Jan.	389.1	2,313.8	2,702.9	1,021.7	1,547.2	5,271.7	214.6	591.7	95.6	6,173.6
Feb.	393.5	2,309.8	2,703.3	1,016.4	1,553.8	5,273.5	228.6	599.2	97.0	6,198.4
March ..	399.6	2,345.9	2,745.5	1,005.6	1,559.1	5,310.2	219.4	602.6	94.5	6,226.7
Apr.	409.4	2,361.3	2,770.7	1,006.3	1,567.5	5,344.5	225.5	611.0	99.5	6,280.5
May	416.6	2,372.0	2,788.7	1,015.4	1,573.4	5,377.4	221.9	609.0	96.2	6,304.5
June	423.0	2,410.4	2,833.4	989.0	1,585.6	5,408.0	217.7	609.2	100.1	6,335.0
July	436.2	2,398.6	2,834.8	1,000.4	1,593.3	5,428.5	223.0	613.0	97.8	6,362.3
Aug.	433.4	2,362.3	2,795.7	1,003.5	1,598.9	5,398.0	226.0	624.1	99.2	6,347.3
Sept.	438.0	2,419.1	2,857.1	993.1	1,600.9	5,451.1	217.6	609.5	100.4	6,378.4
Oct.	444.4	2,421.6	2,866.0	1,019.4	1,605.0	5,490.4	230.7	617.1	99.0	6,437.1
Nov.	448.7	2,465.0	2,913.7	1,003.7	1,611.5	5,528.9	225.1	613.5	103.1	6,470.5
Dec.	468.4	2,480.5	2,948.9	1,040.5	1,642.9	5,632.3	228.8	604.9	102.3	6,568.2
2005 Jan.	459.9	2,506.1	2,966.0	1,015.4	1,655.9	5,637.3	228.7	616.4	99.2	6,581.7
Feb.	463.6	2,506.6	2,970.1	1,013.0	1,660.3	5,643.4	227.0	615.4	114.1	6,599.9
March ..	471.8	2,525.8	2,997.6	1,017.7	1,665.2	5,680.4	227.0	614.5	106.0	6,627.8
Apr.	481.1	2,550.0	3,031.1	1,034.8	1,672.5	5,738.4	226.3	627.8	120.9	6,713.4
May	485.8	2,578.3	3,064.1	1,035.7	1,678.7	5,778.4	239.2	634.8	113.5	6,766.0
June	496.6	2,808.0	3,304.5	1,027.4	1,520.2	5,852.1	238.9	621.3	118.5	6,830.7
July	506.4	2,814.7	3,321.1	1,042.5	1,525.7	5,889.4	238.6	635.1	119.2	6,882.9
Aug.	500.9	2,767.7	3,268.7	1,054.3	1,530.0	5,853.0	249.2	639.7	121.0	6,862.8
Sept.	507.1	2,815.4	3,322.5	1,078.4	1,532.0	5,933.0	234.4	631.5	119.9	6,918.7
Oct.	510.5	2,838.8	3,349.3	1,088.7	1,532.2	5,970.3	241.4	629.0	121.4	6,962.0
Nov.	514.5	2,864.0	3,378.5	1,085.9	1,531.3	5,995.7	239.3	629.6	130.0	6,994.7
Dec.	532.8	2,946.8	3,479.6	1,123.7	1,550.0	6,153.3	221.9	615.8	129.8	7,120.8
2006 Jan.	520.9	2,930.2	3,451.0	1,113.8	1,566.4	6,131.2	237.0	608.4	144.0	7,120.6
Feb.	524.9	2,921.0	3,445.9	1,134.9	1,569.8	6,150.6	235.0	610.2	153.3	7,149.1
March ..	532.3	2,937.6	3,469.8	1,162.1	1,571.4	6,203.4	235.9	603.1	163.8	7,206.3
Apr.	540.3	2,981.7	3,522.0	1,201.6	1,569.8	6,293.4	249.7	613.1	165.4	7,321.6
May	543.6	3,000.9	3,544.5	1,189.2	1,569.0	6,302.7	258.2	620.9	174.8	7,356.7
June	553.7	3,046.0	3,599.7	1,209.1	1,566.1	6,374.9	247.0	615.8	164.9	7,402.6
July	562.7	3,011.1	3,573.8	1,234.1	1,563.1	6,370.9	250.5	627.2	162.0	7,410.8
Aug.* ...	559.0	2,957.8	3,516.8	1,268.4	1,562.7	6,347.8	264.9	634.0	180.0	7,426.7

1 Monetary aggregates comprise monetary liabilities of MFIs and central government (Post Office, Treasury) vis-à-vis non-MFI euro area residents excluding central government.

