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GREECE MACRO MONITOR

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Focus notes: Greece

EU Summit highlights & latest on the sovereign debt crisis

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Highlights of the January 30th EU Summit; Greek PM expects PSI agreement, negotiations with troika to conclude this week

The main focus of yesterday's EU Summit, the first under the Danish presidency, was on ways to revive Eurozone economic growth, bolster youth employment and increase cross-border labour mobility. Specifically, EU leaders pledged to: a) offer more training for young people, so as to ease their transition to the labor force; b) deploy unused development funds to create new jobs; c) reduce barriers in doing business across the EU-27 member states; and d) ensure that small businesses have adequate access to credit.

President of the European Commission Jose Manuel Barroso urged EU leaders to use €82bn in uncommitted structural funds from the EU's 2007-2013 financial period to pay for job creation programmers and help small and medium businesses that struggle to get funding from banks. He clarified that some of the funds could be redirected to finance lending programs for small businesses and help university and college graduates secure apprenticeships. Mr. Barroso presented a special pilot scheme for the eight EU States -Greece, Ireland, Italy, Latvia, Lithuania, Portugal, Slovakia and Spain- currently featuring the highest youth unemployment rates. Furthermore, he proposed the creation of "action teams" that would draw up plans with the involvement of national trade unions, on how to tackle unemployment with the use of EU funds. Member states will have until the end of 2013 to draft, approve and implement new programs to use the funds.

Furthermore, the leaders of 25 EU countries signed up the final text of the so-called "fiscal compact", which encompasses a set of rules to strengthen fiscal integration and enhance economic governance. Only the Czech Republic and the UK refused to sign. The former reportedly remained outside the deal because of parliamentary procedural issues. The latter had already in December rebuffed pleas to join the new treaty after British demands for the provision of certain guarantees to protect the interests of The City of London were rejected.

On a separate issue, the EU heads of state and government reached a unanimous agreement on certain modifications to the ESM Treaty. Specifically, in line with the December 2011 EU Summit

Statement, EU leaders agreed that the rescue fund will come into force one year earlier than expected initially (i.e. in July 2012 instead of July 2013). Note that the ESM will have paid-in capital of €80bn, in additional to €620bn in callable capital, enabling it to act more like a bank and be less dependent on sovereign credit ratings than the present rescue mechanism, EFSF.

In spite of some initial expectations to the contrary, the issue of the combined adequacy of the EFSF/ESM mechanisms was not finally addressed at yesterday's summit. EU leaders reiterated that the overall adequacy of the current rescue mechanism, EFSF, and its permanent successor, ESM, will be reassessed at the next EU Summit in March 2012. ***Comment:*** *Reportedly, several EU officials are mulling the idea of increasing the combined EFSF/ESM lending capacity amid concerns that it may not be high enough to contain contagion risks. According to one option under consideration, when the ESM mechanism becomes operational, its €500bn available lending capacity would come on top of the EFSF's uncommitted resources (currently, around €250bn). As per the December EU Summit statement, the EFSF should remain active until mid-2013 only for bailout programs already in effect.*

Soon after the conclusion of the EU Summit, German Chancellor Angela Merkel expressed her belief that the new pact could be incorporated into EU law "within five years" adding that the agreements on the fiscal compact and the permanent rescue mechanism constitute a "small but fine step" on the path to restoring market confidence . The fiscal compact is expected to be formally signed at the next scheduled EU Summit on March 1, 2012 and will come into force once it is ratified by the parliaments of at least 12 euro area member states. Meanwhile, talking to reporters early on Tuesday following the EU leaders' summit, Greece's Prime Minister Lukas Papademos said that negotiations with private-sector creditors on a debt exchange deal made "significant progress", with the intention to have a final agreement by the end of this week. Mr. Papademos appeared optimistic that negotiations with the troika would also conclude this week, confirming that the major sticking points in the ongoing talks were on deeper spending cuts and labour market reforms (see analysis below).

