Athens, October 16, 2010

Focus Greece: Latest macro & market developments

Highlights

- **Year-to-September central government budget deficit down 31.1% YoY, outperforms 9-month target of -29.0%YoY**
- **Deficit reduction driven mainly by steep cuts in primary spending and, to a lesser extent, lower-than-projected investment outlays**
- **VAT revenues up by ca 17% YoY in September, following 10.8% YoY rise in the prior month and broadly flat growth of in the first seven months of the year**
- **Improvement in VAT revenue collection comes as a result of latest installment of VAT rate hike (July 2010) and strengthened government efforts to rein in tax evasion**
- **IMF signals possibility of extension of Greek support package**
- **Latest T-bill action meets strong demand**
- **ECB funding to Greek banks drops in September for the second consecutive month**
- **September CPI at 13-yr highs: unemployment up again in July**

January-September budget execution data broadly satisfactory

According to preliminary data released by the General Accounting Office (GAO), the central government budget deficit declined by 31.1% YoY year-to- September, reaching ca €16.2bn. This was somewhat lower than the *(revised)* full-year official target of -36.9%, but still better than that for the January- September 2010 period (-29.0%).[1] The strong improvement *(i.e., decline)* in the central government budget deficit over the first none months of 2010 reflects, primarily, steep cutbacks in primary spending as well as lower public investment outlays relative to both this year's official projection and the corresponding outlays recorded in the same period a year earlier. In detail, ordinary budget revenue grew by 3.7% YoY year-to-September, continuing to exhibit lower growth relative to the official target for the full-year (+8.7% YoY). Yet, quite encouraging is the fact that a strong bounce in VAT tax receipts was recorded in both August and September *(up by 10.8% YoY and 17% YoY, respectively vs. broadly flat growth in the first seven months of the year).* This reflecting primarily: (a) strengthened government efforts to fight tax evasion and (b) the second installment of hikes in VAT and excise tax rates on fuels, cigarettes, alcoholic beverages and a range of various luxury items introduced on July 1, 2010. Elsewhere, ordinary revenue before tax refunds in January-September increased by 2.8% YoY, while tax refunds declined by 5.9% YoY.

[1] The -36.9% YoY full-year target for the central government budget deficit is in line with the latest (August 2010) baseline projection of the EC/ECB/IMF stabilization program.

On the cost side, ordinary budget outlays decreased by 7.1% YoY year-to-September, compared with an annual target of -7.85%. Primary expenditure fell by 11.6% (or €4.8bn) vs. the same period a year earlier, an annual pace of decline that remains higher than the full-year target for 2010 (-9.2% YoY). Furthermore, interest expenses in the first nine months of the year amounted to €11.65bn, posting an 8.0% YoY rise relative to January-September 2009. We expect the rate of growth of interest costs to converge towards the 7.2% YoY full-year target in the coming months, as ca 88% of projected interest payments for 2010 have already been made by the end of September.

Finally, in the Public Investment Budget (PIB), revenues fell by 0.5bn year-to-September vs. the corresponding period a year earlier, a decrease of 3.3% YoY which compares with an annual target for a 47.7% rise. On the expenditure side, PIB outlays fell by 2.4bn or 30.3% YoY, undershooting the -6.1% YoY annual target.

Ordinary Budget	January-September 2010 (€bn)	January-September 2010 (%YoY)	Annual target (%YoY)
1. Net Revenues (a-b)	36.52	3.7	8.7
a. Gross revenue	39.78	2.8	8.2
b. Tax returns	3.26	-5.9	3.0
2. Expenditure (α+β+γ)	48.66	-7.1	-7.8
α. Primary expenses	36.77	-11.6	-9.2
β. Transfer to hospitals for the settlement of part of past debt	0.24		
γ. Interest costs	11.65	8.0	7.2
Public Investment Budget (PIB)			
3. Revenue	1.35	-3.3	47.7
4. Expenditure	5.44	-30.3	-6.1
5. Budget deficit (1-2+3-4)	16.23	-31.1	-36.9

Source: Ministry of Economics

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 broader public sector i.e., public hospitals, municipalities and other state-controlled entities[2].

