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December 9th EU Summit: implications for Greece and the euro area

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Part I- December 9th EU Summit: a positive step forward in tackling the debt crisis

The outcome of the December 9 EU Council contained few surprises, coming broadly in line with the proposals unveiled by French President Nicolas Sarkozy and German Chancellor Angela Merkel in a joint press conference held a few days earlier. The main objectives of the new "fiscal compact" are to strengthen fiscal integration, enhance economic governance and prevent future debt crisis in the euro area. A number of important details on the agreed fiscal compact remain to be classified, while the new rules agreed will not be part of the European legal framework as there was no unanimous agreement at the EU-27 level. As an overall assessment, we would agree with the prevailing market view that the measures agreed constitute a major step towards addressing the euro area debt crisis in a more consistent and comprehensive way.

All 17 euro area members plus six EU states (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania) agreed on a set of fiscal rules to be enacted through an intergovernmental agreement. The Czech Republic, Hungary and Sweden will decide whether to sign up the intergovernmental agreement after consulting their parliaments. However, the decisions taken will not involve Treaty changes as there was no agreement at the EU-27 level. UK Prime Minister David Cameron blocked amendments to the Lisbon Treaty, demanding guarantees in a protocol to protect the interests of the City of London in return for his consent. The UK Prime Minister required guarantees that the powers of the pan-European securities market regulator would be not expanded at the expense of Britain's national regulator. He also sought assurances that the European Banking Authority would remain in London. The British demand was reportedly rejected by French President Nicolas Sarkozy.

The decision to seek an intergovernmental accord on the new fiscal compact was reached based on what it is know as "enhanced co-operation" procedure under the Lisbon treaty. This procedure allows a group of at least nine EU member states to "establish advanced integration or cooperation in the area within EU structures" if all 27 member states fail to reach an agreement. The deadline for finalizing the draft of this agreement is March 2012. A national ratification process will commence thereafter. A simple protocol or intergovernmental agreements can be approved by a simple parliamentary vote in national parliaments and may allow the block to avert the need for national referendum in countries like Ireland.

The broad framework agreed at the December 9th Summit centers on the following areas of action:

I. <u>Tighter fiscal framework enshrined in national legislation</u>

- **A fiscal stability rule for all euro area members.** A key element of stricter fiscal discipline entails Eurozone state budgets to be balanced or in surplus. This principle will be deemed respected if, as a rule, the annual *structural deficit*, i.e., the deficit adjusted for the impact of the economic cycle, does not exceed 0.5% of nominal GDP. <u>*Comment:*</u> This rule looks very similar to Germany's "debt brake", incorporated in the country's constitution in 2009. Starting in 2016, the German federal government will be constrained to a deficit ceiling of no more than 0.35%-of-GDP, while the states will no longer be allowed to run deficits from 2020 onwards. The law permits an exception to be made for emergencies such as a natural disaster or severe economic crisis.

- **Fiscal stability rule to be enshrined in national legal systems, at a constitutional or equivalent level.** In each member state, it will be defined on the basis of principles proposed by the Commission. The rule will contain an automatic correction mechanism that will be triggered in the event of deviation. The European Court of Justice will verify the transposition of this rule into national law. Separately, a mechanism will put in place for member states reporting their national debt issuance plans in advance. <u>*Comment:*</u> After Germany, Spain was the second euro area country to approve (September 2011) a "golden rule" of budget stability in its constitution. Italy and France have expressed intention to follow suit. Greek Finance Minister Evangelos Venizelos said during a joint press conference with the Greek Prime Minister soon after the conclusion of the December 9th EU Summit that a fiscal stability rule will be enshrined in the country's constitution after 2013, when amendments are permitted. Until then, the rule will be incorporated as an international law based on Article 28 of the Greek constitution which states that "*The generally recognized rules of international law, as well as international conventions as of the time they are sanctioned by statute and become operative according to their respective conditions, shall be an integral part of domestic Greek law and shall prevail over any contrary provision of the law*".

- **Countries subject to Excessive Deficit Procedure** will have to submit an economic partnership programme to the Commission and the Council, detailing how they plan to implement a lasting correction of deficits. The implementation of the plan will be monitored by the Commission and the Council. **The Commission will also be granted intrusive power to monitor the key parameters of the fiscal stance in national budgetary plans** before they are submitted to national parliaments. In case that the Commission "identifies particularly serious non-compliance with the Stability and Growth Pact, it will *request* a revised draft budgetary plan". <u>*Comment:*</u> Contrary to Germany's initial proposal, the Commission will not be empowered to veto national draft budget bills. A number of countries, including Ireland, France and the Netherlands have expressed certain reservations to the idea of handing too much national sovereignty over budgets to non-elected EU institutions. It is worth noting here that the intergovernmental agreement reached at the December 9th EU Council will not be part of EU law, raising certain questions over its legal status and the extent to which it can use EU institutions to ensure compliance with the fiscal rules. Thus, there seems still more work to be done on the legislative front for the timely implementation of the decisions adopted in principle.

