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GREECE MACRO MONITOR

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Focus notes: Greece

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Budget execution data for January-November 2010 continue to underperform the official target

According to final data released by the General Accounting Office (GAO), the year-to-November central government budget deficit reached ca €18.6 bn, compared to €25.6 bn in the respective period last year, a 27.4%yoy decrease. This is lower than the annual official target of -33.2%yoy as well as the -32.0%yoy target for the January-November period.

The reduction of the year-to-November central government budget deficit was the result of sharply lower primary expenditure and investment program outlays, relative to the same period a year earlier. Moreover, growth in ordinary budget revenue was 4.8%yoy, (the respective amounts were €45.3 bn for 2010 and €43.3 bn for 2009) lower than the annual government target of 6.0%yoy. Year-to-November revenues before tax refunds increased by 4.1%yoy, while tax refunds declined by -2.7%yoy. November budget revenues include – in addition to regular tax revenues from VAT etc. – additional revenues ca of € 0.7 bn from the ongoing process of settlement of past tax obligations. Note here that the Government extended the deadline of the settlement process to end-of-December 2010 (from end-of-November 2010 initially) and additional revenues are expected in December.

VAT revenues increased by 11.1%yoy in November and 4.8%yoy in the year-to-November period as a result of: (a) the government's measures to fight tax evasion and (b) the VAT hikes introduced ιn July 1st, 2010. Moreover custom revenues increased by 33%yoy in November 2010.

Meanwhile, year-to-November budget expenditure decreased by 6.4%yoy compared with an annual target of -7.5% (the respective amounts were €58.3 bn for 2010 and €62.3 bn 2009). Primary expenditure fell by €5.1 bn for the year-to-November period, a decrease of 10.1%yoy compared with an annual target of -9.0%. Interest costs continued below their targets for the second time in the last four months; an increase of 5.7%yoy was recorded compared with an annual target of 7.6%. Finally, Public Investment Budget (PIB) revenues fell by €0.1bn for the year-to-November period, a decrease of 6.8%yoy compared with an annual target of a 41.7% yoy increase. PIB expenditure fell by ca €1.0bn for the respective period, a decrease of 12.2%yoy which is above the annual target of -11.3%.

Ordinary Budget	January-November 2010 (€bn)	January-November 2010 (%YoY)	Annual target (%YoY)
1. Net Revenues (a-b)	45.34	4.8	6.0
a. Gross revenue	49.58	4.1	5.7
b. Tax returns	4.24	-2.7	3.0
2. Expenditure (α+β+γ)	58.32	-6.4	-7.5
α. Primary expenses	45.07	-10.1	-9.0
β. Transfer to hospitals for the settlement of part of past debt	0.34		
γ. Interest costs	12.90	5.7	7.6
Public Investment Budget (PIB)			
3. Revenue	1.46	-6.8	41.7
4. Expenditure	7.16	-12.2	-11.3
5. Budget deficit (1-2+3-4)	18.68	-27.1	-33.2

Source: Ministry of Economics

Second MoU revision: 2010 fiscal deficit will miss the target of 9.4%-of-GDP

According to the December MoU Revision – as well as the December 2010 Progress Report on the Implementation of the EC/ECB/IMF adjustment programme prepared by the European Commission (EC) – the 2010 actual government deficit will be ca 9.6%-of-GDP (in ESA95 terms) which is higher than the revised programme's target of 9.4%-of-GDP. In addition, according to press releases, the 2010 government deficit (in ESA95 terms) is estimated at around 10.0%-of GDP, which is above the official target of the programme.

Note that the EC's estimate of 9.6%-of-GDP for the actual deficit is 1.5%-of-GDP higher than the previous (before the revision) target of 8.1%-of-GDP. It is interesting that, according to the European Commission report, only one third of this 1.5%-of-GDP is attributed to the deficit revisions. Another one third is due to the deeper than expected recession of the Greek economy and the remaining is attributed to revenue underperformance. Nevertheless, in accordance with the revised MoU, the 2011 government deficit target of 7.4%-of-GDP is attainable with the implementation of the new measures of ca 2.3% specified in the 2011 budget.

