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Focus-Greece
Latest macroeconomic and market developments

Highlights

- **Greek PM reshuffles cabinet in an effort to deal better with the lingering debt crisis**
- **EU Commission to approve 2nd loan installment to Greece**
- **January-August budget revenue reported short of expectations**
- **Domestic credit slowed further in July**
- **EMU periphery sovereign debt spreads widening again**

Greek PM reshuffles cabinet in an effort to deal better with the lingering debt crisis

Greek Prime Minister George Papandreou announced yesterday a broad cabinet reshuffle in an effort to strengthen his government's ability to deal with the lingering sovereign debt crisis. The move was signaled well ahead of time, as a number of cabinet members (3 deputy ministers), who decided to run for local office in the upcoming municipal elections on November 7, would need to be replaced. Local media reports have recently suggested that Mr. Papandreou would take advantage of the vote to conduct a wider cabinet reshuffle and thus, neither the announcement itself nor its timing had a significant market impact. As widely expected, Finance Minister George Papakonstantinou retained his post, while Economy Minister Louka Katseli was moved to the labor portfolio. Ms. Katseli will be replaced by public security minister Mihalis Chrysochoidis, who is understood to enjoy strong popular support and has some prior experience with economic policy issues.

ECB extends unlimited liquidity supply operations

In an effort to provide further support to the European banking sector, the ECB decided last week to extend its weekly and monthly full allotment/fixed rate refinancing operations, from mid-October to January 18, 2011. The ECB also announced that its 3-month refinancing operation will be extended for another three months to December 2010. According to the most recent data from the Bank of Greece, the cumulative ECB funding of Greek banks stood at €93.8bn in July, having risen by ca 89% from the end of last year.

European Commission approves capital support mechanism for Greek banks

European Union competition regulators approved last week a €10bn Financial Stability Fund (FSF) for Greek banks. The mechanism constitutes a structural benchmark under the €110bn EU/IMF rescue program. Greek banks will be required to turn to the FSF facility if their capital adequacy falls below minimum levels set by the central bank and they cannot raise the necessary funds from the market. 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 a bank that has tapped the facility cannot repurchase the preferred shares after five years and is unable to meet the capital requirement, its shares will be converted into ordinary stock, empowering the FSF to require a restructuring to make the bank viable.

Greek Fin Min confident on deficit targets

In an interview to a French newspaper late last week, Greek Finance Minister George Papaconstantinou reiterated his confidence that the government will meet the EU/IMF-agreed target of reducing the budget deficit to 8.1%-of-GDP this year from 13.6%-of-GDP in 2009. In these lines, EU Commissioner for Economic and Monetary Affairs Olli Rehn was quoted recently as saying that

"Greece has managed impressive budgetary consolidation during the first half of 2010 and has achieved swift progress with major structural reforms."

Debt management office to announce issue size of upcoming T-bill auctions

In line with the debt management agency's recent announcement regarding a switch from quarterly to monthly T-bill auctions as of this month, Greece is due to sell 6-month and 12-month T-bills on Tuesday September 14th. The exact issue size will be announced on Friday and, reportedly, it is expected to be around €1.0-1.5bn. Auctions of 26-week and/or 52-will bills will take place on the 2nd Tuesday of each month, while 13-moth bills will be supplied at the 3rd Tuesday of the month. It remains unclear whether the debt management agency plans to attempt a longer-term bond auction any time soon, but, certainly, current market conditions would argue against such a move. GGB/Bund spreads are currently some 140-480bps wider -- for the 10-year and 5-year on-the-run issues, respectively -- relative to early May, when the ECB announced its sovereign debt purchasing program.

Greek FinMin and IMF plan a joint roadshow

According to several domestic press reports, the Greek FinMin and IMF representatives are planning for a joint roadshow in Europe later this month. The roadshow is likely to take place in London, Paris and Frankfurt, in an effort to restore investors' confidence in the Greek economy for an eventual return of the country to primary bond markets sometime next year.

ECB President rules out Greece exiting the Eurozone

Speaking at a conference late last week, ECB President Trichet ruled out the possibility of Greece leaving the Eurozone as a result of its fiscal problems, saying that a return to the drachma could be the worst option for the country. In these lines, German Finance Minister Schaeuble said recently that Greece deserves respect for its efforts to cut its budget deficit. Separately in a recent report titled "Default in Today's Advanced Economies: Unnecessary, Undesirable and Unlikely", the IMF dismissed the idea of a Greek default, noting that over the past 30 years a number of countries managed to cut spending on a similar scale relative to that required for Greece without defaulting. The report also read that, although Greece is paying higher rates for new borrowing, the average borrowing rates are lower than those paid by developing countries that had defaulted.

Government appoints advisors for Piraeus Bank's offer

The Greek government announced last week that it appointed three foreign international banks (HSBC Holdings PLC, Deutsche Bank and Lazards Ltd.) as advisers to consult it regarding Pireaus Bank's offer to acquire government states in ATEbank and Hellenic Postbank. In response to government calls for restructuring in the Greek banking sector, Greece's fourth largest lender Piraeus Bank bid for state-controlled ATEbank and Hellenic Postbank (TT) in early summer. The offer stood at €701mn for the government stakes in the two lenders, 77% of ATEbank and 33% of TT. Reportedly, the advisors will submit their draft proposal on Wednesday, September 8.