II. <u>More stringent deficit procedure to enforce fiscal discipline</u>

- **Excessive Deficit Procedure (EDP) to become more automatic.** If the European Commission identifies a member state violating the 3.0%-of-GDP Maastricht deficit threshold, the EDP will be triggered *automatically,* unless a *qualified majority* of states is opposed. Sanctions proposed by the European Commission will also enter into force automatically unless explicitly rejected by a qualified majority. The same applies for the "debt brake", rule under which, countries with a general government debt above the 60%-of-GDP Maastricht Treaty threshold have to reduce this ratio by an amount equal to its deviation from the reference value at a rate of 1/20th per annum. The debt brake rule contains an exemption clause suggesting that, in extraordinary situations (i.e. severe recessions, national disasters) the country will be allowed to deviate from the rule and make some extraordinary expenditure. _Comment_: The above measures are based on the fiscal framework that incorporates the "six-pack" of legislative proposals, voted by the European Parliament on September 28, 2011, almost a year since the European Commission first proposed this package of law aiming to centralize economic decision-making in the EU. Until that time, the Council could impose a fine on a State subjected to the Excessive Imbalance Procedure if the latter had *repeatedly* failed to adopt the corrective measures by the set deadline. This would require a qualified majority of the European Council to *trigger* the sanctions after a proposal by the European Commission, a decision-making procedure that was criticized for providing the leeway for member states to form "blocking majorities". That said, it was not earlier easy to enforce the sanction mechanism and thus, fiscal discipline.

III. Stronger policy coordination and governance

Enhanced cooperation on issues essential for the smooth functioning of the euro area. EU leaders agreed on creating a procedure to ensure that all economic policy reforms planned by member states will be discussed and coordinated at a euro area level, with a view to benchmarking best practices. Euro Summits will be held at least twice a year.

IV. Strengthening the stability mechanisms

- **The EFSF leveraging will be deployed rapidly**. _Comment:_ As agreed at the October 26-27th Summit, the EFSF's lending capacity will be boosted via two schemes. Under the first scheme, the EFSF would create certificates that could guarantee up to a 20-30% of newly issued euro area sovereign bonds in case of sovereign default. The certificate could be detached after initial issue and be traded separately. Under the second scheme, the creation of one or more Co-Investment Funds (CIFs) would attract potential funding from private and public financial institutions and investors. The CIF would provide funding directly to euro area member states through the purchase of government bonds in the primary or secondary markets; such funding could, inter alia, be used by sovereigns for bank recapitalization. Both schemes, expected to be operational by January 2012, could be used simultaneously. Following comments by ECB President Mario Draghi at the December 8th press conference, the ECB will act as the EFSF's "operational agent", conducting bond buying operations on behalf of the rescue mechanism, without committing its own balance sheet. Contrary to an earlier proposition made by a task force headed by European Council President Herman Van Rompuy, the ESM will not be given a banking license to potentially allow it to leverage funds via the ECB. A proposal made by the President of the European Council for the issuance of Eurobonds reportedly met strong resistance from Germany on the basis that common debt issuance would risk creating moral hazard among highly-indebted euro area countries, by reducing their incentive to implement fiscal consolidation and structural reforms. Herman Van Rompuy will present a new report on the benefits of common issuance by March 2012. Longer-term, the issuance of Eurobonds as a natural outcome of fiscal union can not be entirely ruled out, provided that the latter has been well established and successfully tested.

- **Bring forward ESM launch date by nearly a year.** European officials decided the permanent European Stability Mechanism (ESM) to come into force as soon as member states representing 90% of the capital commitments ratify it in their parliaments. The new target for the inception of the ESM is July 2012 vs. mid-2013 envisioned previously (votes in the ESM go according to each country's subscription key in the ECB's capital). According to the new plan, the existing rescue mechanism EFSF and the new ESM facility will co-exist in the period from mid-2012 to mid-2013, increasing the combined firepower available to contain contagion risks. _Comment:_ The EFSF's present (uncommitted) resources are no higher than €250bn (out of the mechanism's total lending capacity of €440bn). With respect to the permanent rescue mechanism ESM, the total subscribed capital stands at €700bn (€620bn in callable + €80bn paid-in capital), with its total lending capacity being set at €500bn.

- **Changes to the ESM's voting framework.** In order to ensure that the ESM is in a position to take the necessary decisions in every case, voting rules will be changed to include an emergency procedure**.** Specifically, a **qualified majority of 85% of member votes** will replace the previously required rule of unanimous consent in case "the Commission and the ECB conclude that an urgent decision related to financial assistance is needed when the financial and economic sustainability of the euro area is threatened". Though, that remains subject to confirmation by the Finnish Parliament. Comment: Under this proposed change in the ESM's voting framework, small countries, including Slovakia, will loose the right to exercise a veto over ESM decisions. It is worth recalling that Slovakia did not participate in the first Greek rescue programme of €110bn approved in May 2010. At the same time, countries with at least a 15% voting share (i.e. Germany) could veto a rescue package that may risk derailing their own public finances. An official from the Finnish parliament said on Thursday that the country would not endorse a change in the ESM's voting rule without a two-thirds parliamentary majority.

