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GREECE MACRO MONITOR

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Focus notes: Greece

Latest macro & market developments

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5th EU/IMF loan tranche for Greece approved

At the July 2 meeting, Eurogroup approved the release of the 5th loan tranche to Greece, after the country's parliament endorsed a sizeable fiscal austerity plan for the period 2011-2015. In a similar move, the IMF Board agreed last Friday on the disbursement of its contribution to 5th loan installment (ca €3.2bn out of a total €12bn), following approval of the 4th programme review. Greece is anticipated to receive the IMF installment as early as July 11, with the proceeds from the respective EU bilateral loans expected to arrive to State coffers by July 15. Receivance of the 5th loan trance would bring the total official financing provided to the country so far to €65bn, under the present €110bn rescue programme.

Sovereign liability settlements in July-August 2011

Greece's first major sovereign liability settlements are scheduled for July 15 and July 22, when respective T-bill redemptions of €2.4bn and €2.0bn are due. These are on top of total coupon payments of €2.956bn by the end of the current month. Further down the road, the next headwind in terms of debt repayments is on August 22, when the 3.9% August 2011 bond redeems for €6.61bn. Next month also brings total coupon payments of €2.404bn as well as €2.480bn in maturing T-bills. In all, Greece's financial needs in terms of debt redemptions and coupon payment until early September, when the next EU/IMF loan tranche (€8bn) is due, amount to €18.85bn. To that amount one would also need to add other, non debt-servicing budgetary expenditure (e.g. wage and pension payments) to derive the overall State borrowing requirement for the period under consideration.

From the funding side, the State treasury is currently estimated to have some €2bn in available cash reserves to augment the 5th EU/IMF loan installment proceeds of €12bn. Assuming then that the State will be able to roll over maturing T-bills of around €6.9bn by early September (ca €4.4bn in July and €2.5bn in August), we are left with an available amount of ca €2bn (plus other state revenue from e.g. taxation and privatizations) to finance non debt-servicing outlays over the period July to August 2011. The calculations above do not necessarily raise red flags with respect to the ability of the government to cover its borrowing requirement until the next EU/IMF loan tranche is due. Yet, they are telling of the tight state of public finances in the present trajectory.

Adding to Greece's liquidity hurdles, press reports claimed over the last few weeks that, as of this summer, the ECB will set a limit on the participation of Euro zone banks in their home countries' T-bill auctions to no more than the average value of respective T-bill holdings in the first four months of 2011. The ECB will also reportedly announce that it will not accept as collateral any T-bill amounts in excess of that limit. Unnamed ECB sources claimed that the Central Bank's aim is to prevent sizable increases in T-bill issues from countries that can not raise longer-term funding in international capital markets.

July 11 Eurogroup: Main parameters of the new rescue plan for Greece to dominate the agenda

At the last Eurogroup meeting on July 2, Eurozone finance ministers made no further decisions about another support package for Greece, despite an earlier agreement (June 19/20 Eurogroup) for the finalization of the main parameters of a new bailout plan by early July. An official statement issued upon conclusion of the July 2 meeting noted that consultations with private sector creditors and rating agencies were still underway and that the precise modalities and scale of private sector involvement and additional funding from official sources will be determined in the coming weeks.

Looking ahead, the main parameters of a new support plan for Greece (i.e., potential size, composition of funding and scale of private-sector involvement) are expected to dominate the agenda at the July 11 Eurogroup meeting. However, as things stand at this point, more time may be needed before all key technical details are hammered out. Thus, a final decision may be delayed until the mid-September Eurogroup meeting, the first after the summer lull.

