Athens, August 26, 2010

Focus Greece: Latest macro developments

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A review of the progress made thus far in meeting the quantitative targets & structural benchmarks of the EU/IMF-agreed stabilization program

Government publishes updated version of Memorandum of Economic and Financial Policies (MEFP) under present EC/ECB/IMF loan facility.

Earlier this month, the Greek government published an updated version of the Memorandum of Economic and Financial Policies (MEFP) and the Memorandum of Understanding (MoU) agreed on May 2010 with the European Commission, the European Central Bank and the International Monetary Fund. The update describes the progress made so far in meeting the quantitative performance criteria and structural benchmarks of the 3-year stabilization program, providing the base for a disbursement of the second loan tranche under of the existing loan facility for Greece *(~€9bn in total, consisting of €6.5bn in bilateral loans by other euro area states and €2.5bn in IMF funding)*. The update also provides additional detail on the fiscal and structural measures already included in the original MEFP as well as additional steps the government plans to take with a view to increase tax compliance, strengthen tax collection and enhance its auditing & budgetary planning mechanisms. Opposition parties reacted strenuously to the unveiling of the updated memorandum between the Greek state and the "troika", accusing the government of announcing new painful measures (i.e., on top of those already agreed in May) that would result in "…more poverty for families and despair for pensioners and even more (business) closures". On its part, the government insists that the updated memorandum *does not* introduce any new measures, but simply offers a review of the progress made so far in stabilizing the economy and specifies some of the already-agreed structural reforms in greater detail. In what follows we highlight some of the key points of the updated MEFP along with our own analysis:

- ✓ **The government has fulfilled all quantitative performance criteria specified in the MEFP, assisted by a strong implementation of the fiscal program.** As we noted in our latest special focus note on Greece, the data on the execution of the state budget for the first seven months of 2010 suggest the government remains on track for meeting the 8.1%-of-GDP deficit target this year.[1] Specifically, the most recent (preliminary) data released by the General Accounting Office (GAO) showed a 39.7% YoY decline in the central government budget deficit year-to-July, which compares with the official full-year target for a deficit reduction by 39.5%.

- ✓ **State budget spending over-performs targets.** As noted in the updated memorandum, the under-execution of the state budget primary spending in the January-June period was €5.6bn. The government intents to maintain this over performance to the end of the year, aiming to generate a cushion of €4bn to cover risks coming from other parts of the general government *(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).* To that end, expenditure containment in the period ahead will primarily focus on operating and consumptions expenses as well as measures to strengthen cost containment in the broader public sector. The progress in cutting expenditure has indeed been quite impressive thus far, as suggested by a 12.6% YoY reduction in the ordinary budget's primary outlays over the first seven months of 2010. Primary expenditure has traditionally been the most inelastic component of overall government outlays, regularly overshooting the corresponding annual targets in the prior years 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, thanks to austere wage policies in the public sector and steep cuts in a multitude of special benefits to civil servants, it is not entirely surprising that a sizeable reduction in primary outlays remains the main driver of fiscal adjustment. A sharper than expected decline in public investment expenditure year-to-July *(-36% YoY vs. a -4% YoY full-year target)* also assisted to contain the state budget deficit in the corresponding period, while concerns remain over the performance of budget revenue, especially the growth of tax receipts.

- ✓ **Government expects revenue growth to accelerate in H2:2010.** The government expects the fiscal measures *(VAT and excises, and, particularly, the benefits from the pension and wage cuts) to* be fully realized in the second half of the year, helping to generate substantial resources to allow all payments and the amortization of any mid-year arrears by end-2010. With respect to the growth of state budget revenue, worries remain over their performance in a domestic trajectory characterized by deepening recessionary pressures. Gross ordinary budget revenue grew by only 3.3% YoY in January-July, underperforming the corresponding annual target (+12.7% YoY) by a sizeable margin. In absolute terms, the underperformance of state revenue in the first seven months of 2010 is estimated at around €800mn (or ca 0.34%-of-GDP). We do not yet have detailed data by the General Accounting Office for the performance of tax revenue in July 2010, but 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. Whatever the reason for that underperformance may be, we should see tax revenue growth picking up pace in the following months to be convinced that the government's efforts to crack down on tax avoidance has started to bear tangible results. On its part, the government continues to expect revenue growth to pick up in the following months, boosted by the most recent hikes in VAT and excise taxes, proceeds from taxing big real estate assets and measures to rein in tax evasion *(penalties imposed to tax evaders generated ca €2.5bn so far this year)* .

