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Latest macro & market developments

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Third EC/ECB/IMF mission to Greece: Focus should be shifted to reform implementation and privatization agenda

EU and IMF inspectors recommended y-day approval of the fourth loan tranche to Greece under the present bailout programme, but urged the government to speed up reforms and target a more ambitious plan for state asset sales. In a press conference held in Athens on February 11, the chiefs of the 3rd EC/ECB/IMF mission to Greece said that the implementation of the country's stabilization programme made further progress on the agreed objectives, despite implementation delays and slippages in certain areas. They urged the government to place increased emphasis on the implementation of structural reform and accelerate its privatizations drive with a view to facilitate a faster reduction in the public debt ratio. An endorsement of the 3rd programme review by the IMF Board and the EU lenders would allow disbursement of next €15bn loan tranche by early next month. On the structural reforms front, the *troika* officials characterized recent developments as encouraging, given that the majority of reforms marked as unfulfilled in the previews programme review (December 2010) are now completed or close to completion. These include, among others: **a)** labor market-related measures in the form of a prevalence of firm-level agreements over industry- and country-level ones, the symmetry in central arbitration and the elimination of automatic extension of sectoral agreements to those not represented in the negotiations (already voted in Parliament), **b)** liberalization of the so called "closed professions" (respective bill already submitted to Parliament, **c)** health care reform (bill already voted in Parliament, other aspects of the reform are under way), **d)** bill on licensing of new firms (still under consultation) and **e)** strengthening the role of the Hellenic Competition Authority (still under consultation).

Nevertheless, the EC/ECB/IMF officials emphasized that the government's focus in period head should shift to the actual implementation of these reforms, and not merely passing the respective bills in Parliament. That is especially as, a return to positive as sustainable economic growth crucially depends on a timely implementation of such reforms. The officials also urged the government to accelerate the planning and implementation of its privatization agenda, with a view to help payout a part of public debt and facilitate a speedier reduction in the debt ratio. With respect to the 7.4ppts-of-GDP budget deficit target for this year, the troika representatives said that the target is achievable, though implementation risks exist, in the form of accumulated arrears in local governments, hospitals and other subnational-level entities. Note here that the process of auditing and publishing the accounts of all general government entities falling under the ESA95 definition has not yet produced the expected results (further analysis on the latter issue to be provided in our next Greece Macro Monitor). Finally, the government's soon-to-be announced medium term budget plan (2012-2015) was deemed as encouraging. The plan envisions a reduction in the fiscal deficit to just €3bn (~ 1.2% of projected GDP) by 2015, from ca €17bn expected this year. According to Greek Finance Minister George Papaconstantinou, ca two-thirds of the targeted deficit reduction in 2012-2015 will come from spending cuts, while the medium-term program will not include further reductions in salaries and wages or new tax hikes.

With regard to privatization and state asset sales, the EC/ECB/IMF representatives stated that the country should commit to a massive €50bn revenue plan in 2011-2015, which would include the sale of state-owned (listed and unlisted) companies as well as real estate assets. The announcement came as a surprise, considering **a)** the state's track record on privatization (no more than €10bn in privatization receipts generated over the past 20 years, according to *Dow Jones* estimates) and **b)** respective amounts envisioned in the Dec. 2010 update of the Memorandum of Understanding with official lenders (€1bn in 2011 plus annual revenues of €2bn in 2012-2020). The EU/IMF call for €50bn in privatization revenues appears to have already ignited an intense political debate domestically (even within the ruling partly), with government spokesperson, George Petalotis, criticizing the *troika* and, purportedly, its shock privatization announcements as a direct interference in internal affairs. We will attempt to provide some further analysis on the feasibility of such a huge privatization plan in our next Macro Monitor, but, as a general assessment, a commitment to an ambitious plan for privatizations would rather be market-positive and reassuring of investors' perceptions regarding the sustainability of Greece's fiscal accounts.