Talks between Greek government and Troika inspectors continue

With negotiations on the Greek PSI in full swing, crucial talks between the government and the troika delegation are to continue this week. The aim is to reach a preliminary agreement on a number of measures, which are deemed as prerequisites for the implementation of new bailout package and, more imminently, the disbursement of a $30bn loan installment for running the proposed bond exchange (PSI). According to the local press, the Greek Premier presented to the cabinet last week a 10-page document (presumably, handed to him by the troika), which contains the general framework and the conditionality attached to the new rescue package agreed at the October 26-27, 2011 EU Summit. The document, titled *"Greece: Defining the new Program"* notes that the memoranda for the existing bailout package (*Greek Loan Facility*) and, primarily, the 5th Review MEFP, will form the basis for the new rescue program. The document also suggests certain refinements to be possibly incorporated into a new program, including: **a)** a set of "prior actions" that need to be completed before a new rescue program is considered, and **b)** possible additions and modifications to the existing program so as to reflect "evolving circumstances". The list of the aforementioned measures is expected to be finalized following consultations with the Greek authorities.

Official lenders want Greece to implement set of *prior actions* before they give green light to PSI, consider new financing package

According to press reports, the troika wants Greece to implement by February 13 a set of measures before they give the green light for the restructuring of Greek public debt via the involvement of private-sector creditors (PSI). These measures will also constitute prerequisites that need to be implemented before a new rescue deal is considered and the relevant loan agreement (and accompanying conditionality) is signed in March 2012. Our understanding is that the aforementioned prerequisites coincide with the "prior actions" highlighted in the document titled *"Greece: Defining the new Program"* that was recently handed to the Greek Prime Minister by the troika of official lenders (see previous paragraph). In the following paragraph we highlight some of these measures:

The most important "prior actions" than need to be implemented by mid-February 2012

i. **Additional fiscal measures worth ca €2.2bn (~1.0%-of-GDP) to compensate for slippages in the execution of the 2011 budget.** Reportedly, the government hopes that no additional austerity measures will be needed to cover the aforementioned shortfall. Instead, it expects to meet that target through planned cuts in defense spending (€0.5bn) and in health expenditure *e.g.* medicines and hospital operating expenses (€1.1.bn-€1.3bn). ***Comment:*** *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 signal upside risks to last year's upwardly-revised deficit target 9%-of-GDP. The data on the execution of the State budget are reported on a cash basis. However, in line with Eurostat methodology (ESA 95), total annual revenues and outlays are measured on a national account basis and will also include certain receipts and expenditure items from the first two months of 2012. Equivalently, the calculation of total 2010 annual revenue and expenditure on a national account basis included a share of receipts and spending items reported (on a cash basis) in the first two months of 2011.*

ii. **Immediate closure of up to a hundred public entities, resulting in 8k-10k of additional layoffs.** ***Comment****: The government's medium-term fiscal programme (MTFS 2011-2015) agreed earlier with official lenders envisions the merging/closure of a significant number of "unproductive" public enterprises. The reform has so far been only partially implemented. Administrative Reform Minister Dimitris Reppas said recently that the number of employees in civil service would not be reduced through mass layoffs but, instead, via the merging/closure of various state entities. The Greek Constitution forbids the dismissal of civil servants on open-ended contracts, unless their positions cease to exist, which would be the case in the event of mergers or closures. Note also that the MTFS targets a downsizing of the overall public-sector workforce by 150k employees by 2015. To facilitate attainment of the aforementioned target - and as a prior action to the 5th EC/IMF/ECB Review - the government passed through parliament last 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 be mandatory. According to reports, since last October only 8% of a total of ca 937 thousand employees who left the public sector were transferred to the labor reserve, with the rest representing employees who either decided or were forced to retire. Greece's Administrative Reform Minister admitted recently that the Labour Reserve reform is no longer in force and that the targeted downsizing of public-sector employment would be achieved through natural attrition and the application of pre-specified hiring limits. On the latter issue, the 10-page document handed to the Greek Premier by the troika last week urges for a vigilant monitoring of the 1-to-5 recruitment rule in the public sector.*

iii. **Adoption of a framework law, establishing a single supplementary fund and implementing cuts on benefits of supplementary pensions for 2013-2014 in line with MTFS targets.** ***Comment****: Reportedly, the size of reductions in supplementary pensions will range between 15% and 35%. New Democracy (ND) party has so far resisted cuts in supplementary pensions and has, instead, proposed to cover the deficit of auxiliary funds (estimated at ca €700mn) with revenues from the state lottery and other sources. New Democracy (ND) is one of the coalition partners supporting Lukas Papadimos' government and currently leads public opinion polls with a 15ppts-plus margin over the social party PASOK.*