EU Commission approved 2nd loan instalment to Greece

The European Commission formally approved yesterday its part of the second loan disbursement to Greece under the €110bn EU/IMF bailout package. After receiving €20bn in May, Greece officially requested in August a further €9bn (€6.5bn from the European Union and an additional €2.5bn tranche from the IMF). Under the existing program, the country is entitled to receive 11 more tranches at three-month intervals, conditional on its progress with respect to the execution of the stabilization program. Slovakia's share of €65mn willl be paid by other eurozone countries, following its refusal to take part in the Greek bailout scheme.

January-August revenues reported short of expectations

According to press reports, net ordinary budget revenues continued to underperform budget targets in August, with the corresponding annual growth rate in the first eight months of the year slowing to 3%yoy, from 4.1%yoy in January-July. Note that the General Accounting Office (GAO) has not yet published budget execution data for August, but it is clear that the revenue underperformance 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 VAT rates and the recent hikes in a range of special consumption taxes on fuels, cigarettes, alcohol and various luxury items (see additional analysis below). Despite these developments, 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 to state coffers additional revenue of around €1bn. According to reports, one alternative measure could reportedly be the equalization of the heating oil tax with that currently applied to motor fuels, but noting official on the issue has been announced yet. We reiterate our view that the government will be able to fulfill the 8.1%-of-GDP deficit target this year, as the cushion created by cutting state budget expenditure by significantly more than projected will fully compensate for any revenue shortfall and/or cost overruns in the broader public sector.

Recession takes its toll on consumer

Retail sales by volume continued to decline in June, albeit at a lower pace compared to the prior month. Sales (excluding fuels and motor lubricants) in volume terms fell by 4.9%yoy in June following a 7.2% yoy drop in the prior month, reflecting lower consumer spending as increased wage restrain and higher taxation (direct & indirect) continue to weigh on disposable incomes. Retail sales by revenue (inclusive of motor fuels and lubricants) rose by 1.2%yoy June after a 4.4%yoy decline in the previous month, deriving (temporary) support from higher year-on-year inflation, the commencing of the discounts season and some anticipatory spending ahead of the new VAT rate hikes on July 1st. Year-to-June, retail sales (excluding fuels and motor lubricants) in volume terms fell by 0.1% yoy, which compares with an 11.4% yoy contraction over the same period a year earlier. The significant slow down in the respective annual pace of contraction in H1:2010 can be mainly attributed to strong retail sales growth in Q1:2010 (+5.9% yoy in volume terms). The strong sales performance in the first quarter of this year has already proved temporary and reflects, among other factors, calendar effects and a general drive by domestic consumers earlier this year to collect retail sales receipts in order to claim the tax-exempt part of their income. We expect retail sales growth to remain in a negative territory throughout the second half of this year, given the deepening domestic recession, anemic credit creation and weak consumer sentiment (currently at record lows).

Domestic credit slowed further in July

With respect to domestic credit developments, the latest data provided by the Bank of Greece showed a further year-on-year deceleration in the outstanding balance of domestic FI loans to the domestic private sector. Specifically, the growth of private sector loans slowed to 2.0% yoy in July from 2.4% yoy in the prior month and 4.2% yoy in December 2009. Credit to domestic households and private non-profit organizations was 1.1% yoy in July compared to 1.6% yoy in the prior month, with mortgage loans growth easing to 1.9% from 2.3% and consumer loans to -0.7% yoy from 0.4% in June. Moreover, credit growth to domestic businesses stood at 2.8% yoy in July against 3.1% yoy a month earlier. For the full-year we expect annual credit growth to the domestic private sector to broadly stagnate or even contact relative to last year, given the domestic recession and lingering difficulties in the funding conditions of domestic banks.

Domestic bank deposits fell further in July

Bank deposits fell for a seventh consecutive month in July to €212.3bn (~ 90% of GDP). Year-to-July, the total pool of domestic deposits has contracted by €25.7bn, or ca 11% yoy, reflecting declining domestic economic activity and heightened depositor fears over a sovereign default in the period leading to the announcement of the €110bn EU/IMF bailout package. A move by a number of large depositors earlier this year to send money abroad due uncertainty related to the government's measures to reign tax evasion also played a role. It needs to be noted though, that a significant part of deposit outflows has been channeled to the foreign subsidiaries of Greek banks, thus effectively remaining within the system. Given subsiding default fears following the announcement of the EU/IMF rescue package in early May, it appears that the July drawdown in bank deposits was mainly the result of domestic households and businesses taping on their savings to cope with falling incomes. Furthermore, according to recent comments by high level bank executives, domestic deposits have broadly stabilized in August.