IMF considers extension of Greek support package

In a recent interview to Bloomberg, IMF Managing Director, Dominique Strauss-Kahn, said that the Fund is prepared to give Greece more time to repay its loans, provided that euro area partners, who are to finance the bulk of the €110bn joint rescue package, agree to do so as well. Along these lines, IMF spokeswoman, Simonetta Nardin, noted that the Fund has currently "no concrete plans" to alter Greece's repayments schedule, as the country is expected from 2012 onwards to fully cover its financing needs from the market. Yet, the IMF official added that, should refinancing worries were to continue, the Fund could consider

[2] 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.

several options, including "lengthening repayment periods, replacing shorter-term with longer-term loans or agreeing to a new program when the current one comes to an end".

Echoing these comments, ECB's Lorenzo Bini Smaghi said last week that the IMF has mechanisms to "transform short-term packages into longer-term packages" for countries receiving financial assistance, adding that the Fund is considering doing so for Greece, though nothing has been decided yet. Separately, Greek Finance Minister, George Papaconstantinou, confirmed that the country is currently discussing to prolong the repayment period of its EU/IMF bailout deal, saying, however, that no official request for such an extension has been submitted yet. On its part, the European Commission has so far played down the prospect of extending the repayment period of loans to Greece under the EU/IMF lending mechanism, while a spokesman of the German Finance Ministry underlined that his country is opposing such a move and expressed confidence that Greece will manage to comply with the conditions incorporated in the bailout agreement.

Although the average remaining maturity of Greek public debt is relatively high (i.e., around eight years), this is primarily due to a few longer-term issues outstanding. As a result, around one-third of the debt stock matures in the next 3 years and almost half comes due in the next 5 years. This renders the net public borrowing requirement particularly demanding in the period 2014-2015 (~€70bn or higher per annum) and, as such, a extension of the EU/IMF loans could go a long way towards making the country's funding needs considerably more manageable[3]. Despite lingering uncertainty over the issue of loan repayments, we are inclined to believe that an extension will finally be granted to Greece, especially if this comes as a reward for successful execution of the EU/IMF-agreed program of reforms.

Greek T-bill action meets strong demand

Greece successfully sold €1.17bn of 26-week T-bills on October 12, 2010, assisted by recent official comments about a possible extension of loans under the EU/IMF bailout package and China's recent pledge to buy Greek government paper once the country returns to primary bond markets. Growing investor confidence over the pace of implementation of the country's fiscal adjustment program in the wake of the release of 2011 draft budget provided additional support to market sentiment. The auction produced a slightly lower-than-expected average yield of 4.54%, down from 4.82% when bills of similar maturity were issued on September 14. Greece's public debt management agency (PDMA) said that about 27% of the T-bills auctioned were purchased by foreigner investors. Investors bid 4.22 times the bills offered compared with a bid-to-cover ratio of 4.5 in the September auction. This was the third T-bill auction since the country switched from quarterly to monthly T-bill auctions as of last month, aiming at 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 debt paper. The Greek debt agency (PDMA) faces rollovers totaling €4.64bn this month; €960mn of six-month paper and €1.28bn of one-year T-bills mature on October 15, while another €2.4bn of three-month T-bills come due on October 22.