iv. **Measures to enhance wage flexibility in the private sector with a view to further reduce labour costs and boost competitiveness.** This appears to be a highly-controversial issue in the ongoing negotiations between the government and the high-level troika delegation in Athens. According to the Greek media, the troika is currently pressing for more radical measures to reduce labor costs in the private-sector and in a number of public sector enterprises (DEKOs). This is presumably on the basis that wage costs in Greece remain higher than in a number of economies in the euro area periphery and in the broader region (*e.g.* Portugal, Spain, Poland and Bulgaria), at least as regards minimum (gross) wages in the private sector. Reportedly, some of the measures under consideration include: **a)** a reduction of the *minimum* gross wage (€751/month) set in the last 2-year national collective labor agreement that was signed in the summer of 2010; **b)** a reduction (or even abolishment) of the 13th and 14th salary installments; **c)** wider use of individual, as opposed to collective, contracts in the private sector; **d)** suspension of the right of industry associations to appeal to the Organization of Mediation and Arbitration (OMED); and **e)** measures to promote part-time employment and remove obstacles to private-sector layoffs. ***Comments:*** *In a new round of labor market-related talks last week, the General Confederation of Employees of*

Greece (GSEE) and the representatives of employers' federations agreed that neither the minimum private-sector wage nor the 13th or 14th salaries should be reduced or abolished. Instead, the General Confederation of Employees of Greece (GSEE) proposed ***i)*** *a 2-year wage freeze in 2013-2014 (i.e., after the current national collective labor agreement expires in December 2012); and* ***ii)*** *lower social security contributions to reduce overall labor costs. From its part the Hellenic Federation of Enterprises (SEV) proposed* ***i)*** *an abolition of automatic pay increases; and* ***ii)*** *a freeze of minimum wages "for as long as the crisis lingers", i.e., abolishment of the automatic hikes in minimum wages under the national collective labor agreement (e.g. by 2.6% in July 2012). Talks between the government and the troika on the aforementioned issues are expected to continue this week. But, as things stand at this point, it appears that the three political parties supporting Mr. Papademos' government are strongly against any cuts in the minimum wage or in the 13th and 14th salary installments. Reportedly, the troika targets a further 20% reduction in economy-wide wage costs, while the government claims that the domestic economic recession and the labor market reforms introduced earlier have already reduced wages by as much as 12% over the last four months. According to press reports, the Greek government is preparing a legislative act to be enforced in the case that talks between social partners do not reach an agreement that is satisfactory for the troika. Reportedly, such a legislative act would suspend wage maturities and automatic salary increases stemming from the national collective labor agreement. It would also introduce a three-year wage freeze and abolish special employment and wage arrangements currently applied to public utilities (DEKOs) and state-controlled banks (e.g. abolition of the permanent tenure for civil servants, abolition of wage maturities, reduction in special benefits and overtime pay etc).*

v. **Full implementation of legislation for liberalizing a range of closed professions.** ***Comment:*** *A new omnibus bill of fiscal measures and structural reforms for the period 2012 to 2015 was submitted to Parliament earlier this month. The bill was mostly comprised by reforms agreed earlier with the troika, such as the merger of a number of public entities (article 4), the opening up of the professions of truck drivers and lawyers (articles 5 and 6) and the reduction of the 13th and 14th pension payments for pensioners of less than 60 years of age (article 24). All of the 34 articles included in the omnibus bill were ratified by the Parliament, except of article 29 which calls for an extension in the opening hours of pharmacies. The said article received only 65 "yes" votes, with 101 lawmakers voting against it. This has raised certain worries over the solidarity of the Mr. Papademos' government, given that the leading tripartite coalition presently controls 252 out of a total of 300 seats in Parliament. The draft law will have to be changed and resubmitted to Parliament, reportedly by the end of this week.*

vi. **Written commitments by political party leaders.** The leaders of the three political parties currently supporting Greece's "national unity" government should reportedly provide written commitments as regards the conditionality underlying the 2nd bailout package. Such commitments should extend to the post-election period and cover the entire life of the new program. According to reports, Greek political leaders should provide these commitments by February 13.

Non-voting instruments to be used in Greek bank recapitalizations

One important proposal included in the Troika's document describing the general framework and conditionality of the new rescue package (*"Greece: Defining the new Program")* is to amend the relevant legislation to allow/require the use of non-voting instruments for bank recapitalization in viable banks. This item has been cited by a number of newswires as being one of the reasons supporting domestic bank stocks last week on the basis that it reduces the risk that a plan to recapitalize domestic lenders after the sovereign debt restructuring would lead to their nationalization (a prospect that has reportedly been strongly opposed by the troika).

