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Highlights

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Greek debt restructuring rumors categorically denied by EU officials

Market speculation about a restructuring of Greece's sovereign debt has been on the rise lately. German FT Deutschland reported last week that the Ecofin discussed at its latest meeting in January 17 a concrete debt restructuring scheme for Greece, involving the European Financial Stability Facility (EFSF). In a similar note, Brussels-based think tank, Bruegel, argued that Greece's debt is unsustainable and a restructuring is inevitable, while delaying such a decision would only increase the penalty, or haircut, for bond holders. Echoing Bruegel's warning, Beatrice Weder di Mauro, one of the advisers to the German government, urged for a "broad solution" to the EMU fiscal crisis, including a possible restructuring of Greek debt over the next 12 months. Separately, speaking on the sidelines of the annual World Economic Forum, the head of the Organisation for Economic Cooperation and Development (OECD) said that the only EMU peripheral economy that may need restructuring is Greece. Furthermore, a Bloomberg Global Poll released this week at Davos showed that 59% of respondents are of the view that at least one or more euro nation would break from the monetary union by 2016, and nearly three-quarters polled thought Greece would default on its debt.

On their part, EU officials and the Greek government continue to categorically deny speculation that discussions for a Greek debt restructuring are currency underway. Speaking at an economic conference early this week, EU Economic and Monetary Affairs Commissioner Olli Rehn reiterated that he does not foresee a debt restructuring in Greece or any other euro area country, given that such a development would have serious repercussions for the stability of the euro area. Along these lines, Greek Prime Minister George Papandreou, speaking at the World Economic Forum in Davos, ruled out the option of defaulting or debt restructuring. Mr. Papandreou expressed his optimism for an extension of the repayment period of the €110bn EU/IMF loan and highlighted his government's commitment to fiscal austerity and structural reforms in order to restore international confidence in the economy.

Notwithstanding these official denials about the debt restructuring scenario, an idea that appears to have been gaining ground lately among EU officials is a bond buy-back scheme involving the EFSF. Such a scheme would allow the EFSF to issue bonds in order to raise the funds needed to buy Greek debt in the secondary market or from the ECB at a discount rate and then sell it on to Greece at a further discount. The key financial aspect of the proposed bond buyback would be the gap in the interest rates though which the EFSF can raise funds (due to its AAA rating) and the Greek sovereign yields. Reportedly, the scheme would be market-driven, as participation would be voluntarily, thus, no one would be forced to realize mark-to-market losses. According to reports, the program would aim to help the debt-laden country reduce its debt burden, while relieving the ECB from its current program of *(sterilized)* securities purchase for the secondary market. *(So far, the ECB has bought nearly €77bn in government bonds from EMU-peripheral economies).*

According to a Dow Jones report quoting unnamed EU official sources, a possibility would be having the EFSF lending money to Greece at an annual effective interest rate below the roughly 5% the country now pays for its EU/IMF loan. Reportedly, Greece would use the EFSF money to repurchase between €50-60bn in government bonds lodged with the ECB at a market value that is now only about 70% of the face value of the bonds. According to some single calculations, such a repurchase would effectively reduce the country's debt to GDP ratio by between €15bn and €18bn (or 6.5ppts to 7.5ppts of GDP).

Irrespective of the way any such bond buying program would work, it would need to be introduced alongside tough fiscal rules to protect against moral hazard and secure future fiscal discipline. Press reports indicate that Germany is not opposed to a structured finance solution to the EU crisis provided that a series of conditions that involve reforms in taxation and pension regimes as well stricter fiscal rules, is incorporated.

A flurry of recent reports suggested that a bond buyback program has been greeted with sympathy by the EU Finance Ministers at their last meeting and has "good chances" of becoming part of a more concrete plan to tackle the EMU debt crisis. But, as Greek FinMin George Papaconstantinou cited in an interview in Davos, the idea of Greece buying back its debt "must be discussed along with" more favorable lending terms and suggestions for an improvement in EFSF flexibility (*for an in-depth analysis on the sustainability of Greek pubic debt, please see our Economy & Markets December 2010 issue*). In a separate note, Eurogroup Chairman Jean-Claude Juncker confirmed earlier this month that the issue of Greece's loan repayment extension was formally discussed at the January 17 meeting, but no concrete decision was taken. Reportedly, an extension of EU/IMF loans to Greece needs to be ratified by EU national parliaments and, as such, it will be a part of a comprehensive package of reforms expected to be revealed in late March when EU leaders are scheduled to meet for a summit.

EC/ECB/IMF representatives arrive in Athens for the 3rd program review

A joint committee of representatives from the European Commission, the European Central Bank and the International Monetary Fund arrived in Athens on January 26 for a scheduled appraisal of the government's process in implementing the EU/IMF-agreed fiscal and structural reforms. A successful review of the program implementation and its future prospects would permit the disbursement of another €15bn of financial aid in March 2011, in line with the present arrangement. The main issues at hand include a) the 2010 fiscal outcome, b) the finalization of the 2012-14 budget plan, c) the implementation of reforms in the public sector enterprises and d) the progress made so far with respect to the revised reform agenda.

