Athens, October 6, 2010

Focus Greece: Latest macro developments

Highlights

- European Commission to revise Greek 2006-09 fiscal data; revisions unlikely to cause significant adjustments to future budget deficit and debt projections
- Year-to-August central government cash deficit down 28%yoy, slower pace of improvement relative to the first seven half of this year likely to prove temporary
- Moody's sees upside risk to Greece's sovereign credit ratings
- China offered to buy more Greek government bonds
- Greek PM urges for banking sector consolidation; Piraeus Bank withdraws offer for TT, ATEbank
- EMU sovereign debt spreads narrow sharply; Greece outperforms

European Commission to revise Greek 2006-09 budget deficit and debt figures

The European Commission said today that Eurostat will soon revise upwards Greece's budget deficit and public debt figures for 2006-2009. The news does not come as a complete surprise as the Commission had earlier (April 2010) signaled the possibility of further upward revisions to Greek 2009 deficit and debt figures by 0.3-0.5ppts and 5-7ppts of GDP, respectively. Meanwhile, a number of reports circulated in the local press earlier today suggested that the EU stats agency is about to revise the 2009 Greek general government deficit to 15.1%-of-GDP, from 13.8%-of-GDP estimated earlier, while the corresponding public debt ratio will be also raised to 127%-of-GDP, from 115.4%-of-GDP. These revisions will be due to a) the reporting of deficits and debts of a number of public organizations b) the realization of various other debt items, hidden previously by swap contracts.

In view of the aforementioned, the 2011 draft budget reportedly contains a number of "grey areas" that need to be clarified in the final budget to be submitted in Parliament in mid-November. Such problematic areas include:

- The expected – but still unknown – size of the forfeiture of bonds issues by organizations in the broader public sector.
- Uncertainties related to the annual fiscal balances of local governments and, to a lesser extent, the respective accounts of hospitals and social security funds, given the lack of relevant public data.
- Uncertainty about the final size of the upcoming upward revisions to past fiscal data

Government sources stated that these revisions will not cause any changes in the deficit and debt targets for 2010 and the following years, with the government currently seeing no need for additional measures to address the upwards revisions. Our take on the above is as follows:

If today's press reports on the size of imminent revisions to Greece's past deficit and debt figures prove accurate, then the revisions will clearly fall on the upper side of market expectations. Yet, we believe that the government has already taken these revisions into account when preparing the 2011 draft budget released earlier this week. That may helps to explain why the 2011 draft budget forecasts a higher debt ratio next year relative to that projected in the EC/ECB/IMF baseline scenario (142.2%-of-GDP vs. 139.4%-of-GDP). This is despite the fact that the new budget's underline assumptions about GDP and inflation in 2010 and 2011 are exactly the same with those in the EU/IMF baseline, while, at the same time, the government has set a deficit target for 2011, which is lower than projected by the troika.

Furthermore, according to our calculations, the baseline projections of the EC/ECB/IMF stabilization program already incorporate certain upward revisions to Greece's past fiscal data (by as much as 7ppts in the 2009 debt ratio). As a result, we do not expect any major revisions to either the government's or the troika's projections regarding the future evolution of the Greek deficit and debt ratios.

January-August central government deficit undershoots target thanks to lower expenses.

According to the final budget execution data for the January-August 2010 period, the central government gap narrowed by 32.2% yoy, exhibiting a lower pace of improvement relative to that in the first seven months of the year (-39.7% yoy). Yet, it was still better than a government target for a year-to-August deficit reduction of -26.5% yoy, helping to generate an overall cushion of ca €1.22bn (~0.9%-of-GDP) that could be utilized to cover any execution slippages during the remainder of the year. Of components, ordinary budget revenue rose by 3.4% yoy year-to-August, coming below a full-year target of +13.7% yoy mainly as a result of weaker-than-expected tax receipts. In particular, VAT receipts for the January-August period stood at €11.54bn, compared with a target of €19.01bn for the full year.

The government expects a pick up in the growth of VAT revenue in H2-2010, given that the latest installments of VAT rate hikes and the recent increases in a range of special consumption taxes on cigarettes, alcoholic beverages, fuels and various luxury items did not come into effect until July 1, 2010. Notably, the August data showed an acceleration in the growth of VAT receipts to 10.8% YoY from -3.9% YoY in the prior month, while according to the finance ministry, this important revenue category recorded growth of 16.9% YoY in September (official data not out yet). Besides a wide range of measures introduced earlier this year to boost tax revenue, the government expects budgetary receipts to derive further support in the following months by a number of additional measures, which, among other items, include a new scheme to settle outstanding tax liabilities to the state. The latter is expected to become operational before year-end and to bring some €3.5bn (1.5pps-of-GDP) of additional inflows to state coffers over the next 12 months (official forecast).

