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Focus notes: Greece

Latest on the euro area debt crisis
Focus-Greece

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July 21th EU Council to discuss 2nd bailout package for Greece, euro area financial stability

In a statement released on Friday by the European Council President Herman Van Rompuy, the leaders of EU-17 will meet on July 21 at 10.00 GMT to discuss "the financial stability of the euro area as a whole and the future financing of the Greek programme". Responding to the European Council President's invitation, a spokeswoman of the German government said "We presume Van Rompuy has issued the invitation trusting there will be a solution for Greece by then" and confirmed that a Chancellor Angela Merkel would attend the July 21th Summit.

Meanwhile a number of reports in the local and international press and newswires suggested over the last few days that a number of options are being discussed by euro area policy makers and representatives from the financial sector on the issue of private-sector involvement in new bailout package for Greece and ways to provide a substantial debt relief to the country, given its overwhelming debt level and adverse dynamics. German weekly magazine der Spiegel reported over the weekend that a bond buyback scheme would be a key component in a 2nd rescue plan for Greece. Citing finance ministry sources, der Spiegel estimated that Greece could cut its public debt by as much as €20bn if it bought back sovereign bonds at current market prices. The German magazine reported that a number of other options, including "a bond swap with a hair cut" and "the extension of maturities of existing debt" are also being discussed, but they appear to be less likely than a bond buyback scheme. Der Spiegel's report followed a number of reports circulated in the local press earlier this week, which quoted unnamed official sources as suggesting that an EFSF-supported bond buyback program could provide a broadly-accepted solution to the debt crisis.

Greek newspaper *To Vima* reported on Sunday that, according to government sources, a preliminary agreement appears to have been reached to deal more forcefully with the lingering EZ debt crisis, which includes a "voluntary" private sector participation in a new bailout deal for Greece. On the issue of debt buybacks, the newspaper reported that these would be instrumented via EFSF loans to Greece. A change in the legislation of the EFSF would also be made so as to allow the temporary rescue mechanism to buy government bonds directly from the secondary market. In a separate column, Greek newspaper *To Vima* quoted ECB Executive Board member Lorenzo Bini Smaghi as saying that "…a useful option would be for the temporary EFSF mechanism to buy bonds in the secondary market. This option, however, is not included in the design of the EFSF. If there was a way to change this, it would be useful".

On the issue of private sector's "voluntary" involvement in the new financing plan for Greece, the same newspaper reported that an increase in the EFSF's effective lending ceiling to "at least" €1trillion, from €44o billion, currently would curb the ECB's earlier objections to any scheme that would engaged further downgrades of Greece's sovereign debt ratings by the major rating agencies. This would reportedly allow the ECB to "get rid" of the Greek government securities that had earlier purchased (at discount) from the secondary market to support their prices. In return, the European Central Bank would relax further it collateral rules for the provision of liquidity thus, continuing to accept Greek government bonds even in the case that Greece is downgraded to "SD" status.

Maintaining as an upfront disclaimer any potential reservation we may have about the accuracy of the aforementioned press reports, we sense that we are getting closer to a broadly-accepted agreement to deal with the lingering sovereign debt crisis in the euro area. As things stand at this point, it appears that a number of important measures will be endorsed by EU-17 leaders in the upcoming EU Summit. Stay tuned!

H1:2011 state budget deficit overshoots official target

Preliminary data for the execution of Greece's State budget in H1:2011 showed a 27.9%YoY rise in the central government deficit to ca €12.8bn. This resulted into an overshooting the respective budget target by €2.4bn, mainly as a result of much weaker-than-projected revenue growth. Year-to-June ordinary budget revenue declined by 8.3%YoY, falling short of the respective revenue target by €3.23bn.

The main reasons driving this disappointing revenue shortfall were: a) the non repetition of an extension granted for the payment of prior year road duties, which inflated State receipts in January 2010 by an estimated €0.39bn, b) reduced receipts from withholding personal income tax in 2011 due to a more favorable tax treatment of personal incomes as a result of the new tax law and the income reduction, c) the fact that credit institutions shifted for July 2011 the payment of 10% on the value of their preferred shares held by the State, d) the lingering domestic economic and e) increased tax refunds by the State for the settlement of past years' tax obligations. Note that refunds amounted to € 2.72bn year-to-June 2011, a 19.7%YoY increase relative to the respective period a year earlier. In an effort to reduce VAT evasion the government introduced last year a scheme linking tax refunds with the volume of retail receipts submitted by tax payers. Reportedly, this was the main reason behind the sharp rise in tax returns in H1:2011 and, as a result, the government is expected to modify the tax refunds scheme in the calculation of taxable income in FY2011.

