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GREECE MACRO MONITOR

January 15, 2012

Focus notes: Greece

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Latest on the euro area sovereign debt crisis

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Merkel, Sarkozy urge for rapid progress on "fiscal compact", Greece's second rescue package

The bilateral summit between German Chancellor Angela Merkel and French President Nicola Sarkozy on January 9 yielded no major surprises. Reportedly, the aim of the two leaders was to iron out their differences and form a common base on their plan to drive forward the agenda for stricter budget rules ahead of a number of key EU policy meetings. Eurozone finance ministers meet on January 23, while the next EU Summit on January 30 will discuss, among others, ways to revive Eurozone economic growth, bolster employment and increase cross-border labour mobility. In this context, another round of talks between the two leaders will likely follow over the next couple of weeks. As per the joint press conference held by the German Chancellor and the French President shortly after the conclusion of the January 9 summit, their discussions centered on the following issues:

The "fiscal compact" agreed at the December 9 EU Summit

According to German Chancellor Angela Merkel, negotiations on the intergovernmental accord to reinforce budgetary discipline are making rapid progress and there is "a good chance" that a preliminary agreement on a draft text will be reached by the end of this month. Her optimism was echoed by the French President who said that the new treaty should be signed by March 1, 2012. As a reminder, all 17 euro area members plus six EU states (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania) reached an intergovernmental agreement at the December Summit, the so-called *fiscal compact*, which encompasses a set of rules to strengthen fiscal integration and enhance economic governance.

As things stand at this point, a number of important details pertaining to the proposed *fiscal compact* are yet to be clarified. These include, among others:

i) The legal status of the intergovernmental agreement and the extent to which it can use non-elected EU institutions to ensure compliance with the fiscal rules. ***Comment:*** *At the December 9 EU Summit, there was no agreement at the EU-27 level and thus, the fiscal compact will not be part of EU law*.

ii) The adequacy of the effective firing power of the EFSF/ESM rescue mechanisms, especially in view of increased market worries that their combined lending ceiling may not be high enough to contain contagion risks. ***Comment:*** *EU leader agreed at the December EU Summit to reassess the adequacy of the overall ceiling of the two rescue mechanisms in March 2012. According to the ESM Treaty agreed last year, combined EFSF/ESM lending should not exceed €500bn*.

iii) The provision of additional resources for the IMF (some €150bn to be contributed from the euro area and up to €50bn from other countries) as well as the specific role the Fund may have in supporting the EU. ***Comment:*** *As things stand at this point, it is unclear whether the €200bn target for total contributions will be reached, especially after the UK rebuffed pleas to join and contribute an estimated share of €30bn. Moreover, a number of countries outside the euro area - including US and Russia - have recently expressed tepid interest in boosting the IMF's resources.*

Regarding the specific proposals pertaining to the *fiscal compact*, the two leaders reiterated during their joint press conference their preference to have the European Stability Mechanism (ESM) coming into force a year earlier than expected previously (*i.e.*, July 2012 vs. mid-2013). ***Comment:*** *As per the December 2011 EU Summit Statement, the ESM could be brought forward, provided that Member States representing 90% of the respective capital commitments ratify it in their parliaments (votes in the ESM go according to each country's subscription key in the ECB's capital). Should this be the case, the existing rescue mechanism, EFSF, will co-exist with the new (permanent) ESM facility in the period from mid-2012 to mid-2013, boosting the combined firepower available to contain contagion risks. The present uncommitted resources of the EFSF are no higher than €250bn (out of the mechanism's total lending capacity of €440bn). As regards to the permanent rescue mechanism ESM, the total subscribed capital stands at €700bn (€620bn in callable + €80bn paid-in capital), with its total lending capacity being set at €500bn.*

The two leaders also note that Germany and France are ready to check - in consultation with other EU countries - to what extent it can be possible to speed up payments into the ESM capital. ***Comment:*** *This is in line with the December EU Summit Statement, which read that "during the phasing in of the paid-in capital, we stand ready to accelerate payments of capital in order to maintain a minimum 15% ratio between paid-in capital and outstanding amount of ESM issuances and to ensure a combined effective lending capacity of €500bn". According to the ESM treaty agreed last year, payment of paid-in shares of the amount subscribed to each ESM member has to be made in five annual installments of 20% each of the total amount.*

Separately, Merkel and Sarkozy called for new measures, at a pan-European level, to revive growth and promote job creation, as an additional strategic pillar to stabilize the common currency. ***Comment:*** *With France's presidential election date approaching (April 22, 2012) and recent opinion polls showing that Mr. Sarkozy is trailing behind his socialist rival, Francois Hollande, the situation in the domestic labour market is of particular concern for the French President. Note that France's unemployment rate rose to 9.3% in November, its highest level in 12 years. In contrast, Germany's adjusted unemployment rate fell to a new record low of 6.8% in November while, according to the German chamber of trade and industry (DIHK), one in three German companies reported in 2011 a shortage of skilled workers double the number a year ago.*

Finally, note that an updated draft of the proposed fiscal compact was circulated in the press earlier this week. The draft contains a clause arguing that the terms of the respective international agreement should be integrated in the existing EU treaties within five years of coming into force. The intended date for the agreement to come into effect is January 2013. The draft also leaves the door open for "accession" to the fiscal compact of EU Member States other than the contracting parties (purportedly, the UK).

Implementation of a financial transaction tax (FTT)

The French President noted that a financial transaction tax (FTT) remains a top priority for his centre-right government and added that he wants France to take the lead in applying it, hoping to spur other EU member states to follow suit. Mr. Sarkozy signaled that his government may present plans for a unilateral levy on bank transactions by the end of January. On her part, the German Chancellor appeared relatively reserved on the issue. She clarified that she is "in favour of thinking about such a tax in the Eurozone" acknowledging, though, that there is currently no agreement on the issue inside her collation government. ***Comment:*** *Senior politicians from the German government's junior collation partner, the Free Democratic Party (FDP), have repeatedly opposed the possibility of such a tax being imposed only in the euro area counties, insisting that it should apply to all EU Member States, so as to avoid "distorted competition". The German Chancellor called European leaders to clarify their stance on the issue by March, 2012. Speaking after his* *first bilateral meeting with the German Chancellor earlier this week, Italian PM Mario Monti stated that he is open to support this initiative, but only if it is applied to all EU-27 countries.*

As things stand at this point, it is rather unlikely that a financial transaction tax will be applied across the European Union. UK has fiercely opposed this proposal, unless adopted globally, on fears that it could undermine the role of City of London as a global financial center. Such fears were also behind Britain's veto of the new fiscal rules agreed at the December 9th EU Summit. At the G20 level, Britain has joined China and the United States in blocking such a tax, with the latter preferring any such levy to be based on the size of a financial institution's balance sheet. Sweden is also reportedly against the imposition of a financial transaction tax, fearing that it would weigh on its financial sector. Similar concerns were reportedly shared by Ireland. ***Comment:*** *The idea of a tax on exchange rate transactions was developed by Nobel Prize-winning economist James Tobin in the early 1970s, with the aim to discourage short-term speculation and cushion exchange rate fluctuations. In September 2011, the European Commission proposed a tax of 0.1 percent on equity and bond transactions and 0.01 percent on derivatives. The tax could raise as much as €57bn a year, funds that would be used to finance the EU budget. According to the Commission's proposal, the tax could be implemented by 2014 and it would be imposed on all transactions of financial instruments between financial institutions, when at least one of the counterparties is based in the EU. The proposed financial transaction levy is set to be discussed at the next EU Summit (January 30, 2012). Among other related issues, the Summit will consider what financial instruments can be taxed and whether currency trades – which make up a large slice of worldwide transactions – will be targeted as well.*

Merkel, Sarkozy urge for swift implementation of new rescue plan for Greece

A the joint press conference held after the conclusion of their bilateral meeting on January 9, the two leaders urged Greece to take all the necessary measures needed to ensure swift implementation of the new bailout plan agreed at the October 26-27 EU Summit and make faster progress in negotiations with private creditors on the voluntary debt restructuring. The German Chancellor warned that only when these issues have been adequately addressed, EU partners will give the green light for the release of the next aid tranche. Moreover, the two Eurozone leaders agreed that the decision made at the July 21st and October 26th EU Summits to seek a voluntary private sector involvement in Greece's debt restructuring constitutes a unique and exceptional case.

Part II – Focus Greece: Latest domestic macro and fiscal developments

2011 State budget execution: central government deficit slightly undershoots *upwardly-revised* full-year target on the back of sizeable reduction in public investment expenditure; weak revenue growth remains a concern

According to the latest *preliminary* data for the execution of the State budget (fiscal basis), last year's central government deficit rose by 0.8% YoY to ca €21.64bn. This compares with a deficit forecast of ca €21.71bn included in the voted Budget for 2012 and an *upwardly-revised* deficit target of ca €19.81bn envisaged in the government's *Medium Term Fiscal Strategy* (MTFS) report published in June 2011 (see also *Table 1* at the end of this document).

In more detail, *net* ordinary budget revenue in January-December 2011 *declined* by 1.7%YoY to ca €49.99bn. This compares with respective *full-year* increases of 6.3% YoY and 0.9% YoY envisaged in the MTFS and the 2012 Budget. The main reasons behind the poor performance in ordinary budget revenue last year include: **a)** the deeper-than-previously expected domestic economic downturn; **b)** reduced withholding personal income tax receipts due to a more favorable tax treatment as a result of the new tax law and the reduction in taxable incomes; **c)** lingering inefficiencies in the tax collection mechanism and widespread tax evasion; **d)** the strike of employees in the Tax and Payment Offices on 29 & 30th of December 2011; **e)** the extension granted for the settlement of outstanding tax obligations until January 20, 2012; and **f)** higher-than-initially-projected tax refunds.

In a move to reduce VAT tax evasion the government had earlier introduced a scheme linking tax returns to the total volume of retail sales receipts submitted to the tax authorities. The measure, which was applied to the calculation of 2010 taxable income, led to a sharp rise in tax refunds in the first months of last year, forcing the government to modify it in the calculation of taxable income earned in 2011. Last December, the Finance Ministry also implemented a general freeze in tax refunds. The latter move may increase tax returns in the following months, endangering the attainability of the 2012 deficit target.