On the expenditure side, the January-August budget execution data showed a 7.6%yoy decline in ordinary budget outlays, outperforming the -5.5%yoy full-year target. In particular, primary expenditures decreased by 12.1%yoy against an annual targeted decline of 5.8%yoy, while interest costs grew by 6.6%yoy against a 5.6%yoy projected increase. All in all, we stick to the view that this year's general government deficit target of 8.1%-of-GDP is attainable, as the government's strong performance in cutting expenditure is likely to more

than offset any revenue-side slippages and/or cost overruns in the sub-government sector i.e., public hospitals, municipalities and other state-controlled entities[1].

Central government cash deficit down 28%yoy year-to-August. According to the most recent data on the central government borrowing requirement released by the Bank of Greece (BoG), the cash deficit was down 28%yoy in January-August 2010, a slower pace of decline relative to the -32.6%yoy reading recorded in the first seven months of the year. According to the ministry of finance, the slowdown is likely to prove temporary as it is mainly due to the lower-than-expected tax revenues and increased interest costs over the summer months. Note that interest payments in July-August covered ca 40% of the corresponding full-year bill. The overall cash deficit of the central government deficit fell to €15.76bn in the first eight months of this year from €21.89bn in the same period in 2009, while the full-year target for 2010 stands at €17.8bn. Of components, ordinary budget revenue on a cash basis rose by 3.4%yoy to €32,814mn in January-August from €31,691mn in the same period last year, while ordinary budget expenditure decreased to €43,519mn compared with €47,993mn in January-August 2009.

Moody's sees upside risk to Greece's sovereign credit rating

Soon after Greece unveiled an ambitious 2011 draft budget which aims to reduce the budget deficit to 7.0%-of-GDP, a senior Moody's analyst said that the rating agency is "impressed" by the government's efforts on the fiscal consolidation front. The analyst added that risks to Greece's sovereign rating "is to the upside", if the reforms effort continues. Moody's downgraded Greece's long-term sovereign rating by four notches into junk-status on June 14, 2010 (to Ba1 from A3), citing concerns that the country could fail to meet its obligations to cut its deficit and pay out its debt. On a less positive note, Fitch's senior analyst for Greece warned a couple of weeks earlier that "the country is clinging on to its investment grade rating but just by a fingernail", adding that the rating agency would take a "long hard searching look" when it visits the country, probably by the end of October. Fitch cut its rating for Greece by two notches to BBB-, on April 14, 2010, the lowest investment grade rating and retained a negative outlook signaling that further downgrades are possible, amid intensified fiscal challenges in the crisis-hit country. We expect positive rating action on Greece by major rating agencies next year, conditional on the country continuing to deliver strong performance in implementing the aggressive reforms program agreed with its EU partners and the IMF in early May.

China offered to buy Greek government bonds

Chinese Premier, Jiaboa Wen, offered Greece a strong vote of confidence during a two-day visit to the country late last week. Speaking to the Greek Parliament, Mr. Wen emphasized China's commitment to assist the fiscally-vulnerable EU country to overcome the debt crisis by supporting the Greek shipping industry and boosting trade ties. The two countries signed 13 bilateral agreements covering areas such as maritime transportation, telecoms and exports, while the Chinese Premier suggested that bilateral trade volume could double in the next five years, reaching $8bn annually. Mr. Wen also said that China is holding Greek government bonds already bought and will continue supporting Greece by participating in bond auctions, once the country returns to primary bond markets. The Chinese Premier did not specify how much Greek debt China would be willing to buy or which Chinese entities would purchase the government bonds.

[1] For more analysis on the attainability of the fiscal targets for this year and the next see Eurobank EFG Research, "2011 budget draft: deficit target attainable", October 5, 2011.

