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Latest macro & market developments

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Highlights

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- **Part III - EMU sovereign credit rating outlook deteriorates; IMF approved disbursement of fourth loan tranche to Greece**
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Part I

March 11 EU Council: Important steps taken to tackle the sovereign debt crisis

On March 11, Eurozone heads of state agreed on an a number of important policy initiatives that will be part of a comprehensive anti-crisis package expected to be finalized at the upcoming EU Summit on March 24-25. Undoubtedly, there was more concrete progress than many market participants had expected at this stage, reflecting the willingness of euro area authorities to address the lingering sovereign debt crisis and prevent a future one from occurring. The agreement reached, envisions among others the following measures:

i) An increase in the size of the EFSF

EFSF's effective lending ceiling will be raised to its full guarantee pool level of €440bn from around €255bn currently. The move is expected to ease market concerns about the facility's capacity to bailout more EMU member states facing severe funding constraints. Moreover, the effective lending capacity of the permanent crisis resolution mechanism (ESM) that will be in effect from mid-2013 will reach €500bn. The latter is the same nominal amount the EFSF and EFSM combined have currently at their disposal. This will likely be achieved through stepped-up guarantees from AAA states, paid-in capital from member states with weaker balance sheets and callable capital. Note than an increase in EU participation to the rescue schemes could itself trigger further additional support from the IMF. The Fund currently contributes 50% of that provided under the EFSF/ESM programs.

Pending issues and political reactions

An agreement on how precisely the bloc's 17 members will share the burden of the enlarged bailout fund hasn't been reached

yet, with options under consideration including: **a)** a higher proportional participation from non-AAA countries, an option reportedly favored by Germany, **b)** additional cash contributions from countries regarded as potential candidates for a bailout *e.g.* Portugal, Spain and Belgium, **c)** an increase in the guarantees provided by the six AAA-rated EMU member states. Note that, on a pro rata basis, guarantees currently stand at 120% of a country's share in ECB capital.

As regards the funding structures of the EFSF/EMS mechanisms, the German government's junior coalition partners are currently opposing an increase in the burden assumed by AAA-rated member states. Furthermore, according to press reports, Estonia and Slovakia as well as a number of aspiring euro area members, including Latvia, Lithuania, Bulgaria and Czech Republic warned that they may block the proposals unless euro zone countries agree on a new capital structure for the ESM. Currently, guarantees providing by euro area member states are in accordance with their respective share in ECB capital. The latter in turn is calculated based on a country's population and gross domestic product as a percentage of the corresponding euro area figures, a formula that several smaller EU countries deem as unfair. Instead, these countries insist that the calculation of a member state's share in ECB capital should take into account additional factors such as the relative size of external public debt burdens and domestic financial sectors.

ii) Measures to increase flexibility of the EFSF and ESM mechanisms

The EFSF will provide loans to member states facing severe funding problems, provided that such financial assistance is deemed indispensable for safeguarding the stability of the euro area as a whole. Aiming to discipline fiscally-vulnerable borrowers and address moral hazard issues, Eurozone leaders clarified that any such decision will be taken unanimously by EMU member states. Financial assistance will require a sovereign borrower to implement a comprehensive macroeconomic adjustment program that will be agreed upon with and monitored by the European Commission and the IMF, in liaison with the ECB.

To maximize the *cost efficiency* of its support, the EFSF may also *exceptionally* intervene in the primary sovereign debt markets, dependent on strict conditionality. This should be interpreted as a pre-emptive "back-up program", providing a back-stop facility for sovereign financing. Indeed, in an effort to avoid costly bailouts after Greece and Ireland had to be rescued last year, the EFSF could take any slack in the debt auctions of a country struggling to attract private investors. Similar to the EFSM, the ESM will have the power to purchase government debt from distressed sovereigns in the primary debt markets, but not from the secondary markets. Reportedly, the ECB hasn't so far succeeded in its attempt to have the EFSF/ESM take over its task of outrightly buying government bonds securities from the secondary market. Note that the European Central Bank has so far bought some €77.5bn in government bonds of EMU-periphery sovereign borrowers.