Eurogroup Chairman says Greek fiscal crisis could have been avoided

Speaking on the sidelines of the October 9-10 International Monetary Fund and World Bank meetings, Eurogroup Chairman, Jean-Claude Juncker, said that Greece's financial woes were well known among top EU officials, but they chose to keep quiet until the fiscal crisis flared up last year. Luxembourg's Premier went a

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[3] Under the existing lending facility, repayment of EU and IMF bilateral loans take the form of eight equal installments between ca 3¼ - 5years after the disbursements of funds under the €110bn bailout agreement.

step further to admit that "the Greek crisis could have been avoided, but not starting last year, starting two or three decades ago". In response to these comments, the ECB President commented that Greece's problems were "obvious" and could have been solved if fiscal consolidation efforts had started earlier. Separately, an EU spokesman said that the fiscal situation in Greece was a regular issue of discussion in the Eurogroup and that the Commission had regularly "warned about the non-reliability of the Greek statistics."

Eurostat to announce revision to Greece's 2006-09 fiscal data

The European Commission announced earlier this month that Eurostat will soon revise upwards Greece's budget deficit and public debt figures for 2006-09. The news did not come as a complete surprise as the Commission had signaled earlier this year (April 2010) the possibility of such revisions. The latter are now expected to be announced on October 22. ***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***.

Greek Privatization Plan lures investor interest

In an interview with The Wall Street Journal, Greek Finance Minister, George Papaconstantinou, confirmed that the government has received broard interest from companies and sovereign funds within and outside Europe in taking partial or complete ownership of state-run assets such as ports, airports, roads, energy, real estate and gaming. The privatization plan targets proceeds up to €3bn over three years as Greece needs to boost FDI inflows and generate additional revenue to help finance its public debt and net external position. Chinese Premier Wen Jiabao, on a visit to Greece last month, announced the creation of a $5bn fund to help Greek shipping companies buy Chinese ships and the two countries signed 13 bilateral agreements coverings areas such as maritime transportation, telecoms and exports. Furthermore, Greece and Qatar assigned in September an Investment Memorandum worth $5bn over the next few years while United Arab Emirates company Abu Dhabi Mar recently bought the Skaramanga Shipyards from German operator Thyssen Krupp.

ECB funding to Greek banks drops in September for the second consecutive month

According to the latest data, ECB funding to Greek financial institutions decreased 1.7%mom in September to stand at €94.3bn, the second straight monthly decline. In a similar tone, borrowing by Portuguese banks from the ECB fell by almost 20% last month, the first decline since the beginning of the year. Speaking during the October ECB press conference, President Trichet welcomed the recent decline in ECB funding as a sign of normalization, a process driven voluntarily by banks and not "engineered by the ECB".

September CPI at 13-yr highs

Greek CPI came in at 5.6%yoy in September, up from 5.5%yoy in August and well above the 0.7%yoy figure reported in the same month a year earlier. This represents a 13-year high and reflects mainly the impact of recent rate hikes in VAT and a range of special consumption taxes. In spite of the ongoing domestic recession, we expect price pressures to remain elevated throughout the remainder of the year with the re-inclusion of heating oil prices in the CPI basket providing an additional boost. For the full year, we forecast average inflation to be slightly lower than 5.0% and expect a return to pronounced disinflation not earlier than H2:2011.

Greek unemployment rises again in July

Following a brief drop to 11.6% in June, Greek unemployment rate resumed its uptrend in July, rising to 12.0%. The latter was almost two percentage points higher than the corresponding EU-16 average rate and well above the 9.6%yoy figure recorded in the same month of last year. The Greek government expects the unemployment rate to increase further over the coming months and to average 14.6% next year *(2011 draft budget projection).* In the industrial sector, production growth dropped by 2.1%yoy in August, a lower pace compared to July's -8.6%yoy. But, in view of lackluster domestic consumption and grim business confidence, there is little to suggest that the recent slowing down in the pace of output contraction signals any sustained improvement in the short-term. In other news, construction activity, measured by the number of new building permits, plunged by 20.5%yoy in July following a 13.8%yoy drop in the prior month, adding to recent evidence of a continuing recession in the domestic housing market. On a positive tone, the National Statistics Agency reported that, according to preliminary estimates, exports growth accelerated 18.7%yoy in August compared to a -29.7% YoY decline in imports, a development that bodes well for the evolution of the trade balance.

