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GREECE MACRO MONITOR

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Focus notes: Greece

Latest macro & market developments

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Highlights

- **Comprehensive plan under construction to tackle EMU sovereign debt crisis**
- **Prolonged domestic recession curbs consumer spending, manufacturing activity continued to contract**
- **EMU sovereign debt spreads narrow sharply on mounting optimism over a powerful policy response to the debt crisis; Greece outperforms**

Part I

Comprehensive plan under construction to tackle EMU sovereign debt crisis

According to a number of press reports, Germany and France are close to an agreement on the main elements of a comprehensive plan aiming to promote closer economic coordination in the euro area and enhance fiscal discipline among member states. Thought not being officially part of the February 4 EU Council agenda, the joint proposals will be reportedly presented at today's Heads of States summit, as part of a comprehensive solution to deal with the lingering crisis. Specifically, a so-called "pact for competitiveness" will need to be implemented within 12 months, in an effort to curb economic imbalances, impose budgetary discipline and enhance growth and competitiveness. According to reports, the new competitiveness pact will call Eurozone states to:

i) "adapt their retirement age to demographic trends", so as to take into account ageing populations

ii) introduce financial policy rules *enshrined into national legislation* with a view to eliminate structural deficits within a specific timeframe

iii) promote a greater harmonization of national tax regimes

Proposals for greater harmonization of corporate taxes, a long-standing German demand, or banning wage indexation schemes, currently existing in Belgium and Portugal, are reportedly under consideration. Other initiatives including a system of national crisis resolution regimes for banks and national constitutional amendments aiming to curb public borrowing -- *i.e., the so-called debt brakes to prevent rampant spending* -- such as these currently existing in Austria and Germany are also likely to be part of the proposed pact. Germany also urges member states to recognize each other's diplomas and technical qualifications. In an apparent move underling France's determination for stricter fiscal discipline, Prime Minister Nicolas Sarkozy announced this week plans to reform the country's constitution to include a "golden rule"

on balancing the budget.

In exchange for stricter budget discipline across states and greater convergence of euro zone retirement and unemployment systems in the euro area, Germany seems ready to reach an agreement on potential changes to the existing EFSF facility, so as to render it more flexible and efficient to address the ongoing sovereign debt crisis.

The main changes to the EFSF framework under consideration reportedly include:

i) **An increase in the EFSF's lending ceiling.** To secure its top credit rating (AAA), total EFSF loans should not currently exceed the €440bn guarantee pool as lenders have to set aside cash reserves. In its current form, the EFSF can not lend more than €255bn. Cumulated with **a)** the EFSM €60bn funds raised by the European Commission and backed by the EU budget and **b)** a further 50% IMF contribution of the total of the EFSF/EFSM programmes, the full amount of the available funds stand at €409.8bn (after subtracting €62.7bn allocated to Ireland). How, this *(i.e., the proposed increase in the EFSF lending capacity)* will be achieved still remains unclear. Chancellor Angela Merkel's spokesman Steffen Seibert said recently that Germany would consider the option of getting euro area countries which do not have an AAA-rating to help boost the capacity of the EFSF by injecting cash (only 6 out of the 17 euro area countries are currently rated AAA: Austria, Finland, France, Germany, Luxembourg and the Netherlands). The above comments presumably reflect Germany's opposition to an outright increase in the size of the EFSF, and thus, a rise in the share of the burden for German taxpayers. Upcoming important state elections in the Eurozone's biggest economy are looming while the junior partner in Germany's coalition government, the Free Democrats (FDP), has lately become increasingly vocal in their opposition to an extension in the EFSF's guarantee pool. A new poll that came out late last week showed that 64% of the German population opposes increasing the size of the EFSF. (Germany is already guaranteeing €120bn or some 30% of the EFSF).

ii) **EFSF to be empowered to buy EMU government bonds from the market outrightly or through loans to debt-laden governments.** A local press report (To Vima) suggested late last week that the EU authorities in liaison with the IMF and the ECB are working on a plan, similar to the "Brady plan" used to rescue Latin America from bankruptcy in the 1980s, to reduce Greece's debt. This would reportedly be a three stage plan that would result in the "reprofiling" of about two-thirds of Greece's total debt (€327.2bn for 2010) by the end of this year. 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. Private lenders owning more than €100bn of Greek bonds would be invited to extend bond maturities to between 15 and 20 years. Along these lines, a Reuters report, quoting unnamed EU official sources, suggested that at the mid-January Ecofin meeting ECB's Axel Weber had proposed extending the maturity of Greece's and Ireland's rescue loans to 30 years from 3 and 7 years respectively.

