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ENV 527
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COVER NOTE

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Brussels, 24.5.2023
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COMMISSION STAFF WORKING DOCUMENT

In-depth review for Greece

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

2023 European Semester – Spring Package

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European Commission

Greece

In-Depth Review 2023

On the basis of this in-depth review for Greece undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2023 Spring Package" (COM(2023) 600 final) that:

Greece continues to experience excessive imbalances. Vulnerabilities relating to high government debt and a high stock of non-performing loans in the context of high unemployment have been receding, but its external position has deteriorated. A key concern is that the current account deficit markedly widened in 2022, despite the recovery in tourism revenue. Even though it is forecast to narrow somewhat this year and next, the external deficit is set to stay well above the level that is required to ensure a lasting improvement in the net international investment position. While the government debt-to-GDP ratio remains the highest in the EU, it improved markedly in 2022, largely thanks to strong nominal GDP growth, and it is expected to recede further in 2023 and 2024. Non-performing loans recorded a sharp fall last year building on large reductions in earlier years, yet remain high and continue to weigh on banks' profitability and lending capacity, which in turn impinges on the capital deepening and on the productivity growth of the economy. The policy response has contributed to the unwinding of imbalances and the implementation of the RRP represents a major opportunity to tackle remaining structural weaknesses. Yet more efforts are

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1. INTRODUCTION

In 2022, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure (MIP), the Commission identified "excessive macroeconomic imbalances" in Greece. ([1]) These imbalances were related to high government debt, incomplete external rebalancing and a high share of non-performing loans in a context of low potential growth and high unemployment. The 2023 Alert Mechanism Report published in November 2022 concluded that an in-depth review (IDR) should be undertaken also this year for Greece with a view to assess the persistence or unwinding of imbalances. ([2]) The Alert Mechanism Report found that concerns related to government and external debt-to-GDP ratios remained, although they had resumed their declining path after the COVID-19 crisis. The current account deficit had continued to increase and was forecast to remain large. Concerns about the banking sector, which was burdened by a high, albeit significantly reduced, stock of non-performing loans, remained. Labour market weaknesses persisted, despite notable improvements.

Following strong growth in 2022 on the back of consumption and investment, growth is set to moderate in the coming years. ([3]) Despite headwinds, Greece's economy grew by 5.9% in 2022, largely on the back of solid private consumption and investment growth as the recovery from the pandemic continued and saw GDP surpass its 2019 level. Going forward, growth is set to slow in 2023 to 2.4% and to 1.9% in 2024, according to the European Commission's spring forecast. Inflation climbed to a historical high, averaging 9.3% in 2022 (0.1 pps above the EU average). However, price pressures appear to have peaked in September 2022 and consumer price inflation is projected to fall to 4.2% in 2023 and to 2.4% in 2024. Labour market developments remain favourable, with employment increasing, albeit at a decelerating rate. The unemployment rate is projected to decline from 12.5% in 2022 (6.4pps above the EU average) to 12.2% in 2023 and to 11.8% in 2024. The main risk comes from further price shocks leading to a longer than expected slowdown in inflation.

This in-depth review presents the main findings of the assessment of macroeconomic vulnerabilities for Greece. Vulnerabilities related to external balances in Greece are also discussed in a horizontal thematic note that was recently published. ([4]) The MIP assessment matrix is published in the 2023 Country Report for Greece. ([5])

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(1) European Commission (2022), European Semester Spring Package 2022, COM (2022) 600 final.

(2) European Commission (2022), Alert Mechanism Report 2023, COM (2022) 381 final.

(3) European Commission (2023), European Economic Forecast: Spring 2023, Institutional Paper 200.

(4) European Commission (2023), External Sustainability Analysis: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 196.

(5) European Commission (2023), Country Report Greece 2023, SWD (2023) 608 final.

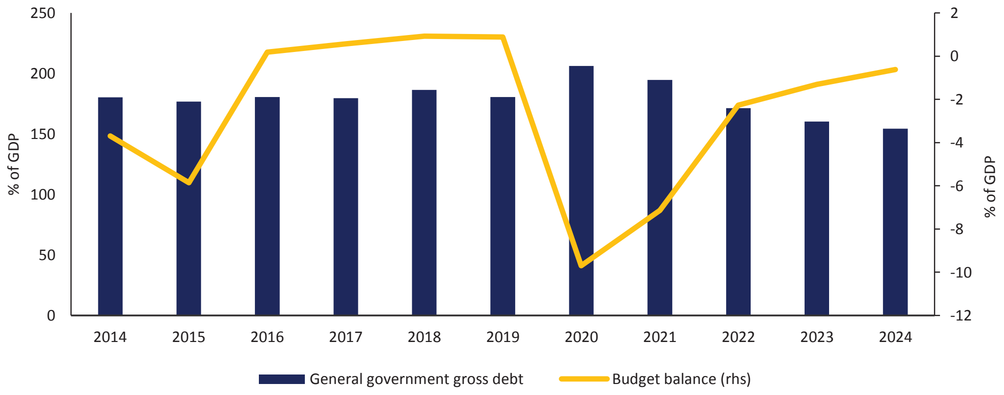
2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

Gravity, evolution and prospects

The Greek public debt-to-GDP ratio declined sharply in 2022 but it remains very high. Public debt fell to 171% of GDP in 2022, driven by an increase in nominal GDP, while a better-than-expected primary deficit limited the need for additional borrowing (see Graph 2.1). This represents a fall of 35pps. from the peak of 206% in 2020 when the pandemic hit, increasing the public debt-to-GDP ratio above the 2014 level of 180% when the adjustment trend started. Going forward, the debt-to-GDP ratio is expected to decline further to around 160% in 2023 and to below 155% of GDP in 2024, and to remain on a downward trajectory thereafter. Despite the emergency measures taken in response to the increase in energy prices, the general government deficit narrowed considerably in 2022, reaching 2.3% of GDP which implies a primary surplus of 0.1% of GDP. The improvement compared to 2021 was due to the recovery of the tax base and the phasing out of the fiscal measures related to the pandemic. Looking ahead, the general government deficit is expected to keep shrinking to 1.3% in 2023 and 0.6% of GDP in 2024. Greece's exposure to increases in interest rates is limited in the short term, since most of its debt is held by official lenders at concessional interest rates with long maturities, and the rest is either at fixed rates or hedged against interest rate risk. In the medium and especially in the long term, as market funding replaces official lending, Greece's exposure to interest rate risk will increase considerably. Still, the Commission's fiscal sustainability assessment shows that the debt-to-GDP ratio remains on a downward path under the baseline scenario. Greece faces high fiscal sustainability risks over the medium term and low ones in the long run. ([6])

([6]) See the DSA in the Commission Country Report 2023 for the latest risk classification and Debt Sustainability Report 2022 (April 2023) for methodological details.

Graph 2.1: **General government gross debt and budget balance, Greece**



Source: Eurostat, European Commission services

The current account balance deteriorated to -9.7% of GDP in 2022, far below its pre-pandemic levels, also in cyclically adjusted terms. The 2022 outturn is far below the level required to return the NIIP to the threshold of -35% of GDP over two decades, and even further below the level required to reach the prudential NIIP benchmark over ten years, even when adjusting for substantial EU fund inflows. Increased energy costs explain only part of the current account deterioration. The trade balance, which was the key driver of the widening of the current account deficit since 2019, stood at -9.4% of GDP in 2022, considerably worse compared to pre-pandemic levels. ([7]) The energy balance worsened from -3.1% of GDP in 2021 to -5.9% of GDP in 2022, which was partly offset by a tourism-induced service balance recovery. Overall, the trade balance excluding tourism and energy stood at -11% in 2022, compared to -7% in 2019.

