Athens, July 22, 2010

Focus- Greece
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Greek T-bill auctions attract solid demand

On July 20, Greece successfully sold €1.95bn *(including €450mn in non-competitive bids)* of 13-week T-bills, capitalizing on growing investor confidence over the pace of implementation of the country's fiscal adjustment program. The auction produced a yield of 4.05%, up from 3.65% when bills with a similar maturity were issued on April 20. Investors bid 3.85 times the bills offered compared with a bid-to-cover ratio of 4.61 in the April auction. Greece's €1.625bn sale of 26-week T-bills earlier this month to roll over maturing paper, also attracted solid demand, pointing to improving market conditions for an eventual return to primary markets. This was the country's first sovereign debt auction since it secured a €110bn EU/IMF rescue package in May. The yield came in at 4.65% and the issue was oversubscribed 3.64 times. Although the auction was mostly absorbed by the domestic market *(according to Greece's PDMA, some 80% of the bills sold was purchased by domestic banks), at* least 10 foreign banks participated in the auction. A total of €2.16bn of one-year and six-month government paper expired on July 16th while an additional €2.4bn of 3-month T-bills matures on July 23.

Central government budget deficit down by 46.0%yoy in H1:2010

The year-to-June central government budget deficit stood at ca €9.65bn, compared to €17.87bn in the respective period last year, implying a 46.0%yoy decrease which is higher than the annual target of 39.5%. Note that the latter figure is different than the 35.1%yoy annual deficit-reduction target reported in the May 2010 budget execution report, because it incorporates the measures included in the EU/IMF adjustment programme for Greece, which was agreed in early May. Overall ordinary budget expenditure *(including interest costs)* dropped by 15.3%yoy in H1, compared with a full-year target of -4.3%yoy. On the revenue side, progress towards meeting the official budgetary targets has been somewhat less impressive with ordinary budget revenue rising by 6.7%yoy in H1, underperforming a +10.1%yoy annual target. We look for positive surprises on the budget-execution front in the period ahead and anticipate the government to fulfill its deficit reduction target this year. Expectations that the nominal GDP growth this year is likely to prove higher (i.e., by at least 2ppts) than that envisioned under the IMF baseline projections, mainly as a result of higher inflation, support our view.

Greek parliament passes pension reform bill

The 300-seat Greek parliament approved the pension reform bill in early July, a major step towards the implementation of the stabilization program. Votes in favor were 159 vs. 137 against. The reform aims to contain the expected rise in overall pension expenditure to less than 2.5ppts-of-GDP/annum by 2060, which compares with a projected increase of

12.5ppts-of-GDP under a no-policy-change scenario. Among other measures, the bill increases the retirement age for everyone to 65 years, introduces a minimum contributory period of 40 years, **initiates** disincentives for early retirement, downsizes the list of heavy and arduous profession and increases the number of contribution years needed to receive a full pension. Note that according to the EU/IMF program's Memorandum of Understanding (MoU), the social security system reform constitutes a structural benchmark for September 2010 and thus the government is implementing the reform ahead of time.

EU Commission, IMF see implementation of the fiscal consolidation program proceeding satisfactorily thus far

In an interim review of the Greek Stabilisation Programe published earlier this month, the EU Commission expressed a positive assessment, noting that program implementation remains broadly on track. The report read that domestic economic activity appears to be developing broadly in line with the macroeconomic targets underlined in the program and that fiscal consolidation is progressing. The report also noted that there has lately been further improvement in fiscal reforms - *including measures to rein in tax evasion and the setting up a single payment authority for public wages* - with authorities also making progress in a broad range of other structural reforms, including, the law to consolidate and downsize the number of local governments and municipalities (end-June structural benchmark/already approved in Parliament) and the law on the transparency of public spending. Yet, the EU assessment report indentified several areas where further progress is needed: **i**) domestic inflation remains elevated, thanks to the recent implementation of hikes in VAT & a range of other indirect tax rates and despite the domestic economic downturn **ii**) no complete set of information and data is available so far for the broader public sector *(outside the central government)*, especially in areas that used to produce large expenditure overruns e.g. public healthcare system **iii**) with respect to budget execution, transfers to the social security funds and a non-negligible amount of state guarantees (to public enterprises outside the general government) are seen as constituting sources of potential risk. In a similar note, the IMF noted in its interim economic report, published on July 16, that nearly all fiscal measures for 2010 have been implemented with authorities making considerable progress in putting public finances on a sustainable path and implementing major reforms. However, the IMF cautioned that challenges remain evident, noting that "performance in the health sector, social security, local governments and in public enterprises could deteriorate, posing risks". A more comprehensive review is scheduled for July 26-August 6 and the ensuing EU/IMF/ECB progress report will be used as a base to recommend the release of the second EU/IMF loan tranche of €9bn to Greece (€6.5bn from the EU and €5.5bn from the IMF), planned to take place in the first fortnight of September 2010.

Greek Fin Min confident on deficit targets, but risks looming

In an interview to Reuters earlier this month, Greek Fin Min George Papaconstantinou underlined anew that no additional austerity measures are needed, provided that the fiscal consolidation programme remains on track. The FinMin ruled out a debt restructuring scenario and expressed his optimism that Greece will return to primary bond markets in 2011. Mr. Papaconstantinou noted that despite forecasts for a 10-15% drop in tourist revenues this year, GDP contraction in 2010 is likely to prove somewhat milder than that projected in the IMF baseline scenario (-4%). Furthermore, he dismissed reports that a one-off corporate tax will be extended beyond 2013 and expressed his confidence that Greek banks will do well in the EU-wide stress-tests. Nevertheless, he repeated his position that domestic financial institutions need to revise their strategies and consider corporate actions that would create larger and stronger banking groups to weather the financial crisis. Mr. Papaconstantinou reiterated his optimism that the government will meet *(and maybe exceed)* the target to reduce the budget deficit to 8.1%-of-GDP this year from 13.6%-of-GDP in 2009. However, he cautioned that risks regarding hospital bills and some pension funds should not be underestimated. 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). The offer stood at €701mn for the government stakes in the two lenders, 77% of ATEbank and 33% of TT. From its part, the government said it will carefully examine Piraeus Bank's offer before making a final decision on the issue.

Six Greek banks take part in European stress tests; results to be released on July 23

The EU-wide bank stress tests will be coordinated on a bank-to-bank basis and will include systemically important cross-border banks as well as smaller regional banks such as the landesbanks, German state owned banks and cajas, Spain's regional savings banks. The total number of banks subject to stress testing was extended to 91 *(from 25 originally),* accounting for ca 65% of the EU banking sector *(in terms of assets).* In addition to the National Bank of Greece, Eurobank EFG, Alpha Bank, Piraeus Bank, Hellenic Postbank and Agriculture Bank of Greece will be subjected to the stress tests. According to preliminary details regarding the methodology, tests will apply a double-digit hair-cut (i.e 23%) on Greek sovereign debt, no hair-cut on German sovereigns and just 0.7% on French bonds. The final results are due for release on July 23. At the July ECB press conference, Mr. Trichet noted that the central bank is pleased with the progress towards EU-wide stress tests and did not rule out that banks which fail the upcoming stress test could tap into the newly set €440bn EU Stabilization Programme which is expected to be operational by the end of this month.

Financial Stability Fund (FSF), a capital support mechanism for Greek banks

A €10bn Financial Stability Fund (FSF), part of the €110bn EU/IMF rescue package, became law after parliament passed the legislation a couple of weeks earlier. 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 TSF 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.

Greek unemployment on the rise; CPI slightly down in June but still at elevated levels

Greek unemployment rate rose to 11.9% in April from March's 11.6% and 9.4% at the same month a year earlier. Greece's April jobless rate was the fourth-highest in the 16-member euro zone after Spain, Slovakia and Ireland and 1.8 percentage points above the Eurozone's average in April. Separately, Greek CPI slowed to 5.2%yoy in June from May's 5.4%yoy. Despite the June drop, price pressures are expected to remain elevated during the remainder of the year as a result of unfavorable base effects and the impact of increases in a range of indirect tax rates. For the whole of the year, the average inflation rate is seen exceeding 4.5% from 1.2% in 2009.

The GSEE labour confederation and the SEV industries signed a three-year wage deal foreseeing a pay freeze for 2010 and wage rises in line with euro zone inflation in the next two years. The first pay increase, estimated at about 1.5% will kick in July 2011 and the second in July 2012.

Table: EMU periphery yield and spread levels

10-yr Government bond yields	Today, July 22, 2010 (11:00 local time)	Change vs. all-time highs earlier this year (in bps)
Greece	10.47%	-199
Portugal	5.52%	-81
Spain	4.36%	-64
Ireland	5.42%	-53
	2.64%	

10-yr Periphery/Bund yield spread (in bps)	Today, July 22, 2010 (11:00 local time)	Change vs. all-time highs earlier this year (in bps)
Greece	783.5	-190
Portugal	288.6	-72
Spain	172	-62
Ireland	278.1	-44

5-yr CDS	Today, July 22, 2010 (11:00 local time)	Change vs. all-time highs earlier this year (in bps)
Greece	788.3	-339
Portugal	277.5	-184
Spain	205.8	-69
Ireland	249.7	-36

Source: Bloomberg

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