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Major hurdles that need to be overcome by the Greek government in the period leading to the release of the 7th EU/IMF loan tranche

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Nov. 29th Eurogroup approves 6th loan tranche to Greece, endorses EFSF leveraging schemes

Euro zone finance ministers approved on November 29 the release of the 6th loan tranche to Greece, worth €5.8bn, under the existing EU/IMF aid programme. The decision was widely expected after the leaders of the tripartite coalition supporting Greece's new national unity government submitted written commitments to the country's official lenders, pledging to support implementation of the new bailout package agreed at the October EU Summit. In the accompanying press conference, Eurogroup President Jean-Claude Juncker said that the disbursement of the next loan installment is expected by mid-December, once the IMF approves the release of its own share worth €2.2bn. Reportedly, the Fund's Board will convene on December 5 to decide on the issue. Greece's sovereign debt redemptions (excluding T-bills) for the remainder of this year amount to ca €2.87bn, with the first one coming due on December 19, when a 3-year bond matures for €1.172bn.

Besides clearing the way for the next loan tranche to Greece, euro area finance ministers agreed on the modalities of the two options endorsed at the October 26-27 EU Summit to increase the EFSF's firepower. Under the first scheme, the EFSF would create certificates that could guarantee up to an 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. The CIF would compromise a first loss tranche which would be financed by the EFSF. Both schemes, expected to be operational by January 2012, could be used simultaneously.

Klaus Regling, head of the EFSF, reportedly said during the meeting that the sharp deterioration in market conditions over the last few weeks suggests that the rescue mechanism's lending capacity is no longer possible to be leveraged by 4-5 times, as EU leaders planned in October. As a result, finance ministers will search for alternative solutions to complement the EFSF, including a stronger involvement of the IMF via bilateral funds from the ECB. Italy's fiscal prospects were also a topic of discussions with Prime Minister Mario Monti vowing that his technocrat government will take additional austerity measures to meet its balanced budget promise in 2013. Reportedly, Italy's PM will present his first package of measures before a council of ministers on December 5.

All in all, the outcome of the Eurogroup reinforced the prevailing market view that EU politicians are still some way off a comprehensive solution to the lingering sovereign crisis. All eyes now turn to the EU leaders Summit on December 9, with hopes building that potential changes to the EU Treaty aiming to promote closer economic integration among member states, may eventually open the door a more holistic approach to resolve the crisis that could, for instance, involve some form of common euro bond issuance.

Major hurdles that need to be overcome by the Greek government in the period leading to the release of the 7th EU/IMF loan tranche

With Greece's newly-sworn national unity government having already secured the timely disbursement of the 6th loan tranche, the next major hurdles that need to be overcome for the release of the 7th EU/IMF loan disbursement of ca €80bn (=€30bn for bank recapitalization + €30bn for the new PSI + €20bn for deficit financing) by early March 2012 include:

i) Parliamentary endorsement of the 2012 Budget, expected on December 7th

One of the main objectives of the new budget is the generation of a primary surplus of 1.1%-of-GDP next year, following estimated primary deficits of 1.8%-of-GDP this year and 4.7%-of-GDP in 2010. The last time Greece managed to run a positive primary position was in 1993-2002, when it generated an average primary surplus of 3.4%-of-GDP. This time around, considerable uncertainty surrounds the attainability of next year's budget targets, given, among others, overshooting risks to the 2011 deficit outcome, the lingering domestic recession, persisting problems with the tax collection mechanism and the still unknown modalities of the new PSI. Yet, never before has Greece undertaken a fiscal consolidation program nearly as aggressive as the present one. (A more thorough analysis regarding the 2012 Budget can be found in *Eurobank EFG Research, Greece Macro Monitor: 2012 Budget: Main Targets & Assessment, November 22, 2011,* http://www.eurobank.gr/Uploads/Reports/FOCUSGreece%20November%2022%202011ii.pdf)

ii) Completion of negotiations with the Troika on the implementation of the new bailout deal agreed at the October EU Summit

According to Greek Finance Minister Evaggelos Venizelos, both the new rescue deal and the corresponding implementation measures supporting the package are expected to be approved by the Greek Parliament by the end of January 2012. More imminently, a senior team of Troika inspectors is scheduled to arrive in Greece on December 12 for a first round of talks with domestic authorities on a number of related issues including, among others, the technical terms of the 2nd bailout plan and the new PSI scheme, the execution of this year's budget with the least possible deviations from the agreed targets, the 2012 budget as well as additional austerity measures for the period 2013-2015. Reportedly, final decisions will be taken at a second round of discussions to take place between January 10 and January 20, 2012, when more information on the full-year State budget execution in 2011 is available.