Greek T-bill action attracts solid demand

Greece successfully sold €300mn of 13-week T-bills on September 21, 2010, capitalizing on growing investor confidence over the pace of implementation of the country's fiscal adjustment program. The auction produced a yield of 3.975%, lower than 4.05% when bills with a similar maturity were issued on July 20. Greece's PDMA announced that about 72% of the T-bills auctioned were purchased by foreigner investors. Investors bid 6.25 times the bills offered compared with a bid-to-cover ratio of 3.85 in the July auction. This was the country's second T-bill auction since it announced in late summer a switch from quarterly to monthly T-bill auctions. Greece's €1.17bn sale of 26-week T-bills in early September also attracted solid demand, pointing to improving market conditions for an eventual return to primary markets.

Greek PM urges for banking sector consolidation; Piraeus Bank withdraws offer for TT, ATEbank

In a briefing to reporters late last month, Greek PM, George Papandreou, urged the country's banks to consolidate, while stressing the need for the existence of at least one state-owned bank. The Greek PM reiterated the government's commitment to structural reforms and ruled out once again any debt restructuring scenarios. The Greek government appointed in late August three foreign banks (HSBC Holdings PLC, Deutsche Bank and Lazards Ltd.) as advisers to instruct it on how to better exploit its stakes in the domestic banking sector. Ever since Piraeus Bank bid for state-controlled ATEbank and Hellenic Postbank (TT) in early summer (public stakes of 77% in the firmer and 33% in the latter), there has been a wave of rumors regarding potential mergers and acquisitions in the banking sector. But Piraeus Bank's deputy CEO announced a few days earlier that the bank withdrew its offer to buy government stakes in ATEbank and Hellenic Postbank, noting that such a decision is not to be made in the immediate future. According to press reports, the government will push back the publication of its advisors' assessment regarding its options with its banking assets, and will only release them following the upcoming municipal elections on November 7.

Greek FinMin denies debt restructuring scenarios

In a recent interview to Financial Times, Greek FinMin Papaconstantinou denied anew a debt restructuring scenario for Greece, underlying that a default would be catastrophic for the country and create contagion effects on other EMU sovereign bond markets. Furthermore, Mr. Papaconstnatinou cited that the government's prime objective is to return the economy to primary budget surpluses and sustainable output growth, facilitating a restoration of investor confidence and regaining access to capital markets. The Greek Fin Min expressed his optimism that GDP contraction in 2010 is likely to be milder than 4.0% projected in the IMF/EU baseline scenario as tourism receipts, one of the country's main revenue resources, is seen declining by only "a single digit" this year.

A possible extension of Greek aid package?

According to press reports, the IMF does not rule out the possibility of extending Greece's €110bn rescue package after 2013 if the country fails by then to restore investor confidence. The potential of rescheduling repayments were also mentioned. As a condition though, Greece would have to fully implement the agreed EU/IMF adjustment program. Nevertheless, the articles stated that the IMF expects Greece to be able to tap international markets by that time thus, removing the need for a program extension. Officials in Greece and the European Union denied the aforementioned press reports. Greece has been virtually shut out of the international credit markets since an explosion of its sovereign bond spreads earlier this year raised funding costs to unbearable levels. The EU/IMF rescue package allows Greece to stay away from bond markets until Q1 2012, but the government intends to continue issuing T-bills on a monthly basis for rolling-over maturing short-term paper.

Greece plans "Diaspora Bonds" to tap Greeks abroad

In an interview to Bloomberg Television in mid-September, Fin Min Georges Papaconstantinou announced that Greece plans the issue of a so-called "diaspora bond" to tap Greek money abroad as the country is slightly behind in terms of revenue collection due to the ongoing domestic recession. The Diaspora Bond Plan is scheduled to be ready by the end of this year. We believe that the indented undertaking is in the right direction but expect more info on issuance volume and other bond characteristics to form a better assessment.

Greek bank stress test postponed

The EC/ECB/IMF "troika" agreed with the Bank of Greek to postpone testing the liquidity and solvency position of domestic banks by one month to the end of October, as it would fall too close in time to the EU-wide stress tests conducted in July and thus, provide little new information. Out of the 91 European banks that were subjected to the EU-wide stress conducted by the Committee of European Banking Supervisors, there were six Greek banks including National Bank of Greece, Eurobank EFG, Alpha Bank, Piraeus Bank, Hellenic Postbank and Agriculture Bank of Greece. The sole laggard turned out to be Agricultural Bank, whose capital fell short by €242.6mn from the required level under a worst-case scenario envisioning a much deeper economic downturn along with a major shock to interest rates and heavy losses on its loans and government bonds portfolio.