French-backed proposal for rolling over private-sector exposures to Greek sovereign debt

Amid ongoing political discussions over the last few weeks about a potential private sector involvement in the new support package for Greece, the French Banking Federation, a group of French banks and insurance companies put forward a draft proposal for a voluntary rollover of Greek sovereign bonds maturing between mid-2011 to mid-2014. The so-call "French proposal", which has received widespread media and investor attention, involves two options for bondholders after the redemption of existing GGBs.

i) Main features of the proposed options

Option 1:

- A minimum 70% of the proceeds from Greek sovereign debt maturing from mid-2011 to mid-2014 would be voluntary reinvested, with the remaining 30% being paid back to bondholders in cash.
- Of the 70% reinvested amount, 50% would be utilized for debt refinancing by investing it into a new 30-year Greek government bond issued by the Hellenic Republic. In turn, Greece would transfer the rest 20% to a special purpose vehicle (SPV). The SPV would use this amount to buy zero-coupon AAA-rated securities from EU sovereigns, supranational institutions or European agencies. The SPV would provide *full principal* guarantee for the 30-year bonds at maturity, a necessary sweetener offered to private investors in orders to induce them to voluntarily participate in the rollover scheme.
- The new 30-year bond will bear an annual coupon of 5.5%, with the prospect of investors receiving an additional premium indexed to Greece's yearly real GDP growth, capped at 2.5% and floored at 0% per annum.
- The new 30-year Greek sovereign paper would be listed on an EU regulated market with restricted trading, until 1st January 2022, implying certain liquidity constraints for bondholders over that period.

Option 2

- Investors would voluntarily rollover 90% (and preferably 100%) of the proceeds from Greek sovereign debt maturing from mid-2011 to mid-2014. The reinvested amount would be placed in a new 5 –year bond issued by the Hellenic Republic with an annual coupon of 5.5%.
- The remaining 10% would be paid back by Greece to bondholders in cash.
- This option does not envisage any guarantee on principal or an uplift in coupon payments linked to the GDP /CPI growth rate of Greece.
- The new 5-year Greek sovereign paper would be listed

on an EU regulated market with restricted trading, until 1st January 2022.

Both options would need to come with strict conditionality, including: i) rating agencies should informally indicate that, under the proposed rollover scheme, the existing and new Greek sovereign bonds would not be downgraded to default or selective default status, ii) ensure adequate sizable private sector participation (up to 80% participation assumed in the proposed plan), iii) the ECB should indicate its willingness not to sell Greek government bonds during the rollover period, iv) the EU and the IMF should continue disbursing funding as provided under the fiscal adjustment programme so as to help promote the medium-term sustainability of the Greek fiscal situation and v) Greece to respect its commitment under the EU/IMF financial adjustment programme.

German banking sector officials voiced their interest in the proposed French plan. German Finance Minister Wolfgang Schauble announced late last week that local institutions would likely contribute €3.2bn, underlying that 55% of German bank GGB holdings mature post 2020. Reportedly, French banks signaled that they could rollover another €2.0bn worth of Greek bonds maturing by mid-2014. With respect to Greek banks, the local press quoted government officials as saying that they are projecting €3-4bn participation from domestic banks, an amount significantly lower relative to that indicated earlier by a number of reports (~€12bn).

ii) Implications for rating agencies and CDS

David Geen, the general counsel of the International Swaps and Derivates Association (ISDA) which has the final say on whether a "credit even" has occurred, said earlier this week that the French proposal is effectively a voluntary rollover and thus, it is unlikely to trigger payment of credit default swap contracts (CDSs). This holds under the assumption that i) there will be no binding element for investors who decide not to participate ii) the terms of the old bonds are not changed and iii) existing bonds are paid back to their holders at they time they mature.

Yet, it seems that the criteria of the main rating agencies are more strict that the ISDA standards with investors getting increasingly concerned that, should the French proposal is finally adopted on its original form, it would probably be labeled as a Distressed Debt Exchange (DDE).