2 Data for the euro area until the end of 2000 concern the Euro-11. As from 1 January 2001, they concern the Euro-12.

3 M3 and its components exclude non-residents' holdings of money market fund shares/units and debt securities of up to two years.

* Provisional data.

Source: ECB.

Table 9

The Greek contribution to the main monetary aggregates of the euro area¹*(Outstanding balances in billion euro, not seasonally adjusted)*

End of period	Overnight deposits			Deposits with an agreed maturity up to two years	Deposits redeemable at notice up to three months ¹	Repurchase agreements (repos)	Money market fund shares/units	Debt securities up to two years	Total ² (M3 excluding currency in circulation) (7)=(1)+(2)+ +(3)+(4)+ +(5)+(6)
	(1)	Sight deposits and current accounts (1.1)	Savings deposits (1.2)						
2001	70.8	16.1	54.7	29.4	2.4	24.2	9.7	0.1	136.7
2002	71.7	15.2	56.5	28.9	2.3	20.0	10.7	0.2	133.8
2003	79.5	17.6	61.9	32.3	2.0	10.8	15.7	0.5	140.8
2004	91.7	20.7	71.0	33.4	1.9	9.5	15.2	0.5	152.3
2005	99.2	24.8	74.4	51.8	4.4	2.7	4.9	0.4	163.4
2004 Jan.	79.5	17.2	61.6	32.5	2.1	10.6	15.2	0.5	139.7
Feb.	79.6	17.3	62.3	32.1	2.1	10.5	15.2	0.5	139.9
March	82.1	17.8	64.3	31.8	2.1	9.5	15.8	0.4	141.6
Apr.	81.4	17.8	63.6	33.5	2.2	9.1	15.9	0.4	142.5
May	82.5	17.0	65.5	32.2	2.1	8.9	15.6	0.4	141.8
June	84.9	18.3	66.6	32.4	2.1	9.4	15.8	0.4	145.0
July	85.5	18.3	67.2	33.0	2.1	9.3	15.9	0.4	146.2
Aug.	84.9	17.7	67.2	33.2	2.1	9.6	15.8	0.4	146.1
Sept.	86.0	18.7	67.3	33.4	2.1	10.5	15.3	0.5	147.8
Oct.	86.4	18.9	67.5	33.6	2.0	10.4	15.4	0.5	148.2
Nov.	87.5	19.6	67.9	33.8	2.0	10.1	15.3	0.5	149.1
Dec.	91.7	20.7	71.0	33.4	1.9	9.5	15.2	0.5	152.3
2005 Jan.	90.4	19.8	70.6	37.8	2.0	5.6	14.9	0.5	151.2
Feb.	91.9	20.8	71.1	39.4	2.0	4.4	14.6	0.5	152.8
March	90.9	20.4	70.6	41.0	2.0	4.2	14.2	0.4	152.6
Apr.	91.1	20.2	70.9	42.3	2.6	3.8	13.0	0.5	153.4
May	91.5	20.2	71.2	42.6	2.8	4.1	12.5	0.5	153.9
June	96.8	23.9	72.9	42.2	3.1	3.7	10.9	0.4	157.2
July	93.8	21.8	72.0	44.4	3.3	3.3	10.7	0.4	155.9
Aug.	93.5	21.2	72.3	45.6	3.6	3.3	10.1	0.3	156.4
Sept.	94.8	22.5	72.3	46.2	3.9	3.3	7.3	0.4	155.9
Oct.	95.5	23.2	72.3	49.2	4.1	2.6	6.2	0.4	158.0
Nov.	94.9	23.1	71.8	50.6	4.5	2.7	5.5	0.4	158.6
Dec.	99.2	24.8	74.4	51.8	4.4	2.7	4.9	0.4	163.4
2006 Jan.	95.8	22.7	73.1	53.8	4.4	2.6	4.7	0.4	161.7
Feb.	95.3	22.6	72.7	55.1	4.5	2.5	4.7	0.4	162.5
March	95.3	22.7	72.6	56.8	4.1	2.5	4.6	0.5	163.9
Apr.	95.6	22.3	73.3	57.9	4.0	2.4	4.6	0.6	165.1
May	95.8	22.6	73.2	59.0	3.7	2.4	4.9	0.6	166.5
June	99.2	25.1	74.0	60.4	3.6	2.5	5.2	0.6	171.5
July	98.0	24.2	73.8	61.7	3.5	2.1	5.3	0.6	171.1
Aug.	97.0	23.4	73.6	63.3	3.4	2.0	5.4	0.6	171.7

¹ Including savings deposits in currencies other than the euro.² As in all other euro area countries, Greece's M3 can no longer be calculated accurately, since part of the quantity of euro banknotes and coins in circulation in each country is held by residents of other euro area countries (as well as non-euro area residents). Owing to these technical problems, the compilation of the Greek M0, M1, M2 and M3 was discontinued in January 2003.