Understandably, private bondholders' acceptance of any voluntary buy-back of existing Greek bonds is uncertain. According to unnamed EU sources, banks are currently holding 80% of Greek debt to maturity to avoid declaring (mark-to-market) losses and only 20% on trading books at discounted fair value. Yet, it is worth noting that, a debt buy-back scheme is not necessarily comparable to a *debt restructuring* plan. A European Commission spokesman underlined earlier this week "A buy-back of bonds is not debt restructuring. It does not concern the whole amount of the debt. It does not involve any negotiation with creditors/bondholders. The state acts as any other market participant buying a limited amount of its own bonds which are available in the debt market".

According to the latest statistics from the Bank for International Settlements (BIS), German banks have the second highest exposure to Greek government debt, at €40.3bn vs. France's €59.4bn (the exposure includes credit to banks, other private sector borrowers, the government and public sector).

iii) **Mounting speculation about an extension in Greece's loan repayment schedule.** Under the existing EU/IMF loan agreement, Greece will need to repay each loan in eight equal installments over a period of 2 years, following an initial grace period of 3-3¼ years. On the other hand, provided that the proposed repayment extension will be granted, repayment of each loan tranche would take place over a 7-year period –as currently stands for Ireland-, following an initial grace period of 4 years. Finally note that as per ECB Axel Weber's recent reported proposal, maturities of EU/IMF loans provided to Greece and Ireland could be extended by a significantly longer period than suggested above. At the November 28, 2010 Eurogroup meeting, EU officials agreed in principle to align Greece's bailout loans with the 7-year maturity agreed for Ireland's €80bn euro rescue package. According to the EU/IMF adjustment programme, Greek debt is projected to peak at 158% in 2012/13 (*for an in-depth analysis on the sustainability of Greek pubic debt, please see our Economy & Markets December 2010*

issue).

iv) **Proposals to lower the interest rate cost of EU/IMF loans to EMU countries receiving bailout funding.**

Reportedly, the German-Franco proposals will be discussed at this week's EU Summit, despite of not being included in the official agenda. Yet, no final decisions should be expected. Energy policy in the EU and the current turmoil in Egypt are scheduled to be the main topic of discussion. Following the conclusion of the February 4 meeting and upon the evolution of discussions, European Union leaders will decide whether an extraordinary meeting will be held on March 4. Negotiations are likely to last for a few weeks until the March 24-25 EU Summit where EU officials have promised to unveil a "broad solution" to the EMU fiscal crisis. On his part, Greek Finance Minister George Papaconstantinou expressed his confidence that European leaders will forge a "comprehensive" agreement next month noting that "it would be a big mistake to conclude an agreement that falls short of these expectations".

Part II - Latest on the domestic economy and markets

Prolonged domestic recession curbs consumer spending, manufacturing activity continued to contract

Greek **retail sales** by volume continued to decline in November for the eighth month in a row as wage restraint and higher taxation continue to weigh on disposable income. Sales (excluding fuels and motor lubricants) in volume terms fell by 13.6.0%yoy, a higher pace of contraction compared to October's 10.2%yoy decline, pointing to a further significant contraction in consumer spending in the fourth quarter of last year. Retail sales by revenue (inclusive of motor fuels and lubricants) declined by 6.3%yoy, after a 2.0%yoy drop in October, weighed down by weak consumer sentiment and anemic credit growth.

Growth in domestic **private-sector credit** weakened further in December, coming in at 0.2%yoy from 0.4%yoy in November and 4.1%yoy in the same month last year. Credit growth to businesses slowed to 1.0%yoy in December from 1.6%yoy in the prior month and 5.1%yoy in December 2009. Consumer credit continued to contract, falling by 1.4%yoy after a 0.6%yoy decline in the prior month. In a similar gloomy tone, the net flow of housing loans was negative with its annual growth rate shrinking by 0.4% yoy after rising a meager 0.3%yoy in the prior month and 3.7%yoy in December last year..

