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Eurobank EFG

GREECE MACRO MONITOR

November 29, 2010

Focus notes: Greece

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Irish bailout, permanent crisis resolution mechanism & implications for Greece

- Greece to be granted loan repayment extension to 2021
- Eurogroup agrees on Irish bailout package. More clarity provided on the proposed permanent crisis resolution mechanism
- Implementation of Greek stabilization programme broadly on track; challenges remain
- Greek government announced new measures to facilitate fulfillment of 2011 target
- ECB funding to Greek banks decreased for a third straight month in October

Greece to be granted loan repayment extension to 2021

In line with a formal statement issued on November 28 that the Eurogroup would "rapidly examine" the necessity of aligning the maturities of the financing of Greece to that of Ireland, Greek Finance Minister, George Papacostantinou, confirmed earlier today that the country will now have until 2021 to repay its €110bn EU/IMF bailout loan. According to Mr. Papaconstantinou, the loan repayment extension will be granted in return for a higher effective fixed interest rate of 5.8 percent, compared to 5.5 percent per annum applied currently. The extension will reportedly need to be approved by national parliaments in EU16.

The repayment extension news did not come as a complete surprise as the possibility for such an arrangement was explicitly signaled in recent months by a number of high-level officials, including the Fund's Managing Director, Stoss Kan, and EU/IMF officials participating in the latest program review mission to Greece. Yet, it undoubtedly constitutes a positive development for the country given that its public debt maturity profile is such that the years 2014 and 2015 will see a significant rise in the government's borrowing requirement to annual levels in excess of €70bn. Note that over 50 percent of Greece's current debt stock matures over the coming 5 years. In our view, a repayment extension would help address possible liquidity problems the state could face after the expiration of the present EU/IMF lending program. The possibility of a new financing program upon termination of the present one constitutes another positive consideration in that direction.

From a medium-term fiscal sustainability standpoint, the extension of loan repayments effectively means that the country will not have to resort to *(potentially-costly)* market financing in order to start repaying its EU/IMF loans as early as in mid 2013. Note that under the existing loan agreement, Greece would need to repay each loan in eight equal installments over a period of 2 years, following an initial grace period of 3-3¼ years. On the other hand, provided that the proposed loan repayment expansion will be granted to Greece, repayment of each loan tranche will take place over a 7-year period, following an initial grace period of 4 years.

Notwithstanding the latter points, however, we reiterate that what is of primary importance for market perceptions about fiscal sustainability is the government's credible commitment to multi-year fiscal consolidation and the reforms program agreed with official lenders. In the case of Greece this is especially true as the country will need to generate significant primary surpluses (in excess of 5.5%-of-GDP / annum) for a number of years in order to stabilize its debt ratio and bring its fiscal position towards a more sustainable path.

Eurogroup agrees on Irish bailout package

Aiming to safeguard financial stability in the euro area and contain contagion risks stemming from the lingering sovereign debt crisis, EU16 finance ministers unanimously endorsed on September 27th an €85bn (US$ 115bn) rescue plan for Ireland and issued a statement outlining the general features of a permanent crisis resolution mechanism that is due to become operational after the present EFSF/EFSM facility expires in mid 2013. The so-called European Stability Mechanism (ESM) has been debated since late October, when the European Council agreed on the need for 'limited' amendments to the Lisbon treaty, which would include, among other changes, the creation of permanent bailout mechanism to replace the existing €440bn facility.

Regarding the agreed Irish rescue deal, a statement issued by EU finance ministers on Sunday read that Ireland would itself contribute €17.4bn to the package, with the remaining €67.5bn of funds coming from Eurozone and non-Eurozone EU members and the IMF. Furthermore, Ireland will cease contributing to the existing aid package for Greece. Financial assistance to Ireland will be provided on the basis of 3-year economic stabilization programme, which has been negotiated with the domestic authorities by the European Commission and the IMF, in liaison with the ECB.

The programme was approved by the Irish government on October 28 and rests on following three pillars: **a)** a major restructuring of the domestic banking system, **b)** an aggressive multi-year plan of fiscal consolidation, aiming to restore fiscal sustainability and eliminate the excessive deficit by 2015 and **c)** a comprehensive package of structural reforms, in particular on the domestic labor market, aiming to boost medium-term economic growth. The main elements of policy conditionality, as endorsed by EU finance ministers, will be formally ratified by Eurogroup and Council decisions on 6 and 7 of December.