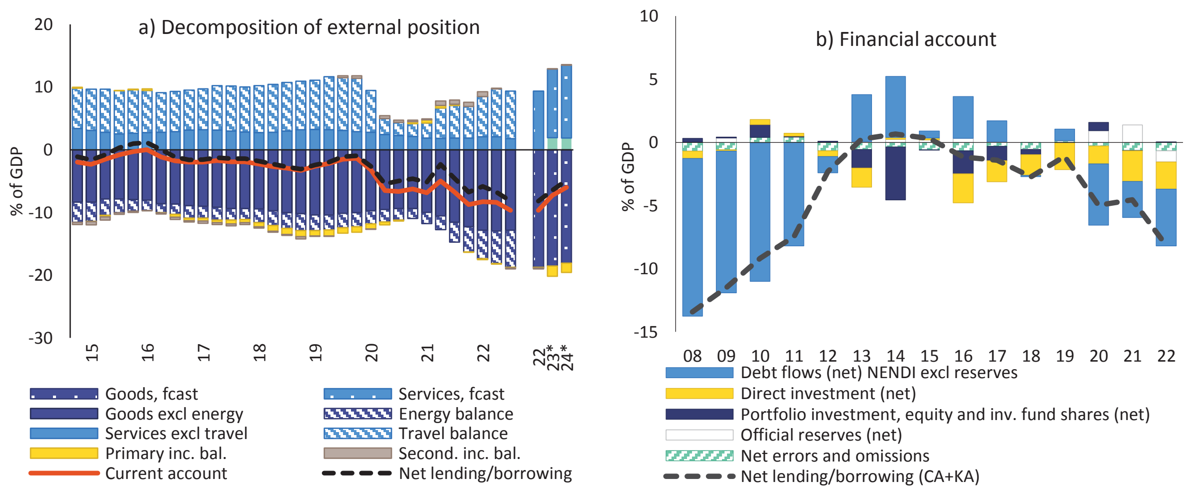
The stock of net external liabilities remains the highest in the EU, albeit a very large share of it is held by official creditors, which contains liquidity risks. Greece's net international investment position stood at -141% of GDP in 2022, improving from -172% of GDP in 2021, and remained far below the prudential NIIP benchmark at around -47% of GDP. The sector with the largest negative net position is still the general government, while the position of the private sector deteriorated in 2021 and further in 2022. Decomposing the NIIP in terms of instruments shows that the large negative position in the form of (mostly public) debt instruments remains at lower levels than before the pandemic. However, given that a substantial part of these instruments is held by official EU creditors at concessional rates, liquidity and rollover risks to external public debt remain limited.

The widening of the current account deficit in 2020-2022 was largely financed by debt issuance. During this period, debt instruments have substantially increased their share in the financing of the current account deficit (see graph 2.2 b)). Following a large increase in 2020 to fund extensive policy programmes shielding households and businesses from the economic fallout of the pandemic, debt instruments continued to play a significant role in financing the widened current account deficit, albeit to a lower extent, in 2021 and 2022. Strong net inflows of debt were related to substantial increases in Greece's Target2 liabilities.

([7]) For details, see: External sustainability analysis: thematic note to support In-Depth Reviews, Brussels, 17 February 2023. The note considers the data up to 2022Q3 and uses Autumn forecast 22, which is updated in the IDR to 2022 and SF23.

Another large share of the financing needs was covered by foreign direct investment, especially in 2022 when they overtook debt instruments. Developments in the 2020-2022 period are in stark contrast to those in 2016-2017 when financing needs allowed a reduction in debt instruments in the economy's balance sheets.

Graph 2.2: **Current and financial account**



Source: European Commission services

The current account balance is projected to improve, but not sufficiently to stabilise the NIIP even at its current level. The current account balance is projected to improve to -7.3% in 2023 and to -6.0% in 2024, driven mainly by improving trade balances. The trade balance is projected to improve from -9.4% in 2022 to -7.6% this year and to -6.4% in 2024. The key driver behind the improvement is the fall in energy prices this year, which accounts for a substantial part of the trade balance deterioration in 2022. However, medium-term projections suggest that even under an optimistic scenario, the NIIP is projected to fall slightly below the current level by 2032. Projections under a baseline scenario result in an NIIP of around -162% of GDP in 2032, while an adverse scenario sees the levels of the NIIP falling to around -180% of GDP by 2032. ([8])

From a savings-investment perspective, the net borrowing position of the total economy is expected to gradually improve. As spending on support measures declines, the government is set to reduce deficits. By contrast, household savings are projected to decline gradually after having increased during the pandemic. Investment is forecast to increase to 14.3% of GDP in 2023 and 14.8% in 2024, levels significantly above those recorded before the pandemic, as projects from the RRP continue to be implemented and support an investment and export-oriented growth model. ([9])

([8]) The optimistic alternative scenario (scenario 1) assumes higher trade balances in 2025 and thereafter by 2 pps. of GDP, and higher real GDP growth in 2025 by 2 pp, than in the baseline scenario. It illustrates a case of a more positive trade balance evolution amid lower energy prices and better export performance than under the baseline. The pessimistic alternative scenario (scenario 2) simulates the impact of a corresponding adverse shock in which it assumes the same timing and the magnitude of deviations from the baseline, but with the opposite sign. See also Graph 3.4 b below.

([9]) Note that capital account inflows from Recovery and Resilience Facility resources to finance RRP projects through 2026 will, by accounting identity, widen the current account deficit, but improve the composition of external financing. See also the thematic note on external sustainability referenced in footnote (21).

Cost competitiveness improved over the last decade, which supported Greek exports, with further gains expected in real terms. Before picking up the pace in recent years, nominal wages had increased only moderately since 2010, slightly below inflation and productivity growth. This led to a steady decline in nominal unit labour costs up until 2020, improving cost competitiveness of Greek exporters. In 2021 and 2022, nominal unit labour costs recorded a slight increase and are forecast to increase further this year and next. However, labour costs in real terms have been shrinking since 2020 and are set to remain on a declining path, set to decrease by 2.6% in 2023 and 1.3% 2024. Exports of goods and services accounted for 49% of GDP in 2022, almost doubling from 2011. Greece’s exports have diversified from tourism and transport services towards goods, which grew from 10% of GDP in 2010 to 26% in 2022. ([10])

The banking sector has strongly reduced the stock of non-performing loans in its balance sheet; nevertheless, the legacy stock of these debts remains in the hand of servicers and continues to weigh on the economy. The ratio of non-performing loans (NPL) ([11]) to total loans in banks’ balance sheet fell to 6.4% in September 2022, compared to 26.5% in 2020 and 47.4% at its peak in September 2016. The state-supported securitisation transactions under the Hercules scheme, expired in October 2022 ([12]), were the main driver behind this sharp reduction. The banking sector’s NPL ratio remains the highest in the EU and continues to weigh on banks’ profitability and lending capacity, which have nonetheless improved. Banks’ in-house management of non-performing loans is expected to bring the NPL ratio closer to the EU average. At the same time, high energy costs and rising interest rates risk undermining households’ and nonfinancial corporations’ debt repayment capacity and may eventually affect banks’ asset quality. Moreover, a large amount of legacy non-performing private debt remains in the hands of credit servicers and thus remains in the economy. At the end of September 2022, servicers held EUR 87 bn worth of loans. The ability of banks and credit servicers to efficiently resolve and restructure new and legacy non-performing private debt will be key to economic performance. The continuous functioning of the non-performing loan secondary market is crucial in these efforts.

Improving bank fundamentals support capital ratios, but the quality of capital remains low, while challenges persist. The impact of the prudential phase-in of IFRS9 ([13]) accounting rules on banks’ capital position was almost fully offset by profits in the first nine months of 2022. As a result, banks’ average Common Equity Tier 1 and Total Capital ratios hardly changed with respect to end-2021 and stood at 13.5% and 16.2% of risk-weighted assets ([14]), respectively, at the end of September 2022, compared to EU averages of 15.3% and 18.6%. At the same time, the quality of capital remains a concern due to the high share of deferred tax credits. The banks’ core profitability has improved and is set to benefit from increasing interest rate margins. In parallel, banks have taken measures to shield their balance sheets

([10]) Source: ELSTAT.