The government's revised medium-term fiscal plan (MTFS) projects a cumulative fiscal gap of ca €7.02bn in 2013-2015, targeting a decline in the general government budget deficit below the respective Maastricht Treaty threshold of 3.0%-of-GDP in 2014. The updated MTFS, which was submitted to Parliament in late November, takes into a more downbeat GDP growth trajectory than that envisioned in the initial plan approved in June 2011 as well as the (full) beneficial impact of the new PSI scheme. The table below shows the evolution of the general government fiscal deficit in euro billions (and in ppt-of-GDP terms) as forecasted in the updated MTFS. The upper part of the table presents a basic scenario, which assumes *no* additional austerity measures, besides those already identified and agreed with official lenders. The lower part of the table depicts the deficit targets of the revised programme, with the last line showing the corresponding fiscal gap in euro billions. Note that without additional corrective measures, the deficit remains above the 3.0%-of-GDP threshold throughout the entire projection horizon.

Table - revised MTFS 2012-2015

Baseline (i.e., no-policy-change) scenario and official targets

In EUR billion

General Government Budget -ESA 95	2012	2013	2014	2015
General Government Balance (basic scenario)	-11.427	-13.166	-11.339	-9.623
(ppt-of-GDP)	-5.4%	-6.1%	-5.1%	-4.2%
General Government Balance (targets)	-14.916	-11.399	-6.385	-2.600
(ppts-of-GDP)	-7.0%	-5.3%	-2.9%	-1.1%
Nominal GDP (EUR bn)	212.544	214.724	220.294	227.563
Fiscal gap	+3.489	-1.767	-3.187	-2.069

Source: Local press, Imerisia, Kathemirini, 26 November, 2011

For 2012, the revised MTFS projects a fiscal 'cushion' of €3.49bn as a result of the beneficial impact of the new PSI. However, this assumes full investor participation in the new debt exchange scheme as well as no overshooting of this year's 9%-of-GDP deficit target. Greek Finance Minister Evaggelos Venizelos said last week that the new fiscal measures aiming to bridge the projected fiscal gap in 2012-2015 will be identified by the next government after national elections are held (February 19, 2012 or later). Yet, according to local press reports, the troika has recently requested a preliminary draft on such measures to be completed by January 2012, at the latest.

iii) Parliamentary endorsement of a remaining package of measures agreed earlier with official lenders

Among others, the new bill will encompass additional measures relating to: **a)** the opening up of as much as 350 closed professions, including *e.g.* taxi and truck drivers; **b)** further reductions in supplementary pensions; **c)** incorporation of a "solidarity tax" in public- and private-sector wages as of January 2012; **d)** the introduction of a new national taxation system; and **e)** the merging or closure of a number of "unproductive" public enterprises. The new bill is expected to come for voting in Parliament before the end of December.

iv) Completion of negotiations with private sector investors on the terms of the new PSI deal by the end of this year

A steering committee that represents the main bulk of private sector holders of Greek government bonds was set earlier this month, aiming to speed up talks with the official sector on a new voluntary bond exchange scheme agreed at the October 26-27 EU Summit. Co-Chairmen of the committee are Charles Dallara, managing director of the IIF, and Jean Lemierre, senior advisor to BNP Paribas. As a reminder, the October EU Summit envisions a 50% nominal reduction in the outstanding notional of privately-held government debt, aiming to facilitate a decline in the public debt ration towards 120%-of-GDP by 2020 (a more thorough analysis regarding the impact of the new PSI on improved terms on official loans on Greece's borrowing needs and debt sustainability can be found in *Eurobank EFG Research, Greece: Debt sustainability outlook post the Oct. 26th EU Summit, October 31, 2011, http://www.eurobank.gr/Uploads/Reports/31%2010%2011%20Greece%20Debt%20Sustainability%20Outlook.pdf*)