The structure of the announced EU/IMF assistance plan for Ireland has the following characteristics**: i)** it will cover financial needs up to €85bn, including €10bn for immediate bank recapitalizations, €25bn in the form of a contingency support scheme for domestic banks and €50bn for budgetary financing, **ii)** half of the package to support the banking system (€17.5bn) will come from domestic sources, including through the Treasury cash buffer and investments on the National Pension Reserve Fund, **iii)** the remaining part of the support package will be shared equally amongst the European Financial Stabilization Mechanism (€22.bn), the European Financial Stability Facility and bilateral loans from the UK, Denmark and Sweden (€22.5bn), and the IMF (€22.5bn). According to Irish official sources, an average interest rate of 5.8 percent will apply to emergency loans from the EU and the IMF.

More clarity provided on the proposed permanent crisis resolution mechanism

In addition to a €85bn rescue package for Ireland, the Eurogroup agreed on September 27th on a general outline for a permanent crisis resolution mechanism that will replace the existing European Financial Stability Facility (EFSF) once it expires in June 2013.

In particular, EU finance ministers agreed that:

i) The private sector would share some of the rescue costs in the event of a sovereign default, but only on "a case-by-case basis", in line with current IMF policies. Thus, private bond holders will not automatically take a "haircut".

ii) The involvement of the private sector would be gradual. Haircuts will be used as a last resort solution. The first response seems to be that, private sector creditors will be encouraged "to maintain exposure" in a EU country facing liquidity problems, provided that the sovereign borrower is deemed solvent on the basis of a debt sustainability analysis conducted by the EC, ECB and the IMF.

iii) The functioning of the new mechanism will be facilitated by the introduction of collective action clauses (CACs) in the local legislation governing public debt issued from June 2013. The CACs could allow a country to restructure its debt repayments - either by extending the maturity of bonds, by reducing interest payments or by haircuts and write offs - provided that a majority of investors, typically 75%, agree. In return, lenders will receive a guarantee that a high portion of the debt will be re-paid at some point in time.

iv) Aiming to reinforce market discipline for lax borrowers and help preventing "moral hazard", EU finance ministers decided that financial support to EU countries under the new mechanism will need to be activated by unanimous decision from the Eurogroup.

v) Loans provided under the new European Stability Mechanism (ESM) will be granted seniority and they will be junior only to IMF loans

Muted market reaction to Irish rescue package, more details about the new European Stability Mechanism

Market reaction to the deal on Ireland and the outlines of the crisis resolution mechanism was muted. After undergoing some modest narrowing earlier today, EMU sovereign debt spreads re-widened in late European trade on Monday, as contagion fears remained on the front seat. Investors are increasingly worried that, in an environment of elevated funding costs, other fiscally vulnerable countries will also have to follow Greek and Ireland and tap the European Financial Stability Mechanism.

Markets are particularly afraid that Spain may ultimately be a potential victim of the EMU debt crisis, with the country's 5-yr CDS spreads breaking above 300bps for the first time ever. A main source of concern is about potential unrecognized property market losses in the Spanish non-listed banks and the resulting liabilities for the public sector. Adding to market jitters, there are growing fears about the ability of Portugal's minority government to implement the 2011 austerity budget, given its increasing unpopularity and mounting social unrest.

In Ireland, uncertainties regarding the durability of the coalition government and hence, the probability of the 4-year fiscal plan and the 2011 Budget being implemented as recently presented, are on the rise. Fine Gael, the largest opposition party, warned that it intends to file a no confidence motion against the coalition government, possibly before December 7 when parliament is scheduled to vote the budget. What's more, market participants are concerned whether the existing EFSM/EFSF/IMF mechanism has sufficient funds to deal with a further escalation of the EU debt crisis.

In the EU sovereign bond space, Greece outperformed in early trade on Monday, supported by FinMin George Papaconstantinou's comment that the country will be given an extension in its EU/IMF loan repayment period. The 10-year Greek government bond (GGB) to German Bund yield spread was standing close to one-week lows of 895bps at the time of writing, after hitting multi-week highs beyond 930bps a few sessions earlier. However, with EMU contagion fears continuing to play a major role in market sentiment, there appears to be limited scope for a further significant spread narrowing in the short-term. Against this environment, consolidation within 850-950bps will likely prevail in the sessions ahead (please see table on the last page).