Greek manufacturing activity continues to deteriorate

Greek PMI-manufacturing index fell to 43.0 in August from 45.3 in the prior month, staying firmly below the threshold of 50 that separates growth from contraction. Off components, output and new orders contracted at an accelerated pace while companies continued to shed jobs for the 28th consecutive month (and at the fastest rate in nearly 1½ years). On a positive tone, export orders rose albeit slightly, marking the first increase in nearly a year.

August CPI steady at 5.5% yoy

Greek CPI came in at 5.5% yoy in August, remaining unchanged from a month earlier. This represents a 13-year high and reflects, mainly, adverse base effects and the impact of recent rate hikes in VAT and a range of special consumption taxes. In spite of the domestic recession, we expect price pressures to remain elevated throughout the remainder of the current year, with year-on-year CPI approaching 6% in the September-October period. With heating oil prices currently running at levels significantly higher from a year earlier, we expect the re-inclusion of heating oil in the CPI basket calculation to add, *ceteris paribus*, as much a 0.5ppst to headline inflation in the following couple of months. For the full year, we forecast average inflation to be slightly lower than 5% and expect a return to pronounced disinflation not earlier than in H2: 2011.

EMU periphery sovereign debt spreads widening again

After narrowing marginally earlier this month assisted by receding global double-dip concerns, EMU periphery sovereign debt spreads widened sharply this week on re-surfacing banking sector worries. An article in today's issues of the Wall Street Journal suggested that EU-wide stress tests missed banks' holdings of potentially risky government debt, a development that undermines their primary goal of reassuring investors about the soundness of the European baking system. The report read that some banks excluded certain sovereign bonds from their disclosures and that many reduced the sums to account for "short" positions they held in EMU periphery debt thus, failing to provide a comprehensive picture of their government-debt holdings. Separately, worries over the state of the Irish banking sector came to the fore once again following news that the Irish Finance Minister is due to meet with EC competition authorities and the ECB later this week to ask for an extension of the government's bank guarantees program. Comments to Bloomberg by Pimco Pacific Investment Management Co. fund manager Andrew Bosomworth that "Greece still faces a substantial default risk as insolvency prevents the nation from repaying its debt when its bailout program expires in three years" accentuated investors' bearish mode towards periphery debt markets. Separately, a BIS report published this week read that, even as Europe's sovereign debt crisis intensified early this year, European banks increased in Q1:2010 their overall exposure to the economies of Greece, Ireland, Portugal and Spain by $109bn. In the sovereign bond space, Ireland was among the main underperformers, with the 10-yr Irish/Bund yield spread hitting fresh all-time highs near 380bps yesterday reflecting mounting worries over the country's banking sector. The corresponding Greek spread soared to levels around 940bps, not far from record-highs recorded in May *(see table on page 5).* Not surprisingly, the costs of insuring government bonds against default in Portugal, Greece, Ireland and Span also jumped over the last few days.

Table: EMU periphery yield and spread levels - September 7, 2010

10-yr Government bond yields	Today, September 7 (13:00 local time)	Change vs. recent multi-session closing lows recorded earleir this month (in bps)	Change vs. all-time closing highs recorded earlier this year (in bps)
Greece	11.67%	38.2	-77.5
Portugal	5.77%	32.6	-51.3
Spain	4.06%	5.0	-82.2
Ireland	6.04% *	38.0	
*: fresh all-time highs			

10-yr Periphery/Bund yield spread (in bps)	Today, September 7 (13:00 local time)	Change vs. recent multi-session closing lows recorded earleir this month (in bps)	Change vs. all-time closing highs recorded earlier this year (in bps)
Greece	941.63	44.82	-23.63
Portugal	351*	26.49	
Spain	180.20	13.04	-40.97
Ireland	378 *	37.62	
*: fresh all-time highs			

5-yr CDS	Today, August 25 (17:00 local time)	Change vs. recent multi-session closing lows recorded earleir this month (in bps)	Change vs. all-time intraday highs recorded earlier this year (in bps)
Greece	914.19	22.29	-93.81
Portugal	321.82	26.09	-121.84
Spain	233.79	11.30	-33.28
Ireland	347.478 *	19.56	
*: fresh all-time highs			

Source: Bloomberg

Written by:
Platon Monokroussos
Assistant General Manager
Head of Financial Markets Research
pmonokrousos@eurobank.gr

Paraskevi Petropoulou
G10 Economist
ppetropoulou@eurobank.gr

Research Team:
Gikas Hardouvelis, *Chief Economist and Director of Research*
Platon Monokroussos, *Head of Financial Markets Research*
Paraskevi Petropoulou, *Economist*
Galatia Phoka, *Economist*

Sales Team:
Fokion Karavias, *Treasurer*
Nikos Laios, *Head of Sales*
Yiannis Seimenis, Ioannis Maggel, *Corporate Sales*
Stogioglou Achilleas, *Private Banking Sales*
Petropoulos Theodore, *Institutional Sales*
Karanastasis Kostas, *Retail Sales*

EFG Eurobank Ergasias, 8 Othonos Str,GR 105 57, Athens,Tel:(30210) 3718 906, 3718 999, Fax:(30210) 3337 190, Reuters Page: EMBA,Internet Address: http://www.eurobank.gr