Athens, September 14, 2010

Focus Greece: Latest macro developments

Highlights

- **Pace of state-deficit reduction slowed in August as a result of weak revenue growth, increased interest costs**
- **Budget revenue growth continues to underperform official targets…**
- **…but drastic expenditure cuts keep government on track to meet full-year deficit target.**
- **Government is strengthening efforts to increase tax compliance**
- **Greek T-bill auction attracts solid demand**
- **PM reassures no additional austerity measures are needed, expresses confidence over deficit targets**
- **Pace of economic contraction accelerated in Q2**

Part I -

Latest fiscal developments

✓ **Pace of state-deficit reduction slowed in August as a result of weak revenue growth, increased interest costs.** The latest state-budget execution data released by the general accounting office (GA0) revealed a 32.2% YoY reduction in the central government deficit over the first eight months of the year[1]. This compares unfavorably with the corresponding decline in the state deficit in January-July (-39.7% YoY) as well as the official target for the full year (-39.5% YoY). Yet, it is still better than the 26.5% YoY deficit reduction expected by the government over the first eight months of 2010. The latter helped to generate an overall cushion of ca €1.22bn (~0.9%-of-GDP) that could purportedly be utilized to offset any expenditure overruns in the broader public sector. According to the ministry of finance, the slowdown in the pace of improvement (i.e., reduction) in the state budget deficit in July-August is likely to prove temporary, as it is mainly due the lower-than-projected tax revenue growth and increased interest costs over that period. According to the finance ministry, interest payments in July-August accounted for ca 40% of the corresponding full-year bill.

✓ **Budget revenue growth continues to underperform official targets…** Ordinary budget revenue in the first eight months of the year continued to undershoot official projections, with the corresponding

[1] The budget execution figures so far released by the GAO relate to the central government deficit that excludes spending by local government, hospitals, social security funds and other state-controlled entities. Under the EC/ECB/IMF stabilization program, Greece has a commitment to also start providing timely data for the broader public sector i.e., the general government (structural benchmark for end-September 2010).

year-on-year growth rate slowing to 3.3%yoy, from 4.1%yoy in January-July and against a full-year target of +13.7% YoY. Note that the General Accounting Office has not yet published a detailed breakdown of the budget execution data for August, but it is clear that the revenue underperformance that month was due to, among other factors, weaker-than-expected growth in VAT receipts. The latter recorded broadly flat year-on-year growth in the first seven months of the year, despite higher rates in a range of special consumption taxes on fuels, cigarettes, alcohol and various luxury items instrumented earlier this year. Whatever the reason for that underperformance might be, we should see tax revenue growth picking up pace in the following months to be convinced that the government's efforts to track down tax avoidance has started to bear tangible results. On its part, the government expects revenue growth to pick up pace in the period ahead, boosted by the most recent VAT rate increase (July 2010), proceeds from taxing big real estate assets and measures to rein in tax evasion (penalties imposed to tax evaders generated more than €2.5bn so far this year).

- ✓ **…but drastic expenditure cuts keep government on track to meet full-year deficit target.** On a more optimistic note, state budget spending in the January-August period continued to undershoot official targets, mainly thanks to steep cuts in ordinary budget primary spending (-12% YoY vs. a full-year target of -5.5% YoY). The government intents to maintain this over performance to the end of the year, aiming to generate a cushion of €4bn so as to cover risks stemming from other parts of the general government.[2] To that end, expenditure containment in the period ahead will primarily focus on operating and consumptions expenses as well as measures to strengthen cost compliance in the broader public sector. The progress in cutting state outlays has indeed been quite impressive thus far, especially with respect to ordinary budget's primary expenditure. The latter has traditionally been the most inelastic component of overall government expenses in recent years, regularly overshooting the corresponding annual targets as a result of untargeted government spending and, primarily, a ballooning bill for wages and pensions. With the latter now expected to contract by as much as 15% YoY this year, it is not entirely surprising that a sizeable reduction in primary outlays remains the main driver of fiscal adjustment. Drastic cuts in the government's operating expenditure (down by ca 50% YoY year-to-July) and lower-than-expected public investment spending (-32.8% YoY vs. a -4% YoY full-year target) are also facilitating the fiscal adjustment effort. All in all we continue to look for a fulfillment of the 8.1%-of-GDP target for the general government deficit this year, with higher-than-expected expenditure cuts helping to offset any slippages on the revenue side and/or expenditure overruns in the broader public sector.

- ✓ **Government is strengthening efforts to increase tax compliance.** Along with its ongoing efforts to increase tax compliance (e.g. use of payment receipts and the cross-checking of tax information with data on wealth and spending habit), the government is planning to introduce by the end of this month five dedicated tax forces in a move to strengthen its fight against tax evasion. The primary aim of these will be to ensure prompt implementation of the new tax legislation, collect outstanding tax arrears, reorganize the large tax payers unit, strengthen the audits for high-wealth individuals and strengthen filing and payment controls, and improving tax payer services. Along these lines, the finance ministry has lately signaled that the government is looking for alternative ways to compensate for a possible decision to cancel an earlier-planned transfer of a number of products/services from the 11% VAT category to the standard category of 23%. The measure involves the transfer of ca 30% of products and services currently under the 11% category, with the aim to bring additional revenue of ca €1bn/annum to state coffers. According to reports, one alternative measure could reportedly be the

[2] *e.g.* related to an undesirable buildup in accounts payable/arrears in hospitals and social security funds experienced in the first months of the year.

equalization of the heating oil tax with that currently applied to motor fuels, but noting official on the issue has been announced yet.

