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GREECE MACRO MONITOR

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Focus notes: Greece

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Visible improvement in investor sentiment towards Greece and progress towards correcting macroeconomic imbalances

Key points

- Significant progress has been made in recent months in correcting past programme implementation slippages and ensuring fulfillment of the fiscal and structural reforms targets agreed with official lenders

- Adjustment in twin deficits is gaining momentum, with the FY-2012 general government primary deficit now seen shrinking below 1%-of-GDP and the current account shortfall being en route to sub-3%-of-GDP levels

- Notably, the anticipated fulfillment/outperformance of the 2012 fiscal targets occurs despite the deeper-than-expected GDP contraction and in the absence of major deviations from the respective public investment program targets

- Gradual improvement in domestic liquidity conditions is expected in the period ahead on increased efforts to boost absorption of EU structural funds, the activation of an agreement with the European Investment Bank to provide funding up to €7bn to small and medium-sized enterprises as well as the resumption of National Entrepreneurship and Development Fund (ETEAN) projects

- Clearance of State arrears commenced in late December, with the government settling some €700mn of outstanding debts to third parties. With some €8.5bn of official funding being earmarked for the settlement of arrears, we expect this progress to accelerate significantly in the months ahead

- The government has already fulfilled the requirements for the release of the next EFSF loan sub-tranche (€9.2bn), we expect the 21 January 2013 Eurogroup to give the green light for the respective disbursement

- The IMF Board is expected to approve later today the release of its next loan disbursement to Greece (€3.3bn)

- The present report also provides a brief time line of key dates and events in Greece for the three-month period ahead

Greece is expected to be mired in recession for the sixth year in a row in 2013, as higher taxation, rising unemployment and the sharp adjustment in domestic wages continue to take a toll on disposable incomes. According to the European Commission's first review of the second adjustment programme for Greece (December 2012), gross domestic output is forecasted to contract by a further 4.2% this year, with the domestic economy now seen reaching a turning point in late 2013, conditional on a rigorous implementation of the agreed reforms programme. Yet, there is no doubt that domestic policy makers have made significant efforts in recent months to correct past implementation slippages and ensure fulfillment of the fiscal and structural reforms targets agreed with official lenders. In return, euro area partners decided at the 28 November 2012 Eurogroup to unlock official funding to Greece under the current adjustment programme and to implement additional fiscal relief strategies, including, among others, a massive debt buyback, in a effort to improve the country's solvency outlook. Against this backdrop, convincing signs of an improvement in foreign investor sentiment towards Greece are already evident, while significant progress has been made in correcting macroeconomic imbalances and laying the ground for a restoration of domestic liquidity conditions and a return to more sustainable output dynamics. More specifically,

(i) *Adjustment in twin deficits is gaining momentum.* According to the latest available data, the execution of the State Budget in the 12 months to last December portrays a pretty encouraging picture, providing further support to our earlier expectations for a likely outperformance of the FY-2012 fiscal deficit target. Along these lines, we now expect the full-year general government primary balance (in ESA95 terms) to record a shortfall lower than 1%-of-GDP, outperforming a revised deficit target of 1.5%-of-GDP envisaged in the new MoU and a deficit realization of 2.3%-of-GDP in FY-2011.[1] Separately, according to the latest available Bank of Greece figures, the current account deficit remained in a downward trend in the first ten months of 2012, falling by 74.4%yoy, compared to a decline of ca 11.4%yoy recorded in the respective period a year earlier, mainly as a result of sizable adjustments in the trade and the income account balances. Assuming that the government continues to vigorously implement the labor market reform and fiscal measures agreed with official lenders, we now forecast the current account deficit for the full-year 2012 to shrink below 3%-of-GDP, from 11.7%-of-GDP in the prior year, before moving closer to a balanced position by the end of the current year[2].