State budget execution data for January 2011 broadly in line with official target

Preliminary data for the state budget execution in January 2011 showed a surplus of €155mn compared with a surplus of €578mn in the same month a year earlier. According to the General Accounting Office, the data were broadly in line with the revenue and expenditure projection included in the 2011 budget. Note also that it is rather customary for the state budget to generate a surplus in the first month of the year, as a result of seasonal factors related to the timing profile of revenue and expenditure realizations. Specifically, net ordinary budget revenue declined by 9.2% YoY, but this was the result of **a)** lower receipts (by €393mn) from car circulation fees relative to the first month of 2010, because the due payment data was not extended to January as happened last year and **b)** lower revenues (by €140mn) from an extraordinary tax on the profits of large companies. On the spending side, ordinary budget expenditure was down by 2.5% YoY, with primary outlays declining by 2.6% YoY and interest costs by 2.3% YoY. In the Public Investment Budget, both expenditures and revenues declined relative to the same month a year earlier (down 14.7 YoY and 63.3% YoY, respectively).

Note that the above data correspond only to the execution of the state budget deficit and thus, do not coincide with the ESA95-defined general government deficit, which includes a number of sub-national entities (e.g. public hospitals, local governments and state-control corporations) and represents the benchmark for the assessing the country's economic policy program. Following an estimated fiscal adjustment of ca 6ppts-of-GDP last year, the 2011 budget targets a 2ppts-of-GDP reduction the general government deficit to 7.4%-of-GDP. Notwithstanding the November 2010 fiscal data revisions, this is in line with the deficit target agreed originally with official lenders under the present 3-year EU/IMF adjustment programme. As we noted in the past, to ensure attainment of the 2011 deficit target, the government included in this year's budget plan a number of new austerity measures *i.e.,* additional to those agreed earlier with the troika (see *Eurobank EFG Research, Greece Macro Monitor, 10 January 2010*).

The Fund estimates these extra measures to be worth 2.2ppts-of-GDP, bringing the total expected size of the 2011 austerity package to ca 6.2ppts-of-GDP (inclusive of a projected carry-over impact of ca *2.4ppts-of-GDP from measures introduced in 2010)*. The above figures suggest that, baring any unforeseen macroeconomic or political developments and assuming full implementation of the 2011 budget, the government should be able to attain the 2ppts-of-GDP targeted reduction in the fiscal deficit this year.

In support of the latter view note that the overall size of the fiscal adjustment package for 2011 appears adequate enough to largely offset the drag from a *(downwardly)* revised macroeconomic outlook, structural spending pressures stemming from higher interest costs, the expiration of a number one-off measures implemented in 2010 *(e.g. the levies on high income individuals)*, and some new fiscal initiatives introduced by the authorities to support growth and the unemployed *(e.g. selected corporate and VAT cuts and a new jobs program)*. Moreover, the lifting of reservations on Greece's fiscal accounts in Eurostat's November 2010 notification, effectively means that any further revisions to the country's past fiscal data would not be due to methodological factors and thus, not nearly as significant in magnitude as the revisions instrumented in the recent past.

Clock is ticking on "comprehensive" anti-crisis EU package

The main elements of the so-called *competitiveness pact* proposed by Germany and France took centre stage in the Feb. 4 EU Summit. The proposals indentified three quantifiable measures for evaluating competiveness in Member States' economies; namely,

a. stability of public finances, from a comprehensive point of view (assessment measures still to be fixed)
b. indicator to measure price competitiveness (e.g. stability of real labour cost and realignment of labor cost according to development of productivity)
c. minimum rate (in percentage-of-GDP terms) for investments in research, development, education and infrastructure (quantitative threshold yet to be fixed)