Source: Bank of Greece.

Table 10

Greece: deposits of domestic firms and households with OMFIs,¹ by currency and type*(Outstanding balances in million euro, not seasonally adjusted)*

End of period	Total deposits	Breakdown by currency		Breakdown by type		
		In euro ²	In other currencies	Sight deposits	Savings deposits	Time deposits ³
2001	101,809.5	79,566.0	22,243.5	13,385.2	58,323.1	30,101.1
2002	104,761.1	87,732.3	17,028.8	13,367.3	60,406.1	30,987.7
2003	115,750.1	98,119.3	17,630.8	15,395.8	65,141.1	35,213.2
2004	128,424.6	110,206.7	18,217.9	18,274.2	73,954.2	36,196.1
2005	156,857.7	135,797.3	21,060.4	22,180.2	79,800.8	54,876.1
2004 Jan.	114,996.0	96,977.6	18,018.4	14,874.7	64,645.4	35,476.0
Feb.	115,491.9	97,036.0	18,455.9	15,089.7	66,332.2	34,070.0
March	117,571.4	98,647.3	18,924.1	15,479.0	67,322.0	34,770.4
Apr.	118,835.4	99,526.4	19,309.0	15,687.6	66,697.8	36,450.0
May	118,645.4	99,905.7	18,739.7	14,995.6	68,548.9	35,100.9
June	120,997.2	102,774.4	18,222.8	16,078.1	69,641.4	35,277.7
July	122,396.3	103,778.5	18,617.8	16,368.9	70,186.6	35,840.9
Aug.	122,065.6	103,347.9	18,717.7	15,579.5	70,397.0	36,089.1
Sept.	123,471.3	104,687.8	18,783.6	16,727.8	70,396.8	36,346.7
Oct.	123,971.8	105,394.3	18,577.5	16,840.4	70,593.6	36,537.8
Nov.	124,875.8	106,408.6	18,467.2	17,304.0	70,903.5	36,668.3
Dec.	128,424.6	110,206.7	18,217.9	18,274.2	73,954.2	36,196.1
2005 Jan.	131,749.7	114,232.0	17,517.7	17,586.6	73,515.5	40,647.6
Feb.	134,088.9	116,771.1	17,317.8	17,866.2	74,096.0	42,126.7
March	134,801.8	116,303.2	18,498.7	17,521.9	73,527.1	43,752.9
Apr.	136,854.8	118,087.9	18,766.9	17,333.7	74,453.1	45,068.0
May	137,472.3	118,223.8	19,248.5	17,189.9	75,046.6	45,235.8
June	142,951.8	123,548.2	19,403.6	20,868.4	77,036.6	45,046.9
July	142,705.3	122,700.2	20,005.1	19,144.9	76,318.4	47,241.9
Aug.	143,733.0	123,239.3	20,493.7	18,436.6	76,764.9	48,531.5
Sept.	146,180.7	125,211.8	20,968.9	19,789.0	77,143.1	49,248.6
Oct.	150,136.2	129,055.6	21,080.6	20,542.2	77,351.8	52,242.2
Nov.	151,140.9	129,736.1	21,404.8	20,228.8	77,297.6	53,614.4
Dec.	156,857.7	135,797.3	21,060.4	22,180.2	79,800.8	54,876.7
2006 Jan.	155,334.6	134,509.7	20,824.9	20,097.8	78,361.8	56,875.1
Feb.	156,125.0	134,733.6	21,391.4	19,797.5	78,114.4	58,213.2
March	157,740.9	136,352.9	21,388.0	20,229.3	77,611.2	59,900.5
Apr.	158,730.2	137,689.9	21,040.3	19,707.4	78,160.7	60,862.1
May	159,942.6	138,812.0	21,130.6	20,063.9	77,829.2	62,049.5
June	164,328.2	143,200.2	21,128.0	22,398.2	78,543.2	63,386.8
July	164,473.3	143,231.3	21,242.0	21,667.6	78,137.8	64,667.9
Aug.	164,706.1	143,088.1	21,618.0	20,710.5	77,844.8	66,150.8

¹ Other Monetary Financial Institutions (OMFIs) comprise credit institutions other than the Bank of Greece and money market funds.² Until 31 December 2001: deposits in drachmas and the other euro legacy currencies.³ Including blocked deposits.

Source: Bank of Greece.