(ii) *Bank recapitalization program heading towards completion*. Greek banks have already received €41bn of official funds (€25bn in May 2012 + €16bn in December 2012) out of a total amount of €50bn earmarked for the agreed recapitalization program. In a report released last month, Bank of Greece confirmed that the €50bn financial envelope is deemed adequate, taking into account losses incurred from the PSI on Greek government bonds, valuation losses on new Greek government bonds and the results of a stress test exercise with a 3-year horizon[3]. As per the conditionality laid out in the revised MoU, all domestic banks are required to achieve a minimum core tier 1 capital ratio of 9% for the whole 2012-2014 period. The bank recapitalisation program is due to be completed by April 2013, through a combination of common equity and contingent convertible bonds.

(iii) *Rebound in domestic bank deposits continues.* According to the most recent Bank of Greece data, household and business deposits in the domestic baking system rose by €644mn in November, the third consecutive monthly increase, amid easing "Grexit" worries and a stabilizing domestic political environment following the June national election. Deposits of domestic household and businesses to the domestic banking system stood at €155.89bn at the end of November 2012, up by €5.3bn from a seven-year low reached in June 2012. During H1-2012, bank deposits declined by a hefty €23.6bn, with some €15.4bn leaving the banking system in the two-month period May-June 2012, mainly due to protractile political uncertainty ahead of the 17 June ballot.

[1] Eurobank Research, *Greece Marco Monitor, "Latest Budget execution data point to a likely outperformance of the revised fiscal targets for FY-2012"*, January 11, 2012, http://www.eurobank.gr/Uploads/Reports/GREECE%20MACRO%20FOCUS%20January%2011%202012.pdf

[2] Eurobank Research, *Greece Macro Monitor, "Greece's external sector adjustment gains momentum", October 25, 2012. http://www.eurobank.gr/Uploads/Reports/GREECE%20October%2025%202012.pdf).*

[3] Bank of Greece, "Report on the recapitalization and restructuring of the Greek banking sector", December 2012, *http://www.bankofgreece.gr/BogEkdoseis/Report_on_the_recapitalisation_and_restructuring.p*df).

(iv) *Gradual restoration of domestic liquidity conditions expected in the period ahead*. Speaking to reporters during a briefing on the pace of implementation of the *National Strategic Reference Framework (NSFR 2007-2013)* last week, Minister of Development & Infrastructure Kostis Hatzidakis said that, after a shortfall in the first six months of last year, Greece outperformed the €2.5bn EU funds absorption target for H2-212, pushing the annual average rate of absorption to 88.9%. Separately, Mr. Hatzidakis said that more liquidity will be channeled in the domestic economy in the period ahead, through the activation of an agreement with the European Investment Bank for funding (up to €7bn) to small and medium-sized enterprises as well as the resumption of National Entrepreneurship and Development Fund (ETEAN) projects. For 2013, the NSFR absorption target stands at € 3.89bn, slightly higher compared to € 3.73bn last year.

(v) *Clearance of state arrears commences.* According to the Greek finance ministry, some €0.7bn of outstanding State arrears to third parties (i.e., government debts outstanding for more than 3 months) was cleared in late December. Under the revised adjustment programme, total financing of €8.5bn has been embarked for the settlement of State arrears (€2bn in December 2012 + 4 equiproportional installments in 2013). According to the latest general government data, the total stock of arrears stood at €8.57bn in November 2012, up from ca €7bn at the end of 2011.