Government appoint board of Financial Stability Fund

The Greek government announced that the €10bn domestic Financial Stability Fund (FSF), part of the €110bn EU/IMF rescue package, will be headed by Mr. Thomopoulos, who served as BOG Deputy Governor from October 26, 1994 to March 3, 2009. The rest of the 7 board seat will be held by experienced professional, academic and political authorities from the ministry of finance. Greek banks will be required to turn to the FSF if their capital adequacy falls below minimum levels set by the central bank and they cannot raise the necessary funds from markets. The FSF will inject capital by buying preferred shares the banks will issue. Banks will have up to five years to buy back their preferred shares at the issue price. Beyond this time limit, they will face a penalty surcharge on the buyback. If banks still cannot repurchase the shares after five years and are unable to meet capital requirement, the shares will be converted into ordinary stock empowering the FSF to require a restructuring to make the bank viable.

Greece, Qatar sign $5bn Investment Memorandum

Greece and Qatar assigned an Investment Memorandum worth $5bn over the next few years. Both countries are expected to set up a joint committee to identify possible investment projects in tourism, real-estate development, infrastructure, finance and energy. No specific projects have been identified by the two states at this initial stage. Press reports suggested that Qatar Investment Authority could be interested in the development of the site of the former Hellinikon Airport. The above followed a similar Investment Memorandum in May which included the construction of a liquefied natural gas terminal and a power station at the western Greek port city of Astakos. We see these developments as particularly encouraging in a period when the country needs to boost FDI inflows and generate additional revenues from the sale/better management of state assets to help finance its debt and net external position.

Ongoing domestic recession, tight lending standards curb consumer spending

Greek retail sales by *volume* continued to decline in July at an accelerating pace compared to the prior month, falling by 9.7%yoy from June's 4.4%yoy. The data point to a further slump in consumer spending in Q3 as wage restrain and higher taxation (direct & indirect) continue to strain disposable incomes. Following

a 1.2%yoy increase in the *nominal* level of retail sales in June, thanks to the discounts season in retail establishments and anticipatory consumer spending ahead of the new VAT rate hikes on July 1st, sales resumed their downtrend in July falling by 3.7%yoy. In a similar vein, Greek consumer sentiment, as measured by the Foundation for Economic and Industrial Research (IOBE), worsened in September coming in at 66.6 from 67.9 points in August. Furthermore, the unemployment rate climbed to a 10-yr high of 11.8% in the second quarter this year from 11.7% in the January-March period, while the government expects the jobless rate to increase to levels above 11.4% in 2011.

Greek manufacturing activity continued to contract in September, albeit at a slower pace
Greek PMI-manufacturing continued to contract in September coming in at 44.7 from 43.0 in the prior month, staying firmly below the boost-or-burst threshold of 50. Adding to the negative tone of the report, the new orders component decreased sharply while the new business sub-index fell for the 13th straight month. Outstanding business dropped for the 27th month in a row, but the rate of decline eased slightly from the prior month.

Domestic bank deposits halt a seven month declining streak
Bank deposits grew by 0.34%mom in August to €213bn, registering the first monthly increase after seven straight months of outflows. In spite of the August rise, deposits are still down by 10.5% yoy (or €24.9bn) year-to August. Shrinking deposits since the beginning of the year have added to the strains of Greek banks, which became heavily reliant on ECB funding for their liquidity needs. We interpret the August reading as a first tentative sign of stabilization in the domestic depositor base and expect the improvement to continue in the following months, albeit at a moderate pace.

Credit slowed further in August
According to the latest data provided by the Bank of Greece, growth of household borrowing weakened further in August, coming in at 0.6%yoy from 1.0%yoy in July. Home loans grew 1.6%yoy, a lower pace compared to a 1.9%yoy increase in July while consumer credit continued to contract 1.5%yoy after shrinking 1.1%yoy in the prior month. Credit growth to businesses also slowed to 2.3%yoy in August from 3.4%yoy in July. For the full-year, we expect annual credit growth to the domestic private sector to broadly stagnate or even contract relative to last year, given the domestic recession and lingering difficulties' in the funding conditions of domestic banks.