EMU sovereign debt spreads narrowing further, Greece outperforms

EMU sovereign debt spreads remained in a narrowing trend over the last few sessions assisted by easing fiscal concerns and allayed worries over a double-dip trajectory in world economy. The Greek bond market has been the star performer in the EMU sovereign space over the last few weeks, boosted by the strong performance of domestic authorities in executing the EU/IMF-agreed reforms program and market speculation over a possible extension of loan repayments. Secondary market volume in the HDAT platform moved higher over the last few weeks, with the most recent Bank of Greece data showing that trading volume rose 125%mom in September to €1.8bn, remaining though well below the corresponding figure recorded in the same month of last year (€51.8bn). Long-dated maturities outperformed with the 2-10-year segment of the GGB curve undertaking some bullish flattening. The corresponding spread stood at a five-week low of 147bps in late European trade on Friday, compared to mid-September levels of ca 200bps. With the 10-yr Bund yield hitting three-week highs near 2.37% on the same day, the 10-yr GGB/Bund yield spread narrowed to 650bps, the lowest since mid-June. Not surprisingly, the cost of insuring Greek government bonds against default fell sharply in recent weeks, with the 5-yr CDS moving below 700bps on October 13 for the first time since late May.

Yield premiums of other EMU periphery sovereign bonds vs. their German peers also narrowed further over the last few sessions. Indicatively, the 10-yr Portuguese/German Bund yield spread dropped to one-month lows of 335bps in late European trade on Friday, after hitting record highs near 427bps just a couple of weeks earlier. In an effort to trim the budget deficit to 4.6%-of GDP next year from 7.3%-of-GDP expected in 2010, Portugal's minority government approved additional austerity measures for 2011 worth €5.1bn or 3%-of-GDP, including a rise in VAT to 23% from 21% and a 5% cut in civil servant wages. A final vote of the 2011 Budget will take place on October 29. Comments by S&P that Portugal is unlikely to default on its debt even as the economy fails to grow over the next two years also favored.

Ireland was a laggard with the corresponding 10-yr yield spread to bund narrowing by 75bps from late September's all-time highs, as worries over the cost of bailing out the banking sector linger. According to a base-case scenario, the Irish central bank estimates capital need of nearly €50bn, higher-than-initially expected, a figure that is seen lifting this year's budget deficit to an astonishing 32%-of-GDP from nearly 14.5%-of-GDP in 2009. Citing the increased cost of state support to the domestic banking sector and the uncertain domestic economic outlook, Fitch downgraded Ireland's sovereign debt to A+ from AA- with a negative outlook.

Looking ahead, Greece is expected to continue outperforming other periphery markets 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 650bps recent lows has the potential to open the way for further narrowing towards 550bps. Should a sustainable break below 650bps fail, consolidation within 650-750bps 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 15 (18:30 local time)	All-time closing highs recorded this year	Change vs. all-time closing highs (in bps)
Greece	8.92%	12.45% *	-353.3
Portugal	5.75%	6.51% **	-76.4
Spain	3.98%	4.88% ***	-89.6
Ireland	6.12%	6.74% ****	-62.2

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

10-yr Periphery/Bund yield spread (in bps)	Today, October 15 (18:30 local time)	All-time closing highs recorded this year (in bps)	Change vs. all-time closing highs (in bps)
Greece	653.59	965.26 *	-311.67
Portugal	336.40	426.7 **	-90.30
Spain	160.10	221.17 ***	-61.07
Ireland	373.50	449.4 ****	-75.90

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

5-yr CDS	Today, October 15 (18:30 local time)	All-time closing highs recorded this year (in bps)	Change vs. all-time closing highs (in bps)
Greece	690.71	1008.35	-317.64
Portugal	361.7	443.06	-81.36
Spain	200.9	267.07	-66.17
Ireland	406.22	485.10	-78.88

Source: Bloomberg

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