- ✓ **New budget law seen strengthening medium-term fiscal management framework.** As noted in the updated memorandum**,** the passing of the new budget law in mid-July implies that the budget for 2011

[1] Eurobank EFG Research, *Focus Greece: Latest Macro Developments, August 20, 2010*

will be part of a three-year rolling medium-term framework, and that the Minister of Finance will be able to set top-down expenditure ceilings for line ministries, local governments and social budgets with a view to broaden the scope of fiscal policy to general government. Also, the budget will now contain standard contingency margins to facilitate absorbing shocks, and the government will set up commitment registers in the line ministries manage better accrual spending. The latter along with the monthly reporting of fiscal deficit for general government entities constitute structural benchmarks for the end of September 2010. Up to now, the General Accounting Office of the Finance Ministry has been only reporting monthly data on the execution of the state budget (central government level), with the Bank of Greece reporting cash-based statistics for the government's borrowing requirement.

- ✓ **2011 budget in line with the commitments outlined in the EC/ECB/IMF-agreed stabilization program.** As specified in the Memorandum of Economic and Financial Policies (MEFP) agreed with the "troika" in May 2010, next year's budget will target a reduction (relative to 2010) in the general government budget deficit by ca 0.5ppts-of-GDP to €17bn or 7.6%-of-GDP. The new budget will be prepared under the new law (see point above) and will be submitted to parliamentary committees in early October. We do not expect the new budget to deliver any major surprises, as the main parameters of the fiscal consolidation effort in 2011 are outlined in the MEFP agreed with the European Commission and the Fund. With respect to the expenditure component of the new budget, the government said that it will take into account the sustainability of envisioned discretionary spending cuts, and if needed replace them with permanent savings.

- ✓ **Government to set-up by end-September five special task forces to enhance tax compliance** Along with current 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 next 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 and income individuals,
    - strengthen filing and payment controls, and improving tax payer services.

- ✓ **Single payment authority to be operational by end 2010/early 2011.** Following the recent completion of a public employment census, the government is moving to establish a single payment authority for public wages. The new system will be operational by end 2010 for central government employees and by March 2011 for people employed in the broader public sector. The single payment authority will provide a uniform and simplified remuneration system for state employees, which is expected to contribute a great deal towards containing budget outlays. In a further move to improve public administration, the government is also proceeding with a functional review of central administration, which is expected to begin in the second half of 2010.

- ✓ **Approved pension reform is judged to be advanced by international standards.** The key pension reform that passed parliament well ahead schedule has been judged (by the troika) to be "advanced" by international standards. The reform establishes a new system consisting of a contributory pension to top-up a non-contributory, means-tested, basic pension, aiming to control the projected rise in pension spending to 2.5ppts-of-GDP between 2009/2060. Under a no-policy-change scenario, the corresponding rise in pension cost would exceed 12ppts-of-GDP. In line with the agreed Memorandum of Economic and Financial Policies, the National Actuarial Authority will need to complete by end-December 2010 an assessment of the effects of the reform on the main pension funds and of the largest auxiliary pension funds by end-March 2011. These assessments will determine whether further adjustments to the parameters of the pension system would be needed to contain the increase in pension spending to the promised levels. Any further necessary adjustments would need to be completed by the end of H1 2011.

- ✓ **Significant progress noted already with respect to the structural reforms agenda.** In line with the country's commitments outlined in the May 2010 memorandum, significant progress has already been made on structural reforms aiming to promote fiscal sustainability, economic growth and competitiveness. To that end, a substantial labor market reform was voted in parliament in July. The new legislation aims to ease employment protection legislation and collective dismissals, reform minimum wages and reduce overtime pay costs for firms. As noted in the updated memorandum, the government is planning to take additional measures to reform collective bargaining, including the elimination of the automatic extension of sectoral agreements to those not represented in the negotiations. The government's reforms agenda also includes new legislation aiming to develop a more business-conducive environment by opening up a range of closed professions and removing impediments to economic activity and innovation. Progress on that front is considered to be broadly satisfactory with the government proceeding with the development of legislation necessary for the timely fulfillment of its structural reforms agenda, without succumbing to resistance provided by various social groups and vested interests.

