Statement by John Spraos, Executive Director
for Greece
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OVERVIEW

1. The Greek economy continues to perform well, despite the Kosovo conflict and a highly destructive earthquake. GDP is growing at roughly 3.5 percent in the current year–the third successive year in excess of 3 percent and the fourth year of faster growth than the EU average. The convergence in real terms that the latter signifies is important for both Greece and its European partners. Real convergence is expected to continue as growth of 3.7 percent is projected for 2000 and of 4 percent for 2001.

2. This growth performance is taking place in the context of an increasingly stable economy in virtually all its dimensions. Right now, the dimensions that are of overriding importance are the five to which the Maastricht criteria for accession to the EMU, phase 3 (EMU3) apply. With respect to four of these–fiscal deficit, exchange rate, long-term interest rate, debt–the criteria are already satisfied, some by a large margin. Most notable among the criteria satisfied by a large margin is that of the fiscal deficit. The General Government deficit in 1999 is shaping at 1.5 percent of GDP against a convergence program target of 2.1 percent (which was subsequently revised in the budget to 1.9 percent) and a Maastricht requirement of 3 percent. To gain perspective, recall that as recently as 1993 the deficit was 13.8 percent of GDP. In 2000 the declining trend will continue, the deficit coming down to an expected 1.2 percent, against a convergence program target of 1.7 percent. The decline will take place despite a substantial package of tax reliefs and social security improvements costing (gross) 1.1 percent of GDP but offset by a rise in tax on stock market transactions bringing the net cost down to 0.6 percent of GDP.

3. Progress along the fifth dimension–inflation–is also very substantial. In September the year-on-year increase was 2 percent in the national CPI, which corresponds to 1.5 percent of the harmonized CPI. The likely Maastricht "reference value" will be 2.0-2.1 percent in terms of the harmonized index, but it relates to a twelve-month average. The Greek authorities expect to satisfy this too by the time the application for accession to the Eurozone is due to be made next March. Accession on 01/01/01 is a national project that has been pursued with vigor and that the authorities are determined to crown with success.

4. The staff mission shared the authorities' measured confidence regarding EMU accession. This common premise, together with the mission's professionalism, competence and diplomatic skills, generated an excellent atmosphere for constructive and purposeful consultations. In the odd places of disagreement the debate was stimulating and instructive.

5. Not everything in the Greek economy is rosy, of course, and one dimension with respect to which performance is clearly unsatisfactory is unemployment–which stands in the range of 10-11 percent of the labor force. Although employment is growing steadily, the labor force is also growing fast as a result of large immigration and increasing participation. The government is highly conscious of the problem and, in addition to aiming at a high growth rate, is embarking on intensive employment-enhancing measures, in parallel with other EU countries.

6. The tight monetary policy that has been operated in pursuit of the inflation target and that is expected to remain tight for the best part of 2000 will lead, as the time of accession nears, to a swift convergence of short-term interest rates to European levels and to a movement of the exchange rate towards its central parity. From present levels and in round numbers, short-term interest rates will have to fall by 6 percent to bridge the gap. The exchange rate stands at 7 percent above its central parity. It is common ground that this can give rise to concern regarding inflationary pressure and that it needs careful attention and close monitoring. But differences, that are not too large, do exist between the authorities and staff on the fiscal stance that best fits the circumstances, and there are bigger differences concerning some staff attempts at quantification of the problem. This whole area will be considered in more detail later.

7. On the structural front, progress is steady but, in keeping with Greek tradition and preferences, gradual. Consensual elements are sometimes built-in in the reform legislation and this can slow down progress on the ground, as in some labor market reforms. Privatizations, however, have gone ahead briskly, aided by a booming stock market. Together with the low fiscal deficit (relatively to GDP growth) they have reduced the debt-to-GDP ratio by 3.4 percentage points in 1998 and a further 1.5 percentage point reduction is expected by the end of 1999, despite some additions of below-the-line debits. At 104.5 percent of GDP, the level of the gross national debt is still very high but is now on a firmly virtuous trajectory. Large areas of the economy, as diverse as, say, passenger shipping and electricity, are being opened to competition or are programmed to be opened in accordance with an EU timetable. But the Competition Committee should become more effective in dealing with monopolistic practices.

