Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

Eurobank EFG

GREECE MACRO MONITOR

January 17, 2012

Focus notes: Greece

Focus Greece - The crucial three months ahead (updated)

Platon Monokroussos, PhD
Assistant General Manager
Head of Financial Markets Research
pmonokrousos@eurobank.gr

Paraskevi Petropoulou
G10 Markets Analyst
ppetropoulou@eurobank.gr

In our Greece Macro Monitor published December 5, 2011, we provided a detailed analysis of the main risks and challenges facing Greece in the crucial period ahead as well as a detailed timetable of the key dates and events leading to the timely disbursement of the next EU-IMF loan tranche. In this issue we update our prior analysis on the basis of the most recent developments and the information we have lately collected from a number of press reports and other sources.

As a reminder, the government expects the next tranche of official funding to amount to as much as €89bn. This will reportedly consist of:

i) €30bn in euro area loans to run the PSI *i.e.,* provide certain *sweeteners* to the deal in the form of *e.g.* an upfront cash payment or, *alternatively*, EFSF bonds offered along with new discount Greek government bonds to existing bondholders participating in the exchange*;*

ii) €30bn to finance bank recapitalization needs that may arise after the sovereign debt restructuring; and

iii) €29bn to cover debt servicing and deficit financing needs, inclusive of some €9bn in EU bilateral loans under the existing *Greek Loan Facility*.

The timely disbursement of the next official loan tranche is of paramount importance for implementing the PSI deal and avoiding a disorderly default. Note here that Greece has to redeem a €14.435bn 3-year sovereign paper on March 20. As things stand at this point, the government will need to fight an uphill battle to overcome a number of important hurdles before a final agreement with official lenders is reached on the second bailout plan decided at the October 26-27 EU Summit. In what follows, we comment on these looming obstacles and provide and timetable of important dates and events investors need to closely monitor in the period ahead.

Parliament vote on omnibus bill incorporating earlier-agreed measures scheduled for January 19

As a preparatory step ahead of the upcoming round of negotiations with the Troika (see below), The Greek government submitted to parliament last week a new omnibus bill of fiscal measures and structural reforms for the period 2012 to 2015, as part of earlier commitments made under the existing adjustment programme. The bill, which is expected to gain parliamentary approval on January 19th, includes, among others, measures relating to: **(i)** the opening up of a number of closed professions *e.g.* lawyers, notaries, taxi and truck drivers; **(ii)** favorable settlement arrangements for taxpayers with overdue debts to the State and for businesses with overdue contributions to the social security system; and **(iii)** the introduction of new objective criteria for the determination of taxable income of self-employed. Such criteria will reportedly include *e.g.* the overall liquidity and net position of the tax payer, his bank deposits and expenses paid in cash. Barring any unforeseen circumstances, we expect the tripartite coalition supporting the current government (252 seats in the 300-seat Parliament) as well as a number of independent MPs to vote in favor of the bill.

Troika mission arrives in Athens this week

Officially, the government's new race to avoid an outright sovereign default kicks off on January 17th, when a technical team of Troika inspectors arrives in Athens for preparatory talks with government officials ahead of the expected arrival – *by the coming Friday or early next week* - of the heads of the IMF/EC/ECB mission. Discussions with domestic authorities at this stage will reportedly focus on the progress made so far on the agreed fiscal consolidation and structural reforms agenda laid out in the existing adjustment programme and the government's updated medium-term fiscal plan (MTFS, 2012-2015). Other important issues of discussion in the upcoming negotiations will also include:

i) ***Additional measures to further reduce wage costs in the broader public sector***. Such measures will include, among others, more staff redundancies and the merging/closure of a number of "unproductive" enterprises. This is especially since the activation of the so-called *Labour Reserve* late last year apparently failed to generate the expected results. As a prior action to the 5th EC/IMF/ECB review, the government passed through parliament in early October a plan envisioning the transfer of some 30k public sector employees to a special reserve by the end of 2011. Employees transferred to the special reserve would receive 60% of their basic wage for a 12-month period, after which permanent separation would be mandatory. According to reports, since last October only 8% of a total of ca 937 thousand employees who left the public sector were transferred to the labor reserve, with the rest representing employees who either decided or were forced to retire. Administrative Reform Minister Dimitris Reppas admitted last week that the *Labour Reserve* reform is no longer in force. Purportedly, the government now expects to reach the MTSF's target for downsizing the overall public sector payroll by 150 thousand employees by 2015 through alternative measures, including pre-specified hiring limits and natural attrition.

ii) ***Measures to enhance wage flexibility in the private sector with a view to further reduce labour costs and boost competitiveness.*** Some of the measures under consideration include: a reduction in the €751 minimum wage set in the latest national collective labor agreement; lower supplementary pensions and lump-sum payments upon retirement; and a reduction (or even abolition) of the 13th and 14th salary installment in the private sector. On the latter issue, the government is reportedly mulling the following three scenarios: **a)** a three-year freeze in the 13th and 14th salaries; **b)** a reduction in the 14th salary to an amount equal to the minimum wage, regardless of the fixed monthly salary an employee currently receives; and **c)** the establishment of a ceiling for the 13th and the 14th salary installments for employees earning a gross monthly salary of less than €3000, as it is currently the case for the public sector. Under that scheme, the 14th and 13th salary installments would be reduced to €500 and €250, respectively. For those earning more than €3000 per month, the 13th and the 14th salaries would be abolished.