With a view to improve competitiveness beyond national legislation, the German-French joint proposal also outlined a six-point reform program to be implemented within 12 months:

i) abolition of wage/salary indexation schemes
ii) agreement on mutual recognition of education diplomas and technical qualifications, with a view to promote cross-border labor mobility
iii) creation of a common assessment basis for corporate taxation, as part of a plan to promote closer economic co-operation. Under the proposed Common Consolidated Corporate Tax Base, or CCCTB, businesses would be given the option to use a single regime, regardless of where in EU-27 they are based in.
iv) adjustment of the pension systems to national demographic developments (i.e., average retirement age)
v) commitment by all member states to enshrine into national legislation a "debt alert mechanism", with a view to eliminate structural deficits within a specific timeframe
vi) establishment of a national crisis resolution regime for banks, getting countries to set up orderly ways to handle bank failures

While there was widespread backing for the principle of closer coordination of budgetary and economic policies, politically sensitive issues such as wage-setting, public pension policy and business taxation, reportedly met with strong opposition by a number of state leaders. Ireland was the most vocal opponent to the proposed common assessment basis for company taxes, due to worries that such a measure would damage its appeal to international businesses (its current corporate tax rate is just 12.5%, one of the lowest in the EU after Cyprus, Bulgaria and Hungary). Belgium, Spain and Portugal were reportedly against the abolition of index-linked wage increases while countries with strong unions and powerful labor lobbies raised strong objections to a proposal for adapting pension systems to national demographic developments. Aggravating concerns that the policy-making process towards a comprehensive solution to the EU debt crisis is not as harmonious as previously thought, Netherlands and Austria, traditional German allies, aired objections to a potential EU-wide agreement on pension ages or wage rates, insisting that such measures are the domain of national governments and not subject to multilateral decision making.

Separately, others EU countries objected to Angela Merkel's purported efforts to sideline the European Commission - charged with drawing up EU legislation -, by pursuing an intergovernmental approach to the present crisis. Besides, much of what the competitiveness pact encompasses - with the exception of the 'debt brake law' that aims to prevent rampant spending- has already been set by the European Commission in its first Annual Growth Survey released earlier this year. This included the so-called *European semester*, which aims to initiate a process of closer coordination for member states' macroeconomic, budgetary and structural reform policies.

According to some commentators, there were probably political incentives behind the German Chancellor's "enhancing competitiveness" drive as she rushed to reach a deal among EU governments ahead of the upcoming elections in seven German states. This is especially so as a number of recent opinion polls suggested that the centre-right CDU/FDP coalition government is likely to suffer a heavy defeat. Meantime, the junior partner in the coalition government, the Free Democrats (FDP), has lately become increasingly vocal in their opposition to an extension on the EFSF's guarantee pool.

Besides the proposed "competitiveness pact", details on a proposed overhaul of the present EFSF facility are also set to be part of a broader comprehensive package of reforms EU officials are expected to hammer by late March. Rending the EFSF more flexible and efficient, so that it becomes more than a bailout lender of last resort, has been the focus of discussion in recent months. For instance, one option is to increase EFSF's effective lending ceiling, especially in view of increased worries that the mechanism might not have enough funds to deal with a further significant escalation of the EMU sovereign debt crisis.

To secure its covered AAA rating, the EFSF can not currently lend more than €255bn. This is significantly less than its guarantee poll of €440bn, as lenders have to set aside cash reserves (*for more details on the modalities and operational characteristics of EFSF, please also see our February 4, Greece Macro Monitor*). Reportedly, deep disagreement remains over how the EFSF could be strengthened, with Germany appearing determined to try to secure stricter budgetary commitments and competitiveness-boosting reforms from other EMU states before agreeing on any significant amendments to the present bailout facility. Giving to EFSF more flexibility on how to utilize its fund, appears to be another source of disagreement. Empowering the fund to buy back EMU government bonds from the market outrightly or through loans to debt laden governments are two alternatives under consideration.

EU policymakers facing a packed agenda in the coming several weeks

The lack of concrete decisions on measures to address the debt crisis so far, have left EU officials with a packed agenda over the next several weeks that, besides the aforementioned issues, includes: new (and stricter) stress tests for European banks; a decision on whether to grand lower interest rates on bailout loans to Greece, Ireland or any other Eurozone state receiving bailout funding and whether (and by how much) to extend Greece's loan repayment periods.