Other features of the ESM will be as agreed at the Eurogroup meeting on November 28, 2010; namely, a) the private sector shall share some of the rescue cost in the event of a sovereign default on a "case-by-case" basis and in accordance to current IMF policies. Thus, a "haircut" will not be automatically imposed, b) any involvement of the private sector would be gradual, with haircuts being used as a last resort solution, c) the new mechanism introduces Collective Action Clauses (CACs) aiming to reinforce market discipline for lax borrowers and help preventing "moral hazard", d) financial support to EU countries will have to be activated by unanimous decision from the Eurogroup and e) loans provided after 2013 will be granted seniority, being junior only to IMF loans.

Pending issues and political reactions

The German parliament approved late last week a motion asking the government to prevent the EFSF from buying government bonds issued by debt-stricken EMU countries. The motion came after the government's three junior coalition partners submitted earlier this month a paper for approval by the lower house of parliament, urging Bundestag to vote on any agreements reached on the March 11 EU Summit. The motion is not binding and thus, the German Chancellor is unlikely to renege on her agreement to bond purchases in the primary market. Purportedly, the vote aims to strengthen the German government's position by sending a clear signal to other EU member states that any final deal on March 24-25 is highly conditional on fixed parameters set in the German constitution.

iii) Improved terms for EU loans to Greece

In recognition of Greece's commitment to the implementation of the present EU/IMF-backed stabilization programme, the effective annual interest rate on loans provided by other EU peer states will be reduced by 100bps. Moreover, the repayment profile of all loans (*i.e.,* provided by both the IMF and EU states) will be extended to an average duration of 7.5 years from 4.5 years, currently. Under the new agreement, Greece will need to repay each loan tranche over a period of 5.5 years (vs. 2 years, previously), following an initial grace period of 4.5 years (vs. 3 years, previously). The Greek government estimates the net benefit of lower interest payments on the present €110bn facility to amount to ca €6bn (~2.6%-of-GDP).

The loan repayment extension and lower interest rate payments will undoubtedly renders future borrowing needs considerably more manageable, especially in the period 2014-2015. Yet, as we have repeatedly pointed out, future borrowing needs remain considerable (€70bn/anmum or higher in the period 2016-2020) and even these improved loan terms might prove inadequate by themselves to sustainably improve investor perceptions over the country's longer-term debt dynamics. As we pointed out in a recent special analysis on the sustainability of Greek public debt (Eurobank Research *Economy and Markets*, *December 2010*), the country needs to generate positive and significant primary surpluses over a number of years in order to facilitate a sustained de-escalation of its debt burden. Such an adjustment would not only need a huge effort to reduce state expenditure and boost budgetary revenue on a lasting basis; it would also require a credible government commitment to aggressive and sustained fiscal consolidation, aiming to eventually restore state access to international credit markets and reduce borrowing costs. A swift restoration of positive and sustainable economic growth and a more ambitious program for the privatization of state assets would also be instrumental for stabilizing debt dynamics and improving investor confidence towards the country.

On a more reassuring note with respect to sovereign solvency, the EU Council's decision to allow both the EFSF and ESM mechanisms to buy government bonds from the primary market provides an important back stop facility for sovereign financing. Note for instance that even under the EU/IMF lending programme, Greece will still need to raise some €40bn from the market next year for debt rollover purposes *(ca €10bn of that amount for rolling over maturing T-bills)*. More importantly, the March 11 Council decisions come with strict conditionality. For Greece, the government has committed to: **i)** fully and speedily complete the €50bn privatisation and real estate development programme it has announced recently, **ii)** rigorously continue structural reforms and **iii)** introduce a strict and stable fiscal framework with the strongest possible legal basis to be decided by the Greek government.

iv) EU Council decisions on "Pact for the Euro'' not calling for member state constitutional changes

The March 11 Council decisions did not call for changes to member states' constitutions. As a result, the so-called "debt brake" systems do not have to be enshrined into national legislation, as initially suggested by the jointly proposed German/French "competitiveness pact". Instead, changes will be implemented to "framework laws" *i.e.,* laws organizing the budget procedures. It is worth nothing that these amendments can be revised more easily than constitution revisions; yet they are practically easier to implement. That is because for a number of euro zone countries constitutional changes would likely take years to implement.

v) More favorable interest rates of bailout loans

Euro area heads of state decided on March 11 to lower the interest rate charge of EFSF loans to fiscally-vulnerable member states. According to the agreement, the interest rate cost of EFSF loans should be lowered to a) better take into account debt sustainability of recipient EMU countries and b) align loan charges with the IMF pricing policies. Importantly, the same principles will also apply to loans provided by the ESM after mid-2013. Eurogoroup President Jean-Claude Junker clarified that "as regards adjusting the borrowing rates, the loan granted to Greece will serve as an example".

