Athens, November 12, 2010

Focus Greece: Latest macro & market developments

Key points

- **January-October central government budget deficit declines by 29.9% YoY; a smaller decline than the 10-month target of -32.0% YoY**
- **T-Bill auction oversubscribed 5 times but at a higher yield than last month**
- **Greece downgrade by 12 positions ranks – from 97th to 109th - in the World Bank's 2011 Ease of Doing Business report**
- **Bank of Greece points out that fiscal consolidation should rely mainly on expenditure cuts, with no room left for higher tax rates**
- **Recent GDP growth, unemployment and inflation readings are in line with the ongoing recession**
- **Revisions of 2009 and 2010 deficit and debt figures are expected in the following weeks**

1. Preliminary budget execution data for January- October 2010 reveals 2010 target may be missed by a small margin

According to preliminary data released by the General Accounting Office (GAO), the year-to-October central government budget deficit reached ca €17.4 bn, compared to €24.8 bn in the respective period last year, implying a 29.9% YoY decrease which is lower than the annual target of -36.9% YoT as well as the -32.0% YoY target for the January-October period.

The reduction of the year-to-October central government budget deficit was the result of sharply lower primary expenditure and investment program outlays, relative to the same period a year earlier. Moreover, growth in ordinary budget revenue was 3.7% YoY, but lower than the annual government target of 8.7% YoY. Encouraging is the fact that, according with press releases, October VAT revenues increased by 15% YoY as a result of (a) the Government's measures to fight tax evasion and (b) the VAT hikes introduced on July 1st, 2010. The increase in the VAT revenues is noteworthy because it took place in a deteriorating environment for the Greek economy and thus points out to the size of tax evasion. Interest costs were below their targets for the first time in the last three months; an increase of 5.5% YoY was recorded compared with an annual target of 7.2%.

Net revenues increased by 3.7% YoY in January – October 2010 (the respective amounts were €41.0 bn for 2010 and €39.5 bn for 2009). Revenues before tax refunds increased by 2.6%, while tax refunds declined by 7.0% YoY. Meanwhile, budget expenditure decreased by 7.0% YoY compared with an annual target of -7.8% (the respective amounts were €53.7 bn for 2010 and €57.7 bn 2009). Primary expenditure fell by €5.7 bn for the period January – October 2010, a decrease of 11.0% YoY compared with an annual target of -9.2%. As already mentioned above, interest expenses increased by 0.7bn or 5.5% YoY, bellow the annual target of 7.2%. Finally, Public Investment Budget (PIB) revenues fell by 0.5bn for the period January – October 2010, a decrease of 3.3% YoY compared with an annual target of a 47.7%YoY increase and PIB expenditure fell by 2.0bn for the respective period, a decrease of 24.6% YoY which is well above the annual target of -6.1%.

Ordinary Budget	January-October 2010 (€bn)	January-October 2010 (%YoY)	Annual target (%YoY)
1. Net Revenues (a-b)	40.99	3.7	8.7
a. Gross revenue	44.61	2.6	8.2
b. Tax returns	3.62	-8.8	3.0
2. Expenditure (α+β+γ)	53.71	-7.0	-7.8
α. Primary expenses	40.65	-11.0	-9.2
β. Transfer to hospitals for the settlement of part of past debt	0.32		
γ. Interest costs	12.74	5.5	7.2
Public Investment Budget (PIB)			
3. Revenue	1.37	-3.3	47.7
4. Expenditure	6.05	-24.6	-6.1
5. Budget deficit (1-2+3-4)	17.41	-29.9	-36.9