With regards to the efficiency of the tax collection mechanism, a report published recently by the *Task Force for Greece* - a European Commission sponsored technical assistance team on fiscal and structural issues - estimates that there are currently ca €60bn in unpaid taxes, with around a half of this amount being the subject of court cases, some of which have been running for over a decade. While the processing of the tax related disputes in the Greek courts remains a subject of particular concern, the Task Force currently estimates that some €7.0bn of outstanding tax obligations could be collected in the immediate period.

On the expenditure side, ordinary budget outlays in the 12-months to December 2011 rose by 2.8% YoY to ca €68.83bn. Over the same period, Interest payments increased by 23.6% YoY, while primary expenditure declined by 1.3% YoY, despite higher grants (by ca €1.95bn or 12.8% YoY) to social insurance and health. In the public investment budget (PIB), full-year revenue grew by 23.9% YoY to €3.81bn, while expenditure was reduced by €21.8bn, reaching €6.61bn.

Note that the data on the execution of the State budget provided above are reported on a cash basis. However, in line with Eurostat methodology (ESA 95), total annual revenues are measured on a national account basis and also include receipts from the first two months of 2012. Equivalently, the calculation of total 2010 annual revenue on a national account basis included a share of revenues reported (on a cash basis) in the first two months of 2011. The final data for the 2011 general government deficit will not be published before March 2012. Yet, the execution of State budget in January-December 2011 as well as the most recent data on General Government arrears (see analysis below) signal upside risks to last year's upwardly-revised deficit target 9%-of-GDP. As a reminder, the 2012 budget targets a decline in the general government deficit to 5.4%-of-GDP, assuming full implementation of the PSI deal envisioned in the October 26-27 EU Statement.

General Government arrears reached €6.67bn or ca 3.0% of GDP in November 2011, signaling overshooting risk to the full-year deficit target

According to the most recent data published by the Ministry of Finance, total general government arrears increased further in November 2011, reaching ca €6.63bn or 3.0 % of GDP. The rising level of outstanding arrears represent a major risk to the achievement of last year's fiscal deficit target, especially given that new arrears were probably created in December 2011, as a result of the delayed disbursement of the 6th EU-IMF loan tranche. As was noted in the 5th IMF review of Greece's adjustment programme, the criterion of the non-accumulation of arrears was missed, primarily due to the delay in the disbursement of the last EU-IMF loan installment (initially planed for mid-September 2011). Other chronic problems, including: a) the lack of sufficient expenditure controls in a number of public entities; and b) administrative delays in social security funds' payment to hospitals, which, in turn, lead to delays in hospital payments to suppliers, have also contributed significantly to the recorded accumulation of arrears.

In other domestic macro developments, Greece's **unemployment rate** rose to a record 18.2% in October 2011, from 17.5% in the prior month. Separately, **Greek CPI** eased to 2.4%YoY in December, from 2.9% in the prior month and a reading of 3.0%YoY recorded in October 2011. Note that the more recent hikes in VAT rates and special consumption taxes implemented since last September caused a temporary spike in domestic headline inflation during the last quarter of 2011.

Table1: State Budget execution (January-to-December 2011)					
	Jan-Dec 2010 *Realization* (€bn)	Jan-Dec 2011 *Realization* (€bn)	FY2011/FY2010 *Annual change* (%)	Annual change (%) *_Projected in 2012 Budget*	Annual change (%) *Projected in MTFS*
Ordinary budget					
1. Net Revenue (a+b+c-d)	**50.86**	**49.99**	**-1.7**	**6.3**	**0.9**
a. Gross revenue	56.16	53.95	-3.9	1.5	-1.7
b. NATO revenue	0.02	0.03	9.3	66.7	67.5
c. Special revenue from licensing public rights	0.00	1.16			
d. Tax refunds	5.32	5.14	-3.4	-39.9	-6.0
2. Expenditure (α+β+γ+δ+ε+στ)	**66.93**	**68.83**	**2.8**	**4.9**	**3.8**
α. Primary expenditure	52.15	51.44	-1.3	-0.3	-0.7
β. Transfer to hospitals for the settlement of part of their past debt	0.37	0.44	18.6	22.6	22.6
γ. NATO expenditures	0.03	0.01	-61.1	21.2	20.8
δ. Military procurement	1.02	0.40	-60.7	47.5	-41.0
ε. Guarantees called to bodies classied outside the General Government	0.15	0.19	32.1	54.5	62.1
στ. Interest costs	13.22	16.35	23.6	21.0	23.9
Public Investment Budget (PIB)					
3. Revenue	**3.07**	**3.81**	**23.9**	**27.8**	**9.5**
4. Expenditure	**8.45**	**6.61**	**-21.8**	**-10.8**	**-18.5**
5. State budget deficit (1-2+3-4)	**-21.46**	**-21.64**	**0.8**	**-7.7**	**1.2**

Source: MoF; Eurobank EFG Research

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