With regards to the 2010 fiscal outcome, note that the official (revised) target was for a reduction in the general government budget deficit (ESA definition) by 6ppts-of-GDP to 9.4%-of-GDP. And, while the most recent state budget execution data showed that last year's central government deficit was actually reduced by more than expected (-36.5%YoY vs. the -33.2%YoY target), a number of reports recently circulating in the local press suggested that the overall deficit actually reached 10%-of-GDP due to cost overruns and accumulated arrears in the broader public sector (hospitals, state-run public enterprises and local governments).

In addition, the EC/ECB/IMF representatives will demand from the government to present a detailed fiscal plan and identify expenditure and revenue measures worth ca €12.8bn (or 5.2% of GDP) for the period 2012-2014. Furthermore, the implementation of reforms aiming to consolidate the broader public sector is an issue of main interest for the troika. Note here that according to the revised MoU, the government expects to save some €0.8bn this year from cutting waste and reducing wages in a number of public enterprises. The respective bill was passed in Parliament in the end of December 2010 and, reportedly, there has been limited process since then.

Government speeds up implementation of EU/IMF-agreed reforms

Program implementation news has been encouraging lately. Reforms passed in the Parliament since the 2nd program review include:

- Bill on the reform of the public sector firms and organizations
- Bill on the restructuring of railroads
- "Fast Track" law for strategic investment projects
- New investment law
- The remaining labor reforms (i.e., level agreements prevailing over industry and country level agreements, symmetry in central arbitration, elimination of automatic extension of sectoral agreements to those not represented in the negotiations).

In addition, a number of reforms are scheduled for the following moths (until March 2011). These include:

- A new bill on the reform of the tax system
- Opening up of a number of "closed professions"
- Implementation of the Services Directive
- Implementation of the business start-up law (general electronic commercial registry, one stop shops for start ups etc)
- Measures to facilitate FDI and investment in strategic sectors of the Greek economy
- Strengthening the independence of the Hellenic Competition Committee
- Further implementation of the health care reform.

The draft bill for the opening up of the "closed professions" was submitted to the Parliament on January 27, 2011. The bill aims to abolish over-regulation, price and any other kind of protection for a series of professions, including lawyers, notaries, engineers and auditors. According to the bill, some of the proposed changes include **a)** different compensation schemes for notaries, **b)** elimination of geographical restrictions, admission to create law firms for lawyers, and **c)** abolishment of minimum tariffs for engineers.

The liberalization of "closed professions" is expected to boost the economy's growth prospect according to a number of studies. Among these, The Greek Institute of Economic and Industrial Studies forecasts that the liberalization of "closed professions" will have positive effects for the Greek economy amounting to gains in GDP of over 10 percent in the long run.

The opening up of "closed professions" is a process that started back in September 2010, with the liberalization of domestic freight transports. The next steps will be the liberalization of the passenger transports and the implementation of the Services Directive. These reforms have an end-of March deadline according with the MoU.

Public support for the opening up of "closed professions" is strong. Two polls (by public opinion research companies Marc and ALCO) conducted in mid January showed an average support of 64% for these reforms.

Tax law reform aiming to improve fiscal revenues

The Greek government submitted for public consultation on January 26th 2010 the new tax reform framework bill. The basic characteristics of the new bill include **a)** introduction of an installments system for the fulfillment of VAT obligations, **b)** imprisonment for persons or entities that owe VAT to the Government, **c)** introduction of an economic-financial prosecutor, **d)** reform of the tax authorities, **e)** centralization of the tax auditing system, **f)** introduction of an internal affairs agency for tax officials' corruption cases, **g)** tax arbitration mechanisms, **h)** introduction of an electronic system of registering receipts.

The new tax bill is complementary to the tax reform that passed in Parliament in April 2010 and aims to improve the efficiency of the tax collection mechanism. The bill will be submitted to Parliament by February 1st 2011.

EFSF debut bond sale met strong demand

With the support of the German Debt Management Office (DMO), and backed by guarantees providing by euro area member states, the EFSF launched its first bond sale this week to raise funds that will be used to finance a fraction of Ireland's $85bn assistance program. The €5bn 5-yr benchmark syndication met exceptionally strong demand, reflecting market optimism that a conclusive solution to the EMU debt crisis will be provided soon. Bids valued at around €44.5bn, roughly nine times the amount on offer, while the book building process used to establish buyers, was completed in just 15 minutes. Investors from Asia bought 38% of the total amount while nearly 20% was purchased by the Japanese government. Other buyers included Germany, (12%), France (7%) and North America (2%). Among the different types of investors participating in the deal, central banks took up the largest share at 43%, followed by fund managers at 31%. Ireland will borrow €3.3bn of the amount raised at a higher rate once fees and other charges are taken into account. The European Financial stability Facility EFSF, is set to raise a total of €26.5bn in capital markets this year and next in standard benchmark maturities of 5, 7 and 10 years denominated in euros, as part of the Irish support program (€17.6bn expected in 2011 and €4.9bn in 2012). The European Financial Stabilization Mechanism (EFSM) which is authorized to borrow €60bn backed by guarantees from the EU budget, has already raised €5bn for Ireland. The European part of financial aid to Ireland is split between two funds: the EFSF and the EU's European Financial Stability Mechanism (EFSM). Further support to Ireland will be made available through the IMF (€22.5bn) and bilateral loans from the UK, Sweden and Denmark totaling €4.8bn. Ireland contributes € 17.5bn.

EMU sovereign credit spreads wider, but underlying sentiment remains positive

Despite this week's widening in EMU-periphery sovereign debt spreads, which could be partially attributed to profit taking, underlying market sentiment remains broadly positive. The EFSF debut bond sale met surprisingly strong demand, amid increased market optimism that a comprehensive package of anti-crisis measures will be revealed by the end of March. Meanwhile, a new string of debt auctions from a number of fiscally-vulnerable EU sovereigns, including Spain, was well absorbed. The Spanish Treasury sold €1.3bn in 6-month T-bills and €945mn in 3-month paper earlier this week, with both auctions producing a lower yield than the previous offers of similar-maturity in December.

Portugal was among the best performers, with the government debt agency, IGPC, saying that it has raised more than €4bn so far this year and its funding programme for 2011 is proceeding according to plan. In another encouraging note, Portugal's Finance Minister Fernando Teixeira dos Santos told reports this week that the 2010 budget deficit has likely outperformed the 7.3%-of-GDP official target, while Prime Minister Jose Socrates reiterated that bailout rumous are unfounded. Ireland was a laggard amid mounting political jitters. Ireland's Green Party, the junior coalition partner, withdrew from the government late last week, soon after Prime Minister Brian Cowen resigned as the leader of the running Fianna Fail party. The withdrawal will force Mr. Cowen to dissolve parliament and bring forward the date of general election, which had originally been set for March 11. The leader of the Green Party, John Gormley, made clear that he expects the Prime Minister to call the dissolution of parliament as soon as vital pieces of budget legislation are approved by the end of the current week. The passing of the new Finance Bill (i.e., 2011 budget) in parliament by the end of Q1 is a key precondition for the release of funds under the government's €85bn IMF/EU bailout agreement. According to the Labour Ministry, the general election will likely be held on Friday, February 25.

Turning to Greece, the 10-yr government bond (GGB) yield spread to German Bund was hovering around 830bps at the time of writing, some 30bps wider from a four-month closing low recording earlier this month, amid persisting market speculation about an imminent debt restructuring. Despite the latest widening move, the 10-year yield spread was still ca 140bps narrower from an all-time high marked three weeks earlier. Technically, a clear move below the 800/750bps zone could open the way for a retest of the crucial 650/660bps area (mid-October lows). On the upside, strong resistance stands at 880/900bps in the way to 935bps (late October highs) ahead of the 974bps record closing high seen on January 7, 2011.

Table: EMU periphery yield and spread levels

10-yr Government bond yields	Today, January 28, (18:00 local time)	Change vs. this week's lows (in bps)	Change vs. all-time closing highs (in bps)
Greece *	11.46%	24.0	-117.8
Portugal **	7.07%	13.8	-5.8
Spain ***	5.46%	22.1	-8.7
Ireland ****	9.16%	27.9	-19.7

* *record highs on Jan. 6, 2011*
** *record highs on Jan. 26, 2011*
*** *record highs on Jan. 10, 2011*
**** *record highs on Nov. 30, 2010*

10-yr Periphery/Bund yield spread (in bps)	Today, January 28, (18:00 local time)	Change vs. this week's lows (in bps)	Change vs. all-time closing highs (in bps)
Greece *	831.17	23.93	-142.47
Portugal **	392.43	14.04	-67.57
Spain ***	231.02	22.32	-52.31
Ireland ****	601.02	30.65	-67.46

* *record highs on Jan. 7, 2011*
** *record highs on Nov. 11, 2010*
*** *record highs on Nov. 30, 2010*
**** *record highs on Nov. 30, 2010*

5-yr CDS	Today, January 28, (18:00 local time)	Change vs. this week's lows (in bps)	Change vs. all-time closing highs (in bps)
Greece *	906.11	58.61	-167.98
Portugal **	454.53	21.20	-91.64
Spain ***	264.85	9.23	-100.19
Ireland ****	618.53	9.38	-49.06

* *record highs on Dec. 31, 2010*
** *record highs on Jan. 10,. 2011*
*** *record highs on Nov. 30, 2010*
**** *record highs on Jan. 10, 2011*

Source: Bloomberg

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