In addition to the aforementioned, it appears that persisting disfunctionalities in the revenue collection mechanism and widespread tax evasion continued to weigh on budget revenues over the first six months of the year. According to a recent Bank of Greece report, tax evasion in the domestic economy amounts to as much as 4ppts-of-GDP per annum. Moreover, the 4th review of the EU/IMF adjustment programme for Greece places particular emphasis on the need to fight tax & social security contributions evasion in a more drastic and effective way.

Note that for the current year as a whole, the State budget targets an 8.5% YoY increase in net ordinary revenue. To achieve the latter target, the government needs to generate additional revenue (mainly from taxation) of ca €33.71bn (or €5.61bn per month) during the second half of 2011. This target seems overambitious but both the government and a number of EU/IMF officials argue lately that the revenue shortfall could be eliminated by the proper and timely implementation of the tax measures incorporated in the recently legislated medium-term fiscal programme (FTFS). The latter provides for additional austerity measures worth ca €28bn for the period 2011-2015, with some €6.4bn of these to be applied this year, so as to help bridge a 2.8ppts-of-GDP projected fiscal gap in the 2011 budget.

On the expenditure side, ordinary budget outlays totaled around €33.16bn year-to-June 2011, a ca 8.8% increase relative the same period a year earlier. This was mainly as a result of a) a 4.5% YoY increase in primary expenditure over the first six months of this year, chiefly because of higher transfers to social security funds and b) a 22.3% YoY rise in interest payments. In the public investment budget (PIB), year-to-June 2011 revenue amounted to €0.69bn, an increase of 79.6% relative to the same period a year earlier. On the other hand, PIB expenditure was down ca 42.3%YoY.

As an overall assessment, the underperformance of the State budget deficit in H1:2011 is a disappointing development, signaling an urgent need to fight tax avoidance and reduce costs in the broader public sector in a more effective way. Although the implementation of a number of new austerity measures (e.g. single payment authority) from July 2011 onwards will likely improve budget execution in the following months, considerable uncertainty continue to surround the attainability of the 7.5%-of-GDP full-year target for the 2011 general government deficit. Besides the weak State budget execution in H1:2011, the continuing accumulation of public sector arrears (> €6bn in January-April 2011) represents an important cause of concern.

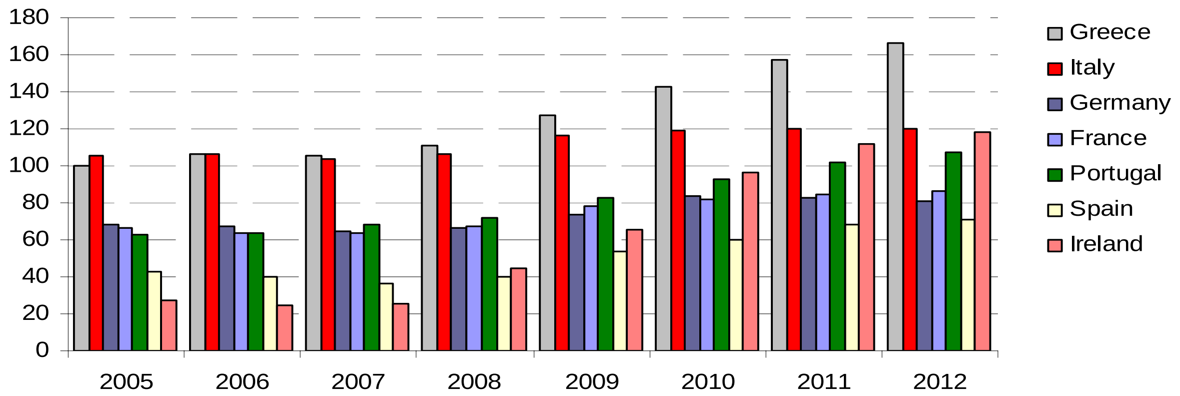
Mounting pressure in EZ peripheral government bond markets; Italian bonds yields soar on heightened contagion fears

Heightened market fears over contagion risks to the larger EMU peripheral countries saw **Italy** underperforming in the euro area sovereign debt space in recent weeks. Italian government bond prices moved sharply lower along the entirely maturity spectrum, with sovereign debt spreads reaching levels well above these recorded following the collapse of Lehman Brothers in September 2008 and the flare up in Greece's the debt crisis in the spring of 2010. Market uncertainty on whether EU policy-makers are poised to agree on a new comprehensive plan to deal with the lingering debt crisis any time soon and, reportedly, political frictions between Italy's Prime Minister Silvio Berlusconi and Economy Minister Giulio Tremonti, have accentuated investors' bearishness towards Italian sovereign debt.