Notwithstanding the aforementioned, the March 11 EU Council left Ireland's loan terms unchanged. Reportedly, the main reason why Ireland was not granted a lower interest rate charge on its EFSF loans is its new Prime Minister's refusal to raise the country's 12.5% corporate tax rate. Ireland's corporate tax rate is one of the lowest in the EU after Cyprus, Bulgaria and Hungary. A likely abolition would purportedly risk damaging the country's appeal to international businesses and curb its growth potential. Discussions between the Irish government and its European partners on the latter issue are expected to continue ahead of the EU Summit later this month.

vi) Plans, compliant with EU state aid rules, should be in place to deal with banks demonstrating vulnerabilities in upcoming stress tests

A new round of EU bank stress tests will be conducted under the newly-established European Banking Authority (EBA). The tests started on March 4 and are scheduled to run run till June. According to EBA, the tests will be based on two main scenarios; a baseline and one envisioning a more adverse macroeconomic trajectory. The base line scenario will incorporate three main elements; namely, a) a set of EU-related shocks, mostly tied to the persistence of the ongoing sovereign debt crisis, b) a negative global demand shock originating in the US and c) a 11% US dollar depreciation vis-à-vis all currencies. The adverse scenario includes a 0.5% contraction in Eurozone GDP in 2011, a 15% drop in European stock markets, a 75bps rise in long-term yields of euro area government bonds, a 125bps increase in short-term interbank financing costs and a sharp decline in real estate values. The EBA announced that the banks to be tested represent more than 65% of total EU banking assets and at least 50% of the banking sector in each state (the list of banks subject to examination has not yet been announced). One crucial element that is still unknown is the minimum capital ratio banks need to to maintain under both scenarios so as to pass the stress tests. The minimum core Tier-1 capital ratio requirement currently varies from country to country and the EBA said that it is still in the process of defining the one to be used for the tests. Overall, the tests are designed to incorporate an economic shock that statistically would occur once every 33 years, compared to the once-in-20-years scenario in last stress tests conducted in June

2010.

vii) Euro area heads of state agree on broad elements of so-caled Pact for the Euro

Specifically, euro area member state should take all necessary measures to pursue the following objectives **a)** improve competitiveness by e.g. aligning wages with productivity developments and implementing competitiveness-enhancing reforms**,** **b)** boost employment via increased labor market flexibility and tax reforms, **c)** improve medium-term sustainability of public finances by aligning the pension system with national demographic trends, limiting early retirement schemes and using targeted incentives to employ old workers and **d)** reinforce financial stability through legislation on banking resolution and regular bank stress tests. Participating member states will pursue these objectives with their own policy-mix, taking into account their specific challenges, but all are supposed to work towards the common objectives.

viii) Enhanced fiscal discipline measures

To protect against moral hazard and secure future fiscal discipline, the deal also included fiscal discipline measures. Euro area leaders agreed that countries that have a debt ratio above the EU limit of 60%-of GDP should reduce it by 1/20 of the amount above 60% each year. Along these lines, European finance ministers who met early last week agreed on tougher rules against excessive state borrowing and macroeconomic imbalances. Following months of negotiations, ministers also decided to introduce financial penalties for states that repeatedly break the Stability and Growth Pact.

The final agreement on the features of the anti-crisis package is almost one week away. In the meantime, a number of details have to be finalized before formally approved at the EU Summit especially regarding the way the EFSF's lending capacity will be increased, more details regarding primary market purchases and the Pact for Euro. Important issues that remain unclear include the exact pricing formula for EFSF/ESM loans as well as whether revisions to Ireland's lending terms will finally be reached. Eurogroup leader, Jean Claude Juncker, called another special meeting of euro area financial ministers on March 21 to discuss further these outstanding issues.

Part II
Year-to-February Greek state budget execution underperforms targets

According to preliminary state budget execution data, the central government deficit reached around €1.0bn year-to-February, compared to €0.94bn in the respective period last year. The latter implies a 9.0% yoy increase, which compares with an annual targeted defict reduction of 3.9% in 2011.

Ordinary budget revenues in January-February 2011 recorded a 9.2% yoy decline as a result of **a)** the non repetition of an earlier extension provided for mobile duties payments to January 2010 (estimated impact: ~€0.4 bn), **b)** lower receipts from an extraordinary tax on profits of large companies (estimated impact: ~€0.1 bn) and **c)** reduced revenues from the withholding personal income tax during the January-February 2011 period.