ii) ***Additional measures in 2012 to compensate for last year's fiscal slippage.*** Other issues expected to be raised in the upcoming negotiations with the Troika inspectors also include: **a)** corrective action that need to be taken this year to offset slippages in the execution of the 2011 budget; and **b)** additional measures for the coming three-year period to close an identified fiscal gap of ca €7bn in 2012-2015. (As per the 5th IMF Review, these are estimated at 3ppts-of-GDP, consisting of 2ppt-of-GDP in adjustment measures and 1ppt-of-GDP in contingency measures). Purportedly, Greece needs to identify and approve these measures by June 2012. Yet, a senior government official was recently quoted as saying that the *present* "national unity" government would probably have to negotiate these measures with the Troika in case that the date for the next national election is delayed more than currently expected (see also comment below).

Labor unions, employer federations signal opposition to proposed reforms aiming to further reduce labor costs, increase wage flexibility in the private sector

In a round of related preliminary talks with government officials over the last few sessions, labor union leaders argued that lower-income employees can not any longer bear the main burden of domestic economic adjustment, on the basis that the minimum monthly wage is already *too low* in comparison with the cost of living. Representatives of employer federations also supported the employees' argument. They currently appear to oppose a reduction in the minimum wage set by the latest national collective labour agreement. Commenting on the latter issue, the President of the Association of Greek Tourism Enterprises (SETE) said recently that his association supports the national collective wage agreement and called for a 10% reduction in social security contributions, which he claimed were the highest in Europe. He added that some regional contracts specific to certain professions in the tourism sector should come under review as they lead to salaries that they are up to 40% above the minimum set in the collective labor agreement. In line with other employer groups, Dimitris Daskalopoulos, the head of the Hellenic Federation of Enterprises (SEV), said that his federation would do "whatever it can" to ensure the minimum wage is not lowered and urged political parties and government ministers to reach a common base on the issue, with a view to help promote competitiveness and employment.

Greek Premier to initiate shortly official talks with social partners on crucial labor market reform

On January 18, Prime Minister Lucas Papademos is scheduled to initiate an official round of talks with trade unions and employer federations on a number of crucial issues concerning wages, pensions and labour relations. Mr. Papademos is expected to hold talks with representatives from, among others, the General Confederation of Greek Labour (GSEE), Greece's largest trade union, the Hellenic Federation of Enterprises (SEV) and The General Hellenic Confederation of Professionals, Craftsmen and Merchants (GSEBEE). According to some press reports, if the upcoming negotiations between social partners fail to yield an agreement leading to a significant reduction in labor costs, the Greek government may proceed with a legislative act to incorporate about half of the 13th and the 14th salaries into the monthly wage. From his side, the Greek Prime Minister kept alive market rumous for a government intervention if unions and employers fail to reach an agreement on reducing labour cost. Responding to a question in parliament late last week over whether legislation could be adopted to force wage cuts, Lucas Papademos said that "we are making every effort to avoid such a development", adding that " we do not have many alternatives; we are obliged to live through a period of adjustment." According to the same reports, the act will also suspend businesses' obligation to raise the basic wage by 2.6% as of July 2012, in accordance with the last national collective labor agreement reached in mid-2010. In a letter sent to the Greek Labor Ministry last week, the Troika noted that while the 13th and 14th salaries have been abolished in the public sector, they still apply to the private sector as well as a number of State enterprises (DEKO) including, among others, the Public Power Corporation and the Athens and Thessaloniki water companies.

PSI negotiations discontinued temporarily; Greek PM confident talks on bond swap to resume "reasonably soon", expects deal to be completed in next two-three weeks.

Talks between Greece and representatives of creditor banks were halted temporarily last Friday, after IIF head Charles Dallara left Athens without a formal agreement on a deal following a new round of negotiation with top government officials. Mr. Dallara was consequently quoted in *Financial Times* newspaper as saying that "an agreement was needed by the end of this week, if it was to be finalized in time for the March bond redemptions". In a separate interview, the same official told Reuters that "some officials" wanted private creditors to accept "completely unreasonable" interest rates, confirming a number of earlier reports suggesting that the latest talks on the debt swap deal stalled mainly due to lingering differences regarding the coupon rates of the new bonds. From his part, the Greek Premier told CNBC on Monday that he was optimistic that talks on the bond swap will resume soon, with an aim to complete the bond swap and the new economic program in the next two-three weeks.