Italy's 10-year government bond yield hit levels close to 6.0% for the first time ever this week, pushing the 10-year Italian/Bund yield spread to record highs near 305bps. This was some 120bps wider compared to levels reached early this month and well above respective levels around 75bps and 120bps recorded in September 2008 and in May 2010. Not surprisingly, the cost of insuring Italy's government bonds against default soared to a record 304bps on Friday vs. levels below 180bps early this month. Against this environment, investors now appear to be getting increasingly concerned that the lingering debt crisis may have already started to take systemically dangerous proportions.

The spill-over of market turmoil to Italy over the past couple of weeks has also been driven by market concerns regarding the country's public debt sustainability against a background of a slow-pacing economic recovery. The IMF projects Italy's real GDP growth to reach 1.0% this year, down from 1.3% in 2010 and far lower than its major euro zone peers, as dwindling competitiveness and lingering structural problems hinder economic prospects. Meanwhile, Italy's public debt stood close to 120%-of-GDP in 2010, one of the highest rates among industrialized countries and the second highest in the Euro zone only after Greece (*please see table 1*).

Table 1: Gross debt, general government, % of GDP

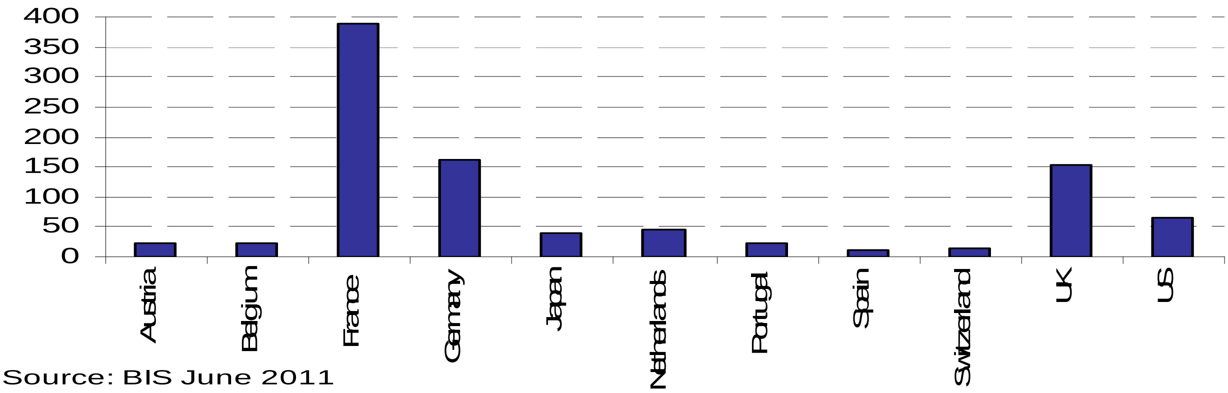


Source: European Commission Spring 2011 forecast

Reflecting on these negative developments, Moody's placed the country's Aa2 rating under review for possible downgrade early this week, citing the coexistence of structural impediments to domestic economic growth – i.e., a rigid labor market, an inefficient public sector, lack of an extensive reform agenda- and fears of contagion from Greece's debt crisis. Moody's move followed the S&P's decision early last month to lower its rating outlook for Italy's sovereign debt from stable to negative citing the country's weak growth outlook and "diminished" prospects for a reduction of government debt amid a "potential political gridlock".

The accelerated endorsement by the Italian lower house of parliament on Friday of a new austerity package for the 2011-2014 period -- which envisions reducing the budget deficit and the public debt rations to 0.2%-of-GDP and ca 90%-of-GDP at the end of the projection period from 4.6%-of-GDP and 119%-of-GDP in 2010, respectively -- failed to provide any significant respite to sovereign borrowing costs (the parliamentary vote was initially planned to take place within the next 60 days). The package consists of €47bn in additional savings, reportedly through, among other measures, cuts in central government ministries' budgets and a crackdown on tax evasion. But, the main bulk of budget cuts and savings are planned to take place no earlier than in 2013 and 2014. Specifically, about €3bn of additional austerity cuts are envisaged for 2011, €5bn for 2012 and €40bn for 2013 and 2014. With the next general elections in Italy being scheduled for March 2013, investors now worry that the 2013/2014 budgetary cuts may be eventually be watered down (or event postponed), raising doubts over the government's determination to meet its fiscal goals. In its annual review of the Italian economy, the IMF expressed their concern that the country's adjustment plan lacks specifics on how consolidation would be achieved beyond 2012, warning that, in the absence of fiscal consolidation, public debt could stay over 100%-of-GDP in the long term.