- ✓ **Challenges remain in containing costs in the broader public sector.** Though the government is already making headwinds in compressing state budget costs, containing the cost structure of the broader public sector is proving to be a more difficult task as reflected in *e.g.* the pace of accumulating of outstanding arrears in the public health sector in H1:2010. The troika had already warned for problems on that front in mid-June. In an interim progress report on Greece's stabilization program released back then, they noted that according to the most recent available data 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. They also said that 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. As we have noted in the past, the cost structure of the public health system is an important problem the government needs to tackles swiftly in the period ahead, as considerable savings can be generated from that source. Note for instance that drug costs in Greece amounted to €9.2bn in 2009 -- as much as four time (in per capita terms) Spain's corresponding costs (~€12bn). To that end, the government is planning to accelerate payments to avoid the buildup of arrears and to limit the carryover of obligations into 2011. Measures taken so far to reduce public health outlays include:

  - A 20% reduction in procurement prices for approved drugs lists
  - Efforts to improve profiles and benchmarking for patients and doctors to avoid unnecessary prescriptions
  - 10 biggest hospital are currently audited by independent accounting firms

  The government is also planning to reduce pharmaceutical costs further by expanding its drugs lists, encouraging the use of generics and by introducing e-prescriptions. In the local government level, an important bill has already voted in parliament aiming to reduce the existing number of local administrations and elected and appointed officials. The new structure is estimated to help generate savings of €1.5bn over a three year period.

✓ **Restructuring/privatization for loss-making state-owned enterprises**. The updated memorandum provides additional detail about the government's plans to proceed with drastic reforms in loss-making state enterprises. Specifically, the ten largest of them will need to have their financial statements through 2009 published on the web before the end of September (structural benchmark). With respect to the debt-ridden public railways company, the transportations ministry will present to the parliament by end-September a draft law to restructure the railway sector. Furthermore, the government will need to approve a major restructuring plan to make the train operator profitable for the fiscal year 2011.

✓**Further important government initiatives to safeguard stability in the domestic banking sector and support the domestic economy include:**

- **Enactment by the Parliament (on July 13) of a Financial Stability Fund (FSF),** providing an important new backstopping facility for a sound level of bank equity. The FSF will be endowed with €10bn out of the €110bn existing EU/IFM lending facility for Greece and it is expected to be operational by mid-September 2010 (structural benchmark).

- **New legislation to tackle delays in the absorption of structural EU funds related** to environmental, archeological, expropriation and other impediments.

Part II -

Latest macro and market developments

Speculation for an imminent cabinet reshuffle grows

During a regular briefing to local journalists late last week, the government spokesman fuelled speculation about a widespread cabinet reshuffle, linking changes in the ministerial council and the PM's office to a new circle of "structural" changes aimed at re-organizing the state. The spokesman said that individuals opting to run for local government offices in the upcoming local elections (November 2010) will have to be replaced, adding that the reshuffle will need to be about "policies and not individuals". According to the press reports, a sweeping reorganization of the government appears to be gaining ground over just the replacement of ministers running as candidates in the local elections. Whatever the case may be, we believe that the primary aim of any cabinet reshuffling in the period ahead will be to improve the functioning of the government, especially in areas where delays have been observed with respect to the implementation of the EU/IMF-agreed reforms program.

Greek FinMin rules out debt restructuring

Speaking before Parliament earlier today, Greek FinMin Georges Papaconstantinou ruled out anew a debt restructuring scenario and expressed optimism that the 2010 GDP contraction will likely be milder than 4.0%. Furthermore, the FinMin underlined that the government's recent pledge to extend guarantees on bank bond issues intends to keep credit flowing to the real economy and help it recover gradually. According to an official announcement earlier this month, the government guarantees offered to banks increased by €25bn to €55bn bringing the entire support plan (including special government bonds and state preference shares) to €68bn.

Debt management office to switch to monthly T-bill auctions

Greece's debt management agency (PDMA) stated earlier this week that it will switch from quarterly to monthly T-bill auctions as of September 2010, aiming at better cash management and more leeway. 26-wek and/or 52-week T-bills auctions will be conducted on the second Tuesday of every month while 13-week T-bills auctions will take place on the third Tuesday of every month. The PDMA will announce the related issue size on the Friday prior to the auction date. Greece faces its next refunding hurdle in September when €974mn of government bonds mature followed by another €2.24bn of one-year and six-month T-bills on October 15 and another €2.4bn of three-month paper on October 22.