Implementation of Greek stabilization programme broadly on track; challenges remain

In a joint statement by the EC, ECB and IMF on the second review mission to Greece released on November 23, the *troika* said that the implementation of the adjustment program remains broadly on track, even though important challenges remain. Specifically, the statement read that progress in reducing the deficit has been significant thus far, while the program's quantitative criteria for the end of September 2010 have all been met.

The report effectively opens the way for a disbursement of the third tranche (€9bn) of funding to Greece under the existing €110bn EC/ECB/IMF loan facility, which would bring the total amount of funds released to €38bn. The Greek government has already agreed with the troika on a revised Memorandum of Understanding (MoU) and a revised document of economic policies that need to be officially signed by both sides before disbursement of the 3rd tranche of funds. The release of new funds (~€2.5bn) by the IMF will take place in mid December, while the respective bilateral loans from the euro area peers (~€6.5bn) are expected to come in no earlier than in the first half of January.

Greece's Finance Ministry issued a statement recently clarifying the EU-funded portion of the next installment (€6.5bn) would be completed with a small delay due to technical reasons. Specifically, the procedure requires at least ten working days after the December Ecofin approves the disbursement, on the basis of the progress Greece has made in fulfilling the requirements of the existing stabilization program. On the fiscal front, the joint EC/ECB/IMF statement noted that the 6ppt-of-GDP expected reduction in the county's budget deficit this year is larger than the adjustment targeted earlier. Note that according to the Greek government's revised fiscal projections for 2010, the general government deficit is expected to decline to 9.4%-of-GDP this year, from an *upwardly revised* shortfall of 15.4%-of-GDP in 2009. Moreover, the Sept. 2010 revised MoU envisioned an overall fiscal adjustment *(i.e., deficit reduction)* of 5.5ppts-of-GDP this year, but this was before the recent announcement of Eurostat revisions to Greece's 2006-2009 fiscal data.

With respect to the structural reforms agenda, the joint EC/ECB/IMF mission statement noted that while significant progress has already been made with a number of landmark reforms - including a major overhaul of the pension system – the program has now reached a critical juncture. As such, a key challenge for the government in the period ahead is to implement an ambitious schedule for these next-stage reforms, which will need to cover the following areas: **a)** Aligning wages more closely with firm-level productivity, including through reform of arbitration and the existing schemes of collective bargaining for setting private sector wages. **b)** The opening up of a range of *closed* professions and the implementation of measures to enhance competitiveness in domestic product markets. **c)** Reforms aiming to unlock the potential of the Greek economy by cutting red tape and barriers to entry. **d)** A more ambitious state asset privatization program.

On the latter points, it appears that since September and, especially, in the period leading to the recent local elections a slowdown has been noted in the pace of implementation of EU/IMF-backed reforms. However, over the last several days the government has managed to pass in Parliament a number of important bills, signaling a strengthening of efforts to accelerate reforms in public administration and the private-sector economy.

Specifically, a "fast track law" was passed aiming to accelerate the licensing procedure for investing in Greece. A new bill was also voted, opening the way for the merging of a number of public organizations and the closure of others that are deemed unnecessary. In addition, the Single Payment Authority (SPA) became fully operational as of November 26. From now on, the wages of almost 1/3rd of a total of 768k state employees will be paid by the SPA, with the remaining 2/3rds expected to be included in the new wage scheme in the following three months. This is considered to be a major reform, facilitating a better control of state wage costs. Note that the full benefits of SPA will be realized in H1 2011, after some 200k employees in the broader public sector will also be included in the SPA.

Despite recent progress in the aforementioned directions, certain delays in tackling long-lasting problems in a number of other important areas continue to endanger the effectiveness of the existing stabilization program. In a joint statement made by the EC/ECB/IMF mission to Greece in mid-November, some of these problematic areas were identified, with the government being urged to place particular emphasis on such priorities as: **i)** a drastic reduction in health-related costs, which remain significant higher in per-capita terms relative to other euro area countries, **ii)** drastic reforms in loss-making public corporations (DEKO), **iii)** a significant improvement of tax administration in order to cure lingering problems related to inefficient tax collection and widespread tax evasion, **iv)** as also noted above, an acceleration in the pace of implementation of the structural reforms agenda, with special focus placed on measures in addition to those included in a labor-market reform bill that was voted in Parliament last July, notably those related to arbitration and collective bargaining systems, **v)** the liberalization of the so-called "closed professions" and **e)** privatization of state owned asets. On the latter, note that the EC/ECB/IMF adjustment program calls for a detailed plan of privatizations by the end of December 2010 (structural benchmark).