In a statement released early this week, S&P stated that, according to its rating criteria and policies, the French proposal for rolling over private investor exposures to maturing Greek sovereign debt would likely amount to default. According to the statement, two conditions must be met for a debt exchange or similar restructuring to qualify as an effective default; namely i) to be viewed as distressed rather than opportunistic and ii) to result in investors receiving less value than the promise of the original securities. The ratings agency clarified that Greece's near-term reliance on EU/IMF official financing, the government's difficulty in reducing its sizable fiscal deficit, and the current pricing of Greek government debt in the secondary market meet the first of these two criteria. With respect to the second condition, S&P cited two potential indications of investors receiving less value: a) the timing of payments is slowed (e.g. zero coupon from quarterly paying, or bullet from amortizing) and b) the maturities of the new securities extend beyond the original bonds participating in the rollover exercise. The rating agency concluded that, under either of the options envisaged by the French proposal, they would likely lower Greece's issuer credit rating to 'SD', indicating that the country has effectively restructured some, but not all, of its debt. S&P also noted that an 'SD' action on the issuer credit rating would likely occur only once, and that in case that either of the two options of the French proposal were to be implemented, a 'D' issue rating would be assigned to the maturing Greek government bonds upon their refinancing in 2011. But, once either option is implemented, the rating agency would assign a new issuer credit rating to Greece after a "short time" reflecting their forward-looking view of Greece's sovereign credit risk. At the same time, they would likely rate all debt issues, including debt refinanced between 2011 and 2014, at the same level as Greece's new issuer credit rating.

Separately, Moody's said earlier this week that it is not involved in talks on a Greek debt rollover plan and will only make its views publicly known once there is a final plan in place. In a report published a couple of years earlier (*Moody's approach to evaluating distressed exchanges, March 2009*), Moody's laid out the criteria for evaluating distressed exchanges, which appear to be broadly similar to these of the S&P. Thus, we would not be surprised to see Moody's finally coming up with a similar verdict, if the French plan were to be implemented. Fitch has also declined so far to comment on the French plan awaiting the full details of the debt scheme before making an assessment. However, the rating agency had noted in a statement released a month earlier (*Potential rating implication of Vienna initiative of debt exchange for Greece*) that any debt exchange or similar mechanism " that offers new securities with terms that are - on the whole - worse than the original contractual terms of the existing debt and where the sovereign is subject to financial distress" would be judged as Distressed Debt Exchange (DDE) and hence a default event, even if bondholders' participation was deemed to be voluntary.

On its part, the ECB strictly opposes to any kind of debt restructuring/ reprofiling/debt rollover exercise that would trigger a credit event leading to default/selective default ratings.

A number of ECB officials have indicated over the last few weeks that a selective default rating would prevent the central bank from continuing to accept Greek sovereign bonds as collateral in its liquidity-providing operations. However, the Financial Times reported earlier this week that the ECB will continue to accept Greek debt as collateral, unless all credit ratings agencies it uses declare Greece to be in default. The press report added that the ECB would rely on the principle of using the best rating available from the agencies: S&P, Moody's and Fitch. The ECB also uses DBRS rating agency to determine collateral eligibility in its liquidity operations but the latter does not rate Greek sovereign debt (of the euro zone countries, DBRS rates eight States including Ireland, Portugal and Spain).

Reportedly, a more feasible alternative to make sure that a default rating would not necessarily trigger a liquidity crisis at Greek banks, which remain heavily reliant on ECB for liquidity, would be the potential use of the so-called Emergency Liquidity Assistance (ELA) (Irish banks have already made repeatedly use of the ELA facility). The use of this facility is at the discretion of the national central banks and is provided in exceptional circumstances on a case-by-case basis to "temporarily illiquid but solvent institutions". This would require a 2/3rd majority vote in the EU governing council to veto ELA usage. According to the most recent official data, Greek banks' reliance on ECB liquidity halted a four-month falling streak in May to come in at €97.5bn, recording a 12.2%mom increase.

iii) Ongoing private-sector discussions over potential changes to the original French rolling-over proposal

In a closely-watch meeting organized by the Institute of International Finance (IIF) in Paris on Wednesday, July 6, senior representatives from banks, insurance companies and other holders of Greek debt discussed a number of potential changes to the original French plan. However, a number of reports in the international press and newswires indicated that there was *not* much progress in the way to a final deal.