Table 11
ECB and Bank of Greece interest rates
(Percentages per annum)

1. ECB interest rates				2. Bank of Greece interest rates				
With effect from: ¹	Deposit facility	Main refinancing operations ³	Marginal lending facility	With effect from:	Overnight deposit facility—first tier ⁴	Overnight deposit facility—second tier ⁴	14-day intervention rate	Lombard rate
1999 1 Jan.	2.00	3.00	4.50	1999 14 Jan.	11.50	9.75	12.00	13.50
4 Jan. ²	2.75	3.00	3.25	21 Oct.	11.00	9.75	11.50	13.00
22 Jan.	2.00	3.00	4.50	16 Dec.	10.25	9.25	10.75	12.25
9 Apr.	1.50	2.50	3.50	27 Dec.	10.25	9.00	10.75	11.50
5 Nov.	2.00	3.00	4.00					
2000 4 Feb.	2.25	3.25	4.25	2000 27 Jan.	9.50	8.50	9.75	11.00
17 March	2.50	3.50	4.50	9 March	8.75	8.00	9.25	10.25
28 Apr.	2.75	3.75	4.75	20 Apr.	8.00	7.50	8.75	9.50
9 June	3.25	4.25	5.25	29 June	7.25	—	8.25	9.00
28 June ³	3.25	4.25	5.25	6 Sept.	6.50	—	7.50	8.25
1 Sept.	3.50	4.50	5.50	15 Nov.	6.00	—	7.00	7.75
6 Oct.	3.75	4.75	5.75	29 Nov.	5.50	—	6.50	7.25
				13 Dec.	4.75	—	5.75	6.50
				27 Dec.	3.75	—	4.75	5.75
2001 11 May	3.50	4.50	5.50					
31 Aug.	3.25	4.25	5.25					
18 Sept.	2.75	3.75	4.75					
9 Nov.	2.25	3.25	4.25					
2002 6 Dec.	1.75	2.75	3.75					
2003 7 March	1.50	2.50	3.50					
6 June	1.00	2.00	3.00					
2005 6 Dec.	1.25	2.25	3.25					
2006 8 March	1.50	2.50	3.50					
15 June	1.75	2.75	3.75					
9 Aug.	2.00	3.00	4.00					
11 Oct.	2.25	3.25	4.25					

1 From 1 January 1999 to 9 March 2004, the date refers to the deposit and marginal lending facilities. For main refinancing operations, changes in the rate are effective from the first operation following the date indicated. The change on 18 September 2001 was effective on that same day. From 10 March 2004 onwards, the date refers to the deposit and marginal lending facilities and to the main refinancing operations (changes effective from the first main refinancing operation following the Governing Council discussion), unless otherwise indicated.

2 On 22 December 1998 the ECB announced that, as an exceptional measure between 4 and 21 January 1999, a narrow corridor of 50 basis points would be applied between the interest rates for the marginal lending facility and the deposit facility, aimed at facilitating the transition to the new monetary regime by market participants.

3 Until 21 June 2000: fixed rate tenders, from 28 June 2000: minimum bid rate in variable rate tenders.

4 On 29 June 2000 the second tier of the deposit facility was abolished; the interest rate thereafter applies to the unified deposit acceptance account.

Sources: ECB and Bank of Greece.

Table 12
Money market interest rates
(Percentages per annum, period averages)

Period	Overnight deposits ¹	1-month deposits ²	3-month deposits ²	6-month deposits ²	9-month deposits ²	12-month deposits ²
2001	4.39	4.33	4.26	4.15	4.10	4.08
2002	3.29	3.30	3.32	3.35	3.41	3.49
2003	2.32	2.35	2.33	2.31	2.31	2.34
2004	2.05	2.08	2.11	2.15	2.20	2.27
2005	2.09	2.14	2.18	2.23	2.28	2.33
2004 Jan.	2.02	2.08	2.09	2.12	2.15	2.22
Feb.	2.03	2.06	2.07	2.09	2.11	2.16
March	2.01	2.04	2.03	2.02	2.02	2.06
Apr.	2.08	2.05	2.05	2.06	2.11	2.16
May	2.02	2.06	2.09	2.14	2.21	2.30
June	2.03	2.08	2.11	2.19	2.29	2.40
July	2.07	2.08	2.12	2.19	2.26	2.36
Aug.	2.04	2.08	2.11	2.17	2.22	2.30
Sept.	2.05	2.08	2.12	2.20	2.28	2.38
Oct.	2.11	2.09	2.15	2.19	2.25	2.32
Nov.	2.09	2.11	2.17	2.22	2.27	2.33
Dec.	2.05	2.17	2.17	2.21	2.25	2.30
2005 Jan.	2.08	2.11	2.15	2.19	2.25	2.31
Feb.	2.06	2.10	2.14	2.18	2.24	2.31
March	2.06	2.10	2.14	2.19	2.25	2.33
Apr.	2.08	2.10	2.14	2.17	2.21	2.27
May	2.07	2.10	2.13	2.14	2.16	2.19
June	2.06	2.10	2.11	2.11	2.10	2.10
July	2.07	2.11	2.12	2.13	2.15	2.17
Aug.	2.06	2.11	2.13	2.16	2.19	2.22
Sept.	2.09	2.12	2.14	2.17	2.19	2.22
Oct.	2.07	2.12	2.20	2.27	2.34	2.41
Nov.	2.09	2.22	2.36	2.50	2.60	2.68
Dec.	2.28	2.41	2.47	2.60	2.70	2.78
2006 Jan.	2.33	2.39	2.51	2.65	2.75	2.83
Feb.	2.35	2.46	2.60	2.72	2.83	2.91
March	2.52	2.63	2.72	2.87	3.00	3.11
Apr.	2.63	2.65	2.79	2.96	3.11	3.22
May	2.58	2.69	2.89	3.06	3.20	3.31
June	2.70	2.87	2.99	3.16	3.29	3.40
July	2.81	2.94	3.10	3.29	3.43	3.54
Aug.	2.97	3.09	3.23	3.41	3.53	3.62
Sept.	3.04	3.16	3.34	3.53	3.64	3.72