- **Avoid explicit inclusion of PSI.** Aiming to help restore investor trust in government bonds of the periphery countries, EU leaders agreed to shift language with respect to an earlier requirement on the use of the ESM mechanism, compelling bondholders to accept losses in the event of a sovereign default or a debt restructuring. Regarding private investor involvement in new sovereign bailouts, the December 9th Summit statement read that the ESM will "strictly adhere to the well established IMF principles and practices". Moreover, EU leaders agreed that the decision made at the July 21st as well as the October 26-27th Summits to seek a voluntary private-sector involvement in Greece's debt restructuring constitutes a unique and exceptional case. Comment: Under Article 12 of the initial ESM framework, explicit PSI clauses would be included in all ESM bonds, stipulating that private bondholders would probably have to share some of the rescue costs, should a sovereign defaults or restructures its debt. At the December 9th Summit, EU leaders indicated that the proposed haircut on the notional value of private-held Greek government bonds is a one-off and that private investors would not necessarily be forced to take part in any future sovereign debt restructuring, a decision that may bode well for the ongoing negotiations on the Greek PSI. In his briefing to reporters shortly after the conclusion of the last EU Summit, Greek Prime Minister Loukas Papademos commented that the elimination of mandatory PSI from future government bailouts "will have a comforting market effect". As a reminder, the October 26-27 Summit Statement envisioned a 50 percent nominal reduction in the outstanding notional of privately-held Greek government debt, with an aim to facilitate a decline in the public debt ratio towards 120%-of-GDP by 2020.

- **Collective action clauses (CACs)** will still be included in the terms and conditions of all new euro government bonds issued under the ESM mechanism, as previously agreed, preventing minority bondholders from blocking a debt restructuring for the majority of bond holders. Comment: The CACs allow a country to restructure its debt payments –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.

- EU leaders opened the door to an increase in the overall firepower of the two rescue mechanisms. Specifically, the EU Summit statement read that they will **reassess the adequacy of the overall ceiling of the EFSF/ESM** in March 2012, reflecting heightened contagion fears. Comment: According to the already agreed ESM treaty, the combined lending capacity of the EFSF and ESM should not exceed €500bn. Reportedly EU officials are mulling the idea to drop the combined EFSF/ESM lending limit amid concerns that it may not be high enough to contain contagion risks. Under this proposal, when the permanent ESM fund becomes operational, its €500bn of new lending capacity would come on top of the commitments already made by the EFSF.

- Besides the prospect of an increase in the overall lending ceiling of the EFSF/ESM mechanisms, the EU leaders "**will consider, and confirm within 10 days the provisions of additional resources for the IMF of up to EUR 200bn**", in the form of bilateral loans from national central banks to ensure that the Fund has enough resources to help sovereigns in financial need. According to the President of the European Council, Herman Van Rompuy, €150bn of the total will come from the euro area and the remainder from other EU countries. EU leaders will also look forward to similar contributions from the international community (probably from the BRICs or other G20 country). Comment: The MF involvement is undoubtedly a positive step in terms of increased available firepower to address the euro area sovereign debt crisis. However, IMF seniority issues for private investors may come under scrutiny while that specific role the IMF may have in supporting the EU is still unclear. Moreover, it is not yet clear what the size of individual contributions from euro area member states will be in this planned lending package to the IMF, with reports suggesting that the Bundesbank will be looking for approval from Bundestag before extending loans to the IMF. Greece, Portugal and Ireland which are already under an EU-IMF economic adjustment programme, will not probably contribute to the IMF loan. The decision of additional funding for the IMF followed Eurozone finance ministers' agreement in the November 29th Eurogroup to search for alternative solutions to complement the EFSF. Reportedly, Euzozone officials are seriously concerned that the rescue mechanism's lending capacity is no longer possible to be leveraged by 4-5 times, as planned initially, due to the recent sharp deterioration in market conditions.

ECB cuts key rate by a further 25bps, introduces additional liquidity support measures

At its December policy meeting, the ECB delivered a widely expected 25bps cut in its key 2-week refi rate, reducing it to a new record low of 1.00%. The ECB also introduced additional liquidity support measures and widened considerably the pool of acceptable collateral to support bank lending and help normalize conditions in the euro area money market. However, ECB President Mario Draghi doused hopes that the Central Bank would take much more decisive action to tackle the debt crisis. He appeared to rule out any substantial expansion of the ECB's Securities Market Programme. Moreover, the ECB President downplayed the possibility of the central bank providing bilateral loans to the IMF to fund euro area governments on the basis that such a plan would be in contraction with article 123 of the Lisbon Treaty ("overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States …. in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited…"). However, he was open to IMF support if funds were provided by non-euro area countries.