([11]) Non-performing loans as a share of total gross loans and advances on a consolidated basis (i.e. including cash balances at central banks and other demand deposits in the denominator) as reported by the European Central Bank. This figure is different from the one reported under enhanced surveillance, which follows non-performing loans as a share of total gross customer loans on a solo basis, as reported by the Bank of Greece.

([12]) Notwithstanding three pending transactions submitted prior to its expiry.

([13]) International Financial Reporting Standards 9.

([14]) On a consolidated basis.

from sovereign yield volatility, given their significant holdings of domestic sovereign bonds. ([15]) Banks, however, face rising funding costs, given their need for further debt issuances to meet regulatory requirements ([16]) and the phasing out of ECB's targeted longer-term refinancing operations. The cost of borrowing is high, particularly for households and small businesses, and growing on the back of higher interest rates, with the weighted average interest rate on new loans rising from 3.75% in February 2022 to 5.57% in February 2023, while underdeveloped capital markets offer limited alternative sources of finance. Any deterioration in asset quality or falling credit demand would pose further challenges for banks' profitability.

The labour market has absorbed the slack accumulated during the pandemic as employment has exceeded its end-2019 level, but the employment rate remains among the lowest in the EU. Approximately 176,000 jobs have been created since end-2019, bringing total employment to a record high of 4.85 million and the employment rate to 66.8% in Q4 2022 which, however, remained 8 pps. below the EU average. Moreover, employment rates continue to vary considerably across the country, with several regions in Western Greece, Western Macedonia, and Epirus showing rates of just above 50%. Meanwhile, the unemployment rate is gradually falling to levels from before the global financial crisis, partly thanks to the short-time work schemes that helped prevent large lay-offs during the pandemic. The unemployment rate stood at 10.9% in March 2023 but remained 4.4 pps. above the EU average. Joblessness disproportionally affects the youth (24.2%) and long-term unemployment remains persistent. The activity rate (ages of 15-64) decreased from 68.5% in 2019 to 65.3% in 2020, but rebounded rapidly in 2021, and increased further in 2022 to 69.4%.

Assessment of MIP relevant policies

Greece is expected to maintain fiscal primary surpluses from 2023 onwards. The fiscal balance of 2022 was considerably better than expected, with a primary surplus of 0.1% of GDP compared to a deficit of 1.7% in the draft budgetary plan. This was the result of the better-than-expected economic performance implying higher tax revenues, combined with ongoing improvements in the tax collection capacity, and of the moderation of energy prices in the last quarter of the year, which reduced the fiscal cost of the energy support measures. It is important that fiscal policy remains prudent and achieves sufficiently high primary surpluses to accelerate debt reduction. Stepping up further efforts in tax collection and reinforcing payment discipline are instrumental in making the fiscal position robust in the medium term.

Implementation of a wide array of measures to enhance growth, competitiveness and export capacity is progressing in the context of the Recovery and Resilience Plan. Timely and full implementation of reforms and investments included in Greece's RRP is expected to contribute to economic growth and support the unwinding of macroeconomic

([15]) In January 2023, 8.6% of total assets of Greek banks was invested in domestic sovereign bonds while their overall sovereign bond portfolio amounted to 12% of total assets, compared to an EA average of 4%.

([16]) Namely the minimum requirement for own funds and eligible liabilities (MREL).

imbalances. The Commission estimates an increase in GDP growth of 2.1 pps. to 3.3 pps over the period 2021-2026, as a result of the implementation of the RRP, even without considering the likely positive impact of structural reforms. ([17]) RRP measures are targeted at addressing the large investment gap, while facilitating the green and digital transitions and the modernisation of the economy, with a view to promoting export-led growth. Several measures under way aim to improve productivity, competitiveness and openness of the economy, such as actions to simplify the business environment, further improve the ease of doing business, including through the streamlining and digitalisation of licencing, regulatory and export processes, and incentivise productivity growth. Key reforms already completed include the adoption of an improved legal framework for attracting strategic investments, tax incentives for green and digital investments by SMEs, as well as tax and other incentives for scale ups through business transformations. The latter is expected to tackle weaknesses associated with the predominantly small size of Greek enterprises and, in turn, to promote higher productivity and increase export capacity. Moreover, the RRP includes measures that promote the development and modernisation of key sectors, such as tourism, agriculture, and industry. The RRP also provides for the digitalisation of public administration and SMEs, as well as increased public-private cooperation in research and development, including the support of start-ups. Finally, the Loan Facility, which concerns the provision of loans at below-market rates for private sector investments, is already financing projects related to the green and digital transitions, research, development and innovation, as well as the expansion of companies' export capacity.

The impact of financial sector reforms is starting to materialise, while efforts continue to address remaining deficiencies. While the recently phased out Hercules scheme has strongly contributed to the clean-up of banks' balance sheets and to the development of the secondary NPL market, the impact of other reforms is only gradually materialising. The ability of banks and credit servicers to efficiently resolve and restructure new and legacy non-performing private debt will be key to economic performance. A functioning non-performing loan secondary market is crucial in these efforts. The use of out-of-court restructurings by banks and borrowers has picked up but the number of cases remains modest, while the use of the other platforms under the new insolvency framework is even more limited. Further improvements to the early warning and preventive debt restructuring framework are being developed continuously, including under Greece's Recovery and Resilience Plan (RRP). The number of e-auctions has risen to the highest number in years, while the recent plenary decision of the Supreme Court should have dispelled legal uncertainty and avert any disruptive effect on enforcement proceedings. ([18]) The share of failed auctions remains high but is slowly declining, partly because of past policy actions. The clearance of the backlogs of household insolvency cases and called state guarantees has accelerated, and completion is envisaged within 2023 and 2024 respectively. At the same time, loan disbursements under the loan component of the RRP - the Loan Facility - have started to support credit growth to businesses and promote private investment.

Actions under the Recovery and Resilience Plan are set to benefit the labour market. The RRP's strong focus on labour market policies has a potential to increase labour market

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([17]) European Commission (2021), Analysis of the recovery and resilience plan of Greece, SWD (2021) 155 final/2.

([18]) For details on the court decision see: European Commission (2023), Post-Programme Surveillance Report, Greece Spring 2023 participation and employment. A comprehensive set of measures in the plan is directed at addressing labour market deficiencies, facilitating a structural increase in employment, and upgrading the education and training system. Currently implemented measures include labour market policy reforms to enhance job creation, improve job quality, strengthen economic and social resilience, promote labour market inclusion, and reduce inequalities, poverty and exclusion. Further, reforms and investments in skills, lifelong learning, vocational education and training, research performance of universities, and digitalisation of all levels of education aim at increasing long term employment and productivity.

Reforms and investment promoting balanced growth are first steps to help safeguard the sustainability of external borrowing. Building on best practices and reforms undertaken as part of the recovery and resilience plan, the review of the tax system and extending the use of electronic payments is likely to support the broadening of the tax base and strengthening tax compliance. Moreover, ensuring to attract the right skills, while maintaining its human resource costs at pre-pandemic levels is set to safeguard the efficiency of the public administration. Banks and credit servicers are expected to further reduce the stock of non-performing loans with improved debt enforcement and a functional non-performing loan secondary market. Further measures could contribute to improving the business environment, for instance by completing the cadastre project, expediting environmental permitting procedures, completing special spatial frameworks in key sectors, and ensuring the effective application of environmental legislation. The labour market could further benefit from an improvement in the effectiveness of activation support, with a particular focus on young people and women. Export capacity continued to improve, but this trend needs to be persistent to enhance external sustainability.