Among other issues, the discussions reportedly focused on a number of alternative proposals aiming to ensure greater participation by private-sector bondholders and lower the effective interest burden on the sovereign borrower. IIF Managing Director Charles Dallara who chaired the meeting told Reuters that the prospect of setting up a €50bn fund to buy back Greek sovereign debt in the secondary market was also in the agenda of the meeting. The latter was also a key issue of discussions at a meeting that took place in Rome on July 7, which was attended by officials from banks and insurance companies, the ECB, the Greek government and the IIF. Reportedly, the objective of the Debt Buyback Facility (DBF) is to lower Greece's outstanding stock of debt, taking advantage of the existing sizable discounts on Greek bonds in the secondary market. Regarding its potential sources of finding, press reports suggest that these may come from the IMF, surplus countries and sovereign wealth funds as well as Greece's privatization proceeds.

Adding to the ongoing difficulties to reach a widely-accepted deal on how private creditors might voluntarily maintain their exposures to Greek sovereign debt, Germany seems to be putting back on the table the option of a Greek debt swap.

Key hurdles that need to be overcome in the way to a new bailout deal for Greece

In all, the next steps that purportedly need to be taken before a final agreement on the potential form of private sector involvement in the new bailout deal for Greece is reached include, among others, the following:

i) secure that the proposed debt rollover is not classified as a credit event by the major rating agencies. In line with the major rating agencies' criteria, this could be avoided by ensuring that: a) it does not feature any element of coercion, b) the terms of the new securities offered to private-sector participants in the debt rollover operation are not worse than those of the old instruments and c) the risk of sovereign default would not increase if bondholders refuse to participate in the rollover scheme.

ii) prevent triggering of Greek CDS pay-out

iii) secure "substantial contribution of bondholders", a key precondition purportedly imposed by, among others, Germany, the Netherlands and Finland, countries that aim to address moral hazard issues and strongly oppose a disproportionate shouldering of the burden of a new Greek bailout between financial market players and tax payers.

iv) Address Finland's warning that it will not endorse a new bailout deal for Greece, unless the latter provides adequate collateral on new loans provided by the EFSF. The Finnish Finance Minister clarified that the guarantees could be in the form of shares in the company managing Greece's state property. According to a number of recent press reports, the potential size of a new bailout programme for Greece will amount to €110bn. Some €60-€70bn of which will come in the form of funding from the EFSF. The remainder amount will be divided as follows: ca €30bn will be in the form of Greece's privatization proceeds and up to €15bn will be secured by the voluntary rollover of private sector exposures to Greek sovereign debt. Note that the latter amount is half the initial target figure of €30bn. Ostensibly, if the new bailout plan for Greece is to be partially financed of EFSF funds, Finland's demand has to be met (or being somehow bypassed). The problem is that the rules of the European Financial Stability Facility imply that decision on new lending requires approval from all the 17 euro area member states. It is worth recalling that Finland, as well as Germany, is one of the few countries that would need to seek parliamentary approval if the new package if funded by the EFSF.

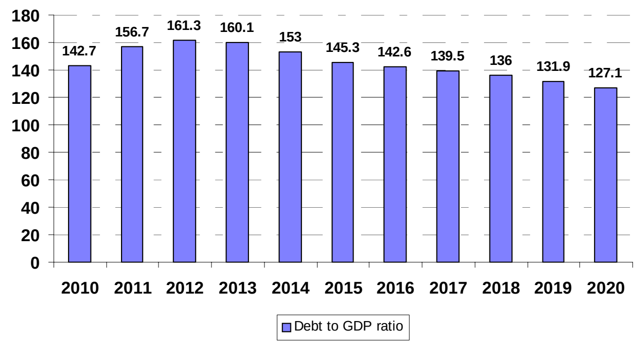
EC/ECB/IMF 4th programme review: Focus needs to shift to reforms implementation and privatizations agenda

The European Commission's 4th review of Greece's economic adjustment program (released on July 2 2011) recommended disbursement of the fifth EU loan tranche, under the present €110bn bailout plan. According to the new Commission projections, the Greek economy is expected to contract by 3.8% of GDP in 2011, before returning to marginally positive growth (+0.4%) next year. Unemployment is expected to rise to 14.5% and 15% in 2011 and 2012, respectively, while domestic consumer inflation is expected to decelerate to 2.9% in 2011 and to 1.0% in 2012. Table 1 below includes the new Commission forecasts for the evolution of Greece's main macroeconomic variables in the period 2011-2015.