Part II- Latest domestic fiscal and macro developments

Q3-2011 national accounts: Non-seasonally adjusted real GDP declines by -5.0%YoY, following 7.4%YoY contraction in the prior month

Greece's real GDP contracted by -5.03%YoY in Q3 2011, according to non-seasonally adjusted data released by ELSTAT last week. (The agency did not publish the corresponding seasonally-adjusted figures). This was the 12th consecutive negative reading (real GDP contracted by 7.4%YoY in Q2 and by 8.3%YoY in Q1 2011). Final consumption contracted by -5.0%YoY in Q3 2011, remaining in a negative growth territory for the sixth consecutive quarter. Among other factors, this apparently reflects the continuing erosion of disposable incomes as a result of the fiscal austerity program, higher unemployment and depressed consumer sentiment**.** The EC's consumer confidence index for Greece stood at -82.3 in November, not far from a record low of -73.6 hit in September 2011. Elsewhere, gross fixed capital formation (GFCF) contracted by -15.2%YoY in Q3 2011, remaining in recession for the 16th consecutive quarter. On a more encouraging note, exports of goods and services increased by 3.20%YoY and imports declined by -4.30%YoY, with the trade balance providing a positive contributor to overall GDP in Q3. (See Table 1).

Table 1: GDP Breakdown (Non Seasonaly Adjusted, YoY, % of GDP)

	Q4 2010	Q1 2011	Q2 2011	Q3 2011
Final Consumption	**-10.90**	**-9.20**	**-8.60**	**-5.00**
Households	-8.90	-8.30	-7.20	-5.50
General Government	-17.50	-13.70	-14.20	-3.90
GFCF	**-19.20**	**-23.40**	**-18.40**	**-15.20**
Exports	**13.10**	**-3.70**	**-0.50**	**3.20**
Imports	**-11.10**	**-10.90**	**-4.90**	**-4.30**
GDP	**-8.60**	**-8.30**	**-7.40**	**-5.00**

Source: ELSTAT

Note to Table 1: *ELSTAT has recently changed the methodology it uses to compile quarterly data for the general government transactions. Specifically, quarterly estimates for the years 2009-2011 are now based on data mainly from direct sources, while for the period 2000-2008 estimates were made by allocating the annual results to the quarters. This affects the comparability of the 2008 and 2009 data. ELSTAT warns that its quarterly GDP growth figures between 2008 and 2009 should be treated with caution. Furthermore, due to the relatively short time span of the available quarterly general government data in the period Q1:2009-Q1:2011, the previously implemented method for the seasonal adjustment did not provide satisfactory results.*

According to the local press, the 5th Review of the EC/ECB/IMF adjustment programme (not out yet) now estimates Greek real GDP to contract by 6.0% in 2011, and by a further 3.0% in 2012. A gradual return to positive growth rates is expected thereafter, with domestic output expected to expand by a modest 0.4% in 2013. Note that the 2012 Budget law forecasts respective real GDP declines of 5.5% and 2.8% in 2011 and 2012. A deeper that earlier expected recession this year and the next may complicate further the domestic fiscal outlook, with a number of reports speculating over the need for additional austerity measures in 2012 (i.e., beyond those already incorporated in the new budget), so as to facilitate fulfillment of next year's primary surplus target of 1.1%-of-GDP.

Preliminary State budget execution data for January-November 2011: central government deficit undershoot slightly revised official target

Preliminary data for the execution of Greece's State budget showed that the central government deficit rose by 5.1%YoY in January-November 2011, reaching ca €20.52bn. This resulted into an undershooting of the *revised* 11-month official target by €0.55bn. Year-to-November net ordinary budget revenue declined by -3.1%YoY to €43.8bn, while tax refunds increased by 8.1%YoY over the same period. For the year 2011 as a whole, the State budget targets a 0.9%YoY increase in ordinary budget revenue. To achieve this, the government needs to generate additional revenue of €7.48bn in the remainder of FY-2011. (Note that according to ESA95 accounting rules, a number of receipts materializing in the first couple of months of 2012 may still be recorded as 2011 revenue). Yet, any serious shortfall relative to this year's budgetary targets may raise the need for addition austerity measures (i.e., beyond those already included in the new budget), so as to facilitate fulfillment of the the 2.8%-of-GDP deficit target in 2012.

On the expenditure side, ordinary budget outlays for the year-to-November 2011 totaled ca €62.71bn, a 6.2% YoY increase. This was mainly the result of a 3.0%YoY increase in primary expenditure over the first eleven months of this year, mainly as a result of: **a)** higher transfers to social security funds by €1.61bn due to lower social security contributions, **b)** higher grants by €0.41bn to the Employment Agency for unemployment benefits and **c)** higher transfers to hospitals (by €1.06bn) to pay old debts.

Interest payments for year-to-November 2011 increased by 20.4%YoY. In the public investment budget (PIB), year-to-November 2011 revenue increased by 81.2% YoY, amounting to €2.64bn. On the other hand, PIB expenditure was down by 40.1%YoY to €4.29bn.