The gradual withdrawal of policy support is set to contribute to better aligning domestic demand growth with external sustainability. In the wake of the COVID-19 pandemic and energy crises, domestic policy intervened forcefully to stabilise incomes. However, with these crises gradually subsiding, domestic demand growth appears to sizeably exceed output growth. The performance of the export sector has improved but did not prevent the widening of the current account deficit. The substantial policy support provided during the 2020-2022 period is set to be phased out which will allow fiscal policy to recalibrate incentives with sustainable domestic demand growth. However, untargeted spending items, such as the interest rate subsidy for young first-time home buyers, could result in further demand growth at a time when there is a need for ensuring external rebalancing. In this context, measures stimulating housing investment and the associated strong inflow of foreign direct investment into the property sector are unlikely to help strengthen the external sustainability of the economy.

Conclusion

Greece's long-standing vulnerabilities relating to high public debt and a high stock of non-performing loans in the context of high unemployment have been receding, but its external position has deteriorated. While the public debt-to-GDP ratio remains the highest in the EU, it improved substantially in 2022, largely driven by strong nominal growth. The stock of NPLs recorded a sharp fall last year, after large reductions in recent years.

However, the NPL ratio remains the highest in the EU and continues to weigh on banks' profitability and lending capacity. Greece's current account deficit widened to 9.7% of GDP in 2022, representing a noticeable deterioration relative to the pre-pandemic period and a potential source of heightened vulnerability. Even though it is forecast to shrink this year and next, the external balance is set to stay well below the level that would be required to ensure a lasting improvement in the net international investment position. While the labour market proved resilient in the face of both the pandemic and the energy crisis, unemployment remains high and employment growth is set to moderate in the coming years in line with slowing economic growth.

The authorities have taken measures to facilitate economic adjustment that contributed to the unwinding of imbalances, but further efforts would be needed to reduce external imbalances. Greece has reduced the legacy of non-performing exposures to banks' balance sheets, reformed labour market, and improved the business environment to support productivity. It maintains a steady pace of implementation of its Recovery and Resilience Plan, which represents a major opportunity to tackle structural weaknesses, boost growth and modernise the economy. Greece has also maintained prudent fiscal policies and overperformed its 2022 target to reach a small primary surplus of 0.1% of GDP. Public policy will continue to play an important role for sustaining and extending these achievements, for example through further strengthening the tax base and tax compliance, enhancing the efficiency of healthcare spending, or accelerating the reduction of the stock of non-performing loans. Yet further efforts would be needed to ensure continued unwinding of imbalances, in particular to ensure that external balances are put on a firmly improving path.

Based on the findings in this in-depth review, the Communication "European Semester – 2023 Spring Package" sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Greece, in line with Regulation 1176/2011. ([19])

(19) European Commission (2023), European Semester Spring Package 2023, COM (2023) 600 final.

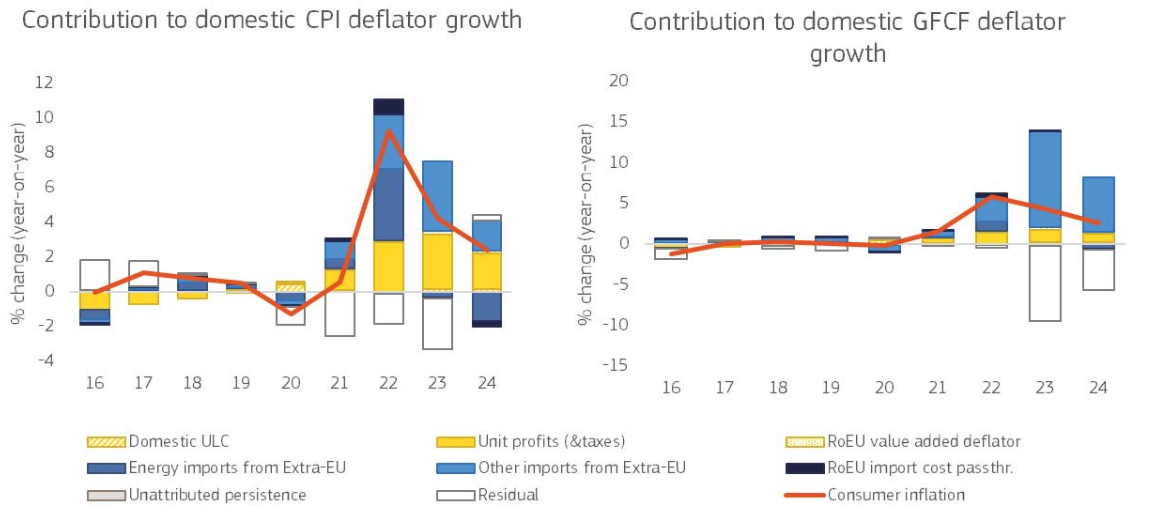
Box 1: Inflation exposures and cross-border pass-through

This box sheds light on the sources of inflation in Greece and its spillovers with EU partners. The period since 2021 has been characterized by pandemic aftershocks and global supply chain disruptions compounding global inflationary pressures and a surge in commodity prices triggered by Russia's war of aggression against Ukraine. As a result, inflation in Greece surged. Wage and profit growth also picked up across the EU, which further added to price pressures in Greece. With input-output data, domestic inflation can be decomposed into the contributions from key cost factors. Taking into account some data limitations, the framework can be used to attribute consumer and investment price changes to i) extra-EU import price changes, which include both directly imported inflation and inflation passed through from EU partners import costs ii) domestic unit labour cost changes iii) domestic unit profit changes, including indirect taxation changes and iv) rest-of-EU value added price changes. ([20])

Data suggests that much of inflation in Greece in 2022 reflected surging import prices as well as domestic factors. In 2022, as shown in Graph 2.3, energy and extra-EU non-energy imports contributed substantially to the increase in consumer and investment inflation. Domestic profits were also an important factor behind surging inflation. In addition, costs passed through EU partners further lifted prices of consumption and investment in Greece. Going forward, domestic factors, particularly profits, are expected to keep consumer and investment inflation elevated over the forecast horizon. Still, non-energy imports are set to become a key driver of inflation. Spillovers from value added inflation in other EU countries are set to remain negligible.

([20]) The graphs below are based on national accounts data and the Commission's Spring 2023 forecast, which are combined through a 'Ghosh' matrix based on Eurostat's Figaro input-output available for 2015-2020. HICP is taken as the measure of the price of private consumption, including non-residents. Energy import prices from extra-EU reflect realised median prices until 2022, and energy price assumptions underlying the Spring forecast thereafter. Other goods prices reflect median European prices per industry until 2022, and forecast non-energy goods and service trade prices for 2023-2024. Value added deflators are assumed to affect all industries within a country to the same degree. Changes in import prices and value-added deflators are assumed to affect demand prices with a delay of 4 months for consumption and investment inflation, respectively. For a similar analysis using an input-output-based methodology, see "Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-Depth Reviews" European Commission 2023, Institutional paper 198.