EMU sovereign debt spreads narrow sharply; Greece outperforms
Yield premiums of EMU periphery sovereign bonds vs. their German counterparts moved sharply lower over the last few sessions on easing fiscal worries. The Irish authorities provided last week the long awaited details regarding the cost of bailing out its domestic banking sector. According to a base-case scenario, the Irish central bank estimates capital need of nearly €50bn, higher-than-initially estimated. This is seen lifting this year's budget deficit to an astonishing 32%-of-GDP from nearly 14.5%-of-GDP in 2009. However, the Irish finance minister underlined that the government remains committed to meet its 3.0%-of-GDP deficit target by 2014 and made clear that there is currently no need to raise additional funds from the capital market to fund the required capital injection. Ireland has even cancelled two scheduled debt auctions in October and November, as its borrowing needs are covered until mid-2011, a development that allayed market worries about an imminent IMF/EU assistance package.

In Portugal, after 2011 budget talks stalled twice last week (2011 budget to be submitted on October 11), the minority government seems to come closer to a deal with the opposition after it announced a new series of austerity measures focusing on lower spending rather than increased revenue. Adding to the recent

positive news flow for EMU sovereigns, Moody's downgraded Spain's sovereign rating by once notch to Aa1, less than some market participants feared, with the outlook rated as stable. Reduced reliance on ECB liquidity at last week's funding operations was perceived as a positive sign regarding the state of the European banking sector. In addition, a string of positive macro data from China over the last few sessions alleviated worries over the outlook of the global economy and helped to boost investor sentiment towards EMU sovereigns.

Greece outperformed in the sovereign bond space over the last few sessions, with secondary market volume on the HDAT platform moving significantly higher. Supportive comments from the Chinese Premier, Moody's remarks regarding upside risks to Greece's rating outlook and a Bloomberg report suggesting that a number of big European and US investment banks are advising clients to purchase Greek government securities also had a positive impact. Short-dated Greek government bonds outperformed longer maturities in recent sessions, with the 2/10-yr segment of the GGB yield curve standing early this week close to its widest levels in 7½ months, after inverting temporarily in early September. With the 10-yr Bund yield standing some way off record lows near 2.10% touched in late August, the 10-yr GGB/Bund yield spread moved below 800bps last Friday for the first time since mid-August (levels around 770bps tested earlier today).

The corresponding Irish and Portuguese spread narrowed by some 40bps each from fresh all-time highs recorded in late September. News that Moody's placed Ireland's sovereign rating under review for a possible downgrade, failed to push spreads markedly wider (S&P and Fitch are already one notch lower than Moody's, AA- against AA). Not surprisingly, the costs of insuring government bonds against default in EMU sovereigns also declined significantly in recent sessions. Greece is expected to continue outperforming other periphery markets in the short-term as the government remains strongly committed to aggressive fiscal consolidation and upcoming data will likely boost optimism that the 2011 deficit target is indeed attainable. The technical picture for the 10yr-GGB/German Bund yield spread suggests that a clear move below 750bps (August lows) has the potential to open the way for further narrowing towards 650-600bps. Should a sustainable break below 750bps fail, consolidation within 800-850bps is likely to prevail in the short-term.

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Table: EMU periphery yield and spread levels

10-yr Government bond yields	Today, October 6 (13:00 local time)	All-time closing highs recorded this year	Change vs. all-time closing highs (in bps)
Greece	9.89%	12.45% *	-256.2
Portugal	6.18%	6.51% **	-33.2
Spain	4.03%	4.88% ***	-85.0
Ireland	6.36%	6.74% ****	-37.8

* *early May 2010*
** *late -September 2010*
*** *mid-June 2010*
**** *late September 2010*

10-yr Periphery/Bund yield spread (in bps)	Today, October 6 (13:00 local time)	All-time closing highs recorded this year (in bps)	Change vs. all-time closing highs (in bps)
Greece	762.92	965.26 *	-202.34
Portugal	391.90	426.7 **	-34.80
Spain	177.30	221.17 ***	-43.87
Ireland	410.10	449.4 ****	-39.30

* *early May 2010*
** *late -September 2010*
*** *mid-June 2010*
**** *late September 2010*

5-yr CDS	Today, October 6 (13:00 local time)	All-time closing highs recorded this year (in bps)	Change vs. all-time closing highs (in bps)
Greece	750.16	1008.35	-258.19
Portugal	392.15	443.06	-50.91
Spain	226.86	267.07	-40.21
Ireland	431.12	485.10	-53.98

Source: Bloomberg

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