Table 2: January-to-November 2011 Budget execution

Ordinary Budget	Jan-Nov. 2010 (€bn)	Jan-Nov. 2011 (€bn)	Jan-Nov. 2011 (%YoY)	2011 new target Jan-Nov. (€bn)	Annual target (%YoY)
1. Net Revenue (a-b-c)	45.24	43.83	-3.1	44.05	0.9
a. Gross revenue	49.58	47.72	-3.7	48.04	-1.7
b. NATO revenue	0.01	0.03	145.5	0.03	67.5
c. Special revenue from licensing public rights	0.00	0.79		0.51	
c. Tax refunds	4.35	4.70	8.1	4.54	-6.0
2. Expenditure (α+β+γ+δ+ε+στ)	59.05	62.71	6.2	63.50	3.8
α. Primary expenditure	45.07	46.41	3.0	46.92	-0.7
β. Transfer to hospitals for the settlement of part of past debt	0.35	0.43	25.8	0.45	22.6
γ. NATO expenditures	0.01	0.01	-20.1	0.03	20.8
δ. Military procurement	0.60	0.27	-55.0	0.48	-41.0
ε. Forfeiture of Government Guarantees	0.11	0.04	-66.9	0.05	62.1
στ. Interest costs	12.90	15.54	20.4	15.57	23.9
Public Investment Budget (PIB)					
3. Revenue	1.46	2.64	81.2	2.62	9.5
4. Expenditure	7.16	4.29	-40.1	4.23	-18.5
5. Budget deficit (-) or budget surplus (+) (1-2+3-4)	-19.52	-20.52	5.1	-21.06	1.2

Source: Ministry of Finance

In other domestic news, the unemployment rate fell to 17.5% in September 2011, from a record 18.4% reported in the prior month. With respect to domestic price developments, consumer price inflation came in at 2.9%YoY in November 2011, easing slightly from 3.0%YoY in the period month. On a month-on-month basis, inflation rose by 0.2% last month. According to the most recent Troika forecasts (Oct 2011), headline inflation in 2011 is expected to average around 3%, with the corresponding reading percent, while constant-tax inflation was forecasted at 1.5%. Note that constant tax inflation excludes hikes in VAT and excise taxes.

What's behind the poor performance of State budget revenue in recent months?

The points below highlight the main trends in central government revenue, as reflected in the State budget execution data for the first 10 months of this year. *(Detail breakdown of November 2011 data not published yet):*

— Lower State receipts from the personal income tax (by ca 12% YoY), as a result of the reductions in average wages and pensions as well as lower employment vs. the same period a year earlier. Total personal income tax revenue in the 10 months to October covered around 80.1% of the corresponding *downwardly-revised* full-year target for 2011;

— Lower receipts from corporate taxation (by ca 13.3% YoY) due to reduced business profitability. Total revenue from corporate taxation in the 10 months to October covered around 80% of the corresponding full-year target for 2011;

— Lower revenues from the special consumption taxes on fuels, tobacco and alcoholic beverages, as a result of reduced consumer demand for such products;

— Lower VAT revenue, despite repeated increases in main VAT rates (twice in both 2010 and 2011). In the 10 months to October, total VAT revenues were down by ca 2.1% YoY, covering around 86% of the corresponding full-year target. Starting in July 2011, the government allowed the payment of the value added tax in three equal monthly installments; this has apparently weighed on State budget revenues in recent months, especially taking into account that VAT receipts accounted for as much as 34.4% of total ordinary budget revenue in the first 10 months of 2011. By comparison, income tax revenue (personal, corporate and other income taxes) cumulatively accounted for ca 25% of ordinary budget revenue over the same period;

— Delays in the collections of other revenue, including in the payment of outstanding tax arrears to the State as a result of the tax amnesty implemented in 2010 as well as in a number of real estate taxes and special levies. Such delays can be mainly attributed to a multitude of bureaucratic and other problems hindering the efficiency of the tax collection mechanism;

— Increased tax returns (by 14.2% YoY) in January-October 2011, compared to a corresponding full-year target for a 6% decrease. In an effort to increase VAT compliance, the government introduced last year a measure linking tax returns on declared personal incomes for 2010 with retail sales receipts submitted to the tax authority. The government has already modified that measure so as to contain the total amount of tax returns in the settlement of 2011 incomes;

Recent trends in central government spending and public investment expenditure

From the spending side, the overshooting of the ordinary budget primary expenditure target in the first 10 months of the year can be attributed to:

— Increased social transfers in the form of *e.g.* unemployment benefits. Ordinary budget primary expenditure - excluding grants to hospitals for the settlement of past debts, NATO & defense-related outlays as well the activation of State guarantees on outstanding debt of entities outside the general government - grew by ca 2.5% YoY in the 10 months to October 2011 against an *upwardly-revised* full year budget target of +0.3% YoY.