With regards to the 2014 government deficit target of less than 3.0% of GDP, the revised MoU envisages that ca 5.0%-of-GDP or ca €12bn of additional (yet unidentified) measures are needed. These measures, as well as a complete plan of fiscal adjustment for the 2010-2014 period, are expected to be specified by March 2011. Note here that according to the Financial Management law adopted in July 2010 the government has to present a 3-year budget plan (for the 2012-2014 period) by March 2011.

Second MoU revision: Anti-tax evasion measures considered adequate; significant headwinds still exist

In order to address the revenue's shortfall mentioned above, the government will implement from January 2011 onwards an anti-tax evasion plan which includes a) centralization of data collection b) dedicated task forces focused on high-income individuals (earners) and firms c) Centralized taxpayer service directorate d) centralization of filing enforcement and other medium term measures (new legislation on risk based compliance framework etc.).

Even though these measures are considered adequate according to the revised MoU for the fight against tax evasion serious risks exist. These include a) too long judicial appeal processes on tax disputes b) administrative obstacles c) inflexibility of the human resources d) ineffective dismissal procedures in case of fraud.

Structural reforms regain pace

Structural reforms recently regained the lost ground of the September – November 2010 period. Reforms – already passed or about to be passed from the parliament in the following weeks - include: **a)** the fast-track investment legislation (already adopted by the Parliament by November-end), **b)** liberalization of the, so called, "closed professions" (expected by January 2011), **c)** law on licensing of new firms (expected by the end of 2010), **d)** strengthening of the competition framework and of the independence and effectiveness of the Hellenic Competition Authority (expected by the end of 2010), **e)** new investment law (under public discussion currently, expected to pass from Parliament by January 2011), **f)** a complete plan of privatizations (expected by the end of 2010. Note here that a token plan of privatizations was already presented in the 2011 Budget back in November. EC's report refers to estimated revenues from privatizations of €7bn in the 2011-2014 period, from which €1bn is expected in 2011.

In addition to the above, the government already passed from the Parliament an "umbrella" law that – among others - includes: **a)** spending cuts in public organizations (DEKO). These entail wage cuts, rationalization of operational expenses etc., **b)** the settlement of the issues left open in last May's labor reform i.e. the labor arbitration system and the collective bargaining process. As far as arbitration is concerned, the new law ensures equal access to all parties involved. With regards to the collective agreements, after discussions between the Labor Ministry and the EC/ECB/IMF officials, it was agreed that firm-level collective agreements can temporarily derogate from sectoral-level collective agreements.

Finally, on December 15th, 2010 a final agreement was reached on the licensing of non-Greek cruise operators in the Greek islands. This reform will increase the number of cruises in the Greek islands with respective increases in the revenues of the sectors that are related (flights, hotels, traditional products etc.).

Domestic economic contraction deepened in Q3

The pace of domestic economic contraction accelerated further in the third quarter of this year. According to provisional data, real GDP growth came in at -1.3/-4.6% qoq/yoy from -1.7/-4.0% qoq/yoy in the prior quarter and revised lower from a flash estimate of -1.1/-4.5% qoq/yoy. Regarding components, growth in gross fixed capital formation was -20.0%yoy, while investment spending on machinery & equipment declined by 25.4%. Total consumption in constant prices was 5.5%yoy lower, reflecting sharp declines in both private and public spending (down by 5.8% and 4.7%yoy respectively). With respect to external-sector developments, the trade deficit contracted by 42.2%, as imports decreased at a faster pace than exports (-17.8%yoy vs. -1.1%yoy respectively). For the current year as a whole, we stick to the -4.2% yoy official forecast for real GDP growth. For next year, we currently see downside risks to the -3.0% yoy official GDP growth projection, but we continue to expect some tentative signs of stabilization in domestic economic activity towards the end of 2011. On a more positive note, we continue to expect medium-term growth to outstrip the IMF´s baseline scenario projections by ca 0.5ppts/annum, for a number of structural reasons (i.e high productivity growth, structural reforms, capturing of the underground economy; for more details, please see *The Greek Economy & Its Stability Programme*, Volume 5, Issue 3, June 2010).