8. As was indicated forcefully in last year's statement, the state apparatus is not as efficient as it should be and its overhaul will yield great economic benefits. Government is being decentralized, the civil service code has been revised, appointments are increasingly meritocratic and the ombudsman is not only up but also running. But a large amount remains to be done. The pronounced improvement in tax collection and the clear signs of budgetary discipline on the expenditure side illustrate the potential waiting to be unlocked. The pay-off from the improved handling of the public finances is so palpable– it will help finance the net tax reliefs mentioned earlier–that it should boost the constituency for the overhaul of public administration, especially in the proximate area of collection/disbursement of social security contributions/benefits. This will not solve the long-term pensions problem but it will ease it perceptibly.

9. There is increasing understanding of the need for pensions reform but the system is so riddled with distortions that its reform is as difficult as it is necessary. The commissioning of an in-depth actuarial study at the highest level of international expertise has been initiated, following the effort being made to consolidate the hundreds of pension funds presently in the state system. A combination of patience and firmness should yield results, as it has done in other areas of the economy. But a quick transformation should be neither expected nor demanded.

10. The public investment budget has been increasing faster than GDP and, jointly with the EU, has been financing, inter alia, major infrastructural projects that are progressing well and are making and (especially) will make a radical contribution to the supply side of the economy.

11. The private sector had been slow in restructuring but this has changed drastically in the last eighteen months. A booming stock market has enabled firms to raise cheap equity capital and thus modernize and deleverage; it has also assisted a big wave of mergers and acquisitions that is transforming the enterprise landscape. Mergers and acquisitions in mature industrial countries have often failed to deliver what they promised, but in Greece there is a strong presumption that they are beneficial because the very small size of enterprises is in clear dissonance with the demands and opportunities of the large EU market and with the size of the competitors in that market. Firms–both private and with state majority–have engaged extensively in outward FDI. Greece is the largest single foreign investor in at least one Balkan country and among the top three or four in a number of others.

12. Inward FDI has been slow in taking off. Staff has not commented on this. The most common conjecture is that the reasons are largely exogenous to the Greek economy. As the inhibiting factors ease, there should be a substantial increase.

13. The banking sector has continued to strengthen both by extending its equity base–on favorable terms thanks to a booming stock market–and by extensive writing off of non-performing loans. The 14 percent of non-performing loans as a proportion of total loans is largely due, as staff report in para. 35, to a single bank, the Agricultural Bank, which is implicitly backed by the state and not just because it is state-owned but because its bad loans are to a considerable extent a legacy of past state actions. In any case, from the risk standpoint, what matters is the share of non-performing loans in total assets, which, as shown in Table 2 of the Staff Report, was only 3.4 percent in 1998.

TRANSITION TO EMU3 AND BEYOND

14. As noted earlier, the one criterion that remains to be satisfied for accession to EMU3 is that of inflation. It is estimated that it will be satisfied if inflation, as measured by the national CPI, averages up to a little above 2.0 percent in the five months October 1999-February 2000 (taking into account the difference between the harmonized and the national CPI). But, while 2.0 percent is the level that prevailed, year-on-year, in the most recent two months and while inflation is on a basically downward trend, an upward blip