On the receiving side, ordinary budget expenditure increased by 3.3% yoy in January-February 2010, mainly as a result of the disbursement of ca €0.4 bn for the settlement of past hospital debts. On the other hand, primary expenditures and interest expenditures over the same period declined by 0.1% yoy and 1.3% yoy, respectively.

In the public investment budget (PIB), revenues increased by 356.4%yoy year-to-February, compared with a full-year growth target of 27.7% yoy. On the other hand, PIB expenditure fell by 67.9% yoy over the same period vs. a corresponding annual target of -6.1%.

The higher-than-expected state budget deficit in the first two months of the year has reportedly triggered the recent resignation of the General Secretary of Taxations and Customs. Special Secretary of the Financial and Economic Crime Unit, George Kapeleris, has been appointed as the new General Secretary of Taxation and Customs. Mr. Kapeleris previous successful record in the Financial and Economic Crime Unit has reportedly been a key qualification for his new appointment.

Ordinary Budget	Jan-Feb 2011 (€bn)	Jan-Feb 2011 (%YoY)	Annual target (%YoY)
1. Net Revenues (a-b-c)	7.94	-9.2	8.5
a. Gross revenue	8.52	-10.2	5.6
b. NATO revenues	0.00		207.7
c. Tax returns	0.58	-22.0	-23.7
2. Expenditure (α+β+γ+δ+ε+στ)	9.32	3.3	6.6
α. Primary expenses	8.11	-0.1	1.9
β. Transfer to hospitals for the settlement of part of past debt	0.35		19.9
γ. NATO expenditures	0.00		73.9
δ. Military equipment expenditure	0.00		57.3
ε. Forfeiture of Government Guarantees	0.01	-87.8	0.0
στ. Interest costs	0.86	-1.3	20.4
Public Investment Budget (PIB)			
3. Revenue	0.61	356.4	27.7
4. Expenditure	0.26	-67.9	0.6
5. Budget deficit (-) or budget surplus (+) (1-2+3-4)	**-1.03**	**9.0**	**-3.9**

Source: Ministry of Finance

Reporting of general government accounts improves; problems remain with respect to the coverage of outstanding arrears

In accordance with the requirements of the present EU/IMF stabilization programme, the Greek Ministry of Finance continues the publication of monthly (cash) data for the general government fiscal accounts. This is considered to be a major step towards better cost management and fiscal transparency in the broader public sector. Yet, problems continue to exist with respect to the reporting of fiscal accounts at a sub-national level, with a large number of local authorities, social security funds and other public entities having so far failed to provide updated data on their spending records and arrears. By the end of December 2010, only 1,196 out of a total of 1,601 general government entities reported outstanding arrears. From the 405 entities that failed to report, 296 were local authorities, 21 were social security funds and 88 were other general government entities. According to the most recent data, total reported arrears decreased by 47.5% mom in December 2010, reaching ca €4.5bn.

As noted in the latest (*i.e.,* third) review of the EU/IMF-backed stabilization programme, the aforementioned drawbacks imply some upside risks to the final budget deficit figure for 2010 (~ 9.6% of GDP according to the latest EC/ECB/IMF projections).

The reporting of general government accounts is expected to improve in the following months, as a result of a) the "Kalikratis" reform of local authorities, b) new accounting standards to be adopted by all sub-national-level entities and c) the electronic registry and auditing of all general government entities. Nevertheless, the Ministry of Finance is considering imposing personal fines to public-sector employees responsible for the settlement of arrears.

Preparation of new privatization plan well under way

At the extraordinary EU Summit of March 11, 2011, Greek Prime Minister George Papandreou committed to an ambitious privatization and real estate development plan, aiming to generate as much as €50bn in revenues to help reduce public debt. According to the 3rd review of the EU/IMF adjustment programme, such a plan, if successfully implemented, would generate a one-off reduction of ca 18pp-of-GDP in the public debt ratio by 2020. In addition, privatization and a better utilization of state assets could also be beneficial for the growth prospects of the domestic economy and the outlook of FDI inflows.

More specifically, the government is currently preparing a detailed €15bn plan of privatizations and utilization of state assets for the period 2011-2013. The plan will reportedly be unveiled by the end of this month and approved by the Council of Ministers by end of July 2011. Among others, the plan is expected to cover the following areas **a)** public real estate development, **b)** restructuring of the railroad sector and development of its real estate property, **c)** concession agreements for regional airports and extension of present concession agreement for the Athens International Airport, **d)** sale of a stake in the post office, **e)** sale of stakes (and, potentially, transfer of management to private investors) in a number of water utilities, **f)** sale of gaming licenses, **g)** privatization of the state lottery and state-owned casinos, starting with a full privatization of Casino Mont Parnes and **h)** reform and privatization of the state-controlled energy sector starting with the Public Gas Corporation (DEPA).

According to the Greek finance ministry, the real-estate development plan will be completed gradually, following the creation of a Real Estate Development Fund. Ownership of public real estate assets will be transferred from various state entities to the newly-created fund that will be responsible for their development. According to the 3rd review of the EU/IMF adjustment programme for Greece, the government has committed to prepare by June 2011 a first list of commercially-viable real estate assets. A more detailed inventory of state assets will be unveiled by the end of this year. Prime Minister George Papandreou also said recently that an initial development plan for the old Athens International Airport (Helliniko) will be completed by the end of March 2011.

Part III

EMU sovereign credit rating outlook deteriorates

Just a few days before the March 11th EU-17 heads of state meeting, Moody's downgraded Greece's sovereign credit rating by three notches to B1 from Ba1, with a negative outlook. The rating agency cited the following main reasons for its latest rating move on Greece:

i) the fiscal consolidation measures and structural reforms needed to stabilise the country's debt ratio remain "very ambitious and subject to significant implementation risks", despite the progress made so far

ii) the country continues to face "considerable difficulties" regarding revenue collection and reforms in the healthcare sector and state-owned companies

iii) the risk that conditions attached to continuing support from official sources after 2013 will reflect solvency criteria that the country may not satisfy, resulting in a restructuring of public debt. Moreover, the risk of a post-2013 restructuring might lead the Greek authorities and investors to participate in a voluntary distressed exchange before that time.

The Greek Finance Ministry reacted angrily to Moody's rating move. In a statement released shortly after the rating announcement, the ministry said that the decision was "completely unjustified", focusing exclusively on downside risks, while ignoring recent significant progress with respect to fiscal consolidation and structural reforms. Along similar lines, the European Commission gave a cold response to the downgrade, with a spokesman stating that "we have our own assessment of what is going on (in Greece)… and we do not react to ratings agency announcements".

Following the latest multi-notch downgrade, Moody's has cut Greek sovereign credit rating by a total of nine notches in just 440 days, starting from the A1 status in late December 2009. Out of the three major credit rating agencies, Moody's has currently the lowest rating for Greece. Moody's rating action on Greece followed Fitch's warning earlier this month that there is a high risk of a multi-notch downgrade, if Greece fails to regain access to wholesale funding markets at affordable rates by the end of this year. Fitch currently rates Greece BB+, outlook negative. S&P also warned Greece earlier this month about a possible downgrade of up to two notches, depending on the outcome of the March 24-25 EU Summit. S&P currently places Greece's sovereign credit rating at non-investment grade BB+, outlook negative.

In a similar move, Moody's cut Portugal's sovereign credit rating by two notches to A3 earlier this week with a negative outlook. Moody's cited concerns about the country's subdued growth prospects, high borrowing costs and uncertainty over the government's ability to meet tough fiscal targets. Moody's currently places Portugal in line with S&P's A- rating. In late November, S&P warned that it could downgrade Portugal within the next three months, but has not announced a decision yet.

Moody's also lowered Spain's sovereign debt rating by one notch to Aa2 earlier this month citing a meaningful risk that the overall cost of recapitalizing domestic banks to be as high as €40bn to €50bn, well above the central bank's estimate of €15bn. The rating agency warned that further cuts might follow in a "relatively short period". Moody's rating on Spain is now equivalent to S&P's AA, outlook negative.

Greece's latest T-bill auction was well received; IMF approved disbursement of fourth loan tranche

Greece's Public Debt Management successfully sold €1.625bn of 26-week T-bills, including €375mn in non-competitive bids, on March 8, in spite of Moody's multi-notch downgrade a session earlier. The auction produced an average yield of 4.75%, just 11bps higher from a previous auction of similar maturity paper in early February. The bid-to-cover ratio was a healthy 3.6, albeit somewhat lower than 4.5 in February. Around 31% of the bills sold were purchased by foreign investors, down from 80% in the February 8 auction.

Greek Finance Minister George Papaconstantinou reiterated last week that the country should be able to return to international bond markets before 2012. However, he added that "in case this does not happen, it is extremely important that the European Fund can buy these bonds of Greece". Along these lines, The Director General of the Greek Debt Management Office stressed out that borrowing costs are still "too high" and the country would need to see government bond yields dropping to between 5.0% and 5.5% before proceeding with longer-maturity debt sales.

Looking head, €176.08mn of10-year paper matures on March 30 while overall principal and interest payments for the remainder of this month amount to €186mn. The head of the debt management agency PDMA announced that Greece did not issue 3-month T-bills on March 15, as planned according to its monthly debt sales programme, because the country's cash balance is adequate.

Greece will need to borrow some €58.1bn for the whole 2011 to finance its deficit and roll over existing debt. Out of this amount, some €46.5bn will be in the form of EU/IMF loans under the existing financial support scheme, with the remaining amount representing net borrowing from the market via T-bill issues. In 2012, borrowing needs total €66bn, with €24bn set to come from the EU/IMF bailout package, €2bn from state assets (target likely to be revised upwards) and €13bn from Treasury-bill sales. The remaining amount correspond to required market access for rolling over maturing longer-term paper,

Greece has raised €5.785bn via T-bill auctions so far this year, while the IMF disbursed last week its fourth loan tranche of €4.1bn, after completing the third review of the country's economic adjustment programme. An additional amount of €10.9bn in the form of bilateral EU loans is expected to come in later this month. Greece has so far received €42.1bn of funding under the €110bn EU/IMF emergency package agreed last May. In 2011, total IMF fining will amount €11bn and will be partnered with €29bn committed by EU states. EU/IMF funding to Greece is disbursed quarterly, conditional on progress made in fulfilling the requirements of the existing stabilization programme.

In other news, the head of the Greek debt management agency PDMA, announced earlier this month that Greece has filed a "shelf registration" with securities regulators in the US to be able to sell the first "diaspora bonds" to tap the Greek-American community. The country plans to raise some €3bn through a series of quarterly or bi-annual issues. According to reports, these issues will offer a sub-5.0% annual yield, with maturities ranging between three and ten years. Greece's debt manager also said that there are similar plans to tap Greeks in Australia but there has been no such filling yet.

On the EMU sovereign space, Portugal was also active this week. The fiscally-vulnerable country successfully sold €1bn in 12-month T-bills at an average yield of 4.33%, up from 4.05% in a previous auction of similar maturity paper in early March and 3.99% a moth earlier. Renewed EMU sovereign credit rating worries and ongoing market fears that Portugal could be next in line to seek a bailout package had an impact. Treasury Secretary Carlos Pina said that the current borrowing rates are still "bearable at the momentum but are not sustainable in the longer term".

EMU periphery sovereign debt spreads remained in a narrowing mode over the last few sessions, in response to recent steps taken by Eurozone heads of state to tackle the lingering sovereign debt crisis. Improving market sentiment after the G7 agreed on joint FX intervention to curb the pace of the JPY's appreciation also favored. Short-dated GGBs outperformed, recovering some of their hefty losses recorded earlier this month amid mounting debt restructuring worries following Moody's multi-notch downgrade. The 2/10-year segment of the GGB curve undertook some bullish steepening with the corresponding spread trading close to -225bps in late European trade on Monday, some 25bps wider from multi-month highs touched a week earlier. With the 10-yr Bund yield resuming its uptrend testing levels above 3.20% on the same day, the 10-yr GGB/Bund yield spread was hovering around 900bps at the time of writing, some 60bps lower from highs recorded ahead of the March 11th EU Council. Not surprisingly, the cost of insuring Greek government bonds against default fell sharply in recent sessions, with the 5-yr CDS moving below 960bps after hitting levels above 1,050 a few sessions earlier for the first time since early January.

Part IV: Latest domestic macro releases

February CPI slows, but still at elevated levels

Greek headline CPI eased to 4.4%yoy in February, from 5.2%yoy in the prior month, reflecting the impact of heavy discounts offered by retail sale establishments during the post-Christmas sales season. Despite its bigger-than-expected decline in February, Greek headline inflation remained well above the 2.8%yoy rate recorded in the same month a year ealier and Eurozone's 2.4%yoy corresponding inflation figure. On a more positive note, domestic inflation excluding the pass-through effect of recent hikes in VAT and a range of excise taxes was nearly zero percent in February, We expect rapid disinflation to resume from H2:2011 onwards, with the annual CPI rate averaging around 2.5% in 2011 compared to 4.7% in the prior year.

Greek unemployment rises again in December; housing market recession deepens

Greece's **unemployment rate** remained in a rising path in December, jumping to a fresh record rate of 14.8%, from 13.9% in the prior month. The Eurozone average jobless rate stood at 10.0% in December 2010. Young people were the most hit, with the jobless rate reaching 39% in the 15-24 age group and 21% for those aged 25 to 34. According to the National Statistical Service, the number of unemployed amounted to an all-time high of 733,645 vs. 505,110 in 2009. The number of employed shrank 5.0% compared to December 2009 or by 223,893 to 4,233,764.

Adding to the gloomy tone of the most recent macro data releases, **total credit** to the domestic private sector remained in a downward trend in January. According to data provided by the Bank of Greece, the corresponding annual growth rate eased to a new post-EMU entry low of -0.3%yoy from -0.1%yoy in December 2010 and 4.1%yoy in December 2009. The annual growth rate of credit to individuals and private non-profit institutions fell by 1.4%yoy, declining further from a 1.3%yoy contraction in the prior month. More specifically, the net flow of housing loans was negative, amounting to -€170mn vs. a positive net flow of €71mn in the same month last year with the annual growth rate decelerating further -0.7%yoy after a 0.4%yoy decline in the prior month. We expect annual credit growth to the domestic private sector to remain broadly stagnated in the coming months as contraction in domestic economic activity continues and difficulties in the funding conditions of domestic banks linger.

On a slightly better tone, the **overall economic sentiment** for Greece –which is complied by the Foundation for Economic and Industrial Research (IOBE)- improved in February for the second straight month coming in at 79.4 from 76.1 in January, on the back of a modest improvement in industry, retail trade and construction sectors. Consumer confidence also edged up in February to its highest level in the last five months (-67.3 vs. –72 in January). Despite February's improvement, consumer confidence remains close to a record low of -75 recorded in December 2010.

ECB funding to Greek banks almost doubled last year, bank deposits down again in January

According to the most recent data from the Bank of Greece, ECB lending of Greek banks stood at €97.67bnn at the end of December 2010 compared with €95.05 in the prior month and almost double from €49.7bn in the beginning of 2010. Bank of Greece data also showed that business and household bank deposits resumed their downtrend in January falling by 2.0%mom to €204.8bn, reflecting declining domestic economic activity and depositor worries over the country's sovereign debt outlook. For the whole 2010, business and households deposits fell by 12.2% or €29.1bn from a year earlier. It needs to be noted thought, that a significant part of deposit outflows has been channeled to the foreign subsidiaries of Greek banks, effectively remaining within the banking system.

In an effort to provide further support to the European banking sector, the ECB decided at the latest policy meeting on March 3 to extend its 3-month full allotment/fixed rate refinancing operations for the next three months and keep full allotment at its weekly and one-month operations, until at least July 12, 2011.

Table1: Greece-Key Indicators	Last	ytd	2009
Macroeconomic indicators			
GDP growth (%YoY)	-6.6 (Q4 10)	-4.5	-2.0
CPI	4.4 (Feb 11)	5.2	4.7
Unemployment growth	14.8 (Dec 10)	45.1	1.3
Labor Cost (%YoY)	-6.9 (Q3 10)	-14.8	3.6
Economic Sentiment (%YoY)	79.4 (Feb 11)	7.7	76.3
Consumer-vigor indicators			
Private consumption in constant prices (% YoY)	-5.5 (Q3 10)	-5.7	-1.5
Retail sales excl. fuels & lubricants volume (% YoY)	-23.1(Dec 10)	-23.1	-0.7
New private passenger car registrations (% YoY)	-49.1 (Feb 11)	-20.7	22.0
Consumer confidence (index level - period average)	-67.3 (Feb 11)	-69.7	-45.7
Retail trade expectations (index level - period average)	-27.7 (Feb 11)	-30.3	-15.4
Industrial-activity indicators			
Industrial production (% YoY)	-5.1 (Jan 11)	-8.1	-17.4
Capacity utilization in industry (index level -period average rate)	68.7 (Jan 11)	68.7	70.5
Industrial confidence (index level - period average)	-13.4 (Feb 11)	-15.9	-28.1
Manufacturing PMI (index level - period average)	42.8 (Feb 11)	42.8	45.4
Construction sector & other investment-activity indicators			
Cross fixed capital formation in constant prices (% YoY)	-26.1 (Q3 10)	-12.6	-25.9
Housing investment in constant prices (% YoY)	-17.1 (Q3 10)	-14.7	-26.5
Other construction in constant prices (% YoY)	-10.4 (Q3 10)	-1.6	-13.4
Private building permits volume (% YoY)	-22.0 (Oct 10)	-25.7	-22.6
Construction confidence (index level - period average)	-62.2 (Feb 11)	-63.5	-39.5
Balance-of-Payments statistics *(euro-terms)*			
Tourism revenues (% YoY)	-20.2 (Dec 10)	-20.2	-10.2
Transportation revenues (% YoY)	-1.8 (Dec 10)	-1.8	-7.9
Customs-based statistics *(€ - terms)*			
Goods exports (% YoY)	39.9 (Jan 11)	-23.5	-3.2
Goods exports to EU (% YoY)	19.6 (Jan 11)	-17.0	4.2
Goods exports to non-EU countries (% YoY)	80.2 (Jan 11)	-30.1	-14.4
Goods imports (% YoY)	-5.1 (Jan 11)	-5.4	1.0
Goods imports from EU (% YoY)	-7.0 (Jan 11)	-13.3	-7.8
Goods imports from non-EU countries (% YoY)	-3.3 (Jan 11)	15.3	1.1
Domestic MFI credit to domestic enterprises & households *(oustanding balances)*			
Private sector (% YoY)	-0.3 (Jan 11)	-0.4	1.5
Enterprises (% YoY)	0.8 (Jan 11)	-0.3	1.0
Households (% YoY)	-1.4 (Jan 11)	-0.5	1.9
Housing loans (% YoY)	-0.7 (Jan 11)	-0.5	3.7
Consumer credit (% YoY)	-4.1 (Jan 11)	-0.6	-1.6
Private-sector credit outstanding (% GDP) *			
Total domestic enterprices & households	113.7 (Jan 11)	-	106.6
Domestic households	52.0 (Jan 11)	-	50.2

Source: Hellenic Statistical Authority, Bank of Greece, ECOWIN

Table 2: EC/ECB/IMF Baseline Scenario	2009	2010	2011	2012	2013	2014	2015	2020
GDP Growth (%)	-2.0	-4.5	-3.0	1.1	2.1	2.1	2.7	3.0
GDP deflator (%)	1.5	2.3	1.6	0.4	0.8	1.2	0.6	1.8
Nominal GDP (€ bn)	235.0	229.0	226.0	229.0	236.0	244.0	252.0	315.0
Current Account (% GDP)	-11.0	-10.5	-8.2	-7.1	-6.6	-5.5	-4.4	----
Interest Rate (%)	4.8	4.9	4.6	5.0	5.4	5.7	5.7	5.9
Bund Rate (bps)	----	225.0	275.0	350.0	350.0	350.0	350.0	350.0
Spread over Bund (bps)	----	550.0	525.0	350.0	300.0	300.0	300.0	250.0
Interest Expense (€ bn)	12.4	14.6	15.1	17.3	19.7	21.2	21.4	23.7
Interest Expense (% GDP)	5.3	6.4	6.7	7.5	8.3	8.7	8.5	7.5
Primary Expenditure (% GDP)	47.9	43.5	44.0	41.7	38.5	33.2	32.2	30.5
General Government Revenue (% GDP)	37.8	40.4	43.1	42.8	42.0	39.3	38.5	36.5
Primary Balance (% GDP)	-10.1	-3.2	-0.9	1.0	3.5	6.0	6.3	5.9
General Government Deficit (% GDP)	-15.4	-9.6	-7.5	-6.5	-4.8	-2.6	-2.1	-1.6
General Government Deficit (€ bn)	-36.2	-22.0	-16.9	-14.9	-11.3	-6.3	-5.3	-5.0
General Government Debt (% GDP)	127.0	143.0	153.0	159.0	158.0	154.0	151.0	130.0
General Government Debt (€ bn)	298.0	327.0	345.0	364.0	373.0	375.0	381.0	409.0

Source: 3rd Review of the EC/ECB/IMF Adjustment Programme for Greece

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