Graph 2.3: **Components of gross fixed capital formation deflator growth and consumer price inflation**



Source: European Commission services

Table 2.1: **Selected economic and financial indicators (Part 1), Greece**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Real GDP	4.1	-5.5	0.0	1.9	-9.0	8.4	5.9	2.4	1.9
Potential growth (1)	3.4	-1.0	-1.9	-0.7	-0.8	-0.3	0.4	1.0	1.5
Contribution to GDP growth:									
Domestic demand	5.1	-7.0	-0.5	1.5	-4.7	6.9	6.5	2.1	1.6
Inventories	0.0	-0.7	0.4	-0.3	1.3	0.8	2.4	-0.1	-0.1
Net exports	-1.1	2.1	0.1	0.7	-5.6	0.7	-3.0	0.5	0.4
Contribution to potential GDP growth (1):									
Total Labour (hours)	0.7	0.9	-0.1	-0.6	-0.7	-0.7	-0.3	0.1	0.3
Capital accumulation	1.0	0.1	-0.5	-0.4	-0.3	-0.1	0.0	0.1	0.2
Total factor productivity	1.7	-2.0	-1.3	0.3	0.2	0.5	0.7	0.8	0.9
Output gap (2)	1.5	-8.3	-13.5	-6.1	-13.8	-6.3	-1.1	0.3	0.8
Unemployment rate	9.8	14.7	24.1	17.9	17.6	14.7	12.5	12.2	11.8
Harmonised index of consumer prices (HICP)	3.3	2.9	-0.2	0.5	-1.3	0.6	9.3	4.2	2.4
GDP deflator	3.1	1.5	-1.2	0.2	-0.9	1.3	8.1	4.7	2.9
External position									
Current account balance (% of GDP), balance of payments	-10.3	-10.0	-1.6	-1.5	-6.6	-6.8	-9.7	-7.3	-6.0
Trade balance (% of GDP), balance of payments	-9.0	-7.2	-1.3	-0.9	-6.8	-7.6	-9.4	.	.
Primary income balance (% of GDP)	-1.5	-2.3	-0.2	-0.9	-0.2	0.2	-0.1	.	.
Secondary income balance (% of GDP)	0.2	-0.5	-0.1	0.3	0.3	0.7	-0.1	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-2.2	-1.7	-1.3	-1.2	-1.1	-1.1	-1.0	-0.9	-0.8
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	0.7	2.9	-0.7	-1.5	-2.8	-1.9	-1.0	-0.6	-0.3
Capital account balance (% of GDP)	1.2	1.2	0.9	0.4	1.7	2.2	1.5	.	.
Net international investment position (% of GDP)	-75.7	-94.2	-138.5	-154.1	-173.8	-171.9	-141.3	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	.	-96.2	-130.1	-133.5	-155.1	-150.2	-118.2	.	.
Net FDI flows (% of GDP)	0.0	-0.1	-1.1	-2.1	-1.4	-2.4	-2.2	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	3.1	2.8	-3.3	0.0	7.2	-3.1	-1.7	1.9	1.5
Nominal compensation per employee	5.6	-0.9	-3.3	-0.3	-0.6	2.3	0.3	3.6	2.8
Labour productivity (real, hours worked)	2.3	-3.5	-1.0	2.0	2.6	-1.4	0.3	1.1	1.1
Real effective exchange rate (ULC)	1.3	0.6	-4.9	-2.2	2.9	-3.3	-5.3	-3.6	-2.0
Real effective exchange rate (HICP)	1.7	0.2	-0.9	-1.8	-0.3	-1.1	-0.3	.	.
Export performance vs. advanced countries (% change over 5 years)	12.7	-5.1	-9.5	1.5	-10.2	14.6	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	84.7	125.6	126.9	110.3	124.9	120.7	98.9	.	.
Household debt, consolidated (% of GDP)	35.3	59.2	61.8	55.9	59.5	55.5	47.7	.	.
Household debt, fundamental benchmark (% of GDP) (6)	9.8	14.2	19.9	23.0	24.8	27.2	30.2	.	.
Household debt, prudential threshold (% of GDP) (6)	31.7	33.3	34.7	31.7	33.0	32.1	27.3	.	.
Non-financial corporate debt, consolidated (% of GDP)	49.4	66.5	65.1	54.4	65.4	65.2	51.2	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	23.1	29.1	35.2	38.6	42.1	46.9	53.4	.	.
Corporate debt, prudential threshold (% of GDP) (6)	52.4	56.4	59.3	53.5	57.5	56.9	48.4	.	.
Private credit flow, consolidated (% of GDP)	13.6	1.8	-2.4	-1.0	5.1	-0.1	0.8e	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	4.8	7.2	7.4	1.0	2.3	0.9	-0.5	-0.4	-0.1
Households, net lending (+) or net borrowing (-) (% of GDP)	-7.4	-4.7	-4.2	-3.2	1.7	1.2	-5.0	-4.1	-3.7
Net savings rate of households (% of net disposable income)	-0.4	-6.8	-13.8	-10.1	-5.1	-3.2	.	.	.

(e) estimate based on ECB quarterly data
(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.
(2) Deviation of actual output from potential output as % of potential GDP.
(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.
(4) This benchmark is defined as the average current account required to halve the gap between the NIIP and the indicative MIP benchmark of -35% of GDP over the next ten years, or to stabilise the NIIP at the current level if it is already above the indicative MIP benchmark. Calculations make use of Commission's T+10 projections.
(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.
Source: Eurostat and ECB as of 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)

Table 2.2: **Selected economic and financial indicators (Part 2), Greece**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	2024
Housing market									
House price index, nominal	7.5	-4.9	-4.3	7.2	4.5	7.6	11.1	.	.
House price index, deflated	4.2	-6.5	-3.3	7.2	5.7	6.6	3.3	.	.
Overvaluation gap (%) (7)	9.8	13.0	-7.0	-4.7	0.1	3.1	5.7	.	.
Price-to-income overvaluation gap (%) (8)	9.7	11.2	-3.8	-6.5	1.8	0.7	-1.8	.	.
Residential investment (% of GDP)	9.7	5.6	1.0	0.8	1.1	1.3	1.6	.	.
Government debt									
General government balance (% of GDP)	-7.1	-11.3	-3.5	0.9	-9.7	-7.1	-2.3	-1.3	-0.6
General government gross debt (% of GDP)	103.7	144.2	180.3	180.6	206.3	194.6	171.3	160.2	154.4
Banking sector									
Return on equity (%)	.	6.0	-8.8	0.7	-7.9	-20.1	.	.	.
Common Equity Tier 1 ratio	.	9.6	15.4	16.2	15.0	14.0	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	.	9.1	35.6	31.3	22.2	7.1	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	43.9	35.5	26.5	8.6	6.4	.	.
Cost of borrowing for corporations (%)	5.8	6.1	4.8	3.9	3.1	3.0	4.7	.	.
Cost of borrowing for households for house purchase (%)	4.4	4.0	3.0	2.9	2.7	2.5	3.7	.	.

(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long-term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long-term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
Source: Eurostat and ECB as of 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)

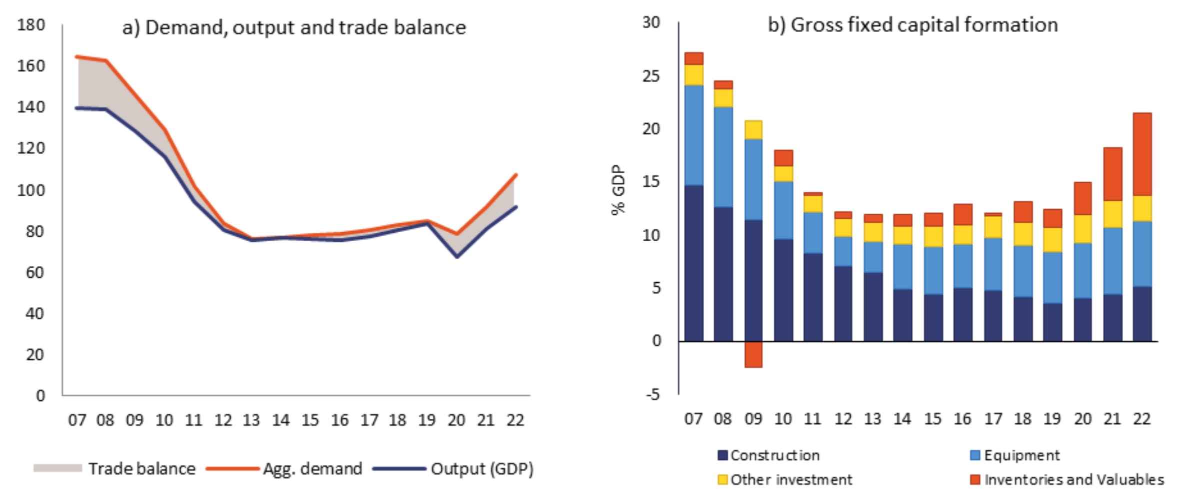
3. THEMATIC CHAPTER: EXTERNAL SUSTAINABILITY