is due in the remaining months of 1999 as the effect of indirect tax cuts initiated a year ago fades out of the inflation arithmetic. (This is a strictly mechanical effect. It does not mean, of course, that the tax cuts affected inflation only transitorily. By accelerating the downward trend, they had a persistent effect also.) This blip needs to be removed and will be removed by a new round of indirect tax cuts that are being phased in. Their estimated effect on the CPI, year-on-year, is 0.8 percent. But their effect on the average CPI over the 12 months ending February 2000 is only 0.3 percent, since the cuts will apply to less than half the period in question. The "only" is important for two reasons. (1) It emphasizes how small the extra distance to be traveled is. (2) It invites a comparison from which it can be deduced that, had the goal posts not moved, the Maastricht reference value, which constitutes the target, would have been comfortably attained without recourse to the new indirect tax cuts. The reference value is calculated by adding 1.5 percentage points to the arithmetic mean of inflation rates in the three countries with the lowest average inflation over the relevant 12 months. The mean for these three countries declined by 0.7 percent between the CPI increases projected for 1999 in the WEO of October 1998 and the estimated increases for the same year in the WEO of October 1999. An unqualified comparison of 0.3 percent with 0.7 percent is no doubt too simplistic. But it is felt that plausible qualifications cannot wipe out the large difference between them. Thus the authorities are satisfied with the progress on the inflation front so far and view as only natural their recourse to an extra player to kick at goal when the goal posts have moved. In light of the evidence, they are also satisfied that the indirect tax reductions of late last year, through their influence on expectations, accelerated the downward trend and thus had, as the authorities expected, a persisting benign effect on inflation. They anticipate the same from the new round of tax cuts, although the mechanical upward blip (in the context of the steeper downward trend) is mechanically inevitable after twelve months.

15. So much for recent history and the short-term future. But is low inflation sustainable in the longer term within a healthy growth environment? Sustainability is the challenge staff concentrated on; rightly so, given that they did not question that EMU3 accession is on track and is unlikely to be derailed. Staff identify as the main threat to sustainability the sharp short-term interest rate decline and exchange rate depreciation that will occur , mostly in the second half of 2000 (see above, para. 6). The authorities share the view that there is such a challenge, are fully cognizant of staff's arguments and view the issue as a proper matter for concern. They differ, but not by much, in the policy stance that is deemed appropriate in the circumstances–more a difference of shade than of color–but they view the results of the quantification exercises undertaken by staff as highly contestable. As staff say, the authorities encouraged them to undertake quantifications but, regrettably, the exercises are a source of disagreement. The distance between staff's quantification of the problem and the policy stance they recommend is big. If this reflects skepticism about the quantification results, it is very welcome. But occasional characterization by staff of their results as illustrative of broad orders of magnitude go the other way and, therefore, before turning to the important business of the policy stance, a few of the criticisms to which the quantifications are open will be set out, albeit in smaller print.

16. One quantification, the one with the most improbable result, is reported in a footnote of the Staff Report (p. 13, footnote 11). The authorities agree with staff that a footnote is the proper home for it. The VAR model from which the result is derived is academically respectable and from a technical standpoint it has been very professionally handled. (See Chapter I of Selected Issues.) But this class of models suffers from an old econometric problem–it cannot tell the difference between supply and demand. Sometimes this does not matter. In this instance it matters a lot because there has been a sea change in supply growth and responsiveness in Greece in recent years, a change critical for the observed improvement in economic performance but largely absent from the period 1987-1998 that provides the data sample.

17. In Selected Issues, staff explicitly acknowledge the relevance of this change for an evaluation of the exercise ("Introduction and Overview, para. 2) but they do not do so in footnote 11. While saying in the footnote that the exercise is "illustrative," they go on to say that "a cumulative fiscal contraction of 3-4 percentage points," which the exercise yields as the required adjustment, "though probably on the high side" is "suggestive of the broad order of magnitude of the task at hand." The last observation is the source of the trouble and it is unwarranted in light of the acknowledged supply-side change.

18. The second quantification (Box 2 in the Staff Report and Chapter II of Selected Issues) addresses the effect of an interest rate change on consumption. This is an important question. Theory does not establish a presumption even for the sign, let alone the size, of the effect when consumers are net creditors, in the sense that they hold a positive balance of fixed interest assets over liabilities.

19. Staff could not get Greek data for the exercise they wanted to perform and so resorted to other countries deemed comparable–Italy, Portugal and Spain. Crucial for comparability in this context is the extent to which households are net creditors because, while the substitution effect of a change in interest rates is independent of the net credit balance, the income effect is crucially dependent on it. On these grounds Spain and Portugal are not comparable with Greece. Government debt that is held by households in these two countries must be considerably less (debt to GDP ratio in Spain is 67 percent, and in Portugal 57 percent, against 106 percent in Greece–all end-1998 data) and household liabilities in the shape of mortgages and consumer finance are much higher (30 percent as a percentage of GDP in Spain, 40 percent in Portugal and only 9 percent in Greece–again 1998 data), so that the net creditor position is very much lower than in Greece. In general it is important not to confuse evidence from industrial countries with high household indebtedness–in many countries much higher than that of Portugal and Spain–with the case of Greece, where households are large net creditors in fixed interest instruments and where, in consequence, the income effect of an interest rate change is large and in the opposite direction to the substitution effect.