Part II -

Other macro and market developments

Greek T-bill auction attracts solid demand

Greece kicked off earlier today its new monthly program of T-bill auctions, successfully selling €1.17bn of 26-week T-bills, including €270mn in non-competitive bids. The auction produced a yield of 4.82%, almost in line with market expectations. Investors bid 4.54 times the bills offered compared with a bid-to-cover ratio of 3.64 in the July auction. The main bulk of the issue was probably absorbed by domestic banks as they can use the T-bills as collateral to borrow funds from the ECB. A total of €190.5mn of 10-year government bonds expires on September 29, while an additional €783.4mn in coupon payments is due by the end of the month. Overall principal and interest payments for the remainder of the year amount to €2,156.5mn. The debt management agency announced last month a switch from quarterly to monthly T-bill auctions as of September, 2010 aiming better cash management and more leeway. The EU/IMF bailout plan allows Greece to stay away from bond markets until Q1 2012, but the government intends to continue issuing T-bills, for rolling-over maturing short-term paper.

Greece receives 2nd loan tranche of EU/IMF support plan

Greece received earlier this week part of the second installment of funds under the €110bn EU/IMF bailout package, worth €6.5bn. Germany and France made the largest contributions providing €1.49bn and €1.12bn respectively. The country will also to have access to another €2.5bn of IMF funds (effective from Tuesday September 14). Greece has so far received €26.5bn of funding from the EU/IMF emergency package. Eleven more tranches will follow at three-month intervals, conditional on Greece's progress with respect to the execution of the stabilization program. In 2010, total IMF financing will amount €10.5bn and will be partnered with €27.5bn committed by EU states. Meanwhile, a delegation of IMF, EU and ECB officials arrived in Athens yesterday to hold preliminary talks with local authorities ahead of the next official review of the EU/ECB/IMF program. According to reports, discussions will focus on the FY2011 state budget, which will be submitted to parliament in early October.

PM reassures no additional austerity measures are needed, expresses confidence over deficit targets

During a press conference on the sidelines of the annual Thessaloniki International Fair last Sunday, Greek PM Georges Papandreou reassured that there will be no new austerity measures, provided that the fiscal consolidation program remains on track. Mr. Papandreou appeared optimistic that the government will meet the deficit reduction target this year and underlined anew that there is no question of Greece defaulting on its debt, given that such a move would be disastrous for the economy and the country's future. Furthermore, he announced a 4ppts reduction to 20% in the tax rate applied to companies' retained earnings, effective from 1.1.2011. All in all, the PM stressed that the government will mainly focus on successfully executing the EU/IMF-agreed stabilization program and announced that ex ECB Vice-President, Loukas Papademos, will be appointed as adviser on fiscal and economic policy issues.

Greek FinMin and the "troika" to hold a joint road show

Greek officials along with representatives from the IMF, the European Commission and the ECB are scheduled to start later this week a joint road show in several European capitals in an effort to restore investors' confidence in the Greek economy. Finance Minister George Papaconstantinou will head the delegation accompanied by Public Debt Management Agency chief Petros Christodoulou. The road show will take place in London, Paris and Frankfurt. In an interview earlier this week, Mr. Papaconstantinou appeared confident about the deficit-reduction target for this year, adding that this would facilitate Greece's return to financial markets as early in 2011. In a related move, Norway's $450bn Government Pension Fund Global –which manages the country's oil and gas wealth- announced earlier this month that it has stocked up on Greek debt –as well as bonds of Spain, Italy and Portugal. Moreover, Norwegian Finance Minister, Sigbjoern Johnsen, said that his government backs this strategy on the view that Greece will not default on its debt.

ECB funding to Greek banks edged down in August

According to Greek Central Bank data, ECB funding to Greek financial institutions decreased to €95.9bn by the end of August from €96.2bn at end-July, the first decline in recent months. However, Greek banks continue to relay heavily on ECB funding as they have suffered deposit outflows over the last few months and have recently lost access to interbank lending markets due to the lingering sovereign debt crisis.

Eurostat head complains on hidden Greek swap deals

Head of the European Union's statistics agency, Walter Radermacher, cautioned earlier this month that Greece has still not disclosed the full details of secret financial transactions it used to conceal debt. The Eurostat official noted that "the Goldman Sachs was the beginning" and that "there are more, or even many, of this kind of swap operations, which we have to clarify". According to a February 21 statement by Goldman, the swaps signed with the bank in December 2000 and in June 2001 reduced Greece's foreign denominated debt by €2.367mn and lowered debt as a proportion of GDP to 103.7% from 105.3%. Recall that Eurostat revised in April Greece's 2009 general government deficit and debt ratios to 13.6%-of-GDP 115.1%-of-GDP, respectively from 12.7%-of-GDP and 112.6% reported earlier. In spite of these revisions, the agency expressed reservation over the quality of data reported by Greece due to "uncertainties on the surplus of social security funds for 2009, on the classification of some public entities and on the recording of off-market swaps". Eurostat warned in April that Greece's 2009 deficit and debt ratios could be revised further upwards by 0.3-0.5ppts-of-GDP and 5-7ppts-of-GDP, respectively.