Updated event risk calendar: *The crucial weeks ahead*

In our previous *Greece Macro Monitor* (Jan. 17, 2012), we provided a detailed timetable of the key dates and events investors need to closely monitor in the crucial period leading to an agreement over a new rescue package for Greece and the timely disbursement of the next EU-IMF loan tranche. In what follows, we provide an updated risk calendar based on the analysis above and the most recent information we managed to collect from a number of press reports and other sources.

Week ending February 3

- Negotiations on the "general terms and conditions" of the Greek bond swap deal (PSI) conclude.
- Parliament approves retroactive insertion of collective action clauses (CACs) in existing local law bonds.
- Government submits to Parliament legislation ("prior actions") than needs to be voted and implemented before the troika gives green light to PSI and signs new bailout deal.

January 31-February 10

- Finalization of the all relevant documentation (legal and other) for the debt exchange offer (PSI).
- Governments and national parliaments of euro area approve €30bn loan for running the PSI *i.e.,* provide necessary *sweeteners* in the form of *e.g.* upfront cash payment of 15 cents offered (along with new discount government bonds) to existing bondholders participating in the debt exchange.
- Eurogroup approves provision of temporary EFSF credit enhancements (up to €35bn) to ensure eligibility of Greek government bonds in ECB liquidity operations. Credit enhancements to remain in place for as long as Greece's sovereign ratings remain on "selective default" as a result of the implementation of the debt swap deal.

February 8

- Emergency EU Summit will reportedly take place

February 13

- Official public offer for the Greek debt swap (PSI).
- Deadline for Greek political parties supporting the coalition government to provide written commitments on the conditionality underlying the second bailout package.

February 13-27

- EFSF provides credit enhancement to preserve eligibility of Greek government bonds in ECB liquidity operations.

February 27

- Deadline for private bondholders to affirm participation in the debt exchange

March 1-2

- EU leaders welcome (or provide guidelines for) the results of the Greek debt exchange as well as the fiscal & structural measures comprising the conditionality of the 2nd bailout package for Greece.

March 5

- Upon agreement with official lenders, Greece decides on voluntary debt exchange offer (CACs?).
- Eurogroup approves disbursement of €30bn for running the Greek debt servicing as well as first loan installment for bank recapitalization (€10bn) and debt servicing (€5.5bn)
- Eurogroup approves the terms of the new loan agreement (i.e., loan installments, timetable of payments).

March 6

- Implementation debt exchange concludes

Second half of March

- Greek parliament endorses the new rescue package & corresponding implementation measures.

March 20

- 3-year bond matures for €14.435bn

BlackRock Solutions completes long-awaited study on Greek commercial banks

BlockRock Solutions's long-awaited diagnostic study on the loan portfolios of Greek commercial banks is reportedly completed and the results were submitted to the Bank of Greece late last week. The findings of the survey were also handed to the senior troika inspectors who arrived in Athens on January 20th.

According to reports, the study was based on two scenarios. The first one assumed additional NPLs of €11bn over a three-year period and the other €15bn of NPLs as a result of a deeper than expected recession. Press reports cited a senior banking official as saying that the needed capital shortfall is "manageable" and pre-provision operating profits could reach or exceed that amount over the relevant thee-year period, provided that domestic economic activity stabilizes and the EU debt crisis subsides.

Bank of Greece (BoG) will use the findings of the BlackRock's survey to make its own evaluation of the banks' additional capital needs for the period 2012-14. The evaluation will take into account, among others, existing provision buffers, expected profitability, deleveraging, business plans already reported as well as bank subsidies' exposure to South East Europe.

According to a reported timetable, Bank of Greece is due to provide BlackRock's report to Greek banks in late January and to complete the evaluation of additional required funds by the end of February. In this crucial project for recapitalizing the local banking sector, Bank of Greece will be assisted by US based consultants Bain & Company.

After receiving the results of the BlackRock's survey, commercial lenders have to submit to the BoG three-year business and capital plans detailing how they are planning to meet their needs for additional capital. Banks' own plans to increase their capital base may reportedly include, among others, sales of real estate properties, other banking subsidiaries and even healthy loan portfolios.

These plans need to be submitted and approved by the Bank of Greece by the end of April. Banks will have until the end of August to implement the planned actions to raise the necessary funds. Provided that projects are judged to be unrealistic, banks should make the necessary adjustments. If banks are not able to raise capital alone, they may have to turn to the Financial Stability Fund, a safety net established by Greece and its international lenders for banks whose capital adequacy fails below minimum ratios but cannot raise funds in the market.

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