20. Italy seems in this respect more comparable to Greece. For Italy staff use two models, one from Oxford Economic Forecasting (OEF) and one from the Bank of Italy. The models are shocked with a change in the rate of interest and the outcomes for consumption and GDP are reported for the first four years. With the exception of the fourth year in the Bank of Italy model, they show a rise in both variables in response to an interest rate reduction, from which staff conclude that the substitution effect outweighs the income effect. The size of the net effect is shown to be large, which could be taken to imply that a big offsetting fiscal tightening is required to contain the inflationary pressures of an interest rate reduction.

21. However, the numbers reported (Box 2 and Selected Issues, Chapter II) represent the combined effects on consumption and GDP of all the changes in all the variables that directly or indirectly are affected by the interest rate shock. But what needs to be ascertained for the purpose at hand is the demand stimulus imparted to the economy by the effect on consumption of an interest rate change **alone**. If something emanating from consumption has to be offset by fiscal tightening, it is this partial effect of the interest rate on consumption, not the combined effect of a hundred and one things. And this can be calculated from the consumption function of the OEF model that is fortunately given in a footnote (Selected Issues, p. 20. Footnote 8). The net effect that comes out of the consumption function is negatively related to the interest rate, so that the substitution effect outweighs the income effect but **the balance is small** when Greek data are used to measure the income loss of households from an interest rate fall.

22. One point from this critical review of the quantifications that seems worth carrying over to the main discussion is that a reduction of interest rates has but a small expansionary effect on consumption. If this was all, the monetary easing could be shrugged off, given also that the interest rate fall has been viewed as a certainty for some time and consumption patterns have been adjusting to it in anticipation, so that even less of an effect is left to come.

23. But it is not all. The interest rate fall will have a residual effect on investment–"residual" because most investments with medium or long horizons must have already incorporated the convergence of interest rates to European levels. Moreover, equity capital has, for some time, been accessible on very favorable terms in a booming stock market.

24. Last, but not least, there is also the other component of the monetary easing, the movement of the drachma towards its central parity. This has an expansionary effect on demand via the current account but it comes with a substantial lag; in the short term the J-curve effect is contractionary. It also has a transitory effect on inflation from the cost side, via the price of imports, that could become more persistent if expectations and wage bargains are influenced adversely.

25. Overall then, there are two aspects of the prospective monetary easing about which the authorities need to be, and are, very mindful, one on the demand side and one on the cost side.

26. On the demand side they think that there is a noticeable expansionary effect but consider that staff's view of it is much exaggerated. As important as the total demand-side effect is its dispersion over time. Arguably, the latter is the more important from the point of view of tailoring an appropriate policy response. As noted earlier, the monetary easing is firmly embedded in everybody's expectations, which means that part of the demand expansion effect has already occurred or is occurring. Of the effect that will occur post easing, most of it is expected to manifest itself in 2001, given that it is intended to keep the bulk of the easing for the second half of 2000 and given also the usual lags.

27. So, only a relatively small amount of demand expansion is left for 2000. In light of the vigorous supply growth of recent years, which, if anything, looks like accelerating, it

could be expected (with all due caveats of course) that this would not create problems and the authorities are therefore satisfied that the fiscal stance for 2000 that they are thinking of adopting–the budget is in the process of finalization–is appropriate in the circumstances. The crucial numbers are an overall deficit of 1.2 percent of GDP (against an estimated 1.5 percent in 1999) and a primary surplus of 6.8 percent (7.2 percent). For 2001, the new convergence program under preparation will set a target of 0.0 percent for the overall deficit (against a previous target of 0.8 percent) to be followed by a small surplus in 2002.