Under the existing EU/IMF loan agreement, Greece will need to repay each loan tranche in eight equal installments over a period of 2 years, following an initial grace period of 3-3 ¼ years. At the November 28, 2010 Eurogroup meeting, EU officials agreed in principle to align the terms of Greece's bailout loans with those to Ireland, under the county's €85bn rescue package. If the proposed repayment extension is to be granted, repayment of each loan tranche would take place over a 7-year period, following an initial grace period of 4 years But, maturities of EU/IMF loans to Greece (and Ireland) could even be extended for significantly longer. Echoing ECB Weber's comments in early February, Eurogroup Chairman Jean-Claude Junker said this week that he would not oppose to a 30-year extension for the repayment of Greece's bailout loan if Germany would consider this idea. Mr. Junker added that he is open to a Greek debt buyback scheme and applauded the government's fiscal consolidation efforts. These comments came on the heels of a recent report in a local newspaper (TO VIMA), suggesting that the EU authorities, along with the IMF and the ECB are working on a three-stage plan to reduced Greece's debt burden. More specifically, the article read that Greece would borrow from the EFSF in order to repurchase government bonds, currently owned by the ECB and private bondholders, at about 75% of their nominal value. The maturity of the bailout loans by the EU and the IMF would then be extended to 30 years and the interest rate applied would be reduced.

According to unnamed EU sources, there is growing support for using the EFSF to enable Greece and Ireland to buy back government bonds from the ECB, while most euro zone governments are leaning towards reducing the annual effective lending rate for both countries to about 3.2%-3.5%, the rate the EU charges non-euro zone members states Romania, Hungary and Latvia for balance-of-payment support loans. Greece and Ireland currently pay between 5.5% and 5.8%). A decision to grant Greece a loan repayment extension needs to be ratified by EU national parliaments and, as such, it will be a part of the expected "comprehensive package" of anti-crisis reforms.

After many EU countries reacted angrily to German-French jointly proposed 'pact for competitiveness', an emergency meeting for the Eurozone heads is set to take place on March 11, after a new government in Ireland taken office (general elections are scheduled for February 25 and a new government will be worn in on March 9). EU leaders will try to find the basis for a compromise ahead of a subsequent summit on March 24-25 when a final agreement on the form of a package of concrete measures to tackle the debt crisis is expected to be reached. Nevertheless, following strong objections to German/French proposals for enhancing competiveness in the euro area, investors are increasingly worried that policymakers might fail to reach an agreement by the expected deadline or that the eagerly-anticipated comprehensive anti-crisis package may well fall short of expectations.

Greece's latest T-bills auction met strong demand

Greece's Public Debt Management successfully sold €390mn of 26-week T-bills on February 8. The auction produced an average yield of 4.64%, lower than 4.80% expected and down 26bps from a previous €1.95bn auction of similar maturity paper that took place in mid-January. The auction was oversubscribed 4.54 times, with some 80% of the T-bills sold being purchased by foreign investors, up from 34% last month, reflecting rising investor hopes that EU policymakers will agree on a comprehensive solution to the sovereign debt crisis by late March.

The EU/IMF rescue package allows Greece to stay away from the markets until Q1 2012, but since September, when quarterly tenders of short-term government paper were abandoned for the sake of a better cash management and more leeway, the government continues to issue T-bills on a monthly basis for rolling-over maturing short-term paper. Greece will need to borrow some €58.1bn for the whole 2011 to finance its deficit and roll over existing debt. Out of this amount, some €46.5bn will be in the form of EU/IMF loans under the existing financial support scheme, with the remaining amount representing net borrowing from the market via T-bill issues.

On a similar positive note, Portugal successfully sold €3.5bn of five-year notes through syndication this week, taking advantage of a limited pipeline of debt supply. Treasury Secretary Carlos Dina said that demand was around €6bn, double the minimum planned placement given by the debt agency IGCP in its 2011 financing programme. Portugal aims to sell a total €18-€20bn in government bonds this year, below the €21.4bn of debt issued in 2010. Ahead of its first redemption payment of €4.53bn in April, the country has already raised €1.25bn at its sole auction so far this year that took place on January 12.

Greek unemployment hits fresh all-time highs in November

Greece's unemployment rate remained in a rising trend in November, jumping to a fresh record rate of 13.9% from 13.5% in October and 10.6% the same month last year, as the ongoing domestic economic recession continued to take its toll on the labor market. According to Hellenic Statistical Authority figures, a record 692,577 people were officially without work in November, a 30% increase on an annual basis. The number of the employed shrank by an annual 3.5% to 4,307,054, its lowest level since April 2005, Greece's unemployment rate was the second-highest in the 16-member euro area in November after Spain, as well as 3.9 percentage points higher than the region's average. According to the 2011 budget plan, the unemployment rate is estimated to rise further to 14.6% this year as the economy is expected to experience its third consecutive year of recession.

Separately, Greek CPI came in at 5.2%yoy in January, unchanged compared to the prior month's level, and not far from a 13-year high of 5.6%yoy hit in September last year as higher energy prices and increased VAT taxes continue to have an impact. In the same month last year, the annual rate of change of the CPI was 2.4%yoy. For the whole 2010, CPI averaged 4.7%yoy while, based on the 2011 budget plan, domestic inflation is seen averaging 2.2%yoy this year, before easing to 0.5% and 0.7% in 2012 and 2013 respectively on warning base effects and a negative output gap. Adding to the recent string of negative domestic macro releases, industrial production dropped by 5.2%yoy in December, a lower pace of decline relative to November's -7.6%yoy, on the back of improved exports of base metals, chemicals and food staff. For the whole of 2010, industrial production dropped by 5.7% compared to -9.4% in 2009.

Private credit growth slowed further in November

With respect to domestic credit developments, total credit to the private sector remained on a downward trend in November. According to data provided by the Bank of Greece, the corresponding annual growth rate eased to a new post-EMU entry low of 0.4%yoy from 1.0%yoy in the prior month. On the other hand, MFI lending to the general government continued to grow at a robust pace, coming in at a hefty 38.6%yoy in November, compared to 37.3%yoy in the prior month. We expect annual credit growth to the domestic private sector to remain broadly stagnated in the coming months as domestic recession deepens and difficulties in the funding conditions of domestic banks linger.

EMU sovereign debt spreads widening again; Greece underperforms

After temporarily hitting multi-week lows mid last week, EMU sovereign debt spreads resumed their widening trend over the last few sessions on worries that the comprehensive solution to the EU debt crisis might fall short of market expectations. Jan Kees De Jager, the Dutch Finance Minister, noted earlier this week that his country is strongly opposed having the EFSF purchase government bonds from the primary or secondary markets or allowing the fund to lend money to fiscally-vulnerable countries for debt buybacks, citing that such proposals could result in a higher burden for taxpayers. Against this environment, well-received sovereign debt auctions from Greece and Portugal, failed to provide comfort.

In the EMU sovereign space, Greece has been among the worst performers on worries that a decision on a loan repayment extension might delay longer-than-expected. After moving above 800bps earlier this week for the first time since late January, the 10-yr Greek government bond yield (GGB) spread to the German Bund was hovering around a two-week high of 825bps at the time of writing, some 65bps wider from a three-month trough recorded earlier this month. Buying-interest for Greek government paper eased over the last few sessions with secondary market volume in the HDAT platform moving lower. The daily average turnover stood around €53.5mn, down from some €100mn last week but still higher compared to ca €35mn last month. Technically, a sustained move above recent highs has the potential to open the way for further widening towards 940bps (Jan. 10 high) in the way to 974bps record highs in early January. On the downside, strong support lies at 755bps year-to-date lows set mid-last week ahead of the crucial 650/660bps area (mid-October lows).

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