1 Euro overnight index average (EONIA).

2 Euro interbank offered rates (EURIBOR).

Source: Bloomberg.

Table 13

Greek government paper yields

(Percentages per annum, period averages)

Period	Yield on one-year Treasury bills	Bond yields						
		3-year	5-year	7-year	10-year	15-year	20-year	32-year
2001	4.08	4.28	4.58	4.82	5.30	5.51	5.76	...
2002	3.50	4.06	4.45	4.78	5.12	5.24	5.52	...
2003	2.34	2.82	3.37	3.83	4.27	4.32	4.91	...
2004	2.27	2.87	3.37	3.81	4.26	4.53	4.77	...
2005	2.33	2.65	2.92	3.22	3.59	3.80	3.92	4.14
2004 Jan.	2.21	2.71	3.34	3.81	4.37	4.33	4.94	...
Feb.	2.17	2.91	3.28	3.90	4.35	4.28	4.91	...
March	2.06	2.71	3.26	3.71	4.17	4.43	4.75	...
Apr.	2.16	2.90	3.45	3.90	4.35	4.72	4.88	...
May	2.30	3.08	3.63	4.07	4.49	4.86	5.01	...
June	2.41	3.19	3.73	4.15	4.55	4.89	5.03	...
July	2.36	3.07	3.61	4.03	4.44	4.79	4.93	...
Aug.	2.30	2.91	3.43	3.85	4.28	4.63	4.78	...
Sept.	2.37	2.91	3.40	3.79	4.22	4.56	4.70	...
Oct.	2.32	2.76	3.25	3.65	4.11	4.47	4.61	...
Nov.	2.33	2.66	3.12	3.53	3.97	4.33	4.47	...
Dec.	2.30	2.59	2.98	3.36	3.77	4.10	4.24	...
2005 Jan.	2.31	2.72	2.96	3.29	3.69	3.99	4.12	...
Feb.	2.31	2.80	2.97	3.34	3.69	3.94	4.04	...
March	2.34	2.88	3.06	3.56	3.92	4.12	4.24	4.49
Apr.	2.27	2.70	3.06	3.37	3.76	3.98	4.11	4.38
May	2.19	2.55	2.89	3.21	3.60	3.82	3.95	4.21
June	2.10	2.35	2.70	3.02	3.44	3.66	3.79	4.05
July	2.17	2.42	2.75	3.06	3.46	3.71	3.84	4.10
Aug.	2.22	2.49	2.79	3.07	3.47	3.69	3.82	4.08
Sept.	2.22	2.42	2.66	2.92	3.30	3.52	3.64	3.91
Oct.	2.41	2.66	2.88	3.11	3.45	3.64	3.75	4.00
Nov.	2.69	2.91	3.15	3.36	3.67	3.84	3.94	4.14
Dec.	2.78	2.95	3.14	3.31	3.57	3.73	3.82	4.02
2006 Jan.	2.84	2.99	3.17	3.32	3.60	3.71	3.79	3.98
Feb.	2.91	3.09	3.30	3.50	3.77	3.86	3.94	4.14
March	3.11	3.38	3.50	3.74	3.95	4.02	4.11	4.29
Apr.	3.22	3.61	3.72	4.01	4.23	4.32	4.41	4.60
May	3.31	3.63	3.80	4.05	4.30	4.38	4.48	4.69
June	3.41	3.70	3.93	4.07	4.31	4.41	4.50	4.72
July	3.54	3.78	3.98	4.10	4.33	4.42	4.50	4.72
Aug.	3.61	3.72	3.88	3.98	4.19	4.29	4.37	4.58
Sept.	3.72	3.71	3.81	3.89	4.06	4.15	4.21	4.39

Source: Bank of Greece.