Prolonged recession, weak economic sentiment curb consumer spending

Greek sales by volume continued to decline in September, albeit at a slower pace compared to the prior month, as wage restrain and higher taxation continue to weigh on disposable income. Sales (excluding fuels and motor lubricants) in volume terms fell by 9.9%yoy following a 1.1%yoy drop in the prior month. Retail sales by revenue (inclusive of motor fuels and lubricants) declined by 3.9%yoy, after a 6.3%yoy drop in August. Adding to the gloomy string of recent macro data releases, Greek overall economic sentiment index, according to the Foundation for Economic and Industrial Research (IOBE), dipped to 67.0 in November, from 67.3 in the prior month, driven by falling business in the services sector. Consumer confidence improved slightly to -69, not far from the -72 all-time low recorded in October. In an environment of deepening domestic recession, anemic credit growth, weak consumer sentiment and rising unemployment, retail sales growth is expected to remain in negative territory throughout the last quarter of this year. In the industrial sector, total output remained in a downward trend in October, declining by 4.2%yoy vs. -7.1%yoy in the prior month as a result of higher goods' exports. The PMI-manufacturing index rose to 43.9 in November from October's 43.6, staying though firmly below the 50 level that separates growth from contraction. Regarding components, production, buying activity, incoming new business continued to contract as a result of lower new order levels, while employment fell for the 31st straight month.

November CPI slows, but still elevated

Greek CPI came in at 4.9%yoy in November, down from 5.2%yoy in the prior month and a 13-year high of 5.6% in September on softer energy costs. Despite the November decline, headline CPI remained well above 2.0%yoy recorded in the same month last year, reflecting the impact of recent rate hikes in VAT and a range of special consumption taxes. Based on the final 2011 Budget, domestic inflation is seen averaging 4.6% this year and 2.2% in 2011 before easing to 0.5% and 0.7% in 2012 and 2013 respectively on warning base effects and a negative output gap.

Greek unemployment rises again in September; housing market recession deepens

Greece's unemployment rate remained in a rising path in September, jumping to a record rate of 12.6%, from 9.1% in the same month of last year and 12.2% in August, as the ongoing domestic economic recession takes its toll on the labor market. In the three months to September, unemployment rate hit a 10-yr high of 12.4%yoy from 11.8% in the April-June period and 9.3% in the third quarter of 2009. According to the final budget plan for next year, the unemployment rate is expected to rise further to 14.6% in 2011 and 14.8% in 2012, before falling modestly to 14.3% in 2013. Separately, contraction in housing market activity continues. The number of private building permits (in volume terms) declined by a further 15.1% in September marking a cumulative drop of 10.7%yoy over the first nine months of the year. Last but not least, total credit to the private sector remained on a downward trend in October. According to data provided by the Bank of Greece, the corresponding annual growth rate eased to a new post-EMU entry low of 1.0%yoy from 1.2%yoy in the prior month. We expect annual credit growth to the domestic private sector to remain broadly stagnated in the coming months as domestic recession deepens and difficulties in the funding conditions of domestic banks linger.

Greece's sovereign credit rating downgrade cycle, probably not over yet

Citing concerns that the permanent European Stability Mechanism would favor public creditors to the detriment of private bond holders, S&P announced last week that it might downgrade Greece's BB+ sovereign credit rating, already in non-investment grade. Specifically, echoing a similar warning issued earlier this month for Portugal and Ireland, the rating agency noted that Greece, a potential recipient of the post-2013 European Stability Mechanism, could have its sovereign rating lowered by 1 or 2 notches if the permanent rescue mechanism would assign "preferred credit" status to public creditors, a development that could be detrimental to the ability of non-official holders of sovereign debt to be repaid. According to general operational characteristics of the European Stability Mechanism (ESM), presented in the Eurogroup meeting on November 28 and confirmed by the EU's heads summit on Dec. 16-17, the private sector would share some of the rescue cost in the event of a sovereign default on "a case-by-case basis" and in accordance to current IMF policies. However, a "haircut" will not be automatically imposed. The involvement of the private sector would be gradual with haircuts being used as a last resort solution. The new mechanism introduces Collective Action Clauses (CACs), financial support to EU countries will have to be activated by unanimous decision from the Eurogroup and loans provided after 2013 will be granted seniority, being junior only to IMF loans. The specific features of the future permanent crisis resolution mechanism are expected to be finalized at the March 2011 Summit as a number of related issues are still unclear (i.e its potential size, the application of the CACs for debt restructuring).