The economy of Greece increasingly depends on external financing, reflected by a rising current account deficit. Greece experienced a substantial widening of its current account deficit in the last three years. The deficit reached 9.7% of GDP in 2022, the highest in a decade, worsening sharply from 1.5% in 2019 and 6.8% of GDP in 2021. Hence, the outturn for 2022 came in closer to the level recorded right after the outbreak of the global financial crisis. ([21])

A strong rebound in domestic demand has not been matched by output growth since 2020. In the eight years up to the pandemic, output roughly matched demand. Real output contracted sharply when the COVID-19 shock hit the Greek economy. The subsequent strong economic rebound, led by consumption and investment, induced strong import growth, and pushed the trade balance into a widening deficit (See graph 3.1a). This raised concerns over Greece's ability to return to a path towards a more sustainable external position in the medium to long run. In 2022, the growth of absorption, i.e., consumption and investment, including inventories, exceeded output growth both in nominal and real terms. In current prices, this was also due to strong increases both in the consumption and investment deflators, strongly influenced by the surge in energy prices (See graph 3.5c and d). The large increase in investment was associated with a significant rise in inventories over 2021 and 2022 (See graph 3.1b). This is the result of specific accounting methods used for the registrations of work in progress and unfinished constructions which fall under this category.

([21]) External sustainability analysis: thematic note to support In-Depth Reviews, Brussels, 17 February 2023. The note considers the data up to 2022Q3 and uses Autumn forecast 22, which is updated in the IDR to 2022 and SF23.

Graph 3.1: **Demand, output and gross capital formation**

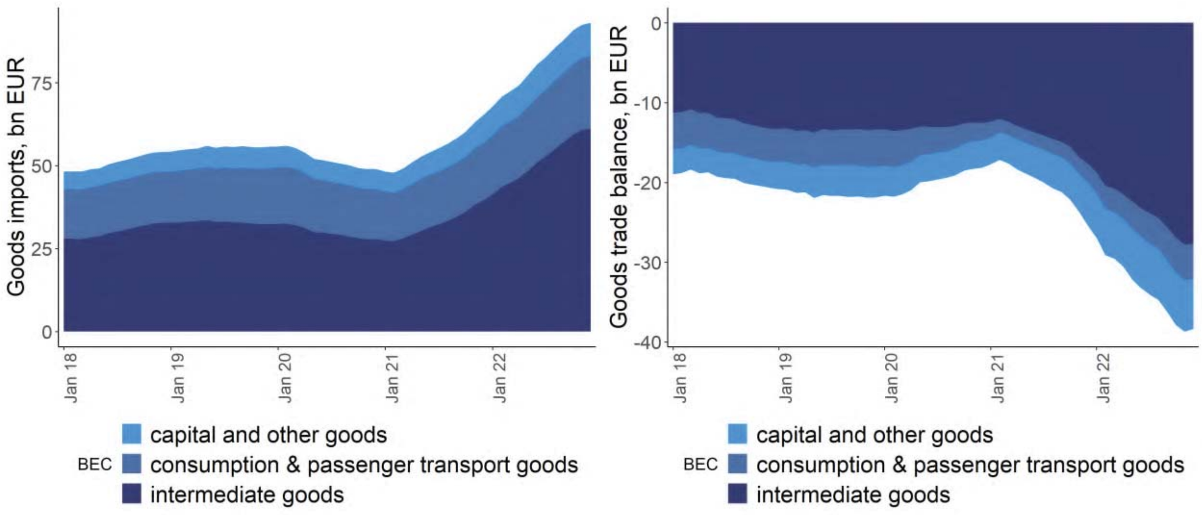


Source: European Commission services

Domestic demand growth has been led by investment in machinery and construction and household expenditure on health and communication after 2019. Investment activity is concentrated in the construction and machinery sector while investment in other potentially more productive sectors is growing at a lower pace. Investment spending outpaced the EU average across almost all categories. The 'machinery' and 'other machinery & equipment, including weapons' were the categories with the highest relative growth compared to the EU average. The increase in dwellings investment may also reflect the increase in construction costs though. In addition, household spending remains strong, although it is set to moderate over the forecast horizon. Above EU average household expenditure was led by spending on health and communication (see Graph 3.6). Disaggregating trade flows according to broad economic categories (BEC), the bulk of the increase in Greece's non-energy trade deficit is primarily due to intermediate goods, followed by capital goods and consumption goods (see Graph 3.2). The substantially increased contribution of intermediate and to a lesser extent capital goods may indicate a higher genuine demand for investment, though it may also reflect supply-side constraints and increased energy prices ([22]).

([22]) Energy inputs are included in the intermediate goods category.
https://ec.europa.eu/eurostat/ramon/other_documents/bec/BEC_Rev_4.pdf

Graph 3.2: **Trade balance and import developments by broad economic category (BEC)**

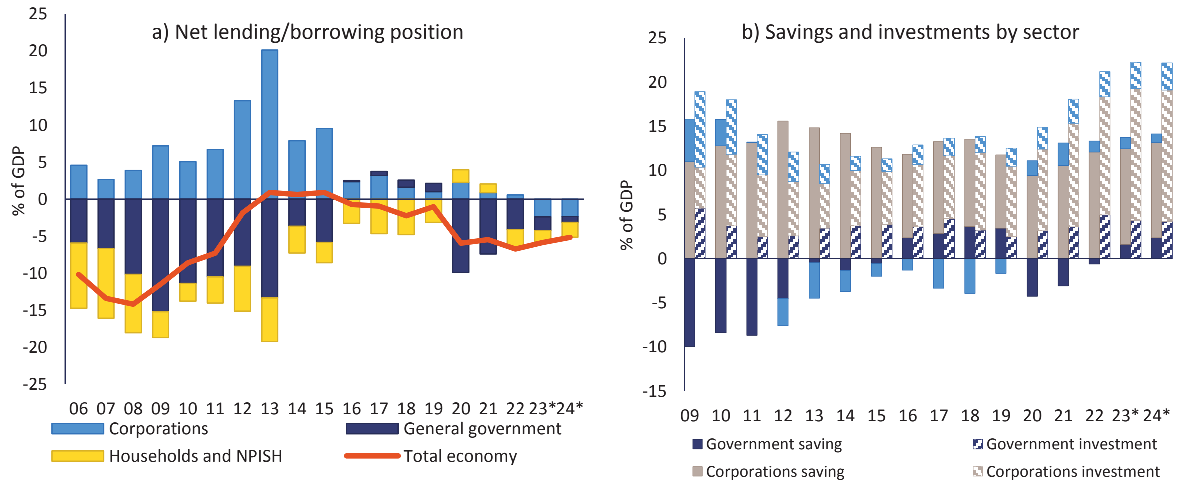


Source: European Commission services

From a sectoral net lending perspective, the widening of the current account deficit after 2019 reflects, to a large extent, the decline in the government net position. High budgetary costs to mitigate the impact of the pandemic crisis widened fiscal deficits to 9.7% in 2020 and 7.1% of GDP in 2021, which were among the highest fiscal deficits in the EU. In 2022, the Greek government introduced one of the largest economic and social support packages among EU Member States, around 2.3% of GDP ([23]), mitigating the economic consequences of the energy price surge. Still, the deficit declined substantially, to 2.3% of GDP, on account of strong nominal growth and the phasing out of pandemic related support measures. During the COVID-19 pandemic, private consumption was suppressed due to containment measures and precautionary motives. As the economy opened up in 2021, households normalised their consumption behaviour and the increased savings of 2020 and early 2021 turned out to be temporary. Households' net position turned negative again, moving from 1.2% in 2021 to -5% of GDP in 2022. Similarly, the net position of corporations declined from 0.9% in 2021 to -0.5% of GDP in 2022 (see Graph 3.3).