Last but not least, the joint EC/ECB/IMF team revealed that there is an agreement between the EU and the IMF on a possible loan repayment extension for Greece or even a new loan if needed. At the same time, the idea of a Greek debt restructuring was rejected on the basis that such an option would yield only short-term benefits.

Greek government announced new measures to facilitate fulfillment of 2011 target

In a recent flash report on Greece (see Eurobank EFG Research - 2011 budget: Main targets and analysis) we provided an in-depth analysis on the next year's budget and assessed the attainability of the 2011 fiscal target. In this section we provide some additional detail on the recently announced austerity measures for 2011.

The 2011 budget targets a 2ppts-of-GDP reduction in the general government budget deficit to 7.4% of GDP. In order to achieve that target the government is planning to implement austerity measures worth 6.4ppts-of-GDP. The latter figure breaks down to new measures (2.7ppts-of-GDP), the carry over from measures taken in 2010 (1.2ppts-of-GDP) and measures included in the August 2010 revision of the MoU (2.5ppts-of-GDP).

Total revenue-side measures in 2011 are estimated to amount to 3.5ppts-of-GDP, including a 0.7ppts-of-GDP carry over from 2010, measures defined in the August 2010 revision of the MoU (1.8ppts-of-GDP) and new measures (1ppts-of-GDP). The latter include, among others, the equalization of the tax rate on heating oil with than on motor fuels, revenues generated by a new scheme (already in place) to settle outstanding tax arrears to the state, renewal of broadcasting licenses and selling of new broadcasting frequencies, and the extension of the Athens airport concession contract.

Expenditure-side measures in 2011 are estimated at 2.9ppts-of-GDP and include carry over from 2010 measures (0.5ppts-of-GDP), measures included in the August 2010 revision of the MoU (0.7ppts-of-GDP) and new expenditure cuts (1.7ppts-of-GDP). Cost-cutting measures include, among others, the rationalization of public health care costs as well as cuts in public corporation and defense expenditure. Targeted costs cuts in public corporations are expected to include: **a)** no renewal of the contracts of some 10k temporary employees in the broader public sector, **b)** relocation of excessive public sector employees from crowded areas to ones that are in need of new personnel. Note that these transfers will count as new hiring in the public sector and not as internal relocations of labor. An implication of this will be that new employment in the public sector will fall below the "1-5" retirement rule that will apply form 2011, c) cuts in the public corporations preferential wages. Finally with regards to private sector wages, an agreement was reached after long discussions with the troika. According to that agreement, firm specific contractual agreements will prevail over the respective sectoral ones. The exact operational details of this agreement will be clarified in the upcoming revision of the EC/ECB/IMF adjustment programme.

Latest T-bill action met with strong demand

Greece's Public Debt Management Agency (PDMA) successfully sold €390mn of 13-week T-bills on November 16. The auction produced a yield of 4.10%, i.e., 35bps higher than a previous auction of similar maturity paper that took place on October 19, reflecting increased contagion effects from the Irish debt crisis. The auction was oversubscribed 4.98 times, with some 30-40% of the bills sold being purchased by foreign investors.

This was the fifth T-bill auction since the country switched in September from quarterly to monthly T-bill tenders, aiming at a better cash management and more leeway as it struggles to emerge from its debt crisis. A €300mn of 26-week T-bills on November 9 also met with solid demand, pointing to gradually improving market conditions and an eventual return to primary markets. The EC/ECB/IMF rescue package allows Greece to stay away from bond markets until Q1 2012 but the government continues to issue T-bills on a monthly basis for rolling-over maturing short-term paper. The PDMA has recently announced that no T-bill auction will take place in December, with the agency now being expected to proceed with its next auction of in early 2011. The country has covered by now most of its roll-over needs for the current year, with a remaining small maturity of €390mn (plus €82mn interest) of three-month paper coming due on Dec. 24.