Table 14

Greece: domestic MFI loans to domestic firms and households, by branch of economic activity

(Balances in million euro)

End of period	Grand total	Firms						Households			
		Total	Agriculture	Industry ¹	Trade	Tourism	Other	Total	Housing	Consumer credit	Other
2001	74,027.4	50,198.7	3,724.2	12,614.9	15,524.3	2,171.3	16,164.0	23,828.7	15,652.2	7,852.0	324.5
2002	86,510.5	55,012.2	3,224.7	14,364.0	15,670.8	2,903.2	18,849.5	31,498.3	21,224.7	9,755.4	518.2
2003	101,178.1	60,979.3	3,082.7	15,865.1	16,514.4	3,488.2	22,028.9	40,198.8	26,534.2	12,409.6	1,255.0
2004	117,201.7	65,566.3	3,248.0	15,675.6	18,821.6	4,040.0	23,781.1	51,635.4	33,126.8	17,053.8	1,454.8
2005	136,981.1	71,282.9	2,954.0	15,753.8	19,958.4	4,189.8	28,426.9	65,698.2	43,199.4	20,850.0	1,648.8
2004 Jan.	102,748.9	61,939.3	3,055.4	16,005.1	16,822.7	3,536.8	22,519.3	40,809.6	26,902.8	12,690.8	1,216.0
Feb.	103,899.7	62,373.0	3,042.0	15,948.2	17,060.8	3,587.7	22,734.3	41,526.7	27,334.5	13,041.9	1,150.3
March	105,263.2	62,632.0	3,095.5	15,831.8	17,012.4	3,661.6	23,030.7	42,631.2	27,894.2	13,442.3	1,294.7
Apr.	106,447.1	62,865.3	3,150.5	15,734.1	17,134.7	3,703.2	23,142.8	43,581.8	28,465.8	13,798.6	1,317.4
May	108,835.0	64,279.3	3,242.6	15,950.4	17,773.5	3,766.9	23,545.9	44,555.7	29,080.6	14,169.3	1,305.8
June	109,806.8	64,817.5	3,324.8	15,831.1	17,952.6	3,801.5	23,907.5	44,989.3	29,035.7	14,585.6	1,368.0
July	111,624.2	65,449.6	3,348.0	15,997.2	18,214.6	3,862.7	24,027.1	46,174.6	29,822.1	14,985.2	1,367.3
Aug.	111,905.0	64,948.0	3,376.4	15,740.2	18,062.7	3,841.8	23,926.9	46,957.0	30,244.2	15,327.8	1,385.0
Sept.	113,392.1	65,419.2	3,402.8	15,743.6	18,335.8	3,865.3	24,071.7	47,972.9	30,832.5	15,722.9	1,417.5
Oct.	114,868.1	65,943.5	3,397.8	15,988.2	18,687.8	3,987.5	23,882.2	48,924.6	31,404.7	16,114.1	1,405.8
Nov.	115,636.5	65,492.4	3,303.2	15,755.2	18,612.8	3,930.4	23,890.8	50,144.1	32,138.9	16,580.3	1,424.9
Dec.	117,201.7	65,566.3	3,248.0	15,675.6	18,821.6	4,040.0	23,781.1	51,635.4	33,126.8	17,053.8	1,454.8
2005 Jan.	118,387.3	65,985.6	3,237.8	15,645.2	18,921.1	4,079.3	24,102.2	52,401.7	33,672.4	17,275.8	1,453.5
Feb.	118,906.4	65,521.9	3,161.6	15,623.8	19,104.7	4,129.9	23,501.9	53,384.5	34,281.6	17,610.7	1,492.2
March	120,704.9	66,096.9	3,079.3	15,565.9	19,309.8	4,180.8	23,961.1	54,608.0	35,091.5	17,995.6	1,520.9
Apr.	123,037.2	67,097.9	3,059.3	15,926.1	19,565.9	4,211.2	24,335.4	55,939.3	35,878.7	18,550.0	1,510.6
May	124,228.8	67,257.5	3,038.1	15,872.9	19,520.5	4,225.7	24,600.3	56,971.3	36,610.2	18,896.4	1,464.7
June	125,452.3	68,474.1	3,096.1	15,918.8	20,142.8	4,293.7	25,022.7	56,978.2	36,102.8	19,386.6	1,488.8
July	127,215.3	69,613.6	3,119.2	16,123.2	20,352.3	4,135.7	25,883.2	57,601.7	37,238.6	18,897.0	1,466.1
Aug.	127,788.5	69,212.3	3,123.3	15,838.2	20,027.5	4,110.4	26,112.9	58,576.2	37,850.0	19,245.1	1,481.1
Sept.	129,507.9	69,305.5	2,939.4	15,674.2	19,985.6	4,073.7	26,632.6	60,202.4	39,022.1	19,628.5	1,551.8
Oct.	131,111.7	69,462.4	2,884.1	15,757.2	19,905.6	4,089.4	26,826.1	61,649.3	40,000.4	20,080.7	1,568.2
Nov.	133,136.0	69,791.5	2,919.6	15,712.5	19,717.1	4,184.2	27,258.1	63,344.5	41,244.2	20,511.7	1,588.6
Dec.	136,981.1	71,282.9	2,954.0	15,753.8	19,958.4	4,189.8	28,426.9	65,698.2	43,199.4	20,850.0	1,648.8
2006 Jan.	137,731.3	70,999.2	2,948.7	15,690.0	19,672.8	4,205.7	28,482.0	66,732.1	44,010.6	21,047.7	1,673.8
Feb.	139,714.7	71,491.8	2,957.3	15,747.6	19,389.1	4,248.8	29,149.0	68,222.9	44,873.8	21,637.5	1,711.6
March	142,633.3	72,960.5	3,086.1	15,955.2	19,843.2	4,356.4	29,719.6	69,672.8	45,919.6	22,045.2	1,708.0
Apr.	144,593.1	73,944.8	3,098.7	16,399.3	20,160.3	4,352.3	29,934.2	70,648.3	46,612.7	22,344.3	1,691.3
May	145,477.5	74,372.3	3,105.7	16,661.9	19,876.8	4,377.7	30,350.2	71,105.2	46,539.9	22,815.5	1,749.8
June	148,322.9	76,259.8	3,192.4	16,900.2	20,531.4	4,416.8	31,219.0	72,063.1	46,929.0	23,275.7	1,558.4
July	150,012.0	76,374.7	3,203.6	16,706.6	20,573.2	4,350.0	31,514.3	73,637.3	48,165.4	23,610.7	1,861.2
Aug.	150,031.2	76,033.8	3,204.1	16,658.0	20,371.5	4,301.8	31,498.4	73,997.4	48,138.4	23,956.0	1,903.0