Macroeconomic scenario under European Commision's 4th Review	2010	2011	2012	2013	2014	2015
Growth rate (real)	-4.5	-3.8	0.6	2.1	2.3	2.7
Domestic Demand Contribution	-7.7	-6.6	-2	1	1.4	1.8
Net trade contribution	2.3	2.7	2.6	1.1	0.9	0.9
Unemployment rate	11.5	14.5	15	14.5	14	13.6
ULC (growth rate)	-0.4	-1.8	-0.2	-0.3	-0.5	-0.9
HICP inflation	4.7	2.9	1	1	1.1	1.1
HICP inflation at constant taxes	1.4	1.3	0.9	1	1.1	1.1
Current account balance (% of GDP)	-11.8	-9.9	-7.7	-6.6	-5.8	-4.9
Debt to GDP ratio (baseline scenario)	142.7	156.7	161.3	160.1	153	145.3

Figure 1 below shows the evolution of the Greek debt to GDP ratio over the period 2010-2020, in line with a baseline scenario, which is partially depicted in Table 1. Note that according to an alternative scenario presented in the 4th programme review, which assumes of 1ppts lower annual GDP growth relative to the baseline scenario, the debt ratio fails to stabilize, hitting 170%-of-GDP by 2020.

Figure 1: Debt to GDP ratio (Baseline Scenario)



The 4th programme review points to a number of slippages in implementing the EU/IMF-agreed reforms and identifies a number of major risks that lay ahead. Specifically, although there was a strong kick-start in the reforms effort, recent developments are not particularly encouraging. The 4th review mentions that even though a series of reforms have been legislated already, there are serious delays in their implementation. These are due mainly to administrative capacity limits, constraints in political coordination as well as political-cost considerations. In order to address these problems, a project-management scheme (together with technical assistance from the EU and the IMF) is proposed to supervise the process of reforms implementation and periodically publish indicators on their effects on the domestic economy.

On the fiscal front, significant weaknesses are observed in the following areas:

- Lingering inefficiencies in the tax collection mechanism even after a year of implementing the stabilization program and a number of new laws already voted in parliament to reform the tax system. It is not by chance that the 4th review urges the Greek government to simplify and streamline its tax legislation further.
- A further significant increase in general government arrears documented in the first four months of this year (according to the latest available data). For more information on general government arrears, please refer to our previous *Greece Macro Monitor, June 30, 2011*.
- The worse than expected downturn of the Greek economy observed in 2010 that poses serious risks to the achievement of the fiscal targets (especially the deficit target for this year).

The Medium Term Fiscal Strategy (MTFS) is considered as an adequate response to the above fiscal challenges. According to the 4th review, the plan includes an appropriate mix or revenues and expenditures measures so as to permit achievement of the 2011-2015 deficit targets. Note that the MTFS introduces additional austerity measures worth ca €28bn and it is broadly evenly split between expenditure cuts and revenue generating measures. Around €6.5bn of these (~ 2.8ppts-of-GDP) will be applied in 2011 with the aim to facilitate fulfillment of this year's general government deficit target of 7.5%-of-GDP.

In addition, the programme envisions as much as €50bn in revenues from the sale/better utilization of state assets over the period 2011-2015 (for a more thorough analysis on the MTFS please see our June 11 and June 30, 2011 Greece Macro Monitors). Nevertheless, the 4th review explicitly states a number of implementation risks facing the MTFS. These mainly include political-cost considerations and the weak managerial abilities of public sector that could delay the implementation of the necessary reforms.

The 4th review also urges the government to accelerate the planning and implementation of its privatization agenda so as to help reduce the public debt burden (€50bn of privatization revenue could reduce the debt ratio by more than 20ppts until 2015) and boost economic activity and competitiveness. A privatization fund which will act as an independent authority is already established (with MTFS Enabling Law) in order to streamline the privatization process. In addition, the inclusion of a new quantitative criterion in the quarterly EU/IMF programme reviews will strengthen the overall monitoring process.

Table 1: Greece-Key Indicators	Last	ytd	2010	2009
Macroeconomic indicators				
GDP growth (%YoY)	-5.5 (Q1 11)	0.2	-7.4	-2.1
CPI	3.3 (June 11)	1.8	4.7	1.2
Unemployment rate	16.2 (March 11)	40.0	14.8	10.2
Labor Cost (%YoY)	-0.6 (Q1 11)	-19.1	-4.2	3.6
Economic Sentiment (index level-period average)	70.0 (June 11)	75.4	75.1	76.3
Consumer-vigor indicators				
Private consumption in constant prices (% YoY)	-7.8 (Q1 11)	1.1	-8.6	-2.2
Retail sales excl. fuels & lubricants volume (% YoY)	-11.8 (April 11)	-20.6	-23.7	-0.7
New private passenger car registrations (% YoY)	-34.1 (June 11)	163.9	-61.9	22.0
Consumer confidence (index level - period average)	-75.0 (June 11)	-69.9	-63.4	-45.7
Retail trade expectations (index level - period average)	-41.6 (June 11)	-33.0	-33.7	-15.4
Industrial-activity indicators				
Industrial production (% YoY)	-10.9 (April 11)	-8.6	-5.2	-6.8
Capacity utilization in industry (index level -period average r	68.5 (April 11)	68.4	68.6	70.5
Industrial confidence (index level - period average)	-22.7 (June 11)	8.6	-22.5	-28.4
Manufacturing PMI (index level - period average)	45.5 (May11)	44.2	43.8	45.4
Construction sector & other investment-activity indicators				
Cross fixed capital formation in constant prices (% YoY)	-21.8 (Q1 11)	-2.6	-7.6	-15.1
Housing investment in constant prices (% YoY)	-21.7 (Q1 11)	-5.1	-18.5	-24.8
Other construction in constant prices (% YoY)	-10.9 (Q1 11)	-2.8	-11.7	-4.7
Private building permits volume (% YoY)	-72.9 (Jan 11)	-71.6	-8.6	-22.6
Construction confidence (index level - period average)	-73.9 (June 11)	-67.4	-55.4	-39.5
Balance-of-Payments statistics *(€-terms)*				
Tourism revenues (% YoY)	6.5 (April 11)	126.8	21.0	-10.2
Transportation revenues (% YoY)	-11.8 (April 11)	-9.3	-7.7	-7.9
Customs-based statistics *(€ - terms)*				
Goods exports (% YoY)	30.9 (April 11)	-6.6	43.8	-3.2
Goods exports to EU (% YoY)	5.1 (April 11)	-8.9	17.1	4.2
Goods exports to non-EU countries (% YoY)	76.4 (April 11)	-3.1	89.8	-14.4
Goods imports (% YoY)	-17.5 (April 11)	-23.5	-6.7	1.0
Goods imports from EU (% YoY)	-7.0 (April 11)	-9.6	-15.7	-7.8
Goods imports from non-EU countries (% YoY)	-29.3 (April 11)	-26.0	8.0	1.1
Domestic MFI credit to domestic enterprises & households *(oustanding balances)*				
Private sector (% YoY)	0.4 (May 11)	-1.8	0.0	1.5
Enterprises (% YoY)	-8.9 (May 11)	-1.9	1.1	1.0
Households (% YoY)	-2.6 (May 11)	-1.6	-1.3	1.9
Housing loans (% YoY)	-1.7 (May 11)	-0.9	-0.4	3.7
Consumer credit (% YoY)	-3.9 (May 11)	-3.6	-4.2	-1.6
Private-sector credit outstanding (% GDP) *				
Total domestic enterprices & households	113.5 (May 11)	-	112.0	106.6
Domestic households	52.0 (May 11)	-	51.3	50.2

Source: Hellenic Statistical Authority, Bank of Greece, ECOWIN, AMECO, Eurobank EFG Research
* AMECO's nominal GDP Spring forecasts for 2010 (€ 230.2 bn) and 2011(€ 222.8 bn) were used.

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