COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997 on the updated stability programme of Greece, 2002-2006

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to this Council and the Commission by 1 March 1999. In accordance with Article 5 of the Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Committee set up by Article 114, the Council delivered an opinion, following its examination of the programme.

According to the Regulation, the updated stability programmes, to be presented annually, may be examined by the Council in accordance with these same procedures. The first update of the stability programme was submitted in December 2001; the Council issued an opinion on 12 February 2002[2]. The first stability programme of Greece covering the period 2000-2004 was submitted in December 2000 and assessed by the Council on 12 February 2001[3]. The 2002 update of the stability programme of Greece was submitted to the Commission on 2 December 2002. It extends the period covered by the 2001 update by two years to 2006.

The Commission services have carried out a technical evaluation of this updated programme, namely taking into account the Communication from the Commission to the Council of 27 November on strengthening the coordination of budgetary policies[4]. This evaluation warrants the following assessment.

> The Greek economy has been growing at robust rates in recent years, considerably higher than the EU and the Eurozone average, supported by the effects of eased monetary conditions stemming from interest rate convergence to those prevailing in the euro-area, significant inflow of financial resources from Community structural funds and investments related to the preparation of the Olympic games of 2004. In 2002, real GDP growth decelerated somewhat to 3.8%, as estimated in the updated stability programme or 3.5% in the Commission Autumn forecasts, as compared with 4.1% in 2001. Price developments in 2002 were influenced by a number of factors pointing to opposite directions: bad weather conditions in the first months of the year boosted food prices and the change-over to the euro implied high inflation rates in the first quarters. Inflation as measured by consumer prices stabilised in November but at a high level, among the highest in the euro zone and well above the EU

[1] OJ L 209, 2.8.1997
[2] OJ C 51, 26.2.2002
[3] OJ C 77, 9.3.2001
[4] COM (2002) 668 final, 27.11.2002.

average. The CPI rose 3.6% (year-on-year) in November from 4.4% in January and the HICP rose by 3.9% from 4.8% respectively.

According to the 2002 update, real GDP growth is expected to continue in the period covered by the programme and to average around 3.8% in the years 2003-2006, with a peak of 4% in 2004 and some deceleration as from 2005, reflecting faltering activity-boosting effects from the Olympic Games; however, some durable effects on economic activity can be reasonably expected beyond 2004, mostly related to the continuation of the 3rd Community Support Framework inflows until 2006. For the external environment, the 2002 update relies on the Commission assumptions underlying the Autumn 2002 forecasts until 2004 and on the OECD medium-term projections for the years 2005 and 2006. The projections provided for real GDP growth rates in Greece in the updated programme seem attainable in the medium term; however, uncertainties surround developments beyond 2004, when activity will be less sustained by the above mentioned specific factors. Price increases are expected to gradually slowdown after the second round effects of the oil prices hike are fully absorbed; however, the economy growing above potential allows positive real wage increases; the recent tax reform is having a positive impact on disposable income; demand-led pressures are materializing preventing significant deceleration in price increases. The inflation rate is consequently expected to stabilise to around 3% or slightly above in the entire period covered by the programme. The medium-term outlook for price increases in the update is quite similar to the Commission forecasts for the period until 2004, accompanied, however, by upward risks, mostly related to uncertainty associated with the external assumptions.

Against a background scenario for real GDP growth similar to that of the previous update, the 2002 updated stability programme sets significantly different budgetary targets until 2004. This is largely explained by the fact that the 2002 update incorporates the revised government accounts that resulted from decisions adopted in agreement with the Commission in the course of 2002 in order to ensure compliance with national accounting rules, which led to the reclassification and the correction in the treatment of a number of operations. Following these revisions, the previously estimated government surpluses for 2000 and 2001 turned into deficits, changing thus significantly the starting point of the medium term budgetary projections. In addition, the government debt ratio increased in 2000 and 2001, while a reduction was estimated for these years in the previous update. Overall, in the period 1996-2001, the government debt ratio declined by only 4 percentage points, standing at 107% of GDP in 2001, i.e. by 7.4 percentage points of GDP higher in the 2002 update than in the 2001 updated stability programme. The evolution of the debt ratio was mostly affected by sizeable financial operations, reflected in abnormally high stock flow adjustments, which reached 7.1% of GDP in 2001 and still exceeded 4% of GDP in 2002.

The budgetary developments as portrayed in the revised data, and more particularly the slow pace of reduction in the government debt ratio in a period when the Greek economy has been growing at high rates, is a matter of serious concern. It calls for urgent action from the Greek authorities, necessary in order to undertake a credible and efficient budgetary consolidation leading to a satisfactory pace of debt reduction.

According to the 2002 update, the general government deficit would be declining until 2004, turning into surplus of 0.2% of GDP in 2005, rising to 0.6% in 2006. A reduction in the government debt ratio by 17.4 percentage points during 2003-2006 is projected corresponding to 4.4 percentage points of GDP per year, to 87.9% of GDP in 2006. The budgetary strategy of the programme relies, as in the past, on high and rising primary surpluses and declining interest payments over the time-horizon of the programme. However, the primary surplus, at 4.8% on yearly average, stands at lower levels as compared with the average levels of 6% of GDP projected in the previous update, following the methodological revisions of the government accounts; yet it does not decline over the period as projected in the previous update. Thus, in the current update the contribution over the programme period of the primary balance to the improvement of the government budgetary position almost equals the projected reduction in debt servicing costs.

The budgetary adjustment path of the updated programme is subject to strong uncertainty in the light of the scant measures provided. The reduction in the central government deficit is projected to be higher than the overall improvement in the general government balance as the surpluses of the social security funds are set to gradually decline. However, the central government deficit increased by 0.8 percentage points of GDP instead of declining by 1.5 percentage points as projected in the 2001 updated stability programme. Although this was partly due to the data revisions, the possibility of implementing decisive cuts in current primary spending, in particular in the wage bill, in a repetitive way in the next four years which would compensate for lower tax revenues following the implementation of the 2002 tax reform, seems rather disputable; recent experience shows that government consumption has become a quite inelastic category of expenditure, while it may be also influenced in the short-term by the political cycle, as general elections will take place at the latest in April 2004. Thus, the considerable reduction in the central government deficit which underpins the general government budgetary adjustment, might result difficult to achieve under such circumstances.

Moreover, the adjustment effort presented in the updated programme is strongly back-loaded and, in this sense, lacks credibility. The general government deficit is projected to fall by only 0.2% of GDP in 2003 and then, suddenly, by 0.5% of GDP on average in the period 2004-2006. The fact that the expected budgetary adjustment is to a large extent postponed to the years beyond 2003 is one of the weakest aspects of the programme and even more so, taking into account that in the period 2004-2006 uncertainties surround the macroeconomic assumptions on which expenditure and revenue projections are built.

The 2002 update provides estimates of the cyclically adjusted budgetary position applying the production function methodology; they indicate that, while the cyclically-adjusted budgetary balance deteriorates marginally in 2003, it improves considerably in 2004, reaches a balanced position in 2005 and remains unchanged thereafter. However, a different configuration emerges when the production function method using Commission parameters is applied to the projections provided by the 2002 update. The cyclically adjusted balance improves at a slower pace than estimated in the 2002 update, but regularly throughout the period, getting closer to a balance position at the end of the period, although a cyclically-adjusted deficit of the order of 0.6% of GDP, still persists in 2006.

The 2002 updated stability programme contains a section on the sustainability of public finances. It includes national projections for public expenditures on pensions which show an overall increase of some 10 percentage points of GDP between 2005 and 2050; this is somewhat lower than the EPC projection as it takes on board the impact of the "second phase" of the social security reform. On the basis of current policies, the risk of unsustainable public finances in terms of emerging budget imbalances cannot be excluded. This can almost be entirely attributed to the very large projected increase in spending on public pensions. In the strategy presented in the programme to meet the budgetary costs of population ageing no details are provided on future plans to reform the pension system. A comprehensive and ambitious strategy is needed which adequately reflects the seriousness of the policy challenge. Further deep reforms are required without delay to the pension system to avoid an unsustainable increase in public spending.

Some progress was achieved in implementing structural reforms in 2002 as announced in the 2001 updated programme, in particular with respect to the reform of the tax and the pension systems. The budgetary cost of the tax reform is embodied in the tax revenue projections for the year 2003 and 2004. Proceeds from privatisation were non-negligible, although the initial plans of the government were not successful, most likely due to unfavourable conditions in the Stock exchange. The government intends to pursue its privatisation efforts in 2003 and to follow a more proactive approach by introducing new methods of privatisation and by lifting the upper privatisation limit for some companies. Significant privatisation proceeds are expected in 2003 as implied by the projected low stock-flow adjustment in this year as compared with previous projections and with the other years. Nonetheless, given the conditions prevailing in the stock exchange and in the absence of a clear new strategy in implementing the privatisation plans, more decisive steps are required to improve the functioning of the markets and to raise funds effectively used to pay-off public debt.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the updated stability programme of Greece and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997 on the updated stability programme of Greece, 2002-2006

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission, after consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [21 January 2003] the Council examined the 2002 update of the stability programme of Greece, which covers the period 2002-2006. The programme conforms with the requirements of the Code of Conduct on the content and format of the programmes endorsed by the ECOFIN Council on 10 July 2001. The programme partly conforms with the recommendations of the BEPGs.

In 2002, real GDP growth decelerated somewhat, as a result of deteriorating external environment, but remained robust, at 3.8%, as projected in the 2001 stability programme. Inflation pressures under the impact of second round effects from the oil prices hike and other transitory factors, such as bad weather conditions, although easing in recent months, are still persisting with the inflation rate remaining high: the HICP was increasing by an annual rate of 3.9% in November 2002.

The 2002 update of the stability programme projects annual real GDP growth at around 3.8% in yearly average for the period 2003-2006, and marginally lower rates than the 2001 update for the period until 2004. The Council considers the projected real GDP growth as attainable, particularly until 2004 as economic activity will be underpinned by high private and public investment related to the preparation of the Olympic Games and sustained by the inflow of financial resources from the 3rd Community Support framework. However, the Council notes that, after 2004, uncertainties surround the impact on real GDP growth of faltering specific supporting factors.

The Council notes that the general government accounts deteriorated in 2000 and 2001, when compared with the estimates of the 2001 update, due to a large extent to the revisions of the government accounts figures, in order to ensure compliance with ESA national accounting rules. As a consequence, the starting point of the budgetary projections changed considerably as compared with the 2001 update: according to the 2002 updated stability programme a general government deficit of 1.1% of GDP is estimated for 2002 instead of a surplus of 0.8% of GDP as projected in the 2001 update. Similarly, the government debt ratio is estimated at 105.3% of GDP in 2002 in the current update, to be compared to 97.3% of GDP in the previous update.

The Council considers that the budgetary developments as portrayed in the revised data, in particular the slow pace of reduction in the government debt ratio, in a period when the Greek economy has been growing at high rates, is a matter of serious concern.

The Council notes that the 2002 update projects the government balance to turn from a deficit equal to 1.1% of GDP in 2002 to a surplus of 0.6% of GDP in 2006; at the same time, the government debt ratio is expected to decline from 107% of GDP in 2001 to 87.9% of GDP in 2006; in particular, during the period 2001-2004, from a higher initial level, the debt ratio is projected to decline by 10.9 percentage points of GDP instead of 9.6 percentage points as projected in the 2001 update.

The Council notes that the improvement in the government balance in the period from 2002 to 2006 relies both on the reduction in interest payments and on the retrenchment in current primary expenditure. However, the Council considers that, taking into consideration recent experience, fast and continuous reductions in primary current expenditure is difficult to achieve. Indeed, the Council regrets that no clear binding norm for current primary expenditure has been defined by the Greek authorities as it was recommended in its opinion on the 2000 stability programme[2] and on the 2001 update[3]. The Council re-iterates its recommendation for explicit expenditure norms accompanied by the introduction of appropriate mechanisms to ensure effective expenditure control.

The Council regrets the absence of further budgetary adjustment effort until 2004. The Council considers that the budgetary adjustment projected in the 2002 update is back-loaded and that this aspect weakens the credibility of the adjustment itself. Moreover, the Council notes that, according to Commission calculations, it emerges that the cyclically adjusted

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1 OJ L 209, 2.8.1997

2 OJ C 77, 9.3.2001

3 OJ C 51, 26.2.2002

government deficit would still stand at 0.6% of GDP deficit in 2006, though coming closer to balance. However, the Council considers that the level and recent developments in the government debt ratio require a stronger and more robust medium term budgetary adjustment, less relying on not warranted strong real GDP growth. This is also required given the perspective of increasing budgetary costs stemming from the ageing population. The Council urges the Greek government to take advantage of the current favourable macroeconomic situation to undertake determined effort in order to implement a durable budgetary adjustment leading to an improvement in the underlying budgetary position and a satisfactory pace of debt reduction.

The Council notes that strengthening structural reforms is a key economic policy objective of the updated programme; it considers that although progress has been made in recent years in this area, implementation of structural reforms must continue in the product, services and labour markets in order to ensure the efficiency in the markets and the competitiveness of the economy; the Council encourages the government to proceed to the necessary reforms rapidly and welcomes the intention of the government to implement reforms in the area of budgeting and management of expenditure in the public sector.

The Council welcomes the information provided in the updated programme on long-term sustainability of public finances. The Council considers that on the basis of current policies there is a serious risk of budgetary imbalances emerging in the future due to the ageing population. In this context the Council notes the information provided in the updated programme on the "second phase" of the reform of the social security system introduced in 2002 as recommended in its opinion on the 2001 updated stability programme[1]. The Council considers that further deep reforms are required without delay to the pension system to avoid an unsustainable increase in public spending.

[1] OJ C 51, 26.2.2002