Adding to the recent sting of negative data releases, manufacturing activity remained in contractionary territory in the first month of 2011, with the Markit manufacturing purchasing managers' (PMI) index for Greece declining to a seven-month low of 42.8 in from 43.1 in the prior month. The headline index has deviated further away from the 50 boom-or-bust level that separates growth from contraction. The pace of contraction in output and employment accelerated while new orders declined for the 17th straight month. Input price inflation hit a 30-month peak, putting upward pressure on manufacturing charges.

Meanwhile, Greek overall **economic sentiment index**, according to the Foundation for Economic and Industrial Research (IOBE), edged up to 75.6 in January from 73.3 in the prior month on the back of a modest improvement in industry and retail sectors. **Consumer confidence** recovered slightly to -72, from an historic low of -75 in December with Greek households remaining pessimistic due to heightened economic uncertainty and rising unemployment.

Separately, after remaining in a downward trend over the last few months, **business and household bank deposits** posted tentative signs of stabilization in December, coming in at €208.86bn, little changed compared to the prior month's level. However, for the whole 2010, business and household deposits fell by 12.2%yoy or €29.1bn. Shrinking deposits since early 2010 when Greece's sovereign debt crisis flared up, have added to the strains of Greek banks which have become heavily reliant on ECB funding for their liquidity needs.

EMU sovereign debt spreads narrow sharply on mounting optimism over a powerful policy response to the debt crisis; Greece outperforms

After temporarily hitting multi-session highs late last week, EMU debt spreads resumed their narrowing trend on mounting optimism that a comprehensive response to the current EMU debt crisis is likely to be announced in a few weeks time. A fresh

string of well-received bond auctions from Portugal and Spain this week, also assisted market sentiment towards EMU peripherals. Meanwhile, a flurry of positive macro data from both sides of the Atlantic reinforced market optimism over the global growth outlook. Against this environment, news that the ECB's government purchase program came to a halt last week in view of easing EMU debt worries, failed to dampen market sentiment.

Greece has been among the best performers on mounting market talk of an extension of the EU/IMF €110bn loan repayment period. Spain followed suit. S&P affirmed the country's AA sovereign credit rating with a negative outlook, citing a significant acceleration in both budgetary consolidation and the structural reform effort since last year (the government targets a decline in this year's budget deficit to 6.3%-of-GDP from 9.3-of-GDP in 2010). Spanish 17 savings banks provided details about their exposure to the domestic real estate and property market this week, a move that was perceived as a precursor to a cleaning up of their balance sheets. Additionally, the Spanish government announced that savings banks struggling to find private-cash as part of new recapitalization rules, will have access to the state-backed Fund for Orderly Bank Restructuring (Frob) from March, earlier than September initially planned. The mostly unlisted savings banks, highly exposed to an ailing property market, were requested in late January to raise core capital levels by attracting private investors by September or face nationalization. The Frob has so far pumped just over €11bn into savings banks –up to €99bn is still available- to ease an overhaul of the sector in which consolidation has seen the number of banks falling to 17 from 45 in under six months. Separately, the Spanish government, union and business leaders, after weeks of negotiations, signed a "grand social and economic pact" this week. According to Prime Minister Jose Luis Rodriguez Zapatero the pact has three main objectives: growth enhancement, increased unemployment and the sustainability of the country's public finance.

Ireland lagged behind. According to official data from the Irish Central Bank, deposits in key domestic banks decreased by €40bn in December compared with an outflow of €27bn in November. Adding to the recent negative news flow for Ireland, the central bank downgraded its 2011 GDP forecast to just 1.0% this year, sharply lower from 2.4% initially predicted. Snap elections are scheduled for February 25.

The 10-yr Greek government bond yield (GGB) spread to the German Bund was hovering around 771bps at the time of writing, not far from a three month low of 754bps recorded earlier this week. Buying-interest for Greek government paper rose significantly over the last few sessions especially from US Funds with secondary market volume in the HDAT platform moving higher. So far this month, the daily average turnover stood around €100mn, up from some €35mn last month but still lower compared to €922mn the same month a year earlier. Technically, a sustained move above recent lows couple open the way for a retest of the crucial 650/660bps area (mid-October lows). On the upside, strong resistance for to 10 year GGB/Bund yield spread stands at 830bps recent high (mid-January).

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