Athens, August 20 2010

Focus Greece
Latest macro developments

Key points

- **January-July budget execution data suggest 8.1%-of-GDP deficit target remains attainable; concerns remain over performance of tax revenue**
- **Q2 GDP contracts by 1.5/3.5 QoQ/YoY; domestic recession seen worsening in H2**
- **Domestic inflation running high due to aggressive indirect tax hikes; rapid disinflation to resume in H2 2011**

January-July budget execution data suggest 8.1%-of-GDP deficit target remains attainable; concerns remain over performance of tax revenue

With respect to the execution of the fiscal program, according to the most recent cash-based statistics released by the Bank of Greece, the net borrowing requirement of the central government in the period January-July 2010 was €11.45bn, some 41.8% YoY lower from a year earlier. According to the same report, the revenue of the ordinary budget *(which is effectively the central government budget excluding public investment)* fell by 7% YoY in the first seven months of this year, while primary spending *(which excludes debt servicing costs)* was reduced by 15.3% YoY. The General Accounting Office of the Finance Ministry has also released data on the execution of the central government budget for the first seven months of 2010. Specifically, the central government deficit declined by 39.7% YoY, broadly in line with an official full-year target for a deficit reduction by 39.5%. The January-July 2010 deficit amounted to €12.05bn, covering around 65% of the corresponding target for the whole year. The growth in gross ordinary budget revenue in January-July underperformed the corresponding annual target by a good margin (+.3% yoy vs. a full-year target of +12.7%yoy), while the decline in the deficit of the public investment budget (-47.4% yoy) was more than double relative to that projected for the whole year. The latter was due to a sharp contraction in public investment spending (-36% yoy).

On a more positive note, primary expenditure, which generally constitutes the most inelastic component of the central government budget, was reduced by 12.6% yoy in the first seven months of the year, a pace of contraction significantly faster than the full-year rate projected in the country's fiscal adjustment program *(-5.8% yoy).* We anticipate a faster pace of growth in tax revenues in the following months, when the main bulk of revenue-generating measures *(including the second installment of VAT rate hike introduced in early July and a property tax)* become fully implemented. We do yet have detailed data by the General Accounting Office for the performance of tax revenue in July, but as we noted above, cash-data released by the Bank of Greece showed a 7% YoY decline in ordinary budget revenue that month. Since ordinary tax revenue is primarily comprised by (direct and indirect) tax receipts, we conclude that the latter experienced a *(broadly unexpected)* decline in July, which can be partly attributed to a strike by customs officials that month.

Whatever the reason for that underperformance may be, we should see tax revenue growth picking up pace in the following to be convinced that the government's efforts to track down tax avoidance has started to bear tangible results. To that end, a number of government officials have been recently quoted as saying that even more emphasis will be paced on big cases of tax evasion, in particular among self-employed and people who own big real estate and other assets. The government is also reportedly done with taxing low wage-earners and pensioners, who are already sharing a disproportionate share of the fiscal adjustment program. Efforts are now

mainly concentrating at reducing waste in the broader public sector (hospitals, loss-making public enterprises and the local government), applying better control on discretionary spending and taxing the rich. Regarding the latter, a new tax law already in effect introduces new tax scales that shift the tax burden to annual incomes of more than €40k. But, as Finance Minister George Papakonstantinou said recently, about 95 percent of individual tax filings are below €30k! This is a clear manifestation of the extent of tax avoidance currently underway.

As we noted above, the reduction in the deficit of the state budget is proceeding in line with the full-year targets. However, some concerns remain about the performance of the broader public sector. Note here that although timely data on the execution of the central government budget are now available on a monthly basis, data for the general government budget (= central government budget + broader public sector, where broader public sector = defense costs + budgets of local governments and other public entities + budgets of social security funds + other national account adjustments) are released once or twice a year[1]. The reason for this is the lack of availability of timely data for the broader public sector (local governments, public security funds etc), but this is going to change soon as Greece has a commitment under the EC/ECB/IMF program to start providing timely data for the general government as well. As noted in an EC/ECB/IMF interim progress report on Greece's stabilization program released in mid-June, recent available data suggest that health care costs are running high and social security and local government accounts underperforming (by ca 0.6%-of-GDP year-to-April), offsetting the strong state budget performance. Financial conditions for state-owned enterprises appear to have been affected by the sovereign crisis and according to EC/ECB/IMF projections an estimated €1.5bn in guarantees could be called during 2010. This should *ceteris paribus* increase the public debt ratio, but would not alter our corresponding baseline projections as we have already accounted for such an eventuality. We continuer to forecast the public debt ratio to peak both earlier and at a lower level than projected in the IMF's baseline scenario[2].

All in all we continue to expect fulfillment of the 8.1%-of-GDP general government deficit target this year as tax revenue growth is anticipated to pick up in the coming months. The government can also contain discretionary spending further *(e.g. public investment)* if needed to meet its annual fiscal target. As we noted earlier, public investment budget (PIB) outlays are already down by ca 36% YoY year-to-July. According to the EC/ECB/IMF stabilization program, investment expenditure for the full-year should decline by only 4% YoY, while a part of the PIB is necessary to finance EU co-funded projects. Public investment is also important for the economy in an extremely adverse environment as the current one where private investments are constrained by elevated funding costs and scarce credit and housing activity remains trapped in a severe downtrend *(building permits down by 12.4% YoY and by 7.5% YoY year-to-May*). Yet, given the outmost importance of meeting this year's fiscal deficit target (not only for satisfying the quantitative targets of the stabilization program but also for market-signaling reasons), we do not rule out a significantly sharper-than-projected reduction in PIB outlays this year. For 2011, the general government deficit target is 7.6%-of-GDP (i.e. a reduction of only 0.5ppts relative to 2010) and, baring unforeseen circumstances, the government is expected to meet that target as well, without additional measures besides those already included in the EC/ECBIMF stabilization program.

Q2 GDP contracts by 1.5/3.5 QoQ/YoY; domestic recession seen worsening in H2

The flash Q2 GDP data (-1.5%/-3.5% QoQ/YoY) as well as the most recent readings in a range of higher-frequency macro indicators of domestic economic activity point to a deepening of the domestic recession in the second half of this year. Among them, the growth in the volume of retail sales (excluding fuels & lubricants) was running at a -7.2 YoY pace in May, while consumer confidence stood in July at an all-year low of -66. We expect

[1] An estimate for the running full-year balance is provided in the draft budget for the coming year and a final estimate for year *T* is provided by March of year *T+1*.

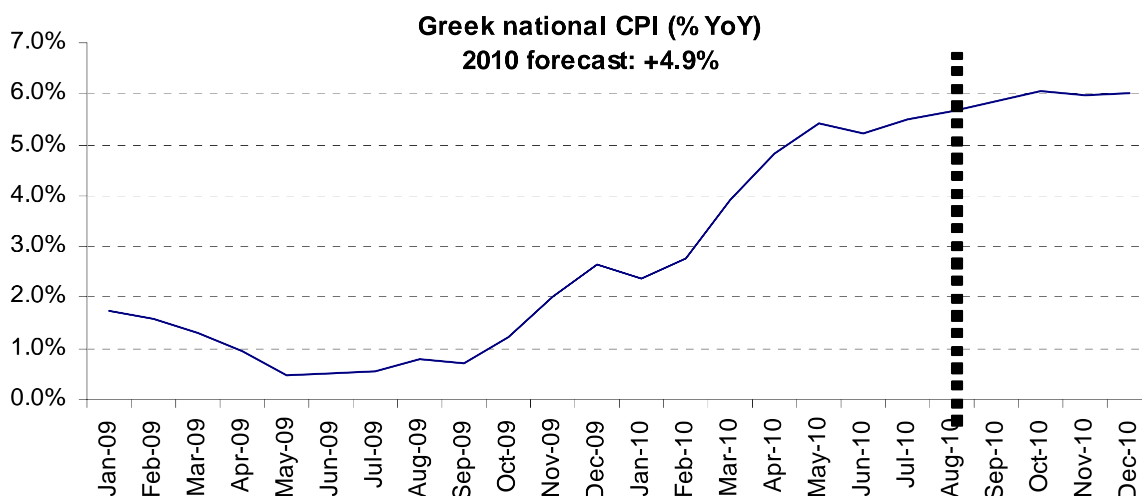
[2] For a full set of our more recent macro forecasts on Greece please refer to *Eurobank EFG Research "The Greek Economy & Its Stability Programme", June 2010.*

private consumption growth to return to negative territory from Q2:2010 onwards as a result of rising unemployment (12% in May vs. 8.5% in the same month a year earlier) as well as the hit in disposable incomes due to wage restrain, higher taxation (direct & indirect) and elevated inflation rates. Note that the Q1 GDP report for Greece recorded a positive growth reading (+1.5% yoy) for private consumption for the first time in five consecutive quarters. Retail sales in volume terms also posted positive growth in Q1:2010 (+5.9% yoy) despite the domestic recession and the skydiving of consumer sentiment over that period. In our view, that consumer spending resilience was partially due to special factors (e.g. consumers' anticipatory spending ahead of the recent hikes in VAT rates & special consumption taxes as well as spending ahead of the Easter holiday in early April). However, it was also a reflection of the government's measures to reign in tax avoidance, which appears to have boosted VAT filings in Q1.

In the industrial sector, total output contracted by an average year-on-year rate of 4.8% in Q2 despite higher industrial goods exports, while the headline PMI index stood at 45.3 in July, up from 13-month low of 41.8 hit in May but still in a contractionary territory. Last but not least, the deep recession in the domestic housing sector continues, with the number of building permits declining by a further 7.5% yoy year-to-May. All in all, we expect the pace of domestic economic contraction to accelerate to -4% YoY or higher both in Q3 and Q4 2010, though we stick the -4.0% figure for the full-year envisioned in the EC/EU/IMF baseline scenario. For next year, we currently see downside risks to the -2.6% YoY GDP growth baseline forecast. On a more positive note, we continue to expect medium-term growth to outstrip the IMF´s baseline scenario projections by at least 0.5ppts /annum for a number of structural reasons we have already analyzed in a number of recent research pieces.[3]

Domestic inflation running high due to indirect tax hikes; rapid disinflation to resume in H2 2011

Domestic inflation accelerated further in July, reaching 5.5% YoY, reflecting unfavorable base effects relating to evolution of domestic fuel prices since the same period a year earlier and the impact of a range of aggressive hikes in VAT and other indirect taxes as part of the fiscal adjustment effort. The EC/ECB/IMF stabilization program for Greece initially forecasted very low inflation rates in 2010-2011 despite the increase in indirect taxes; the troika has already acknowledged this misjudgment and they recently revised their 2010 inflation projection from 1.9% to 4.7%. We broadly agree with the latter forecast, though we see some upward risks to that projection *(see graph)*.



[3] See for instance Eurobank EFG Research "How much did competitiveness of the Greek economy decline since EMU entry?", *July 2010.*

Just to mention one such risk, note that the heating oil component enters the calculation of the national CPI figure in the last quarter of the year and with heating oil prices currently running at 40% YoY we expect the corresponding impact to be a 0.5ppts boost to year-on-year headline inflation. Although higher-than-projected domestic price pressures can help to inflate-out public debt, persistently higher inflation relative to main trading partners (especially in the tradable sector) is bad for competitiveness. As such, it is not a coincidence that one of the main stated aims of the EC/ECB/IMF stabilization program is to promote an "internal devaluation", especially in view of the fixed nominal exchange rate. On that front, we continue to expect significant competitiveness gains to the economy in the period ahead thanks to the rapid decline in unit labor costs. Moreover, although we remains somewhat worried about the degree of pass-through of the recent tax hikes to the final consumer, especially given the domestic recession, we expect disinflation to resume next year, especially from H2.

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