Olli Rehn optimistic on Greece's prospects

In an article to the Wall Street Journal earlier this week, EC Economic and Monetary affairs Commissioner Olli Rehn expressed his confidence that debt-laden Greece will overcome its current economic and fiscal problems. The EU official praised Greece for taking "…drastic, sometimes painful, steps to turn an unsustainable situation around", adding that "impressive" progress with structural reforms is likely to lead to "a higher-than-assumed GDP growth". The official added that debt restructuring is unlikely arguing that i) a radical pension reform is being implemented ahead of schedule, greatly reducing spending pressures in the future ii) broader structural changes to the economy have strengthened medium-term growth prospects, reducing the pressure on debt financing and iii) those advocating debt restructuring tended to understate the costs, both economically and politically. In these lines, Commission spokesman Amadeu Altafaj said late last week that Greece is on track to reach the 2010 deficit target if it sticks to its commitment to reduce government spending by some €4bn below plans as to offset fiscal risks stemming from the broader pubic sector.

Greece submits official request for second installment of EU/IMF support package

In a letter submited to the European Union, the ECB and the IMF early this month, Greece requested the second installment of a €110bn EU/IMF aid package on the grounds that the country is implementing successfully enough the stabilization program agreed with the 'troika' earlier this year. The goverment requested €6.5bn from the European Union and an additional €2.5bn from the IMF (over the 3-year period, 10 further tranches will follow at three-month intervals, conditional on Greece's progress with respect to the execution of the stabilization program.). In spite of Slovakia's recent decision not to participate in the Greek bailout plan, the Commission is expected to approve formally its part of the installment at its upcoming meeting on September 7.

Bank deposits down again in June

Greek business and household bank deposits shrank for a sixth straight month in June to stand at €216.5bn from €219.8bn in May. The decline was even steeper for the domestic households reaching nearly EUR4.5bn as they seem having begun drawing down on savings to compensate for lower disposable incomes due to wage restrain, higher taxation (direct & indirect) and elevated inflation rates.

Worries over EUR-periphery markets on the rise again

While Eurozone periphery government bonds strenghtend early this month on easing banking sector-related concerns in the wake of the EU-wide bank stress test results, gains proved short-lived. The FOMC downgraded its assessment of US growth prospects at its August 10 meeting, reviving market concerns about the sustainability of the global economy. Meanwhile, worries over the prospects of the Eurozone economy have been on the rise lately. EU Commissioner Olli Rehn warned recently that a slowdown in Asia would have a "serious negative impact" on Eurozone growth outlook while ECB's Weber cautioned about a likely moderate slowing in the pace of Germany's economic recovery in H2 2010. Against this environment, Eurozone core government bonds gained sharply supported by flight-to-safety flows with the longer-dated paper outperforming favored by global equity markets' weak performance. As a result, EMU periphery/core government bond yield spreads reversed course to move sharply higher. Ireland underperformed in the wake of the S&P's decision to downgrade the country's long-term sovereign credit rating from AA to AA- and retain a negative outlook, citing high fiscal costs of supporting the ailing financial sector. The Irish/German 10-yr government bond hit a fresh record high near 350bps earlier today while, in a similar vein, the corresponding Greek spread moved above the 900bps level for the first time since early May when the ECB adopted a plan of outright (sterilized) purchases of public & private debt securities.

Table: EMU periphery yield and spread levels

10-yr Government bond yields	Today, August 25 (17:00 local time)	Change vs. recent multi-week intrday lows recorded in late July/early August (in bps)	Change vs. all-time intraday highs recorded earlier this year (in bps)
Greece	11.43%	134.5	-103.2
Portugal	5.38%	37.9	-95.2
Spain	4.02%	-0.7	-97.5
Ireland	5.58%	69.7	-27.8
10-yr Periphery/Bund yield spread (in bps)	**Today, August 25 (17:00 local time)**	**Change vs. recent multi-week intrday lows recorded in late July/early August (in bps)**	**Change vs. all-time intraday highs recorded earlier this year (in bps)**
Greece	928.67	184.43	-36.59
Portugal	323.70	96.13	-25.12
Spain	187.20	53.55	-33.97
Ireland	343.10	127.09	37.18
5-yr CDS	**Today, August 25 (17:00 local time)**	**Change vs. recent multi-week intrday lows recorded in late July/early August (in bps)**	**Change vs. all-time intraday highs recorded earlier this year (in bps)**
Greece	922.5	234.17	-108.43
Portugal	320	105.34	-140.01
Spain	246.5	78.51	-44.71
Ireland	320.67	125.79	17.45

Source: Bloomberg

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