Based on a number of recent reports, it appears that an agreement has already been reached between official lenders and the representatives of creditor banks on a number of important parameters of the Greek debt exchange deal. These include:

i) an upfront cash payment of 15 cents (or, equivalently, EFSF bonds) and a new discount Greek government bond (with 35% notional) offered for every old bond being tendered for exchange;

ii) *pari passu* treatment of the new bonds and the €30bn EFSF loan provided to Greece to run the debt exchange;

ii) an offer of certain additional *sweeteners* to GGB bondholders participating in the exchange; these could take the form of *e.g.* GDP warrants offered with new bonds as detachable and separately tradable instruments; and

v) Issuance of new bonds under UK law.

As we noted earlier, it appears that one of the major hurdles that need to be overcome in the PSI negotiations relates to the coupon structure of the new bonds. Reportedly, the creditor banks have already proposed a structure involving an average coupon in the vicinity of 5.00%, which would imply an NPV loss of ca 60% to participating investors. That is, assuming a 30-year maturity for the new bonds and "exit yield" of ca 9% for discounting the future steam of cash flows. Greek newspapers reported over the weekend that Greece's official creditors are currently pressing for lower coupons *(i.e., in the area of 2% to 4%)* on the new bonds on the basis that, due to deteriorating conditions domestically and in the economies of main trade partners, higher concessions would be needed by private investors, so as to facilitate a gradual reduction in Greece's debt ratio towards the 120%-of-GDP target envisioned in the October 26-27 EU Summit Statement. These views appears to be in agreement of a number of earlier reports suggesting that the IMF has already warned EU partners that, due to the deteriorating growth prospects of the Greek economy, the EU should either increase its contribution to the 2nd Greek bailout package or debt holders should accept an even larger haircut in order to render the country's debt sustainable.

Suggested timetable for the implementation of debt exchange deal and 2nd Greek bailout package

In what follows, we present an *indicative* timetable for the timely implementation of the debt exchange and the sealing of the 2nd bailout package agreed at the October 26-27 EU Summit. The timetable discussed below is based on a number of press reports and it *purports to* secure adequate State financing, so as to avoid unforeseen liquidity shortages ahead of the next sizeable bond redemption on March 20.

As things stand at this point, negotiations on the Greek bond swap should optimally be completed over the next few weeks so as to have a final deal available by February 10. A one week notice could then be given to private bondholders to affirm participation in the debt exchange. In the meantime, a *preliminary* agreement on the new conditionality underling the 2nd bailout package should be signed between Greece and the Troika to allow disbursement of the initial installment (€30bn) of the next loan tranche (€89bn), which is required for implementing the PSI scheme. If all goes well, the debt swap will then be completed by the end of February.

Note also that according to the terms of the new rescue package EU leaders agreed in late October, temporary EFSF credit enhancements (of up to €35bn) will be provided to ensure the eligibility of Greek bonds in ECB liquidity operations. Such credit enhancements will purportedly remain in place for as long as Greece's sovereign ratings remain on "selective default" due to the implementation of the debt swap.

Of course, all the above assume that a voluntary deal is reached with private-sector bondholders and the debt swap generates *sufficient* participation. If the latter conditions are not met, then a *non voluntary* restructuring should not be *technically* excluded, especially since the Greek government has already signaled that it seriously considers introducing Collective Action Clauses (CACs) in existing GGBs subject to Greek law (ca 90% of GGBs outstanding are subject to Greek law). Reportedly, the mere introduction of CACs (via a parliamentary decision to change the respective law) would not constitute a "credit event". However, their activation would likely trigger CDCs.

Based on the results of the debt swap (i.e., participation rate), the terms of the new loan agreement would then be finalized. According to the Minister of State, Pantelis Kapsis, the new rescue deal and the corresponding implementation measures supporting the package should be approved by the Greek parliament by mid- March.

In the meantime, the above will also have to be endorsed by the IMF and be ratified by the national parliaments of a number of EU countries (i.e. Finland). Consequently, official lenders will give the green light for the disbursement of the remaining installment of the 7th loan tranche (€29bn for debt servicing & deficit financing + €30bn for bank recapitalization to be implemented in April).

Finally, assuming that everything goes according to plan, and that Greece successfully completes the agreement for the 2nd bailout package, national elections are likely to be held by late April 2011.

Research Team

Financial Markets Research Division
Platon Monokroussos: *Head of Financial Markets Research Division*
Paraskevi Petropoulou: *G10 Markets Analyst*
Galatia Phoka: *Emerging Markets Analyst*

Sales Team
Nikos Laios, Head of Sales
Vassillis Gulbaxiotis, Head of International Sales
Yiannis Seimenis, Ioannis Maggel, Corporate Sales
Stogioglou Achilleas, Private Banking Sales
Alexandra Papathanasiou, Institutional Sales

Economic Research & Forecasting Division
Dimitris Malliaropulos: *Economic Research Advisor*
Tasos Anastasatos: *Senior Economist*
Ioannis Gkionis: *Research Economist*
Vasilis Zarkos: *Economic Analyst*
Stella Kanellopoulou: *Research Economist*
Olga Kosma: *Economic Analyst*
Maria Prandeka: *Economic Analyst*
Theodosios Sampaniotis: *Senior Economic Analyst*
Theodoros Stamatiou: *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr