Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

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GREECE MACRO MONITOR

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Focus notes: Greece

Written By:

Dr. Platon Monokroussos
Assistant General Manager
Head of Financial Markets Research
pmonokrousos@eurobank.gr

Paraskevi Petropoulou
G10 Markets Analyst
ppetropoulou@eurobank.gr

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Latest on the euro area debt crisis and what to expect in the weeks ahead

Eurozone to boost IMF bailout funds by €150bn; Merkel, Sarkozy to meet in Berlin on January 9

German Chancellor Angela Merkel and French President Nicolas Sarkozy announced earlier this week that they will hold a bilateral summit in Berlin on January 9 to talk about a range of amendments to the proposals agreed at the December 9 EU Council. The next EU Summit will take place on January 30, a week after a scheduled meeting of the EU-27 finance ministers. 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" encompasses a set of rules to strengthen fiscal integration and enhance economic governance. The deadline for finalizing the draft of the agreement is March 2012. Until then, a number of important details on the agreed fiscal compact remain to be clarified, including, among others, the legal status of the intergovernmental agreement and the extent to which it can use EU institutions to ensure compliance with the fiscal rules. Moreover, EU leaders agreed to reassess the adequacy of the overall ceiling of the EFSF/ESM in March 2012.

On a separate issue, EU finance ministers held a conference call on December 19 to meet their own deadline to finalize additional funding to the IMF. According to an official statement released shortly after the conclusion of the teleconference, 13 euro area member states agreed to lend to the Fund an additional amount up to €150bn. Ireland, Greece and Portugal, which are already under an EU-IMF economic adjustment programme, will not contribute to the IMF funding. However, it still 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. UK Finance Minister George Osborne reportedly argued that his country will not provide any additional funds, unless this would be part of a broader international effort. According to press reports, Mr. Osborne stressed that the IMF's mission is to protect "countries, not currencies" and that the 17 eurozone members should take more decisive action to tackle the crisis themselves.

Meanwhile, countries outside the EU have so far expressed tepid interest to contribute directly to the IMF. Russia said recently that it is prepared to offer at least $10bn, conditional on further details of the EU authorities' plans to confront the crisis. In the US, 26 Republic Senators have submitted a bill which is intended to prevent the IMF from using taxpayers' money for extending loans to fiscally-vulnerable euro area countries. Bundesbank President Jens Weidmann has reportedly signaled that the German Central Bank will contribute up to €45bn in loans to the IMF, provided that other European and non-European countries would follow suit, including the US. Separately, the Czech Republic, Denmark, Poland and Sweden agreed to grant loans to the IMF, though approval from their national parliament may be needed. A boost to the Fund's resources would be seen as a positive step towards addressing the euro area sovereign crisis. This is especially true given that the sharp deterioration in market conditions means the EFSF's lending capacity may not be possible to be leveraged by 4-5 times, as Euzozone officials planned initially.

EZ periphery sovereign debt spreads kick off the New Year at elevated levels; euro area liquidity conditions remain tight, despite huge participation in ECB's 3-year refinancing tender

Yield premiums of euro area periphery government bonds vs. their German peers kicked off the near year at elevated levels, as a number of recent initiatives by EU authorities to address the sovereign debt crisis have broadly failed to stabilize market sentiment (please see table below). The yield spread of the 10-year benchmark Greek government bond (GGB) vs. the German equivalent stood at ca 3,320bps in late trade on Tuesday, some 60bps narrower from a record high hit on December 21, but substantially higher from levels around 952bps recorded in late December 2010. In a similar note, Greece's 5-year CDS was hovering around 8,800bps at the time of writing, compared to an all-time high of 11,310bps reached on December 21 and levels around 1,000bps recorded in the last few trading days of 2010.

In its last auction of long-term government bonds in 2011, **Italy** successfully sold €7bn of 10-year benchmark bonds on December 30. The auction produced an average yield of 6.98%, down from a euro lifetime record of 7.56% recorded a month earlier, but still within striking distance from the key 7% area where other euro area countries – *i.e.,* Greece and Ireland - were earlier forced to seek international financial assistance. The head of the Italian Treasury's debt management department announced last week that total gross issuance this year will be around €450bn, up from €430bn last year.

The first week of 2012 kicked off with a flurry of sovereign debt issuance from the euro area, with more supply anticipated in the coming days. In one of the first crucial auctions of the year, **Germany** sold €4.057bn of 10-year Bunds on Wednesday, January 4. The security which matures on January 6, 2012, bears a 2% coupon. Demand was higher compared to a similar tender in November which was poorly received. Total bids amounted to €5.142bn, exceeding the initially planned €5bn amount, with a bid/cover ratio of 1.3 (vs. 1.1 in the prior auction). Around 19% of the issue was retained, an amount significantly lower compared to 40% before. Furthermore, the average accepted yield eased to 1.93% compared with 1.98% six weeks ago.

Similarly, **Portugal's** borrowing costs fell in a separate auction held on the same day. In detail, the Portuguese government sold €1bn of securities which mature in April 2012, at an average accepted yield of 4.346% and a bid-to-cover ratio of 2.4. The amount allotted topped the country's debt management agency (IGCP) target of €750mn-1bn. At a previous tender of similar maturity paper on December 7, the average accepted yield was at 4.873% and the bid/cover ratio stood at 2.0.

France's T-bill tender of short-term BTF bonds on January 3, 2012, was also well received. The Agence France Tresor public debt management agency (AFT) allotted €8.715bn in 12-, 23- and 45-week bills, on the toppish side of its €7.6-8.9bn target range. In detail, AFT sold €4.438bn of 12-week bills maturing on March 29, with a bid/cover ratio of 1.72% and an average accepted yield of 0.023%, a tad higher from the near-zero 0.005% level achieved at an earlier BTF auction of similar maturity paper on December 19. The agency also issued €2.202bn in 23-week bills with maturity on June 14 and a yield of 0.074% (vs. 0.034% at the previous tender) and a bid-to-cover ratio of 2.83. It also allotted €2.075bn of 45-week bills which mature on November 15. The bid-to-cover ratio stood at 2.17, while the average accepted yield eased to 0.136% from 0.176% last month.

As to the ECB's Securities Markets Programme (SMP), which was reinitiated last August following a 4-month-long halt, the Central Bank currently appears to have a tacit weekly limit of €20bn on debt purchases. Until now the average weekly amount of purchases is estimated to have been much lower, at around €6.6bn, which implies that there is substantial room for further maneuvering. More importantly, the €20bn unofficial ECB limit appears to be adequately matching the maximum quantity anticipated to be redeemed from Italy and Spain in February and April. Indicatively, the highest cumulative monthly redemptions for these two countries is estimated at €80bn, while over the last four months the ECB has spent less than double of that amount (ca €140bn) on EZ government bond purchases.

Table: EMU yield, spread and 5-yr CDS

10-yr Government bond yields	Today, January 3 (17:30 local time)	Change vs. record highs hit during 2011(in bps)	Change vs. 2011 close (in bps)	Change vs. 2010 close (in bps)
Greece	34.70%	-100	-20	2223
Portugal	13.49%	-56	13	689
Spain	5.29%	-141	20	-16
	3.05%	8	305	305
Italy	6.90%	-36	-21	209
France	3.28%	-51	13	-8
Belgium	4.27%	-159	18	30
10-yr Periphery/Bund yield spread (in bps)	**Today, January 3 (17:30 local time)**	**Change vs. record highs hit during 2011(in bps)**	**Change vs. 2011 close (in bps)**	**Change vs. 2010 close (in bps)**
Greece	3285.9	-98.3	-27.6	2335.04
Portugal	1158.71	-24.69	5.43	794.92
Spain	338.95	-129.65	13.02	90.03
Italy	499.2	-53.37	-28.78	314.08
France	137.77	-52.86	5.83	97.9
Belgim	236.64	-123.46	10.53	136.01
5-yr CDS	**Today, January 3 (17:30 local time)**	**Change vs. record highs hit during 2011(in bps)**	**Change vs. 2011 close (in bps)**	**Change vs. 2010 close (in bps)**
Greece	8786.4	-2523.885	0.02	7776.4
Portugal	1081.77	-133.905	-0.1	580.8
Spain	380.315	-112.605	-0.035	30.315
Italy	491.37	-102.38	-11.72	252.91
France	218.33	-34.17	-4.01	111.33
Belgium	316	-94.5	-0.03	90.86

Source: Bloomberg

Meanwhile, in spite of the huge liquidity Eurozone banks absorbed from the ECB at its *first ever* 3-year refinancing tender on December 21, they seem to remain reluctant to lend to each other, extend credit to the domestic economy or use some of the funds to increase their holdings of government bonds. ECB's LTRO allotment totaled a record €489bn, with demand coming from 523 banks. According to recent ECB data, most of the liquidity absorbed by euro area banks has been placed back at the central bank, mainly in the form of deposits. Presumably, euro area banks remain apprehensive about counterparty risk, with liquidity needs being further exacerbated by some €230bn of maturing bank bonds in Q1 2012. In addition, many Eurozone banks need extra liquidity to address the risk of rising deposit withdrawals and eroding collateral values, amid intensifying credit rating jitters in recent weeks.

On a separate note, S&P put the long-term sovereign credit ratings of 15 eurozone nations on negative watch early last month. In a similar move, Fitch placed on credit watch negative - which traditionally signals the possibility of a downgrade within three months - the sovereign credit rating of six eurozone countries, including Belgium, Cyprus, Ireland, Italy, Slovenia and Spain. Fitch noted that "the systemic nature of the eurozone crisis is having a profoundly adverse effect on economic and financial stability across the region". The same rating agency also revised the outlook of France's AAA rating to negative and warned that a possible downgrade could come in two years. Such a development could have serious implications for the evolution of the euro area sovereign debt crisis. Among others, it would reduce the EFSF's €440bn lending capacity, which is based on guarantees from the eurozone's six triple-A countries (France's guarantee commitment amounts to €158bn). Alternatively, the EFSF could be downgraded leading to an increase in the Facility's borrowing costs. This would, in turn, mean higher borrowing costs for *fiscally vulnerable countries* receiving financial assistance.

Part II

Focus – Greece: The crucial three months ahead

In his New Year's address to the nation, Prime Minister Lucas Papademos called Greeks to prepare themselves for a "very difficult" year ahead and noted that solidarity and determination are necessary to retain the country's accomplishments of the last decades. The Prime Minister underlined that the next three months will be critical and will define the course of Greece in the coming decades, noting that 2012 could become a year of hope, provided that all political forces work together and Greeks put their political differences aside. Purportedly, the current government's most crucial target is to ensure the timely release (*i.e.,* by early March 2012) of the next EFSF/IMF loan disbursement of ca €89bn (=€30bn for bank recapitalization + €30bn to run the new PSI + €29bn for deficit financing, inclusive of some €9bn in EU bilateral loans under the existing *Greek Loan Facility*). Bear in mind that a critical date for Greece in terms of sovereign debt redemptions is March 14 when a 3-year bond matures for €14.435bn. In order to ensure the timely disbursement of the next loan tranche, the government has to overcome some important hurdles, including, among others, the following:

— ***Completion of negotiations with the Troika on the implementation of the new bailout deal agreed at the October 26-27 EU Summit.*** According to a recent comment by Greek Finance Minister Evaggelos Venizelos, both the new rescue deal and the corresponding implementation measures supporting the package should get parliamentary approval by the end of January 2012. More imminently, a team of senior Troika inspectors is scheduled to arrive in Athens in mid-January for a round of discussions with domestic authorities on a number of important issues, including, among others, the technical terms of the second EU-IMF bailout package, the new PSI scheme, additional austerity measures (to those already included in the 2012 budget) so as to account for an *expected* overshooting of the 2011 general government deficit by at least 1ppt-of-GDP as well as a preliminary draft on additional austerity measures for the period 2013-2015. The government's revised medium-term fiscal plan (MTFS) projects a cumulative fiscal gap of ca €7.02bn in 2013-2015, targeting a decline in the general government budget deficit below the respective Maastricht Treaty threshold of 3.0%-of-GDP in 2014. Purportedly, Greece needs to identify and approve the new austerity measures by June 2012. Yet, a senior government official was recently quoted in the press as suggesting that the present government would probably have to negotiate these measures with the Troika in case that the date for the next national election is delayed more than currently expected. On the latter issue, conservative *New Democracy* party, one of the three political parties currently supporting Mr. Papademos' government, appears to have lately dropped its earlier insistence on holding elections as early as February 19, 2012. According to a party spokesman, New Democracy could agree to an extension under certain circumstances but said that elections would have to be held at the latest by Greek Orthodox Easter, which falls on April 15, 2012. According to the same official, any change to the *earlier agreed* February 19 deadline would depend on the progress made in the ongoing debt swap talks with private investors.

— ***Parliamentary endorsement of new legislation encompassing a package of measures already agreed with official lenders.*** Among others, the new bill will include additional measures relating to: **a)** the opening up of a number of closed professions in transportation (taxi and truck drivers) as well as other sectors of domestic economic activity (reductions of fees for lawyers and notaries and the operation of attorney firm branches); and **b)** further reductions in supplementary pensions, though certain differences remain on the latter issue among the parties supporting the current government. Reportedly, the aforementioned package is tentatively planned to come for parliamentary approval before the arrival of the Troika team in mid-January.

— According to local press reports, two other important areas of negotiation with the next Troika mission to Athens will include: i) additional measures to further reduce wage and pension costs in the broader public sector, mainly through staff redundancies and the closing/merger of a number of "unproductive" government enterprises. This is especially since the activation of the so-called Labour Reserve last year has reportedly failed to generate the expected results. As a prior action to the 5th EC/IMF/ECB review, the government passed through parliament in early October a plan envisioning the transfer of some 30k public sector employees to a special reserve by the end of 2011. Employees transferred to the special reserve would receive 60% of their basic wage for a 12-month period, after which permanent separation would occur, in the absence of rehiring to the public sector subject to objective criteria and the pre-specified hiring limits. According to reports, since last October only 8% of a total of ca 9.37k employees who left the public sector were transferred to the labor reserve, with the rest representing people who either decided or were forced to retire; **ii)** separately, the Troika is reportedly urging the government to take additional measures to enhance wage flexibility in the private sector with an aim to reduce further labor costs and boost competitiveness. Purportedly, some of the main issues under consideration include: a reduction in the minimum wage set in the latest national collective labor agreement by at least €100/month (from €751/month, currently); significant cuts in (or even abolition of) the 13th and 14th wage installments; and lower social security contributions for both employees and employers.

— ***Completion of negotiations with private sector investors on the terms of the new PSI deal.*** As a reminder, the October 26-27 EU Summit statement envisioned a 50% nominal reduction in the outstanding notional of privately-held government debt, aiming to facilitate a decline in the public debt ratio towards 120%-of-GDP by 2020. In a statement released on January 4, the group representing private-sector GGB holders said that progress have been made in recently talks and added that it is essential that a *voluntary* deal is concluded in the days ahead on the basis of the terms and parameters agreed in Brussels on October 26/27, 2011. According to reports, a preliminary agreement has already been reached between private- and official-sector representatives as to the main parameters of the debt exchange. This will reportedly involve the offer of an upfront cash payment of 15 cents and a new discount Greek government bond (35% notional) for every old bond being tendered for exchange. The new bonds will enjoy *pari passu* treatment with the €30bn EFSF loan provided to Greece for running the PSI. They will also include certain sweeteners (in the form of *e.g.* GDP warrants offered with new bonds as detachable and separately tradable instruments) and will be issued under UK law. Yet, an agreement between private sector representatives and the official sector on a number of other important elements of the proposed debt exchange has yet to be reached. Among others, such elements include certain legal issues and, most crucially, the financial structure of the exchange (*e.g.* coupons, maturity profile and grace periods). *A more thorough analysis regarding the impact of the new PSI and the improved terms on official loans on Greece's borrowing needs and debt sustainability can be found in Eurobank EFG Research, Greece: Debt sustainability outlook post the Oct. 26th EU Summit, October 31, 2011,* http://www.eurobank.gr/Uploads/Reports/31%2010%2011%20Greece%20Debt%20Sustainability%20Outlook.pdf.