Source: Ministry of Economics

2. Greek T-bill action successful despite negative internal and external developments but at a higher cost

Greece successfully sold €0.48bn of 26-week T-bills on November 11, 2010, in a worsening international economic environment due to fears about Ireland and the possibility this country to be the first to use the Financial Stability Mechanism established within the Eurozone. In addition, signs of the Greek governments delays of the structural reforms included in the EC/ECB/IMF adjustment programme as well as the shortfall in budget revenues affected negatively the market sentiment. The auction produced an average yield of 4.82%, up from 4.54% when bills of similar maturity were issued on October 12. Investors bid 5.15 times the bills offered compared with a bid-to-cover ratio of 4.22 in the October auction. This was the fourth T-bill auction since the country switched from quarterly to monthly T-bill auctions, aiming at better cash management and more leeway. The EU/IMF bailout plan allows Greece to stay away from bond markets until Q1 2012, but the government intends to continue issuing T-bills for rolling-over maturing short-term debt paper. The Greek debt agency (PDMA) faces only interest payments of €0.04bn in November.

3. Greece ranks 109th in the World Bank's 2011 Ease of Doing Business, down from 97th in 2010

Greece was downgraded 12 places – from 97 to 109 – in the World Bank's 2011 Ease of Doing Business Rankings, despite the efforts of the Government to improve the business environment earlier this year. Even though the Government has passed through Parliament the necessary bill on Business Start-Ups, serious delays in its implementation remain. The General Electronic Commercial Registry (GECR) is not fully operational yet and the same is true for the "one-stop shops for Business Start-Ups" provisioned in the respective Start-Ups bill. Note here that the activation of the GECR was an end of December 2010 conditionality in the EC/ECB/IMF adjustment programme. According with press releases there is very slow progress towards its implementation.

With regards to the 2011 Ease of Doing Sub indexes, the most important changes include the 46 places downgrade – from 107 to 153 - in the Registering Property Index. This was due to the increase of transfer property taxes from 1% to 10% in 2011. The 3 places downgrade – from 146 to 149 - in the Starting a New Business Indicator was due to the ineffectiveness of the reforms mentioned above.

The Ease of Doing Business Ranking is conducted annually for 183 countries by the World Bank and is considered as a proxy for each country's competitiveness ranking. Singapore retained in 2011 its previous year's 1st place. Among the OECD countries, New Zealand is in the first place, while the United Kingdom, the United States and Denmark are in the 2nd, 3rd and 4th positions respectively. Greece ranks 30th, the worse performance among the OECD countries, with Italy ranking second to last.

4. Bank of Greece, interim report: fiscal consolidation should rely mainly on expenditure cuts, no room left for higher tax rates

According to the Interim Report of the BoG submitted to Parliament in October 26, the domestic economy is expected to contract by 4.0% this year while recession is seen continuing in 2011, albeit at a slower pace. The economic report underlined that, in order to limit the depth of the recession and speed up economic recovery, it is necessary to encourage private business activity which is currently being suppressed by weak demand, low competitiveness, the slowdown in credit expansion and the increased tax burden. The BoG noted that there is no room for further tax rates hikes for businesses and individuals. In order to achieve the necessary increase in public revenues, policies should be geared towards broadening the tax base and combating tax evasion.

In addition, the BoG proposes an even faster rate of fiscal consolidation via drastic limitation of the public sector expenses. A detailed list of the areas from which this limitation can come includes: (a) reform of the public sector in order to improve the efficiency of its employees, (b) cuts of inefficient expenses in the public education system, (c) better implementation of the local government reform (Kallikratis), and enforcement of certain expenses ceilings in heavily indebted municipalities, (d) better control in public hospitals' expenses via better programming of procurements and introduction of the international accounting standards in their day – to – day operations, (e) development of the public sector's real estate property, (f) mergers of broader public sector entities and abolishment of those deemed unnecessary, (g) privatization of public sector enterprises, (h) reforms in the public transportation system in order to improve revenues and reduce expenses.

At the same time, the BoG proposes a series of measures aiming in improving the efficiency of the Greek tax collecting system. The most prominent of these measures are: (a) simplification of the tax collection system and respective laws, (b) introduction of a new tax registration number for all Greek citizens together with an e-register of all tax related information, (c) introduction of new types of tax audits targeted to population groups that have a high probability of tax evasion, (d) improvement of the services provided to the general public by the tax authorities (e) anti-corruption measures and internal control in tax authorities.

According to the BoG, the enhancement of the growth potential of the Greek economy will necessitate switching to a new export-oriented growth model that will take into account the comparative advantages of the country, as well as making use of medium-term strategic plans aiming in boosting exports. This process will be reinforced by the (a) modernization of structures and improvement of transparency in all levels of the public sector, (b) further liberalization of the labor market, (c) enhancement of competition by the opening up of closed segments of the market (the so-called "closed professions"), the activation of the general electronic commercial registry, the business start-ups law etc., (d) encouragement of the new export oriented model via EU Structural (ESPA) funds (e) improvement of the efficiency of the public education system including Universities.

The BoG's report acknowledged that the country has made significant progress in its fiscal consolidation efforts over the first year of the EC/ECB/IMF adjustment programme. However, the BoG warned that that there is still A long way to go, while risks of missing the targets remain due to, among other factors, the upcoming Eurostat's revision of the Greek 2006-2009 fiscal data.

As far as the domestic banking sector, the BoG stressed that, given particularly adverse macroeconomic conditions, the gradual implementation by 2018 of the new international regulatory framework "Basel III" and the prospect of the ECB eventually phasing out the non-standard measures, banks should seek to maintain high capital adequacy and liquidity levels. BoG believes that strategic alliances and mergers will contribute to the achievement of these goals.

5. Indicators point towards a still deteriorating economic environment

Hellenic Statistical Authority GDP flash estimates show a decline in Q3 growth by 4.5% YoY and 1.1% QoQ. This is due to the decrease in final consumption expenditure and gross fixed capital formation. On the other hand, the external sector contributed positively to GDP growth since imports continued their downwards trend.

Unemployment increased in August 2010 to 12.2% from 12.0.0% in July 2010 and 9.0% in August 2009. Given that August is at the peak of the tourist season for Greece, this increase is indicative of the worsening economic environment. Provisional data on Building Activity (Private and Public) for August 2010 also point to the worsening of economic conditions. The number of building permits decreased 5.5% YoY in August 2010 while the respective volume decreased by 24.9% YoY. Moreover, inflation data show that October CPI decreased to 5.2% YoY from 5.6% YoY in September. This is in line – for the first time- with the ongoing domestic recession. Note that according to EFG Eurobank Research the 2010 unemployment rate will reach 12.0% and at the same time CPI will be slightly lower than 5% YoY.

6. Bottom Line

The deficit reduction is bellow the respective target for the January-October period and this raises concerns for the achievement of the end of year targets. Nevertheless the Government expects that the revenues shortfall will improve in the last two months of the year. It is encouraging that developments in the revenue side reveal the size of tax evasion and constitute a new reference point for the VAT revenues growth until the end of the year. We expect that VAT hikes implemented from July 1st, as well as the fight of tax evasion and the taxes on property, will yield in the following period. The downgrade in the 2011 Ease of Doing Business ranking constitutes a negative sign concerning the improvement of business environment that is a perquisite for growth. The increase in unemployment reinforced our previous note that the June 2010 decrease was only temporary.

Even though Greece passed successfully the local elections test (see Focus Note Greece (November 11th, 2010)) the following weeks are of extreme importance for the Greek economy. On November 15th the revisions of central government deficit and public debt are expected to be announced by Eurostat. On November 18th the final draft of the 2011 budget is expected to be presented in the Parliament. Finally, in November 22nd the Government is expected to announce its revised estimates for the 2010 deficit.

According to Finance Minister G. Papakonstantinou and press releases, the 2009 fiscal deficit will be revised upwards from 13.6% to ca 15.3% of GDP; the 2009 public debt will also be revised from 115.1% to 127% of GDP. Revisions are expected also in the 2010 public debt figure, now expected at 130.0% of GDP. This is due to the inclusion of past swap contracts, the forfeiture of broader public sector organizations guaranteed debt as well as the reporting of public organizations deficit previously ignored. Our estimates suggest that all these will drag the 2010 debt to ca 137% of GDP.

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