¹ Comprising manufacturing and mining.

Source: Bank of Greece.

Table 15

Greece: bank rates on new euro-denominated deposits of euro area residents

(Percentages per annum, period averages unless otherwise noted)

Period	Deposits by households			Deposits by non-financial corporations		Repurchase agreements (repos)
	Overnight deposits ^{1,2}	Savings deposits ²	Deposits with agreed maturity up to one year	Overnight deposits ²	Deposits with agreed maturity up to one year	
2003	0.93	0.92	2.48	0.63	2.49	2.24
2004	0.91	0.90	2.29	0.55	2.17	1.98
2005	0.91	0.88	2.23	0.60	2.09	2.00
2004 Jan.	0.88	0.86	2.26	0.55	2.18	1.99
Feb.	0.88	0.87	2.18	0.57	2.17	1.98
March	0.89	0.87	2.29	0.54	2.13	1.95
Apr.	0.89	0.88	2.26	0.56	2.13	1.97
May	0.90	0.89	2.24	0.56	2.23	1.95
June	0.91	0.90	2.29	0.54	2.16	1.97
July	0.91	0.91	2.32	0.56	2.18	1.97
Aug.	0.92	0.91	2.31	0.60	2.19	1.96
Sept.	0.93	0.92	2.33	0.53	2.12	1.97
Oct.	0.94	0.93	2.35	0.53	2.17	1.98
Nov.	0.95	0.94	2.36	0.51	2.18	2.00
Dec.	0.96	0.94	2.30	0.55	2.20	2.01
2005 Jan.	0.96	0.95	2.25	0.56	2.08	1.97
Feb.	0.95	0.94	2.19	0.55	2.07	1.97
March	0.93	0.91	2.22	0.55	2.02	1.97
Apr.	0.89	0.86	2.22	0.55	2.07	1.98
May	0.89	0.87	2.20	0.56	2.04	1.99
June	0.89	0.86	2.21	0.58	2.07	1.99
July	0.88	0.86	2.20	0.60	2.07	1.98
Aug.	0.89	0.86	2.19	0.59	2.08	1.98
Sept.	0.89	0.87	2.19	0.70	2.09	1.98
Oct.	0.89	0.87	2.22	0.65	2.10	1.97
Nov.	0.90	0.87	2.27	0.65	2.11	1.99
Dec.	0.91	0.88	2.39	0.71	2.32	2.18
2006 Jan.	0.93	0.90	2.44	0.69	2.33	2.23
Feb.	0.93	0.90	2.45	0.65	2.35	2.25
March	0.99	0.95	2.58	0.73	2.57	2.42
Apr.	0.98	0.95	2.63	0.73	2.61	2.50
May	0.98	0.95	2.66	0.73	2.57	2.47
June	1.02	0.98	2.76	0.75	2.70	2.60
July	1.02	0.98	2.84	0.74	2.79	2.60
Aug.	1.04	1.00	2.95	0.83	2.96	2.74

1 Weighted average of the current account rate and the savings deposit rate.

2 End-of-month interest rate.

Source: Bank of Greece.