Regarding the execution of the public investment budget (PIB), the latest available data suggest that it has contributed significantly to the containment of the overall central government deficit in the 10 months to October as a result of:

— Significantly lower public investment outlays comparing to the same period a year earlier (-37.4% YoY) and relative to a full-year budget target of -10.6%; and

— Higher PIB revenue (by 38.1% or €521mn vs. the first 10 months of last year).

As an overall assessment, the most significant contributors to the year-on-year widening in the central government deficit in the first 10 months of this year were:

— Higher interest expenditure
— Lower indirect tax receipts (from VAT, special consumption & other taxes)
— Higher tax refunds

On the other hand, the sharp reduction in public investment outlays was the most significant factor preventing a more sizeable widening in the central government deficit (see Table 1).

Table 1
Contributors to the 11.2% YoY rise of the central goverment deficit in Jan-Oct 2011(*)
In percentage terms

Ordinary budget gross revenue	57.8%
of which	
Direct tax receipts	-3.3%
Indirect tax receipts	81.7%
Other ordinary budget revenue	-20.6%
Tax refunds	25.8%
Ordinary budget primary expenditure	48.4%
Interest payments	122.7%
Other ordinary budget outlays	-16.4%
Public investment budget	-137.5%
Total	*100.0%*

Source: MoF, Eurobank Research
(*) Positive sign means respective item has contributed to a rise in the overall deficit by x% (and vise versa)

State budget execution: Full-year outlook

Looking ahead, State budget revenue in December (and, again, from the beginning of next year) are expected to derive support from a number of recently announced measures including, among others:

— A recent special *solidarity levy* imposed on annual declared incomes in excess of €12,000
— A flat €300 levy on the self employed
— A recently announced levy on property assets (to be collected via electricity bills)

(Collections of the aforementioned levies are expected to be completed by Feb 2012)

— 2011 revenues are also expected to derive more support from an earlier reduction in the tax exempt threshold for personal incomes to 8k/annum from 12k/annum for individuals of 30-65 years of age. (More recently, the tax except threshold was reduced further to 5k/annum)
— The completion of the most recent tax amnesty
— Receipt of a multitude of other special taxes, including those based on objective criteria
— The equalization of special consumption tax rates on heating oil and motor fuels in 2012

For the spending side, the phasing in (as of 1.11.2011) of the *equal-pay-for-equal-work* scheme (Single Payment Authority), a significant reduction in higher pensions and a number of other recently announced measures are expected to contribute to the containment of government outlays in the last months of 2011 and beyond

From a longer-term perspective, the anti-tax evasion bill voted in parliament in April 2011 is expected to deliver concrete results, though it is not entirely clear at this point whether the aforementioned bill has so far contributed to a significant reduction in tax avoidance.

Overshooting risks to the 2011 general government deficit target?

In this section we provide a brief analysis on recent fiscal developments related to the execution of the *general government* budget in January-October 2011 (latest available data). Please note that, in addition to the State budget (central government level) the general government budget also incorporates: **a)** a number of extrabudgetary funds; **b)** local governments; and **c)** social security funds.

According to monthly cash data for the execution of the general government budget, the cumulative fiscal deficit in the 10 months to Oct. 2011 reached ca €23,145mn (or 10.6%-of-projected GDP). *By comparison, the draft 2012 budget forecasts the full-year general government deficit (ESA-95 terms) to reach 9%-of-GDP in 2011 (i.e., to overshoot by 0.5ppt-of-GDP the upwardly-revised official target of 8.5%-of-GDP for this year)*.

Although the latest available data are provided on a cash basis (and thus, not being directly comparable to ESA-95 data), the widening of the general government deficit in the first 10 months of this year points to overshooting risks surrounding the full-year target (unless significant primary surpluses are generated in Nov-Dec.).

A particularly worrying development is also the continuing accumulation of government arrears (up by €1.33bn in the first 10 months of this year to €6.67bn in October 2011).

Overall, it appears that the general government deficit for 2011 is likely to exceed earlier forecasts, reaching levels in excess of 9.5%-of-GDP. Full-year data for the general government deficit will not be published before Feb. 2012).

2012 Budget: Main Targets & Assessment

(Excerpt from our *Nov 22, 2011 Greece Macro Monitor*, http://www.eurobank.gr/Uploads/Reports/FOCUSGreece%20November%2022%202011ii.pdf)

The 2012 budget is framed around a particularly adverse macroeconomic environment, envisioning a real GDP growth decline of 2.8%, after an expected contraction of 5.5% this year. Domestic inflation is expected to decelerate further in 2012, averaging 0.6% vs. 2.8% in 2011. (*Note: According to a number of foreign contacts, the 5th IMF Review (not out yet) will forecast Greek real GDP to contract by 6% in 2011 and by a further 3% in 2012!)*

As to the main targets of the new budget, the general government deficit (ESA-terms) is seen declining to 5.4%-of-GDP in 2012, from 9.0%-of-GDP in 2011. That is, assuming full implementation of the new PSI deal envisaged in the October 26-27 EU Summit Statement. Furthermore, the general government's primary balance (which excludes interest rate payments) is seen switching into a surplus of 1.1%-of-GDP, following deficits of 1.8%-of-GDP this year and 4.7%-of-GDP in 2010.

The beneficial impact of the new PSI on the 2012 budget mainly stems from lower interest rate payments on the privately-held government debt. Excluding this effect – and on a ceteris paribus basis – the 2012 general government deficit is seen falling to 6.7%-of-GDP.

As a reminder, the October 26-27 Summit Statement envisioned a 50 percent nominal reduction in the outstanding notional of privately-held Greek government debt, with an aim to facilitate a decline in the public debt ratio towards 120%-of-GDP by 2020.

Naturally, realized savings in 2012 due to lower interest pate payments on privately-held Greek government debt will be a function of the final structure of the new PSI (e.g. notional discounts & coupon rates of new bonds), which remains unknown at this point.

The implementation of the PSI bond exchange is projected to facilitate an incremental reduction of the overall general government deficit (ESA-95) in 2012 by ca €2.36bn (or around 1.3ppt-of-GDP). This is expected to result from the interplay of lower interest rate payments (by ca €5.15bn or 2.4ppt-of-GDP) and the ensuing losses infected on domestic social security funds' bond portfolios.

Fiscal multipliers and the efficiency of the applied austerity program

Last year, total fiscal measures worth ca €23.5bn were implemented to reduce the general government deficit by €12.1bn (from €36.3bn in 2009 to €24.3bn in 2010). This implies an efficiency coefficient of 0.515 (=12.1/23.5) for the fiscal adjustment measures applied in 2010[1].

In 2011, it is estimated that total measures worth €19.4bn (or ca 8ppt-of-GDP) have been applied to reduce the deficit by ca €5.6bn (from €24.3bn in 2010 to €18.7bn targeted in 2011). This implies an efficiency coefficient of 0.29 (=5.6/19.4) of the fiscal adjustment measures applied in 2011. In other words, for every one euro of austerity measures applied (i.e., in the form of expenditure reductions and/or higher taxes) the fiscal deficit was actually reduced by only 0.29 euros.

The apparent worsening of the estimated efficiency coefficient of fiscal measures is a worrying development, purportedly relating to higher interest rate payments in 2011 (up by ca €2.9bn from last year) and the impact of the economic recession on ordinary budget revenue and expenditure.

Finally, according to the latest OECD estimates, the applied fiscal austerity program slashed some 3.6ppts off Greece's nominal GDP in 2010 (estimated fiscal multiplied: 0.35). In 2011, the austerity measures are expected to reduce nominal GDP by a further 3.4ppts (estimated fiscal multiplied: 0.38).

[1] OECD Economic Surveys: Greece, August 2011

Table 3: Greece-Key Indicators	Last	ytd	2010	2009	2008	2007
Macroeconomic indicators						
GDP growth (%YoY)*	-5.0 (Q3 11)	-	-3.5	-3.2	-0.2	3.0
Budget deficit (% of GDP, forecast for last)	-9.0	-	-10.8	-15.8	-9.9	-6.8
Gross public debt (% of GDP, forecast for last)	161.7	-	144.9	129.3	113.0	107.4
CPI	2.9 (Nov. 11)	2.4	4.7	1.2	4.2	2.9
Unemployment rate	17.5 (Sept. 11)	35.9	14.8	10.2	8.9	8.9
Labor Cost (%YoY)	-5.2 (Q2 11)	-11.7	-4.2	3.6	0.6	3.5
Economic Sentiment (index level-period average)	68.6 (Nov. 11)	73.0	75.1	76.3	76.1	94.9
Consumer indicators						
Private consumption in constant prices (% YoY)	-5.5 (Q3 11)	-5.5	-3.6	-1.3	4.0	3.7
Retail sales excl. fuels & lubricants volume (% YoY)	-5.2 (Sept. 11)	-21.2	-6.9	-9.3	-1.4	2.3
New private passenger car registrations (% YoY-cumulative ytd)	-16.5 (Nov. 11)	-33.1	-35.6	-17.8	-4.5	4.5
Consumer confidence (index level - period average)	-82.3 (Nov. 11)	-73.3	-63.4	-45.7	-46.0	-28.5
Retail trade expectations (index level - period average)	-34.9 (Nov. 11)	-35.3	-33.7	-15.4	14.2	34.2
Industrial-activity indicators						
Industrial production (% YoY)	-12.2 (Oct. 11)	-9.5	-5.2	-6.8	-8.2	2.0
Capacity utilization in industry (index level -period average rate)	66.0 (Oct. 11)	67.7	68.6	70.5	75.9	77.0
Industrial confidence (index level - period average)	-23.6 (Nov. 11)	-20.4	-22.5	-28.4	-5.9	5.2
Manufacturing PMI (index level - period average)	40.5 (Oct. 11)	44.0	43.8	45.4	50.4	53.8
Construction sector & other investment-activity indicators						
Gross fixed capital formation in constant prices (% YoY)	-15.2 (Q3 11)	-	-9.2	-23.1	-5.5	13.1
Housing investment in constant prices (% YoY)	-23.5 (Q3 11)	-	-18.4	-20.2	-25.8	-5.8
Other construction in constant prices (% YoY)	-15.7 (Q3 11)	-	-5.9	18.2	44.3	-5.5
Private building permits volume (% YoY-cumulative ytd)	-37.4 (Feb. 11)	-58.8	-24.1	-26.8	-17.3	-5.0
Construction confidence (index level - period average)	-70.2 (Nov. 11)	-69.0	-55.4	-39.5	-9.6	-9.2
Balance-of-Payments statistics *(€-terms)*						
Tourism revenues (% YoY-cumulative ytd)	7.1 (Sept. 11)	9.5	-7.6	-10.6	2.8	-0.3
Transportation revenues (% YoY-cumulative ytd)	-5.3 (Sept.11)	-10.8	13.8	-29.4	13.3	18.3
Customs-based statistics *(€ - terms)*						
Goods exports (% YoY-cumulative ytd)	28.8 (Sept. 11)	37.5	11.3	-19.5	4.5	3.8
Goods exports to EU (% YoY-cumulative ytd)	18.7 (Sept. 11)	13.4	9.2	-21.5	4.1	25
Goods exports to non-EU countries (% YoY-cumulative ytd)	55.3 (Sept. 11)	50.1	12.9	-18.6	3.5	-20.9
Goods imports (% YoY-cumulative ytd)	-7.4 (Sept. 11)	-9.3	-4.4	-21.8	11.2	9.3
Goods imports from EU (% YoY-cumulative ytd)	0.5 (Sept. 11)	-7.2	-13	-17.8	5.4	16.4
Goods imports from non-EU countries (% YoY-cumulative ytd)	-22.3 (Sept. 11)	-16.5	-0.3	-35.6	10.9	0.6
Domestic MFI credit to domestic enterprises & households *(oustanding balances and net flows)*						
Private sector (% YoY)	-2.2 (Oct. 11)	-2.6	0.0	4.2	15.9	21.5
Enterprises (% YoY)	-0.4 (Oct. 11)	-1.3	1.1	5.2	18.9	20.8
Households (% YoY)	-3.6 (Oct. 11)	-3.6	-1.2	3.1	12.6	22.2
Housing loans (% YoY)	-2.4 (Oct. 11)	-2.0	-0.3	3.7	11.2	21.5
Consumer credit (% YoY)	-6.7 (Oct. 11)	-4.8	-4.2	2.0	16.0	22.4
Private-sector credit outstanding (% GDP) **						
Total domestic enterprises & households	115.3 (Oct. 11)	-	113.4	107.8	107.2	96.7
Domestic households	52.3 (Oct. 11)	-	52.0	51.7	50.3	46.7
Stock Indices***						
Athex General Index (level, %ytd, end of year level 2007-10)	661.8	-53.2	1413.9	2196.2	1786.5	5178.8
FTSE/ASE 20 Index (level, %ytd, end of year level 2007-10)	255.9	-61.4	663.1	1125.4	932.5	2752.5
Athex Banks Index (level, %ytd, end of year level 2007-10)	247.5	-80.2	1251.0	2661.7	1899.4	7296.4
Baltic Dry Index (level, %ytd, end of year level 2007-10)	1930.0	8.9	1773.0	3005.0	774.0	9143.0
Bond/CDS spreads ***						
10yr Bond Spread over Bund (bp, %ytd, end of year level 2007-10)	3293.0	246.3	950.9	238.7	227.4	32.2
5yr Bond Spread over Bund (bp, %ytd, end of year level 2007-10)	5251.3	351.5	1163.1	254.2	264.3	21.2
2yr Bond Spread over Bund (bp, %ytd, end of level year 2007-10)	14410.6	1170.3	1134.4	211.9	240.1	26.8
5yr CDS Spread (bp, %ytd, end of year level 2007-10)	10304.7	893.4	1037.3	282.8	238.0	-
T-Bills, Auction Rate						
26-Weeks average rate (%, last auction, last auction of year)	4.89	-	4.82	0.35	5.09	4.18
13-Weeks average rate (%, last auction, last auction of year)	4.63	-	4.10	0.59	4.46	4.14

Source: Hellenic Statistical Authority, PDMA, Bank of Greece, ECOWIN, AMECO, Bloomberg, Eurobank EFG Research

** Non-seasonally adjusted GDP data were used for columns Last and ytd. Seasonally adjusted data not available. Growth rates for 2007-10 include the recent ELSTAT's revision.*

*** 2011 GDP forecast at market prices (€ 230 bn) from the 2012 Budget was used.*

***As of 12/12/2011. Note that from mid-September 2011 Greek CDS spreads are prised on an upfront basis

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