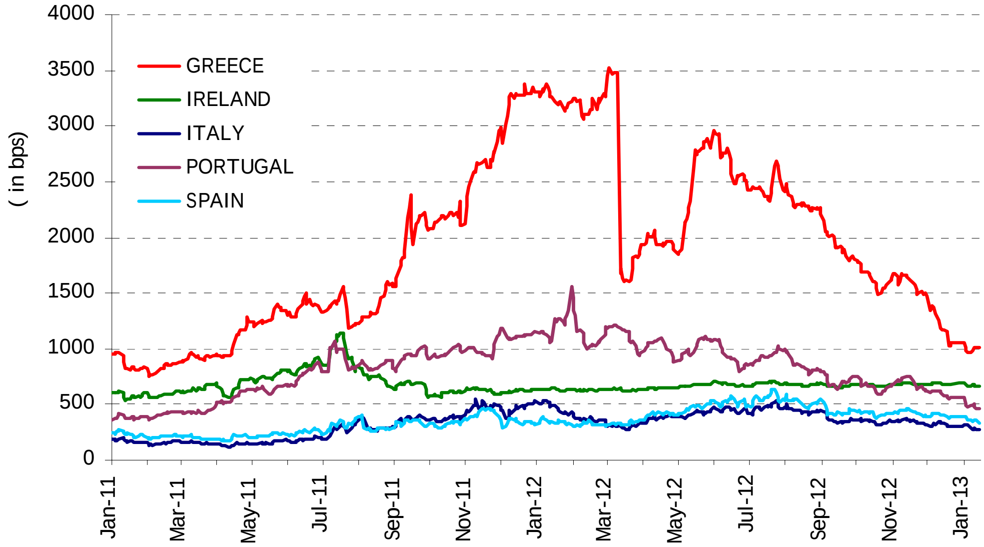
(vi) *Improvement in competitiveness indicators continues*. Greece has made significant improvements lately as regards a range of institutional factors affecting economic competitiveness. Against this background, the annual World Bank "Doing Business 2013" report released in late 2012 showed that Greece was placed 78th, rising 11 places in a ranking of 185 countries globally with respect to improvements made in the domestic regulatory environment aiming to facilitate entrepreneurship.

Reflecting improved market sentiment and encouraged by the determination of euro area partners to help Greece secure its euro membership status, rating agency S&P raised on December 19 Greece's long-term sovereign credit rating by six notches to B-, with stable outlook. S&P had cut Greece's rating to *Selective Default* earlier that month, soon after the Greek government invited eligible private sector bondholders to participate in a debt buyback. The other major sovereign credit ratings, Moody's and Fitch, currently place the country's sovereign credit rating at C and CCC respectively (five and one notch respectively lower compared to S&P). As such, further positive credit rating action on Greece appears likely in the period ahead. Coming on the heels of the S&P upgrade, the ECB decided in late December to resume acceptance as eligible collateral (subject to the necessary eligibility criteria on special haircuts) of all marketable debt instruments issued or fully guaranteed by the Hellenic Republic for the purpose of Eurosystem credit operations. As a reminder, the ECB had decided six months earlier to temporarily suspend the eligibility of Greece's sovereign debt instruments, vowing to review its assessment after the conclusion of the 1st review on Greece's adjustment programme.

EMU sovereign debt spreads narrowing further; Greece outperforms

Greece's rating upgrade by S&P and the resumption of collateral eligibility of Greek sovereign debt instruments in Eurosystem liquidity operations assisted EMU-periphery credit spreads undertake a further narrowing in recent weeks. Easing contagion worries after the 9 December 2012 EU Summit agreed on further steps to enhance fiscal integration among Member States, abating concerns about Spain's year-end financing needs and news over a long-awaited *fiscal cliff* deal in the US, provided additional support to EU periphery debt markets. The Greek government bond (GGB) market has been one of the main outperformers in the EMU sovereign space lately, with the Feb. 2023 GGB cash yield hovering slightly above 11.5% as of the time of writing this report (European trade, 14 Jan. 2013), not far from a two-year low of 11.2% a week earlier and sharply below levels around 15% recorded in early December. The corresponding yield spread against the 10-year German counterpart stood slightly above 1000ps in late trade of January 14, compared to a closing low of 971bps hit last week and levels around 1.180bps in early December (*Graph 1*). It is worth mentioning that the Greek sovereign bond market was ranked by both the European Federation of Financial Analyst Societies and Bloomberg as top performer among 174 sovereign debt indexes in FY-2012. Along similar lines, Greece's ASE benchmark general stock index retained a firm tone in recent weeks, standing close to 996 at the time of writing (Jan. 15, 2013) after surpassing the 900 level in mid-December for the first time in four months. Looking ahead, we expect Greece to remain a strong performer in the EMU sovereign debt space in the period ahead, provided that the tripartite coalition government remains committed to aggressive fiscal consolidation and structural reforms. The technical picture for the 10-year-GGB/German Bund yield spread suggests that strong support stands at 971bps recent low in the way to the 945/950bps area (early Dec. 2011). Yet, a temporary corrective (widening) move towards 1.150bps or slightly higher levels should not be ruled out in the short-term, as the recent tightening move has probably gone too far, too fast.

Graph 1- EMU-periphery sovereign 10-year debt spreads on a narrowing trend over the last few weeks



Source: Bloomberg, Eurobank Research

Prior actions for the release of the next sub-tranches of the second loan disbursement

Notwithstanding its recent successes, the Greek coalition government has to overcome further significant challenges in the period ahead, so as to help jump-start the domestic economy and put the country's public finances in order. One of the most imminent challenges lying ahead is the fulfillment of a number of prior actions for the release of the remaining sub-trances under the 2nd loan disbursement. As a reminder, the 13 December 2012 Eurogroup formally approved the release of the 2nd EFSF loan disbursement, which amounts to a larger-than-expected €49.1bn. According to the official statement, the EFSF funds would be released in four monthly sub-tranches by end Q1-2013 conditional upon a strong implementation by the Greek side of a number of agreed MoU milestones.

In the third week of December, Greece received the 1st EFSF sub-tranche of €34.3bn, consisting of €16bn (in the form of short-EFSF paper) for bank recapitalization, €7bn in cash for budgetary purposes and €11.3bn (in the form of short-term EFSF notes) to cover the financing required for the purchase of the full amount of bonds validly tendered in the Greek debt buyback operation. The 2nd EFSF sub-tranche, amounting €9.2bn, is scheduled for release by the end of this month, conditional on approval by the January 21st Eurogroup. *(The EWG has already recommended the release of the January 2013 tranche and, more or less, we considered it to be a done deal).* Out of this, €7.2bn is expected to come in the form of short-term EFSF notes for the completion of the bank recapitalization program, with the remaining €2bn being earmarked for servicing debt and covering other budgetary needs. The 3rd and 4th EFSF sub-tranches amounting €2.8bn each, are scheduled for release in February and March respectively (*Table 1*). Greece is also due to receive an additional amount of €3.3bn by the end of this month from the IMF (2 installments of €1.65bn each), subject to approval of the Fund's executive board, which convenes on January 16.

Table 1- Detailed composition of 2nd EFSF disbursement			
December 2012 sub-tranche			
December 2012 sub-tranche	34.3		
o/w for bank recap and resolution (notes)	16.0		
o/w for bank resolution		5.8	
o/w for bank recap		10.2	
o/w for DBB (notes)	11.3		
o/w for budget (cash)	7.0		
January-March 2013 sub-tranches			
Total disbursement January - March 2013	14.8		
o/w for bank recap/resol. (notes) -Jan		7.2	
o/w for budget (cash) - Jan-March		7.6	
o/w January			2.0
o/w February			2.8
o/w March			2.8
Total disbursement EFSF	49.1		

Source: EC, "The Second Economic Adjustment Programme for Greece, First Review", (December 2012)

Prior actions to the release of the January 2013 sub-tranche

(As presented in the European Commission's 1st programme review)

i) *Adoption of income tax reform (**completed**)*. After a heated debate in Parliament, the so-called "mini" tax bill was approved on January 11, with the backing of all 163 ruling coalition MPs. (**Table 2** in the Annex section of this report presents the main elements of the new tax bill). According to Greek Minister of Finance, Yiannis Stournaras, the income tax reform is anticipated to generate revenue of €2.3bn in 2013-2014, with the main bulk (ca €1.14bn) expected to come from the abolishment of the tax-free threshold and a change in the scale of effective income tax rates for professionals and self-employed.

ii) *Ministerial decision to adjust end-user prices for low voltage customers, effective as of January 2013 (completed)*. The Greek Ministry of Environment, Energy and Climate Change, announced on January 13 an increase (of up to ca 10%) in electrify prices for households this year to help state-owned Public Power Corporation (PPC) cover the cost of *transmission rights (estimated at €270m)*, as laid out in the conditionality of the revised MoU.

Prior actions for the release of the February 2013 sub-tranche

Update of the Medium-Term Fiscal Strategy (MTFS) for 2013-2016, including binding 3-years expenditure ceilings for the central government, the health sector and other general government sub-sectors.

Prior actions for the release of the March 2913 sub-tranche

i) *Completion of the staffing plans for line Ministries. These will be used for the identification of redundant positions and employees and, on this basis, quarterly targets of mandatory exits through end-2014 will be set.* The agreed target is for a 150k reduction in the total public sector employment over the period 2011-2015 via, mainly, (a) the application of the attrition rule (1 new hire against 5-10 retirees); (b) outright dismissals of public employees who have found guilty of serious discipline offense or have an administrative inquiry ordered against them; and (c) transfer to a special *mobility scheme* of employees of closed or merged state entities who will score poorly in regular evaluation tests or/and have limited qualifications. Under the latter scheme, transferred employees will be receiving 75% of their basic monthly salary for a year before being subject to permanent separation. That is, in case they are not transferred to a new position in the public sector. Some 2.5k public employees have already been transferred to the special mobility scheme and an additional 27k is expected to be transferred by the end of this year.

ii) *Downward revision in the price of medicines, based on the three EU countries with lowest prices (quarterly update of price list).* As per the conditionality laid out in the revised MoU, the planned downward revision of medicine prices, coupled with a number of additional initiatives (i.e. provision of incentives for the use of generic medicines), is projected to ensure that the outpatient pharmaceutical expenditure will not exceed the agreed targets of €2.44bn in 2013 and €2bn in 2014.

Timeline of key dates and events in the period ahead

In what follows, we present a short timeline of the key dates and events investors need to closely monitor in the period leading to the timely release of the next EFSF/IMF loan tranches to Greece and the successful completion of the 2nd adjustment programme review.

January 16

IMF executive board meets to decide, among others, on the release of the next loan tranche to Greece (€3.3bn) under the county's 2nd adjustment programme.

January 18

Greece has €2bn in T-bills redemption.

January 21

The Eurogroup meets. We expect euro area finance ministers to give the green light for the release of the January sub-tranche, amounting €9.2bn, following the successful completion by the Greek side of the agreed prior actions.

Late January- Early February

Update of the Medium-Term Fiscal Strategy (MTFS) including binding 3-years expenditure ceilings for the central government, the health sector and other general government sub-sectors (prior action for the release of the February sub-tranche).

January 31

Euro Working Group meets to prepare the ground for the February 11 Eurogroup.

February 8

Greece has €1.975bn in T-bills redemption

February 11

Eurogroup meets. The release of the February sub-tranche, amounting €2.8bn is expected to be included in the agenda.

February 15

Greece has €1.6bn in T-bills redemption

Second half of February

Troika high-level officials return to Greece for the next review of the country's adjustment programme.

Late February

Greece is expected to have successfully completed the agreed prior actions for the release of the March sub-tranche, amounting €2.8bn.

March 4

Eurogroup meets. The agenda is expected to include the release of the March sub-tranche to Greece.

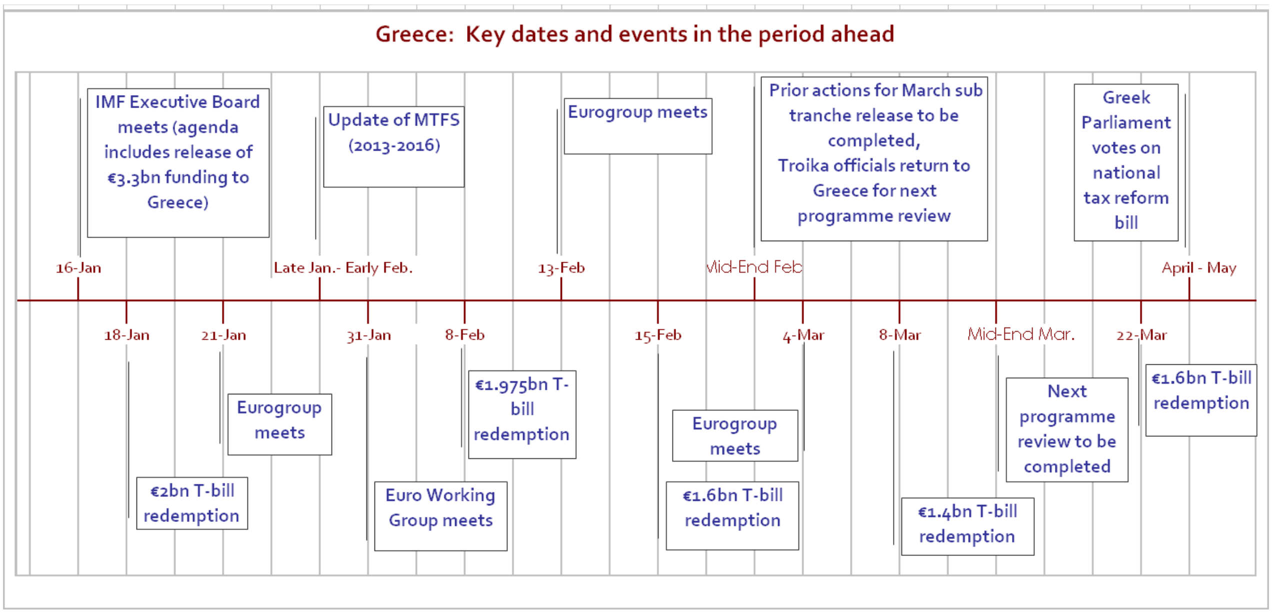
March 8

Greece has €1.4bn in T-bills redemption.

March 22
Greece has €1.6bn in T-bills redemption.

Mid-to-end March
Completion of the next review of the adjustment programme for Greece.

April-May
Greek Parliament votes on the so-called "maxi" national tax bill (as per the revised MoU, the national tax reform should have been parliamentary endorsed by June 2013). The said bill is planned to introduce measures aiming to improve collection of taxes and strengthen the fight against tax evasion and corruption.



Annex - Table 2: Main features of the income tax bill (voted in Parliament on Jan 11, 2013)

(i) *Simplification of the personal income tax system.* The number of tax brackets for salary workers and pensioners is being reduced from 8 to 3. A 22% tax rate will be charged on declared annual income up to €25.000; a 32% rate will be levied on the portion of declared annual income from €25.001 to €42.000; and the highest rate of 42% will be applied on the portion of income in excess of €42.000.

(ii) *Elimination of special tax credits and personal tax threshold allowing the emergence of a wider tax base and the generation of additional revenues.* The income tax-free threshold of €5.000 per year will be abolished and be replaced by a maximum tax reduction of €2.100 for annual income up to €21.000. This tax reduction will shrink by €100 for each €1.000 of income exceeding €21.000. Annual incomes in excess of €42.ooo will see no reduction at all. Tax exemptions are abolished (i.e. mortgage interest payments, life insurance payments, student expenses) with the exception of medical expenses, divorce settlement and donations to public institutions.

(iii) *Conversion of personal tax allowances for children into means-tested benefits.* The additional tax-free thresholds for families with children have also been abolished and replaced by benefits. Specifically, families with three or more children declaring income up to €45.000 per year will be entitled to a new allowance amounting €500/per child annually.

(iv) *Introduction of a new integrated tax regime for self employed and professionals with no personal tax allowance*. Self-employed and professionals whose net annual income is no higher than €50.000 will be taxed at a rate of 26%, while a 33 % rate will be levied on the portion of income exceeding the aforementioned amount.

(v) *A restructured tax regime for corporate profits* with a corporate tax rate of 26% (from 20% previously) and a tax on distributed dividends of 10% (from 25% previously) resulting in a gross tax rate on distributed profits of 33.4% (instead of the current tax rates of 20% and 25% respectively, resulting in a gross tax rate of 40%). The aim is mainly the reduction in the tax avoidance induced by the transferring of profits to other EU countries, though the increase in the effective tax rate may adversely affect non-equity financing of investment.

(vi) *Elimination of special tax regimes based on imputed income, such as those currently applied to farmers***.** VAT returns and grants of duty diesel for farmers will be reduced. Moreover, as of 2014, farmers' agricultural income will be taxed in line with accounting standards (book keeping for revenue and expenses) and the imposed tax rate will stand at 13%.

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