Table 16

Greece: bank rates on new euro-denominated loans to euro area residents

(Percentages per annum, period averages unless otherwise noted)

Period	Loans to households ¹					Loans to non-financial corporations ¹		
	Loans without defined maturity ^{2,3}	Consumer loans		Housing loans		Loans without defined maturity ^{3,4}	With a floating rate or an initial rate fixation of up to one year	
		With a floating rate or an initial rate fixation of up to one year	Average rate on total consumer loans	With a floating rate or an initial rate fixation of up to one year	Average rate on total housing loans		Up to €1 million	Over €1 million
2003	14.41	10.57	10.47	4.51	4.78	6.86	5.29	3.98
2004	13.81	9.55	9.86	4.30	4.51	7.01	4.98	3.67
2005	13.36	8.47	9.06	4.06	4.15	6.90	5.08	3.62
2004 Jan.	13.92	9.82	9.94	4.36	4.68	6.74	5.12	3.92
Feb.	13.97	9.94	9.99	4.35	4.63	6.85	5.16	4.09
March	14.00	9.44	9.87	4.37	4.63	7.13	4.88	3.45
Apr.	14.06	9.56	9.85	4.36	4.55	7.11	5.15	3.49
May	13.79	9.82	10.07	4.33	4.54	7.02	4.91	3.45
June	13.89	9.71	10.05	4.30	4.54	7.06	4.89	3.58
July	13.84	9.60	9.67	4.24	4.43	7.03	4.84	3.53
Aug.	13.77	9.70	10.05	4.34	4.53	7.06	4.95	3.52
Sept.	13.62	9.37	9.91	4.23	4.43	7.05	4.87	3.80
Oct.	13.72	9.68	9.87	4.29	4.45	7.02	4.86	3.83
Nov.	13.75	9.40	9.72	4.23	4.36	7.05	5.06	3.61
Dec.	13.41	8.58	9.36	4.21	4.37	6.97	5.04	3.77
2005 Jan.	13.42	8.85	9.39	4.23	4.39	6.95	4.89	3.54
Feb.	13.72	8.99	9.62	4.20	4.34	6.95	5.08	3.53
March	13.51	8.53	9.43	4.15	4.27	6.94	5.00	3.70
Apr.	13.74	8.58	9.37	4.13	4.23	6.94	5.09	3.58
May	13.63	8.88	9.13	4.12	4.21	6.89	4.96	3.47
June	13.48	8.16	8.78	4.07	4.18	6.87	4.82	3.46
July	13.14	8.45	9.35	4.06	4.14	6.82	5.01	3.50
Aug.	13.16	8.48	9.39	4.11	4.18	6.84	5.12	3.50
Sept.	13.23	8.36	8.79	3.99	4.05	6.82	5.06	3.57
Oct.	13.07	8.32	8.68	3.94	4.01	6.85	5.06	3.79
Nov.	13.09	8.28	8.56	3.88	3.93	6.93	5.41	3.84
Dec.	13.07	7.78	8.26	3.86	3.91	7.00	5.41	3.93
2006 Jan.	13.18	7.77	8.30	3.92	4.00	6.94	5.26	3.70
Feb.	13.18	8.06	8.51	3.89	3.97	6.99	5.44	3.74
March	13.22	8.09	8.44	3.92	4.02	7.13	5.50	4.15
Apr.	13.24	7.82	8.48	3.93	4.08	7.09	5.57	3.92
May	13.22	7.84	8.66	4.00	4.15	7.10	5.61	4.17
June	13.45	8.09	8.75	4.22	4.32	7.18	5.65	4.41
July	13.41	7.85	8.59	4.28	4.36	7.19	5.70	4.40
Aug.	13.60	7.97	8.76	4.51	4.53	7.26	5.88	4.27

1 Associated costs are not included.

2 Weighted average of the rates on loans to households through credit cards, on open account loans and on overdrafts from current accounts.

3 End-of-month interest rate.

4 Weighted average of the rates on corporate loans via credit lines and on overdrafts from sight deposit accounts.

Source: Bank of Greece.