Greek government intends to increase guarantees for bank funding through ELA

In a speech before parliament's financial committee last week, Greek Finance Minister Evaggelos Venizelos signaled that, following a relevant request by Bank of Greece (BoG), the government intends to increase the size of its present guarantees program to €60bn from €30bn, in an effort to provide additional funding to domestic banks through the Emergency Liquidity Assistance (ELA) facility. According to the most recent BoG data, ECB lending to domestic banks declined by 16%mom to €78.13bn in September, recoiling further from all-time highs of €103.11bn recorded last June. Furthermore, the data showed that Greek banks resorted to the recently-activated ELA facility for the second month in row in September to cover their cash needs, apparently pressured by dwindling ECB-eligible collateral assets and continuing deposit outflows. Specifically, Greek banks borrowed over €20bn in September from the ELA facility, bringing total emergency liquidity provided under that scheme to €26.56bn. The Greek ELA facility was activated for the first time in August 2011.

Deposits outflows continued in September on heightened domestic political uncertainty

Reflecting intensified liquidity strains in the domestic banking sector, the most recent official data from the Greek Central Bank showed that private-sector deposits in commercial banks declined by €5.46bn in September 2011, reaching ca €183,2bn, the lowest level since May 2007. According to local press reports, the outflow of deposits continued in October and in early November, reflecting, among other factors, increased market jitters in the euro area and rising domestic political uncertainty following a surprise decision by former Prime Minister George Papandreou to call a referendum on the new bailout deal agreed at the October EU Summit. Bank of Greece Governor George Provopoulos said before a parliamentary committee earlier this week that private-sector deposits in the domestic banking system declined by a further 4.6%mom in October, reaching €174.6bn. As of October 2011, domestic private resident deposits to domestic banks were down by 26.5% from an all-time peak of €237.5bn recorded in December 2009. Total deposit outflows amounted to ca €35bn in January-October 2011. In a more encouraging sign, recent anecdotal evidence points to a stabilization in the domestic deposits base over the last few of weeks on reduced political uncertainty following the creation of Greece's national unity government.

Ongoing recession continues to weigh on consumer spending

Greek retail sales remained in a downward trend in September for the 18th month in a row, as higher taxation, rising unemployment and weak consumer sentiment continued to weigh on disposable incomes. Sales in volume terms (including fuels and motor lubricants) fell by 6.5%yoy, marking a higher pace of decline relative to August's 1.5%yoy drop and pointing to a further contraction in consumer spending in the third quarter of the year. Retail sales by revenue (including fuels and motor lubricants) declined by 3.7%yoy after a 1.4%yoy fall in the prior month. We expect consumer spending to remain in negative territory in the coming months with net exports providing the sole positive contribution to gross domestic product. Adding to the recent string of recent domestic macro economic data releases, manufacturing activity remained in a contractionary territory in November. The **Markit manufacturing purchasing managers' (PMI)** index for Greece came in at 40.9, a tad higher from 40.5 in the prior month. Despite the November improvement, the index remained firmly below the 50 boom-or-bust level that separates growth from contraction for the 27th month in a row. Employment fell by the highest pace in 15 months, new orders declined markedly while those from abroad dropped at an accelerated pace.

In other news, the **Organization for Economic cooperation and Development** reported in its updated World Economic Outlook released earlier this month, that Greece's real GDP is expected to decline by 6.1% this year- more than -5.5% envisioned in Greece's 2012 Budget- and by a further 3.0% in 2012 before the economy returns to anemic growth of 0.5% in 2013. The report also read that the acceleration of structural reforms could help mitigate the recession and reduce the unemployment rate which is expected to a hit a record of 18.7% in 2013. The OECD report urged the Greek government to tackle decisively tax evasion, noting that "the sizable consolidation required to arrest and reverse increases in the high debt-to-GDP ratio leaves no scope for fiscal easing".

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