ECB funding to Greek banks decreased for a third straight month in October

Bank of Greece (BoG) data revealed that ECB funding to Greek financial institutions decreased by 2.1%mom in October, the third consecutive monthly decline, to stand at €92.4bn, confirming a recent stabilization in bank deposits following months of turbulence. A further slowing down in the flow of credit to domestic businesses and households may have also been be a reason for banks' reduced demand for funds in the ECB's refinancing operations. National Bank of Greece SA, the country's biggest lender, announced earlier this month that it secured €4.7bn of repo lines (maturities up to 12 months) with international markets, using Greek government bonds as collateral. National Bank of Greece strengthened its balance sheet last month following a successful €1.8bn rights issue and is eyeing additional proceeds from the planned sale of a 20% stake in Turkish unit Finansbank. Similarly, EFG Eurobank Ergasias SA, one of the country's biggest lenders, announced in early November that it secured a total of ca €3bn in repo lines with foreign banks and has another €1bn available to finance bonds or other activities. EFG Eurobank Ergasias tapped the interbank lending market in mid-October using long-term government bonds as collateral, the first such transaction since the eruption of the country's sovereign debt crisis. ECB funding to Greek banks stood at €49.7bn at the beginning of the year.

Total credit growth slowed further in August

According to provisional data provided by the Bank of Greece, total credit expansion slowed further in August, coming in at 5.7% YoY, from 6.3% YoY in the prior month. Lending to the private sector remained on a downward trend

, with the corresponding annual growth rate easing to a post-EMU entry low of 1.4% YoY, from 2.2% in August. On the other hand, MFI lending to the general government continued to grow at a robust pace, coming in at a hefty 25.5% YoY in September compared with 24.7% YoY in the prior month. We expect credit to the domestic private sector to remain broadly stagnant in the following months, given the ongoing domestic recession and lingering difficulties' in the funding conditions of domestic banks. compared 24.7% YoY in the prior month. We expect credit to the domestic private sector to remain broadly stagnant in the following months, given the ongoing domestic recession and lingering difficulties' in the funding conditions of domestic banks.

Greek unemployment rises again in August; housing market recession deepens

Greece's unemployment rate remained in a rising path in August, jumping to a record 12.2%, from 12.0% in July and 9.0% in the same month of last year. The August rate was the fourth-highest in EU16 after Spain, Slovakia and Ireland and 2.1 percentage points above the corresponding euro area average. 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 as a result of the economic recession, before falling modestly to 14.3% in 2013. Regarding construction activity, building permits (in volume terms) continued to decline in August, dropping 24.9%yoy following a 29.1%yoy in the prior month, adding to recent evidence of a continuing recession in the domestic housing market. Also in a negative tone, industrial production dropped by 7.1%yoy in September, a higher pace of contraction compared to -2.1%yoy in August

October CPI eases from a 13-yr peak a month earlier

Greek CPI eased to 5.2%yoy in October after hitting a 13-year high of 5.6%yoy in the prior month as the adverse base effects from oil price are waning. Based on the 2011 final budget plan, domestic inflation is expected to remain at elevated levels for the remainder of the year with the annual CPI rate averaging 4.6% in 2010 and 2.2% in 2011 before easing to 0.5% and 0.7% in 2012 and 2013, respectively.

Table: EMU periphery yield and spread levels

10-yr Government bond yields	Today, November 29 (18:30 local time)	Change vs. multi-session/week closing lows recorded early this month (in bps)	Change vs. all-time closing highs recorded earlier this year (in bps)
Greece	11.79%	47.0	-66.2
Portugal	7.03%	93.2	-0.2
Spain *	5.45%	120.2	
Ireland *	9.27%	216.7	

* fresh record highs on Nov. 29

10-yr Periphery/Bund yield spread (in bps)	Today, November 29 (18:30 local time)	Change vs. multi-session/week closing lows recorded early this month (in bps)	Change vs. all-time closing highs recorded earlier this year (in bps)
Greece	903.90	81.61	-61.36
Portugal	428.20	66.08	-31.80
Spain *	267.70	91.36	
Ireland *	650.70	188.76	

* fresh record highs on Nov. 29

5-yr CDS	Today, November 29 (18:30 local time)	Change vs. multi-session/week closing lows recorded early this month (in bps)	Change vs. all-time closing highs recorded earlier this year (in bps)
Greece	991.86	134.09	-55.14
Portugal *	542.98	153.26	
Spain *	350.80	125.24	
Ireland *	603.71	108.28	

* fresh record highs on Nov. 29

Source: Bloomberg

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