28. To understand the Greek situation, the truly radical improvement in the behavior of the supply side of the economy needs to be fully appreciated. This improvement has to be nurtured and encouraged. The authorities must therefore balance their concerns about overheating with the need to keep demand up to the fast pace of supply. Their forecast for GDP growth for 2000 of 3.7 percent (against an estimated 3.5 percent in 1999) is based on a cautious view of the supply potential and the authorities would not associate a further two or three decimal points on the growth rate with overheating. Sustaining a high growth rate, within a stable macroeconomic environment, is hugely important to Greece: it is the means for attaining real convergence–the next national project. It is important also for Greece's EU partners: they are providing large transfers designed to enhance growth and want to see a good "return" on their money.

29. Staff's fiscal prescription for 2000 focuses on the primary surplus and they recommend 7.0 percent "as an absolute minimum." "Absolute minimum" aside, the primary surplus of 6.8 percent that is intended by the authorities differs from staff's by only two decimal points. They do not consider this a substantial difference. It is well within the margin of error for guestimations of the right policy stance.

30. The authorities, most certainly, do not want significant overheating and will remain vigilant on that score, ready to take dampening action in response to worrying signals. They believe that vigilance, in tandem with the fiscal stance and monetary policy that they are adopting, is the best combination right now for supporting a rising growth rate while guarding against the threat of inflation. Vigilance is an essential part of this combination.

31. On the cost side there will be pressures in the second half of 2000 arising from the depreciation of the drachma towards its central parity and from the exiting from the price index of the effect of this year's indirect tax reductions. The former will affect inflation only transitorily if its side effects are contained. Staff project an end-of-2000 inflation rate of 3.3 percent (national CPI). The authorities will aim at a significantly lower number. This will be possible if the downward inflation trend continues perceptibly in the first 6-8 months of 2000, if nominal wage increases are moderate, if the expected supply effects on prices (through productivity) materialize and if the greater competitive pressures, as monetary union approaches, work as expected. The importance of nominal wage moderation and of efficiency gains in public enterprises, which staff rightly emphasize, cannot be exaggerated, especially the first. As staff note, the change in the

wage-bargaining culture in the private sector is remarkable and this is percolating to the public enterprises. The narrow public sector (the General Government) is sheltered from the pressures of the monetary union by the non-tradeable character of its activities but the government intends to play a leading role in sustaining nominal wage moderation.

32. In the second half of 2001 the effect of drachma depreciation will come out of the system and will leave the field clear to wage moderation and efficiency gains, the persistence of which will be much encouraged by monetary union pressures. Staff share the view of receding inflation in late 2001. In terms of annual averages, however, it is not expected that there will be much difference: the new convergence program under preparation is placing the inflation rate in 2000-2002 at 1.9-2.0 percent in terms of the harmonized index.

33. A priori, it seems likely that under a monetary union and as a consequence of the increased intra-union competition, inflationary pressure would result more in a current account deterioration and less in a deviation of price increases from the average than would be the case in the absence of a union. There are pluses and minuses from this for macroeconomic management in general. But it is worth making the point that Greece is right now in a position to view such a phenomenon with some equanimity because its current account seems to be running at a deficit perceptibly below 3 percent of GDP , which has been viewed for a long time as a sustainable level. ("Seems to be" rather than "is" because Greek balance of payments data continue to have problems. Despite perceptible progress, it is mainly the weakness of these data that keeps Greece out of the SDDS.)

34. Staff calculations of the Balassa-Samuelson effect give Greece a margin of 1.2 percent excess inflation over the EU average without loss of competitiveness (Box 3 of Staff Report and Chapter III of Selected Issues). The authorities have not yet examined the paper that reaches this conclusion. They are not surprised that there is a Balassa-Samuelson effect and that it is substantial, but they would be surprised though gratified if it were that high. At its face value, this finding suggests that even in the peak inflation months of late 2000-early 2001 the loss of competitiveness is likely to be counted in decimal points only. It would also imply that the inflation differential, current or expected, vis-à-vis the Eurozone member-states is not due to a difference in the business cycle phase (as some observers think) but is largely a structural phenomenon.

35. A concluding thought. It is hoped and expected that by the next Article IV discussion Greece's application for accession to EMU3 will have been approved. It is too early to bring out the champagne but perhaps not too early to start polishing the glasses.