Following a similar move by S&P, Moody's became the second rating agency to put Greece on Watch for a possible downgrade this month. Even though the rating agency acknowledged that Greece has made "significant" progress in implementing a large fiscal consolidation effort, it warned that a multi-notch downgrade could be possible if the country fails to reduce its debt to "sustainable levels" in three to five years, taking into account this year's budget revenue shortfall and the recent upward revisions to Greece's 2006-2009 fiscal figures. Moody's also cited heightened concerns about whether the EU support subsides after 2013 in case the country's access to wholesale funding markets remains cut off. Moody's, which plans to complete its review on Greece "as quickly as possible", currently places the country's sovereign rating at Ba1, equal to S&P's BB+, the highest junk status rating. Fitch is the only major sovereign rating agency that offers Greece an investment grade status rating at BBB-, one notch above S&P and Moody's. But a further imminent downgrade may well be in the offing, underpinning the notion that the rating downgrade cycle for Greek government bonds is probably not over yet. The agency placed Greece's credit rating on Watch for a possible downgrade earlier this week, pending the outcome of a rating review now in progress. The review, which was initially planned to be concluded by the end of the year and is now expected to be completed in January 2011, will "focus on an assessment of Greece's fiscal sustainability in the wake of the measures that the authorities have taken this year under the IMF-EU programme", the outlook for the Greek economy and also the political will and capacity of the government to carry the measures required.

ECB extends unlimited liquidity supply operations

In an effort to provide further support to the European banking sector and preemptively stem spill over effects from the EU sovereign debt crisis to banks, the ECB opted again at the December meeting to delay its exit from non-standard measures. More specifically, the ECB decided to extend its weekly and monthly full allotment/fixed rate refinancing operations for at least another three months to April 12, 2011. The Central Bank also announced that its 3-month refinancing operation will be prolonged till the end of Q1 2011, held at indexed rate i.e. fixed at the average rate of the MORs –main refinancing operation- over the life of the operation. President Jean-Claude Trichet also highlighted at the post-meeting press conference that the Securities Market Program "is ongoing" and it will continue without any given limit. Furthermore, the ECB President made clear that the council is "constantly alert", leaving the door open for large-scale government bond purchases, if needed. According to official data, the ECB has purchased some €72bn of sovereign bonds since early May when, in parallel with the EU FinMins' agreement on an IMF-backed emergency loan package, decided to conduct outright purchases of public and private debt in secondary market in order to "address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism". Reinforcing speculation that the ECB is likely to become more active in sovereign bond buying in the weeks/months ahead, the Central Bank decided at its regular non-policy mid-month December meeting to increase its subscribed capital by €5bn, to €10.76bn, marking the first capital hike in 12 years during which its balance sheet "has growth considerably". The official reason provided was that the decision "was deemed appropriate in view of increased volatility in FX markets, rates, gold and credit risk". The national Central Banks will pay their contribution in three equal annual installments with the first installment due on December 29, 2010.

IMF head backs Greek repayment extension; decision in this issue to be reached early next year

On his first visit to Athens since Greece's EU/IMF/ECB bail-out agreement in May to discuss recent economic developments with members of parliament, IMF chief Dominique Strauss-Kahn highlighted that the country's fiscal consolidation program is broadly on track. However, the IMF head underlined that difficult challenges still lie ahead and the government needs to launch the next phase of structural reforms to restore economic growth including, *inter alia*, resolute fight against tax evasion, opening-up closed professions, labor market reforms, reducing health system expenses, restructuring of state-controlled firms and municipalities. He further noted that "if everything goes as planned", economic growth is expected to start picking up by the end of 2011. With regards to the extension of the €110bn EU/IMF loan repayment schedule for Greece, Mr. Dominique Strauss-Kahn pointed out that the IMF is in favour of a longer period of debt repayment without any additional clauses. Nevertheless, the IMF head noted that such a decision should be taken jointly by the EU and the IMF. The IMF chief also called for a "comprehensive solution" to the EU debt crisis, as the current approach of dealing with the problem on a country-by-country basis has failed to restore investor confidence and remove the risk of contagion.