([23]) See communication from the commission to the European Parliament, the European Council and the European Central Bank, on the 2023 Draft Budgetary Plans: Overall Assessment 22-11-2022.

Graph 3.3: **Net lending/borrowing position and savings/investment developments**

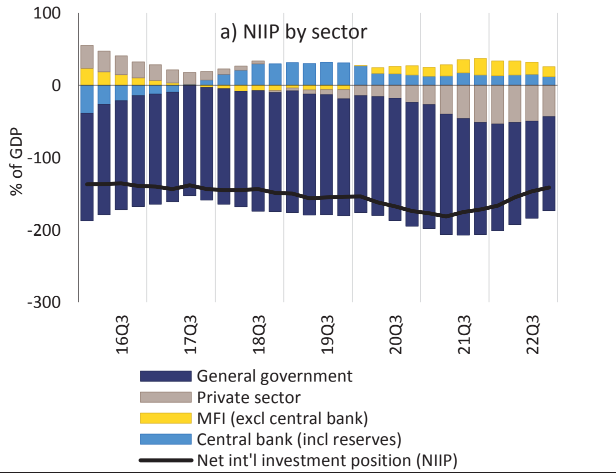


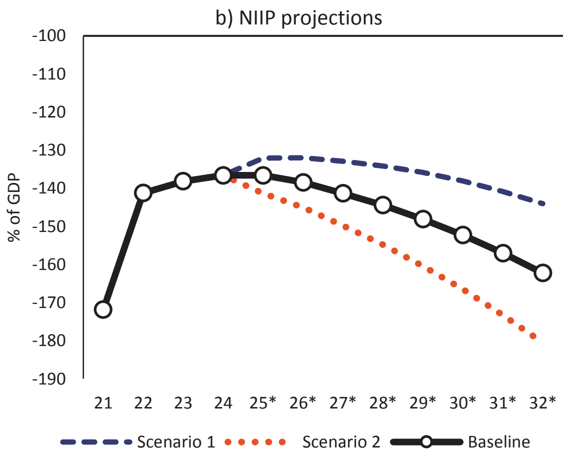
Source: Eurostat and European Commission services

The large inflows of EU funds improve the net borrowing position of the Greek economy, while foreign direct investment (FDI) inflows cover an increasing share of external financing needs. The net borrowing position net of borrowing financed by EU funds shrank to a still substantial -5.9% of GDP in 2022. Greece continues to attract large FDI inflows, which have recently exceeded the longer-term pre-pandemic levels. FDI inflows covered 28% of net financing needs in 2020 and 53% in 2021 and 26% in 2022. A large part of FDI was concentrated in the real estate sector, where a significant increase was observed in 2022 vis-à-vis previous years. However, the use of debt instruments in financing the external deficit also increased in recent years. In 2022 debt instruments covered more than half of net financing needs. More specifically, the net outflows of portfolio investment debt were more than offset by strong net inflows of debt in the form of other investment.

Considering Greece's substantial negative net international investment position (NIIP), high current account deficits do not bode well for the resilience of the economy to adverse shocks. The net international investment position of Greece remains the lowest in the EU. Following a protracted period of economic stagnation in the last decade, the Greek economy entered the COVID-19 crisis with the NIIP at -154% of GDP (see chart 3.4 a). The position deepened considerably in 2020 as the income from tourism, a key external source of income of the economy, plummeted. At the same time, generous fiscal support, which mitigated the hit to domestic demand, relied on external financing. After a broad stabilisation in 2021, the NIIP improved to slightly below 2019 levels in 2022, driven mainly by nominal growth. Nevertheless, at -141% of GDP in 2022, the NIIP remained the lowest in the EU and considerably below prudential levels (-46% of GDP), as well as levels explained by fundamentals (-78% of GDP). The Greek economy is leveraging the Next Generation EU funding and the favourable interest rate structure to raise investment to improve potential growth and living standards. As the financing costs are expected to increase, the burden of financing the large negative NIIP will add to the challenge of narrowing the current account deficit, just when EU transfers start to decline.

Graph 3.4: **Net international investment position**





Source: European Commission services

Going forward, the current account balance is expected to remain well below benchmarks in 2023 and 2024. According to the Commission's Spring 2023 forecast, the current account deficit is forecast to improve to 7.3% of GDP in 2023 and to 6.0% in 2024, as the fiscal balance is projected to remain in deficit and domestic demand to stay strong. In particular, the significant growth in investment in real terms, also boosted by RRF disbursements, is projected to persist, while consumption growth is set to stabilise at around 1.5% over the forecast horizon. Energy commodity prices, including prices of oil and petroleum products on which the Greek economy is most reliant, have fallen recently, helping to reduce somewhat the current account deficit. The spring forecast assumptions for commodity prices imply a reduction in the current account deficit by around 2.7% of GDP in 2023. ([24])

More efforts would be needed to ensure that external balances are put on a firmly improving path. The projected current account balances are below the Commission's estimates of Greece's current account "norm" ([25]), i.e. the current account level implied by economic fundamentals, of around -1% of GDP. In addition, the deficit persists well below the level required to halve the gap to the fundamental NIIP benchmark over 10 years, which is estimated at around -0.9%, and below the current account required to reach the prudential threshold over 10 years, estimated at 3.9%. Moreover, with a deficit of this size, the NIIP cannot even be stabilised at the current deeply negative level over the next ten years. ([26]) Even if considering the reduction driven by expected lower energy prices, the

(24) The energy price impact is set to fall from -4.1% in 2022 to -1.4% in 2023.

(25) Current accounts norms, i.e. current accounts in line with fundamentals, are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018.

(26) The NIIP-stabilising current account benchmark is defined as the current account required to stabilise the NIIP at the current level over the next 10 years. The current account required to reach a specific NIIP target is the current account required to reach the prudential threshold over the next 10 years, or to halve the gap to the NIIP in line with fundamentals, whichever is higher. NIIP prudential thresholds are determined from the maximisation of the signal power in predicting a balance of payment crisis, taking into account country-specific information summarised by per-capita income. NIIP in line with fundamentals (NIIP norms) are obtained as the cumulation over time of the values of the current account norms. For the methodology for the computation of NIIP prudential and fundamental

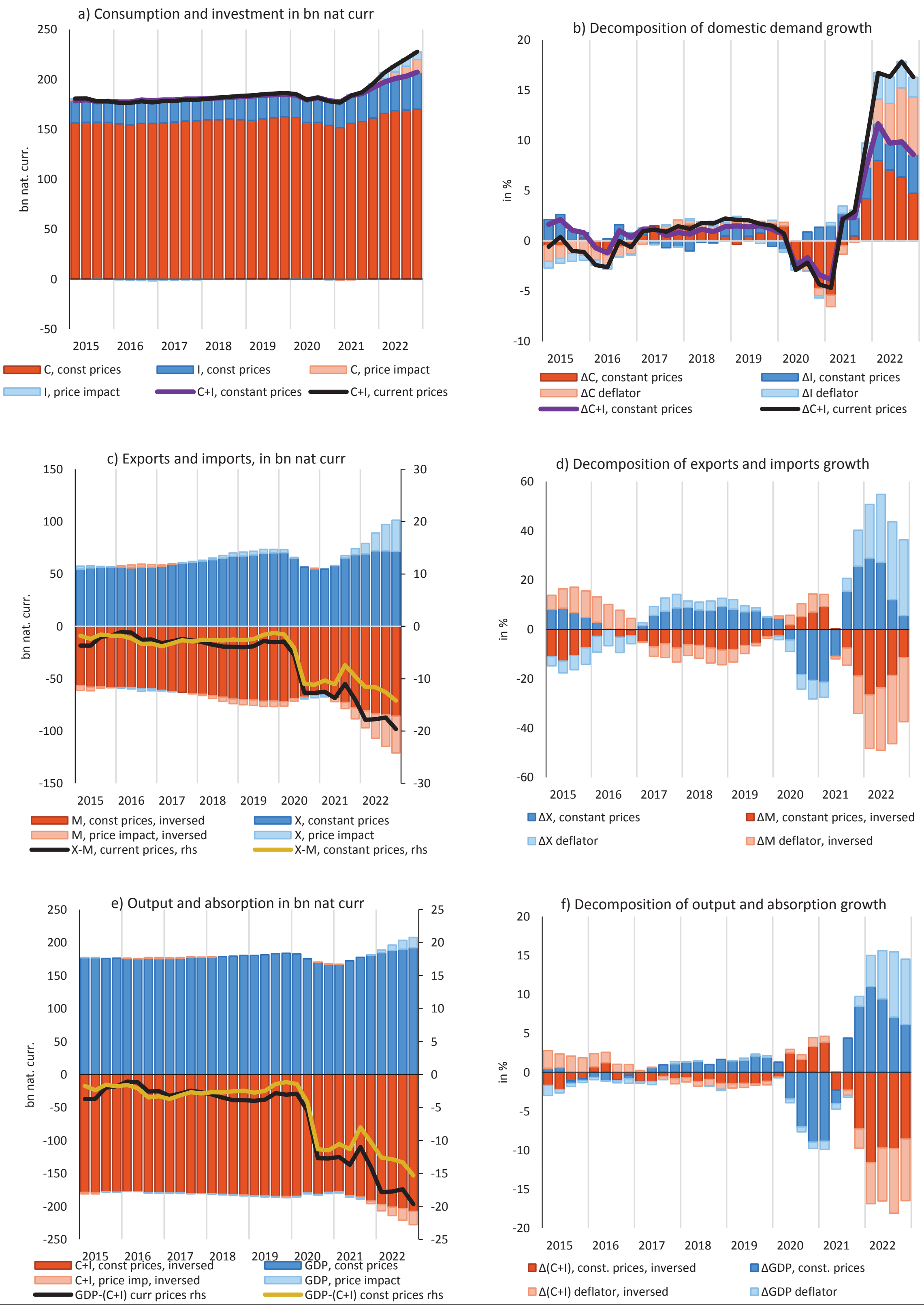
current account would still be considerably below the norm benchmarks. As a result, the NIIP is set to deteriorate. ([27]) According to the Commission's spring forecast, the position is expected to remain broadly stable this year and next. However, medium-term projections point at a gradual worsening of the NIIP even under favourable assumptions. Baseline assumptions for growth, inflation and trade balances see the NIIP to fall to around -162% of GDP by 2032 (see Graph 3.4b). Should economic growth and trade perform better than assumed in the baseline (scenario 1), the NIIP would unlikely improve above current levels by 2032. ([28]) In a scenario, in which economic growth and international trade underperform the baseline assumptions (scenario 2), the NIIP deteriorates considerably in the medium-term. Hence, public policy will continue to play an important role to ensure that domestic demand growth is consistent with external sustainability by appropriately calibrating demand incentives and by paying attention to the composition of tax and spending items. To further improve the external sustainability of the Greek economy, while closing the significant investment gap, national savings need to increase significantly. Supporting productive investment needs to be consistent with putting external balances on a firmly improving path.

benchmarks, see A. Turrini and S. Zeugner (2019), "Benchmarks for Net International Investment Positions", European Economy, Discussion Paper 097/2019.

([27]) Overall, the large inflows under the Recovery and Resilience plan (which amount to 17% of 2021 GDP in total) cover part of the external financing needs. Their projected impact on the capital account and secondary income balance are taken into account in the NIIP projections referred to above.

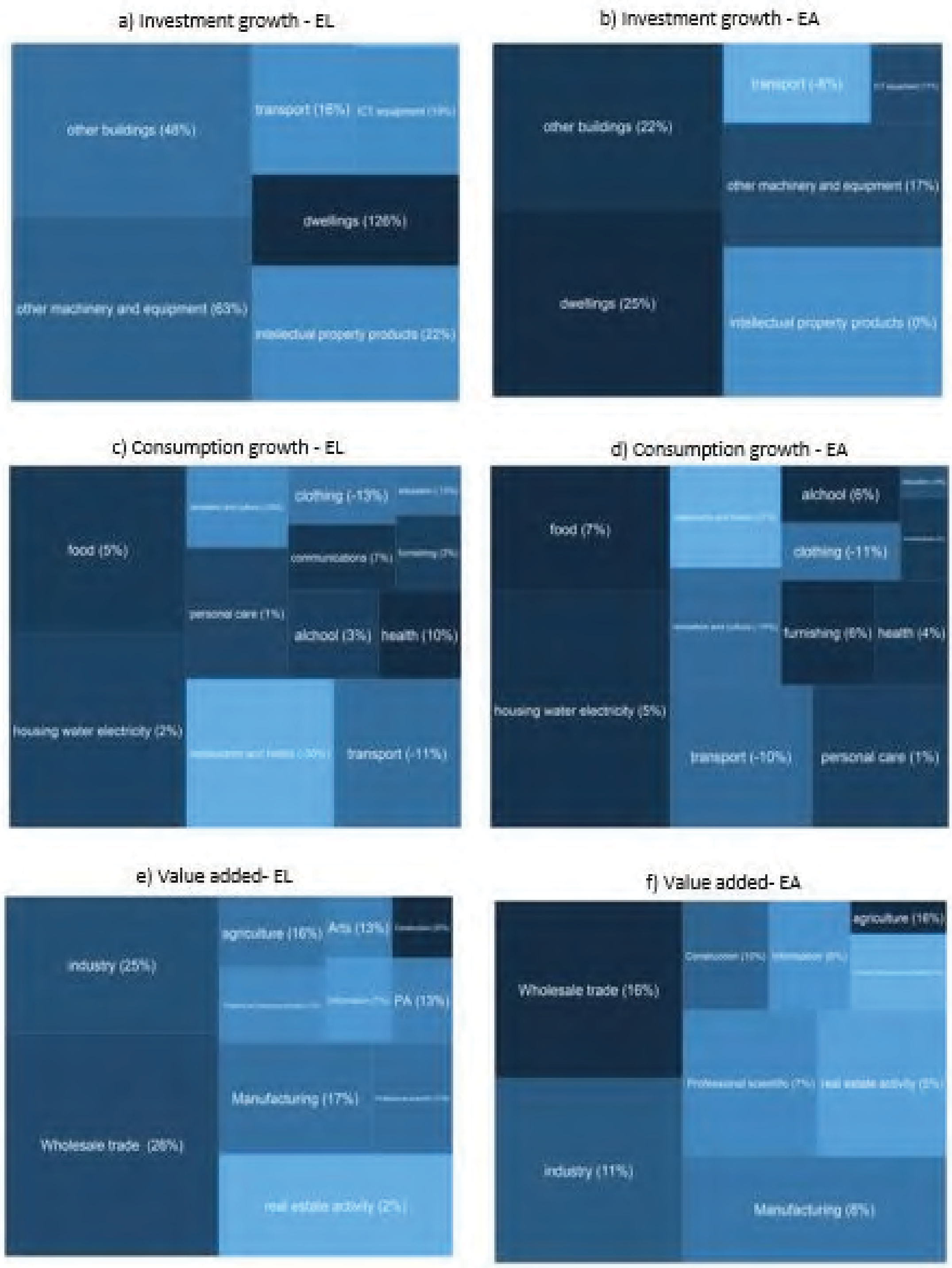
([28]) See footnote 7 for the details of the scenarios.

Graph 3.5: **Consumption and investment, export and import developments**



Source: European Commission services

Graph 3.6: **Investment and consumption growth by sector - Greece vs. Euro area**



area of the squares represent the weight on total consumption/investment and the colour represents the intensity of the growth rate
Source: Eurostat and European Commission services