Greece slips 12 positions in WEF's competitiveness list

The World Economic Forum published its country rankings based on WEF's competitiveness index last week, according to which Greece fell to the 83rd place out of 139 countries, down from 71st in 2009, reflecting a worsening domestic macro-economic environment. Switzerland remained at the top of the list, followed by Sweden (up from the 4th place in 2009), Singapore, the US (down from 2nd place in 2009) and Germany (up from the 6th place in 2009). Greece ranked 84th in institutions, 42nd in infrastructure, 123rd in macro-economic environment, 40th in health and education, 42nd in higher education, 94th in market efficiency, 93rd in financial market development, 46th in technological readiness, 39th in market size, 74th in the specialization of enterprises and 79th in innovation.

Pace of economic contraction accelerated in Q2

The pace of domestic economic contraction accelerated further in the second half of this year, with real GDP growth coming in at -1.8/3.7% QoQ/YoY, from -0.8/2.3% QoQ/YoY in Q1:2010. Of components, growth in gross fixed capital formation was -18.6% YoY in Q2, while investment spending on residential housing and machinery & equipment declined by 19.3% YoY and 10.6% YoY, respectively. Total consumption in constant prices was 5.1% YoY lower, reflecting sharp declines in both private and public spending (down by 8.4% YoY and 4.2% YoY, respectively). With respect to external-sector developments, the trade deficit contracted by 28.1% YoY in Q2 relative to the same quarter of 2009, as imports contracted faster than exports (-13.5% YoY vs. 5.0% YoY). All in all, we expect the pace of domestic economic contraction to accelerate further in H2:2010. For the full year, we stick to the -4.0% forecast envisioned under the EC/EU/IMF baseline scenario. For next year, we currently see downside risks to the -2.6% YoY baseline GDP growth 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.

Greek unemployment slightly down in June, but still at elevated levels

Greek unemployment rate eased to 11.6% in June, from 12.0% in the prior month, mainly as a result of a seasonal increase of temporary employment in the tourism industry. However, on an annual basis, the June rate, which was the fourth-highest in the 16-member euro zone, stood sharply higher compared to 8.6% in the same month of last year. In other news, industrial production dropped by 8.6% YoY in July, a higher pace of decline relative to June's -4.5% YoY. Last but not least, construction activity, measured by the number of building permits, plunged by 13% YoY in June following a 7.5% YoY drop in the prior month, adding to recent evidence of a continuing recession in the domestic housing market.

Greek sovereign debt spreads remain at elevated levels

Yield premiums of EMU periphery sovereign bonds vs. their German peers moved higher again early this week as investor concerns about the Eurozone growth outlook resurfaced following a decline in the key ZEW sentiment index to negative territory for the first time since March 2009. Poorly received Italy's 2015 and 2025 debt auctions, added to market jitters especially as heavy Eurozone government debt issuance lies ahead. This week's issuance calendar in the euro area features around €27bn of bond supply, higher compared to an average weekly supply of around €19.4bn year-to-date. All in all, the most recent price action suggests a lack of fundamental themes to offer bond markets a clear short-term direction. Against this environment, participants are expected to scrutinize closely forthcoming macroeconomic data releases from both sides of the Atlantic for more clues about the sustainability of the world economic recovery. Upcoming developments/events in the European banking sector are also expected to take centre stage. Until then, volatility is likely to prevail.

Table: EMU periphery yield and spread levels

10-yr Government bond yields	Today, September 14 (16:00 local time)	Change vs. recent multi-session closing lows (in bps)	Change vs. all-time closing highs recorded earlier this year (in bps)
Greece	11.43%	6.1	-101.8
Portugal	5.73%	5.5	-56.0
Spain	4.20%	16.2	-68.2
Ireland	5.86%	13.8	-15.2
10-yr Periphery/Bund yield spread (in bps)	**Today, September 14 (16:00 local time)**	**Change vs. recent multi-session closing lows (in bps)**	**Change vs. all-time closing highs recorded earlier this year (in bps)**
Greece	905.20	10.84	-60.06
Portugal	337.20	6.86	-16.86
Spain	178.60	7.20	-42.57
Ireland	347.50	8.40	-25.32
5-yr CDS	**Today, September 14 (16:00 local time)**	**Change vs. recent multi-session closing lows (in bps)**	**Change vs. all-time closing highs recorded earlier this year (in bps)**
Greece	919.5	2.04	-88.85
Portugal	330	9.47	-113.06
Spain	229.31	10.23	-37.76
Ireland	371.39	9.61	-3.04

Source: Bloomberg

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