Table 1a: Debt exposure to Italy by bank nationality (public and private end-Q4 2010, in $bn)



Source: BIS June 2011

Should the pace of rising borrowing costs continue in the sessions ahead, they may reach levels that would make Italy's debt dynamics unsustainable. It is worth noting that Italy's overall principle and interest payment for the remainder of this year amount some €202bn with the first major headwind in terms of debt redemptions coming on August 1, when the 5¼% August 2011 bond redeems for €20.196bn. With Italy's bond market being the third largest in the world after Japan and US and with foreign bank claims on Italy standing much higher than those on other EZ States, rising funding pressures entail the risk of systemic implications, not just for Europe but for the global economy (*please see table 1a*). It is also worth noting that, according to the most recent BIS data (June 20112), the overall exposure of EU and other foreign banks to Italy's debt (public and private) amounted €1,096bn (compared to €160.9bn to Greek debt, €846.4bn to Spanish, €225.5bn to Portuguese and €652.3bn to Irish debt), with French banks being the biggest foreign holders of Italian sovereign paper.

Spain also fared poorly over the last couple of weeks, amid concerns about the solidity of the domestic banking system and, especially, the still vulnerable small regional savings banks 'Cajas'. This holds especially as there is no full clarity on the recapitlisation/restructuring process for the Cajas, many of which recorded huge losses when the domestic property bubble burst three years ago. The Bank of Spain announced this week that the financial system will be fully capitalised by September 30 and that four saving banks (Cajas), representing 8% of the Spanish banking system, will need financial aid from the state-backed Fund for Orderly Bank Restructuring (FROB).

Greek debt remained under pressure over the last couple of weeks amid lingering market uncertainty about the timing and the form of the new adjustment plan. Short-dated government bonds underperformed longer maturities in recent sessions, with the 2/10-segment of the GGB yield curve undertaking some further inversion, pricing in a higher risk of some form of a credit event than previously the case. Meanwhile, the 10-year GGB/Bund yield spread stood at ca 1,488bps in late trade on Friday, ca 44bps wider for the week and not very far from last month's 1,505bp all-time high. With investors eagerly awaiting the EU Summit on

July 21 for more details over the specific modalities and parameters of the new rescue plan for Greece, jitters in EMU peripheral markets will likely persist near-term. The technical picture indicates that only a sustained move below1,180 bps (100-day MA) has the potential to negate the current rising trend in the 10-year spread.

Greece's 26-week T-bill auction was well received

Greece's Public Debt Management (PDMA) successfully sold y-day €1.625bn of 26-wk T-bills, including 400mn in non-competitive bids. The auction produced an average yield of 4.90%, 9bps lower from a previous auction of similar maturity paper in mid-June. Investors bid 2.88 times the T-bills offered compared with a bid-to-cover ratio of 2.58 in the June 14 auction. Around 22% of the T-bills sold were purchased by foreign investors, lower than 37% last month.

PDMA faces rollovers totaling €4,4bn this month: €2.4bn of 26-week T-bills mature on July 15, while another €2.0bn in €13-week T-bills come on July 22. For the remainder of the year, overall principal and interest payments amount to €37bn. Greece has raised 18.162bn via T-bill auctions so far this year and has received €65bn of total funding under the current €110bn EU/IMF adjustment programme in five separate installments.

According to the July 2011 update of the EU/IMF programme released late last week, Greece is unlikely to regain access to private markets by early 2012, as initially envisaged, given the current difficult financing circumstances. With Greece's privatization proceeds expected to help reduce the country's financing needs, the Fund estimates that a residual gap of about €70bn will remain through the end of the program period, mid-2013 (the IMF added that the projected financing gap will probably raise to a total of €104bn through mid-2014 if market access is further delayed). This projected gap is expected to be covered by a soon-to-be agreed new bailout package for Greece, consisting of EFSF loans, privatization revenues and additional resources from the private-sector's involvement in the plan.

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