Mr. Dominique Strauss-Kahn's comments followed European Commission President Jose Manuel Barroso's remarks earlier this month that the technical details of the EU/IMF loan repayment extension to Greece (i.e. the exact rescheduling of the repayment program, interest, size of repayments) "are now under study and should be finalized soon". The Commission President also said that Greece has done enough to deserve the third loan disbursement from the European Union, worth €6.5bn, due to be released on January 19, 2011. Following the completion of the second review of Greece's economic performance, the IMF authorized earlier this week the disbursement of the third tranche worth €2.5bn, bringing the total funding from the EU/IMF emergency package so far to €31.5bn.

After EU/IMF agreed on Ireland's €85bn bailout package on November 28, Eurozone finance ministers opened the way to an extension of Greece's debt repayment as a means of aligning the maturities of the financing of Greece to that of Ireland. A repayment extension until 2021, as Greek FinMin George Papaconstantinou noted recently, would certainly help the state address possible liquidity problems it may face after the expiration of the present EU/IMF lending program in Q2 2013. Reportedly, the EU wishes to see a number of structural reforms being legislated before finalizing the loan repayment extension. Along these lines, EU monetary affairs commissioner Olli Rehn stated during a conference in Athens a couple of weeks earlier that the European Union will likely decide early next year on extending Greece's loan repayment period.

Bank deposits resumed their downtrend in October, ECB lending rose again last month

Following a modest rebound in August and a nearly flat reading in September, total bank deposits of domestic household and business resumed their downtrend in October, to stand at €211.5bn from €212.8bn in the prior month. The ongoing contraction in domestic economic activity, lingering sovereign default fears, uncertainty related to the government's measures to rein on tax evasion and taping into saving from businesses and domestic households trying to cope with falling disposable incomes, seem to be the main drivers behind the October decline. In its monthly report, the ECB said that, Greek banks have lost around 11.3% of their saving deposits year-to-October or ca €26.5bn (from €238bn at the end of December 2009 to €211.5bn in October 2010). Shrinking deposits add to the strains of Greek banks, which, seriously hit by the country's sovereign debt crisis, have been shut out from wholesale funding markets and relay heavily on ECB liquidity over the last few months. Confirming the renewed downtrend in bank deposits, Bank of Greece (BoG) data revealed that ECB funding to Greek financial institutions rose in November, halting a three-month declining streak. More specifically, ECB funding increased by 2.9%mom last month to stand at €95.05bn.

EMU periphery sovereign debt spreads moving wider again

In thin pre-Christmas markets, yield premiums of EMU periphery sovereign bonds vs. their German peers moved wider again over the last few sessions after easing temporarily to multi-week lows earlier this month on reports suggesting that the ECB has been aggressively purchasing peripheral eurozone government bonds. Renewed worries over further sovereign credit rating downgrades were the main driver behind the latest bout of risk aversion in EMU sovereign bond markets. Moody's lowered Ireland's sovereign rating by five notches to just three notches above junk, the largest ever single cut made by that ratings agency- and warned that further downgrades could follow if the country fails to stabilize its debt in the foreseeable future. Moody's also placed Spain's Aa1, Portugal's A1 and Greece's Ba1 debt rating on review for a possible downgrade. In a similar move, S&P put Greece's BB+ and Portugal's A- sovereign debt under Watch. Fitch downgraded Ireland's debt by three notches amid concerns about fiscal costs of bailing out the banking sector, lowered Portugal's debt by one notch to A+ on the back of "a much more difficult financing environment" and placed Greece's BBB- credit rating on Watch a for possible downgrade, pending the outcome of a rating review which is now in progress

Furthermore, the eagerly awaited EU's heads summit on December 16-17, failed to provide a concrete plan to forcefully address contagion fears stemming for the lingering sovereign debt crisis. Instead, Eurozone leaders confirmed the general framework of a permanent crisis resolution mechanism i.e the so-called European Stability Mechanism (or ESM), that were drawn in the Eurogroup November 28 meeting. They also agreed on limited changes that will enable member states to establish this Fund, which will replace the existing European Financial Stability Facility (EFSF) once it expires in June 2013.

What's more, investors are worried whether the existing EFSM/EFSF/IMF mechanism has sufficient funds to deal with a further escalation of the EU debt crisis. Last but not least, worries over the outlook of the European banking sector continue to mount. In its latest half-year Stability Review, the ECB warned that Eurozone banks could face problems in refinancing €1,000bn of debt due over the next two years as the overall economic and financial situation is still "fraught" and risks for financial stability linger. The Central Bank also noted that the banking sector will have to compete against the heavy bond issuance of eurozone governments.

In the EU sovereign bond space, Ireland was the main regional underperformer, weighed down by mounting debt worries and the publication of a paper on the ECB website which suggested that the Central Bank has serious concerns about the legislation introduced by the Irish government on the ECB-eligibility of the Irish bank bonds. Following a brief drop near 500bps a couple of weeks earlier, the 10-yr Irish government bond to German Bund yield spread was standing slightly over 600bps at the time of writing, the highest level so far this month. The corresponding Greek spread was hovering around 925bps at the time of writing, some 55bps wider compared to a five-week closing trough recorded in mid-December while the cost of insuring Greek government bonds against default moved sharply higher. Specifically, the 5-yr CDS spread hit fresh all-time highs of 1056bps earlier today in the wake of a local press report suggesting that the Greek government is considering restructuring its debt after mid 2013 once the EMU/EU €110bn rescue package expires. The technical picture for the 10-yr Greek government bond (GGB) to German Bund yield spread suggests that a clear move above 920/930bps could open the way for further widening towards 960bps (all-time highs, May 7). Should a sustainable break above that area fails, consolidation within 900-950bps is likely to prevail in the sessions ahead (please see table on the last page).

Our assessment on the latest developments in the Greek economy

Currently the Greek economy is in the middle of a contractionary period. Our own, as well as the EC/ECB/IMF's growth projections of -4.2% of GDP for 2010 and -3.0% of GDP for 2011 are in line with the gloomy outlook. The early months of 2011 are of crucial importance for the Greek economy since a large number of reforms is expected to pass from the Parliament or implemented directly. Failure to complete these reforms or delays will likely endanger the limited medium term growth prospects of the

Greek economy, as well as the disbursement of the third tranche of the EC/ECB/IMF loan due in March 2011.

Structural reforms are a necessary condition for future growth prospects of the Greek economy. Their implementation is crucial irrespective of what happens with the EC/ECB/IMF repayment extension or the European Stabilization Mechanism that is under discussion. In addition, the programme of privatizations needs to become a first priority for the Government since it provides a credible way of debt reduction.

Finally, public support is still high even though there are signs of reform fatigue. Public support will be an important factor in the following period as the government will implement its programme of waste cuts in the public organizations.

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Table: EMU periphery yield and spread levels

10-yr Government bond yields	Today, December 23 (12:00 local time)	Change vs. multi-week closing lows recorded earlier this month (in bps)	Change vs. all-time closing highs recorded earlier this year (in bps)
Greece *	12.21%	64.2	-24.5
Portugal **	6.65%	71.8	-38.7
Spain ***	5.47%	41.4	-5.3
Ireland ****	9.00%	85.6	-35.3

* *record highs on May 7*
** *record highs on Nov. 10*
*** *record highs on Dec. 17*
**** *record highs on Nov. 30*

10-yr Periphery/Bund yield spread (in bps)	Today, December 23 (12:00 local time)	Change vs. multi-week closing lows recorded earlier this month (in bps)	Change vs. all-time closing highs recorded earlier this year (in bps)
Greece *	923.74	53.15	-41.52
Portugal **	368.10	64.81	-91.90
Spain ***	249.70	30.30	-33.63
Ireland ****	603.40	101.76	-65.08

* *record highs on May 7*
** *record highs on Nov. 11*
*** *record highs on Nov. 30*
**** *record highs on Nov. 30*

5-yr CDS	Today, December 23 (12:00 local time)	Change vs. multi-week closing lows recorded earlier this month (in bps)	Change vs. all-time closing highs recorded earlier this year (in bps)
Greece *	1056.14	127.80	
Portugal **	499.31	73.86	-44.68
Spain ***	344.86	50.46	-20.17
Ireland ****	599.76	64.33	-10.67

* *record highs on Dec. 23*
** *record highs on Nov. 30*
*** *record highs on Nov. 30*
**** *record highs on Nov. 30*

Source: Bloomberg

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