Overshooting risks to the 2011 deficit target

The latest available data on the *State* budget execution and the *General Government* accounts signal significant overshooting risks to the 9.0%-of-GDP *revised* fiscal target for 2011. A strong indication supporting the latter view is provided by a reported rise in the general government deficit to 10.6%-of-*projected* GDP over the first 10 months of this year. Furthermore, accumulated arrears already reached ca €6.7bn in October 2011. *(The monthly general government accounts are provided on a cash basis and they may not be directly comparable to ESA-95 accrual-basis statistics. Yet, they still appear to provide a strong indication of the magnitude of overshooting risks surrounding the attainability of the 2011 fiscal target).*

In our view, a full-year reading for the general government deficit (ESA-95) of 10%-of-GDP or more should not be ruled out. If so, the *efficiency coefficient* of the fiscal adjustment program would fall to 10% or lower, from ca 51.5% in 2010. The latest figure is based on recent OECD and Bank of Greece estimates. *Note that the efficiency coefficient is measured as the ratio of the nominal reduction in the fiscal deficit to the total worth of measures applied over a certain year (~ €19.4bn in 2011).*

The apparent worsening of the estimated efficiency coefficient of fiscal measures is a worrying development, purportedly relating to higher interest rate payments in 2011 (up by ca €2.9bn from last year) and the impact of the economic recession on ordinary budget revenue and expenditure. Yet, last year's estimated fiscal slippage appears to be beyond any standard estimates of the potential impact of the economic recession on government finances. Apparently, these developments have a number of policy implications. As per the 5th IMF program Review, domestic authorities need to further advance various *agreed* structural reforms, so as to underpin the adjustment effort. On the fiscal institutional front, the 5th Review calls for increased emphasis on cracking down on tax evasion, a second installment of measures to overhaul the social security system as well as a fully-fledged tax reform (to be introduced by March 2012).

On that basis, we broadly concur with the view that a further realignment may be needed in the government's medium-term fiscal plan (MTFS) towards expenditure-side measures. This should be an important area of discussions in future negotiations with the Troika on (i) the corrective actions than need to be taken to offset slippages in the execution of the 2011 budget and (ii) the identification of additional measures for the period 2013-2014. As per the 5th Review, these are estimated at 3ppts-of-GDP, consisting of 2ppt-of-GDP in adjustment measures and 1ppt-of-GDP in contingency measures.

Note

In our Dec. 13, 2011 Greece Macro Monitor (page 9, last section titled "Fiscal multipliers and the efficiency of the applied austerity program") we provided a brief assessment of the efficiency of Greece's fiscal austerity program in the period 2010-2011. Part of this assessment was based on data and analysis provided at the OECD's *Economic Surveys; Greece (August 2011)* and Bank of Greece's *Interim Policy Report* (November 2011). Due to technical problems our reference to these sources was erroneously omitted. We apologize for any inconvenience caused.

Research Team

Financial Markets Research Division

Platon Monokroussos, *Head of Financial Markets Research Division*
Paraskevi Petropoulou, *G10 Markets Analyst*
Galatia Phoka, *Emerging Markets Analyst*

Sales Team

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Olga Kosma, *Economic Analyst*
Maria Prandeka, *Economic Analyst*
Theodosios Sampaniotis, *Senior Economic Analyst*
Theodoros Stamatiou, *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr