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# Greece: Staff Report for the 1999 Article IV Consultation

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GREECE

**Staff Report for the 1999 Article IV Consultation**

Prepared by the Staff Representatives for the 1999 Consultation with Greece

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September 23, 1999

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1. The 1999 Article IV consultation discussions were held in Athens during June 17–28, 1999. The mission[1] met with the Minister of National Economy and Finance, the Governor of the Bank of Greece, the Office of the Prime Minister, other senior officials, leaders of the trade union and employers' organizations, and market participants. The mission also assisted the authorities in completing a self-assessment against the *IMF Code of Good Practices on Fiscal Transparency—Declaration on Principles*. In addition to their traditional release of the mission's concluding statement, the authorities have indicated their intention to participate in the pilot project on the voluntary release of Article IV staff reports.

2. At the **conclusion of the last consultation** in August 1998, Directors commended the authorities' commitment to strengthened policy adjustment which, along with entry into the ERM, had enhanced the prospects of EMU participation by January 1, 2001. At the same time, they stressed that EMU qualification was a demanding goal to be realized within a limited time span. In particular, achievement of the Maastricht criterion for inflation, while feasible with policy rigor, was not yet secure; in this regard, a number of Directors expressed reservations about the intention to limit inflation through indirect tax cuts. Directors recommended a stance centered on fiscal and monetary policy restraint, as well as ambitious structural reforms that would aid disinflation and improve Greece's relative growth performance.

3. **Prime Minister Simitis' left-of-center Pasok government** has made EMU participation its prime economic goal and, on present plans, intends submitting Greece's request for membership in March 2000. National elections are to be held by October 2000, but would need to be brought forward if the presidential elections in March do not yield the required parliamentary majority.

## I. Background

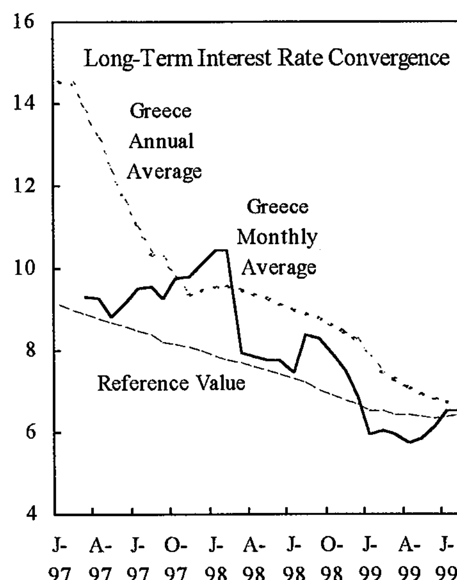
4. **Greece made considerable advances toward convergence in the 1990s but, by late 1997, was finding progress under the "hard drachma" policy increasingly arduous**. In the course of 1997, rapid wage growth and signs of a deteriorating current account performance underpinned assessments of drachma overvaluation and fueled market expectations that an exchange rate correction would be unavoidable before intended EMU participation. The resulting exchange rate pressures and sharp rise in interest rates risked derailing growth and fiscal targets for 1997–98, placing the strategy toward EMU participation in peril.

5. **In March 1998, the government opted for an alternative strategy of devaluation and ERM entry—an approach that has succeeded in generating the virtuous circle essential to the success of the drive to EMU**. The "regime switch" represented by the drachma devaluation, ERM entry, and the accompanying strengthening of policies was deemed essential also by the staff, both for competitiveness and confidence reasons. The virtuous circle of interest rate declines (at this stage, predominantly at the long end) that aid fiscal consolidation, and of

[1] Messrs. Leipold (Head), Halikias, Lutz, Swagel (all EU1) and Mr. Allan (FAD); Mr. Spraos, Alternate Executive Director, also participated in the meetings, and Mr. Faini, Executive Director, attended the concluding meetings.

subdued price expectations that help elicit nominal wage restraint, is underway—staff reservations about the balance of the policy mix and the quality of certain measures notwithstanding. The pace of nominal and real convergence with the rest of the EU has accelerated: economic growth has picked up (with the economy now estimated to be operating at around potential), the fiscal deficit has fallen well below 3 percent of GDP, and the debt-to-GDP ratio is declining (Tables 1 and 2). After rising in the wake of the devaluation, inflation has moderated, albeit also as a result of cuts in indirect taxes and other administrative measures. As expected, clearing the Maastricht inflation hurdle is proving the most demanding. (Further details on developments in the real economy following ERM entry, and the administrative measures taken to contain inflation, are provided in Box 1).

6. **The monetary policy stance—centered on high interest rates and a strong drachma—has been tight, contributing to the anti-inflationary effort**. In its monetary policy statements, the Bank of Greece has set price stability (defined as an inflation rate not in excess of 2 percent, to be achieved by end-1999) as its preeminent policy objective. To this end, the Bank has maintained high official interest rates (keeping the key 14-day deposit rate unchanged at 12 percent since early 1999; Figure 6) and allowed the drachma to appreciate within the ERM band (in a range of 8–8¾ percent above its central parity since shortly after ERM entry; as from January 1999, the drachma joined ERM2 with margins of +/-15 percent). Financial markets have reacted favorably and, despite the uptick observed during the summer, the 10-year government bond yield is more than 400 basis points below the level prevailing before ERM entry. The 12-month moving average used to test for convergence has narrowed to some 20 basis points above the Maastricht reference value.



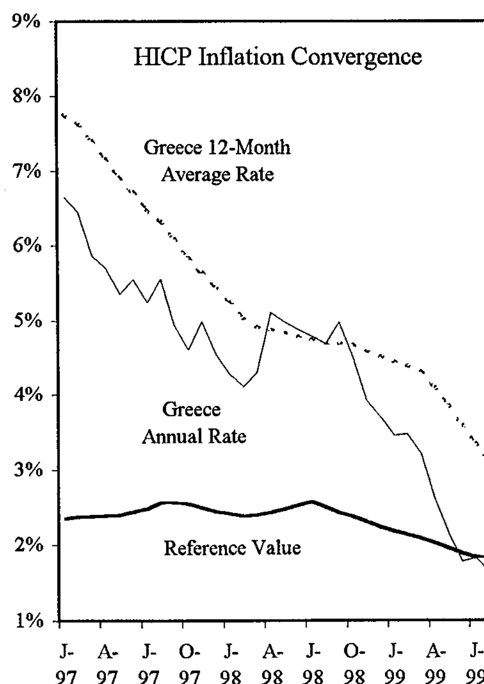

7. **But the effectiveness of monetary policy is diminishing in the run-up to EMU**. The high level of interest rates has given rise to capital inflows, especially in the first part of the year, which found their counterpart in a marked buildup of foreign exchange reserves (to US$ 21.4 billion in August) and in a pace of credit expansion above its indicative range (6–9 percent). The growth of mortgage and consumer lending has been particularly brisk, raising Bank of Greece concerns about its potential inflationary impact.[2] At the same time, the ability of interest rate policy to curb credit growth is

[2] While this largely reflects an adjustment of consumer lending to financial liberalization, and the share of consumer loans in total private sector bank credit or their ratio to GDP are below those in other EU countries (Table 3), the pace of expansion is of concern. In addition, some of this lending appears to have financed stock exchange purchases, fueling a boom that has recently further intensified, raising related concerns about overvaluation.

## Box 1. Post-ERM Developments in the Real Economy

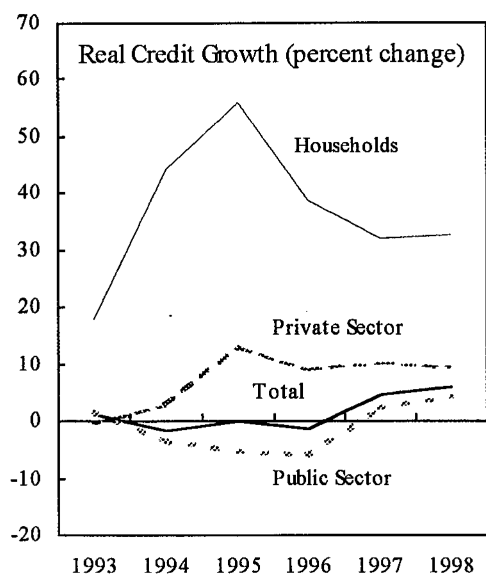
**Growth is relatively strong, with the economy in the sixth year of an expansion that is estimated to have brought output back to potential** (Figure 1).[1] With the end of the Kosovo conflict, estimates of its negative impact have been scaled back, and staff now projects GDP growth at 3¼ percent in 1999, slightly above Consensus. This would be in excess of the EU average for a fourth consecutive year, a welcome contrast to the absence of any catch-up in the first decade of EU membership. Activity is being led by high rates of public and private investment (Figure 2), buoyed by improved absorption of EU transfers, strengthened profitability, new tax allowances, lower capital costs, and a booming stock market (the share index rose by 85 percent in 1998, and has more than doubled so far this year). Though wage moderation and stagnant employment have restrained the growth of disposable income, private consumption appears to be picking up, sustained by brisk consumer lending. Export performance has also strengthened, reversing a protracted decline in market shares, and the current account deficit is projected to improve slightly (to 2.3 percent of GDP in 1999; Figure 3), with increased government and private sector saving rates allowing for the rise in investment. The prolonged recovery has failed, however, to dent still high unemployment (Figure 4).

**Post-devaluation inflation proved persistent, inducing the authorities to introduce a series of administrative measures aimed at observing the Maastricht criterion.** Following the devaluation, inflation peaked at 5.3 percent (national index) in May 1998, and remained close to that level for the next four months (Figure 5). In the fall of 1998, amidst mounting concern about inflation prospects (in light also of the possible triggering of wage catch-up clauses at end-year), the government (a) reduced indirect taxes on a range of products; (b) entered into a series of "gentlemen's agreements" to cap price increases; and (c) limited adjustments in administered prices. All told, these measures are estimated to have reduced headline inflation by about 1 percentage point. With the post-devaluation effect falling out of the year-on-year calculations, inflation has declined further, to 2.0 percent in August 1999—lower than in several euro-area countries. However, the latest harmonized inflation differential with the three best EU performers on the basis of the Maastricht definition (12-month moving average) remained some 1¼ percentage points above the differential allowed in calculating the reference limit. But this differential is clearly on a declining path, aided also by additional indirect tax cuts in August and September.




**Disinflation has been aided by a sharp moderation of labor costs.** The current two-year national wage agreement (through 1999) is moderate by Greek standards and, in contrast to earlier experience, has not been undermined by higher sectoral accords—even though, as noted, the operation of wage catch-up clauses was avoided by recourse to administrative measures. Strong gains in labor productivity, spurred by high capital growth, have contained unit labor costs; for 1999, ULCs in manufacturing are projected to grow broadly in line with those of EU partners.

[1] For a discussion of potential growth in Greece, see "Potential Output and the Output Gap in Greece: A Third Face for Janus?" in IMF Staff Country Report No. 98/100. In updating those estimates (in light also of the prospect for continued high investment under the Third Community Support Framework), the staff places potential growth at around 3½ percent in the next few years, with appreciable upside scope depending on the pace of structural reforms. Technical work by the Bank of Greece and the Ministry of National Economy points to an average growth rate of potential output within a range of 3.0–4.3 percent in the period 1999–2001, with the higher figure resulting from a "convergence scenario" (i.e., full implementation of the convergence program's investment plans and reforms).




being undercut by the fully anticipated terminal point of interest rate convergence in the approach to EMU. In this setting, the Bank of Greece imposed temporary credit controls in mid-April 1999 (in the form of nonremunerated deposits for an amount equivalent to the growth of credit above specified rates); at end-July 1999—in the face of still rapid consumer lending—the penalty for excess lending in this category was doubled.

8. **Although there was no tightening of the fiscal stance between the pre- and post-devaluation situations in 1998, the fiscal sights were raised in 1999.** At the last consultation, the Board had encouraged the authorities to pursue a better-than-budgeted deficit outcome in 1998, in order to return inflation rapidly to the ambitious path required for EMU. The authorities took the view that a fiscal tightening beyond the original target for 1998 risked being too uncertain an instrument to reduce inflation rapidly by year-end, a relevant time-frame given the operation of wage catch-up clauses. They accordingly opted to offset only the direct impact of the devaluation on the fiscal accounts, retaining an unchanged deficit target (2.4 percent of GDP). The target was met (Figure 7) despite a sizable overrun in primary current spending (equal to ½ percentage point of GDP), offset by a commensurate overperformance of revenues (in part reflecting the higher drachma value of EU transfers following the devaluation). The debt-to-GDP ratio declined further (to 106.1 percent of GDP), aided by high privatization revenues. For 1999, the budget set a deficit target of 1.9 percent of GDP, improving on the convergence program's objective of 2.1 percent of GDP. Despite the costs of additional indirect tax cuts introduced in August and September (see below), and those arising from the earthquake of early September (still being assessed as this report was being finalized, and at all events likely to be financed by a redirection of EU funds and spread over a number of years), developments to date indicate the likelihood of a better-than-budgeted outcome.

9. **On structural reforms, progress has been visible with regard to privatization and some aspects of public enterprise restructuring, but much remains to be done, while broad social security and labor market reforms remain largely on hold**. Upon ERM entry, the authorities announced a detailed privatization and partial flotation program, which, with a few delays, has been essentially implemented (Table 4). In the banking system in particular, these sales—along with EMU prospects—have sharply intensified competitive pressures. But other major sectors continue to be dominated by public enterprises, and liberalization is being deferred as long as permissible under EU derogations. The restructuring of loss-making public enterprises faces recurrent political hurdles, but some ground-breaking advances in key enterprises have nonetheless been recorded.[3] In the labor market, measures taken in August 1998 have to date

[3] Such as the conclusion of a private management contract for Olympic Airways and steps to address the Public Power Corporation's unviable pension situation, a prerequisite to flotation.

remained largely unapplied. Fundamental reform of the social security system has been deferred to after the 2000 elections; nonetheless, measures taken under a "mini" package hold the promise of both appreciable savings and increased efficiency.

## II. Policy Discussions

10. **Despite the hurdle represented by the Maastricht criterion on inflation and the sustainability of price stability, a positive outcome of Greece's drive to EMU participation by the January 2001 target date is now generally anticipated**. The authorities stressed their deep commitment to this goal and their determination to see it through, including—if needed—by means of additional indirect tax cuts later in the year, as has indeed occurred. In this setting, a shared premise of the discussions was that the EMU process will be kept on track and current market confidence in a positive outcome maintained. The authorities' resolve is firm and market confidence (reflected also in upgradings by credit rating agencies) has proven remarkably resilient to several tests (including, most recently, the Kosovo conflict—Figure 8).

11. The discussions thus had a "pre-in" flavor and focused primarily on **the policies required to secure a low inflation performance on a sustainable basis and to enhance growth prospects within monetary union**, seeking responses to the following main questions:

- what is **the remaining contribution that monetary policy can provide to price stability**, and is there any leeway to attenuate the degree of monetary easing in prospect?

- what is the **appropriate stance for fiscal policy** that is consistent both with Greece's medium-term requirements and with the need to ensure the sustainability of price stability, given the current cyclical position, the reliance on administrative measures to date, and the easing of monetary conditions in the run-up to EMU?

- what **additional efforts in the structural area** are critical to tackle the supply side sources of inflationary pressures, reduce structural unemployment, and contribute to a more rapid convergence of GDP per capita to that of partner countries?

### A. Achieving and Sustaining Price Stability

12. **The main policy challenge is to achieve and sustain price stability**. The authorities were working on the assumption that the Maastricht reference value for inflation would be around 2.2–2.3 percent (in terms of the national index, equivalent to some 2 percent on a harmonized basis) by early 2000, at the time of their request for EMU membership.[4] There was

[4] This implied some pickup in the average of the three lowest EU inflation rates due to recent oil price developments. The authorities thought it prudent to base policy on the assumption of a strict interpretation of the Treaty for the inflation criterion to be applied to second-round EMU entrants. The related assessment of sustainability is, by its nature, mainly of a judgmental character.

agreement that, on current trends and barring further measures, inflation in Greece was likely to average slightly above this value (by 0.3–0.4 percentage points). The authorities expressed particular concern about the obstinacy of inflation (at some 5–6 percent) in private services and certain retail sectors, a possible indication of demand-driven pressures as well as inadequate competition in these sectors. Staff furthermore noted that inflation was set to rise again in late 1999–early 2000, as the one-off impact of last year's indirect tax cuts dissipated.

13. The discussions thus covered **the role of different policy instruments in achieving a low and sustainable price performance** in the run-up to EMU and once within monetary union. These ranged from the administrative measures employed by the authorities to traditional macroeconomic policies and structural reforms, reviewed in turn below.

**Administrative measures: transitory or more durable effects?**

14. **Given the above outlook and the need to contain inflation within a certain reference period, the authorities stated their intention to resort again to administrative measures as required**—and, with inflation declining more slowly than expected, they did so in August and early September 1999.[5] The staff recognized that, having eschewed what it saw as the preferable option of an immediate post-devaluation tightening of the fiscal stance, the authorities had left themselves with limited policy tools to restrain inflation within the short time span available to the Maastricht test date. But it stressed the shortcomings of such an approach. Indirect tax cuts, by their nature, have essentially transitory effects on inflation. While restraining inflation during a given reference period, they would not in themselves ensure the sustainability of price stability required under Maastricht—as demonstrated by the need for additional measures to compensate for the end of the effects of the 1998 package. With these measures having since been introduced, and the unwinding effect thus postponed to the second half of 2000, the staff's updated projections indicate observance of the Maastricht criterion for most of 2000, but an appreciable pickup in inflation in the latter part of 2000 and in 2001 (Table 5).[6] Furthermore, the approach inserted short-term considerations related to inflation performance that are extraneous to the setting of tax policy in the longer term. Finally, such tax relief adversely affected the fiscal accounts and, in some cases, risked fueling consumption (as evidenced, for example, by booming car sales following the reduction in the relevant VAT rate).

15. **The authorities were more positive about the enduring effect of such measures on inflation, and noted that strong revenue performance allowed for indirect tax cuts without endangering the fiscal targets**. While they agreed that, from a narrow technical angle, the effect of such measures on inflation was indeed temporary, they noted that—to the extent that the measures had served, at end-1998, to avoid the adverse second-round effects of the operation of wage catch-up clauses (and would do so again at end-1999, when such clauses would be

[5] By reducing the excise taxes on gasoline, heating oil, and car purchases.

[6] For 2002, the projections reflect a dissipation of the effects of the drachma's depreciation in the run-up to EMU and a beneficial impact on prices from the liberalization of the telecommunications and electricity sectors.

triggered for inflation above 2 percent)—their impact on wage developments and on inflationary expectations was of a more lasting nature. The moderation observed in sectoral wage accords was reassuring in this respect, and the authorities suggested that an incipient, EMU-related change in wage-setting behavior was at work, with a growing realization of the consequences of the regime shift implied by monetary union. Staff observed that it was as yet premature to be confident on this score: empirical evidence suggests that Greek trade unions have tended to target real wages and incorporate current losses of purchasing power into future contracts.[7] Regarding fiscal and tax policy, the authorities noted that a number of the cuts had aligned excise taxes more closely to EU averages, while others would be reversed in due course, and that the fiscal targets were in no way at risk as a result of the measures.

**The remaining contribution of monetary and exchange rate policy**

16. **The Bank of Greece intends to maintain a tight monetary stance for as long as needed in the run-up to EMU**. The staff agreed that interest rate cuts would need to await clear evidence of lower actual and expected inflation on a sustained basis. A piece of evidence in this regard could be a deceleration in the pace of credit expansion in the fall of this year.

17. The Bank was however also keenly aware of **the waning effectiveness of monetary policy in the approach to EMU**. It noted that the **conduct of monetary policy was constrained** by a combination of (a) the traditional capital inflows dilemma (and related sterilization costs) faced by exchange-rate based disinflation approaches and (b) the EMU convergence process that largely predetermined expectations regarding interest rates. In this setting, the ability of monetary policy to curb credit growth was eroded, on the demand side, by the public's widespread perception that interest rates would *per force* decline in the coming period, and, on the supply side, by banks' readiness to effect anticipatory reductions in lending rates in their vigorous pursuit of market shares. It was this set of circumstances that had induced the Bank to introduce administrative measures to restrain credit growth in April 1999. Sharing staff views about the drawbacks of such measures, the Bank stressed their temporary nature, and aspects of their design that limited the degree of intervention in banks' decisions. It remained concerned that, given the intensity of competition in the banking sector, the controls would not "bite" to the extent desired; indeed, continued excess growth in consumer lending subsequently induced it to tighten requirements in that area. The Bank had also sought to supplement its policy interventions with more vocal public pronouncements aimed at modifying behavior and shaping expectations—including, for example, a clear indication in its Annual Report that the pace of interest rate reductions would be contingent on firms and the self-employed contributing fully to the anti-inflationary effort in their price-setting behavior.

18. **Looking forward, the eventual alignment of domestic interest rates with those in the euro area and the depreciation of the drachma to its central parity would entail what the staff saw as a sizable relaxation of monetary conditions**. Given the conditions prevailing in

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[7] See "Post-devaluation Inflation Prospects: An Empirical Investigation," in IMF Staff Country Report No. 98/100.

Greece (the drachma at some 8¼ percent above its central parity, and short-term interest rates 730 basis points above equivalent euro rates), such easing was set to be much larger than that experienced in other economies that joined EMU in the first wave (Figures 9 and 10). In the wake of this easing, several of these countries had been recording inflation rates appreciably above the euro average.

19. **The authorities pointed to a number of factors that, in their view, attenuated the extent of monetary relaxation**. First, they noted that the degree of easing would depend on the evolution of the euro/U.S. dollar rate, and pointed to some firming of the euro then underway. Second, and most importantly, they felt that the easing implied by lower interest rates would be significantly diminished by its dampening effect on household incomes. The staff thought that the influence of this channel was being overplayed—while nonnegligible (given the large share of government debt and bank deposits in household financial assets), it was unlikely to have such a strong depressing impact on consumption as to offset the positive impulse of lower interest rates stemming from concurrent wealth and substitution effects. The authorities expressed interest in a quantification of these arguments, which however proved difficult due to data limitations; nonetheless, empirical results from other southern euro area countries indicate that the income effect on households cannot be relied upon to offset the expansionary impact of a reduction in interest rates (see Box 2 and Selected Issues paper). In addition, there was no disagreement that the exchange rate depreciation would impart an inflationary impulse. The discussions also reviewed the likely timing of the effects of the monetary easing: while such easing could, in some respects, be seen to have already largely occurred (long-term interest rates have converged substantially, and convergence at the short end is fully anticipated, influencing behavior), the Bank of Greece estimated that—given the time lags involved—the bulk of the remaining effects of monetary easing would most likely be felt in 2001.

20. **The staff raised the question of possible scope for containing the degree of monetary easing by entering EMU at an exchange rate somewhat above the current ERM2 central parity**. It noted that the initial devaluation (12.3 percent) fell within a range (10–15 percent) that the staff had judged appropriate at the time based on a series of considerations (competitiveness indicators, medium-term saving-investment trends, and market assessments; see SM/98/186, 7/15/98). Updated estimates based on the staff's macroeconomic balance approach tend to confirm this finding.[8] The staff thus deemed the central ERM parity as broadly appropriate from a medium-term perspective—which also needed to take into account the likely decline of EU transfers from the substantial level (some 5 percent of GDP annually) secured in part under the Third Community Support Framework through 2006. Nonetheless, other indicators (including the strength of trade performance, the absence of a deflationary impulse imparted by the current level of the exchange rate, as well as a possibly telling lack of complaints by exporters), suggested some scope for flexibility in this respect—considering also the margin of error in calculations of equilibrium exchange rates. But the staff acknowledged that any scope for a more appreciated lock-in rate than the central rate was likely to be quite small and of lesser import in

[8] For a description of this approach, see IMF Occasional Paper 167, *Exchange Rate Assessment: Extensions of the Macroeconomic Balance Approach*, 1998.

## Box 2. Household Consumption and Interest Rates—Evidence From Other Countries

The run-up to EMU participation will entail the convergence of Greek interest rates to the levels prevailing in the euro area. While this process is already underway, a sizeable further easing is in store, especially at the short end of the maturity spectrum. The impact of this factor on household income is substantial, given the large share of government debt that is held by domestic households and the prominence of bank deposits in household financial assets. Specifically, the Bank of Greece has estimated that interest rate convergence will reduce household interest income by about Dr 1.2 trillion (or some 3 percent of GDP).

**The question thus arises as to whether this "income effect" can have such a strong depressing impact on consumption as to offset the positive impulse of lower interest rates on aggregate demand.** Economic theory cannot offer a definitive answer to this question; indeed, even the impact of a change in the real interest rate on consumption is not in principle unambiguous. Specifically, the above-noted income effect operates along other factors that work in the opposite direction. Thus, a decline in interest rates results in capital gains for bond holders—a "**wealth effect**" that can be expected to boost consumption. Moreover, a reduction of the real rate of interest should entail some substitution of current saving for current consumption, with this "**substitution effect**" having a similarly expansionary impact on demand.

**In the face of these ambiguities, the question at hand needs to be resolved empirically.** Such an empirical investigation for the case of Greece is severely **hampered by data deficiencies**—notably, the unavailability of household income accounts and the lack of quarterly national accounts. Still, some tentative conclusions can be drawn from a survey of the **empirical results for three southern European countries that currently participate in the euro area**—Italy, Portugal, and Spain. These countries have already undergone a process of interest rate convergence and, to varying degrees, bear some important similarities to Greece's economic structure. At first glance, the experience of these countries raises doubts about the relative quantitative importance of the income effect. Interest rate convergence was accompanied by a boom in consumer credit and private consumption in Portugal and Spain; even in Italy, where there is considerable economic slack, consumer spending has accelerated and is one of the few factors underpinning economic activity.

We first present **simulation results from the Oxford Economic Forecasting (OEF) model**, which is used by EU1 desks as an input to their projections. OEF is a backward-looking error-correction model of OECD economies (excluding Greece, for lack of quarterly data), whose relatively small size and common structure makes it suitable for international comparisons, albeit at the cost of missing some country-specific features. On the question at hand, the model estimates a strong substitution effect of a change in interest rates for all three countries under consideration, but does not explicitly include wealth as a determinant of consumption. Presented below are the estimated effects on consumption and GDP of a permanent 100 basis point reduction in interest rates over a four-year horizon. The simulation results for all three countries raise doubt about the relevance of the income effect: consumption is estimated to respond positively, and in a sustained manner, to a decline in interest rates, constituting a major transmission channel to economic activity.

Simulations using OEF
(Percent deviations from baseline)

| Year | Italy | | Portugal | | Spain | |
|---|---|---|---|---|---|---|
| | Cons. | GDP | Cons. | GDP | Cons. | GDP |
| 1 | 0.28 | 0.16 | 0.23 | 0.35 | 0.44 | 0.28 |
| 2 | 0.44 | 0.28 | 0.44 | 0.30 | 0.50 | 0.35 |
| 3 | 0.29 | 0.26 | 0.36 | 0.19 | 0.41 | 0.37 |
| 4 | 0.17 | 0.19 | 0.30 | 0.16 | 0.36 | 0.31 |

**A second set of simulations, based on the Bank of Italy's quarterly model (BoI), was run specifically on Italy**, which is a good comparator to Greece in terms of the debt ratio, its maturity structure, and the extent to which it is held by domestic households. Compared to the OEF results, BoI specifies a much smaller substitution effect, but at the same time explicitly introduces a wealth effect relating to capital gains on bond holdings as a determinant of consumption (results below again refer to a permanent 100 basis point interest rate reduction, alternatively treating the exchange rate as exogenous and endogenous). A salient difference compared to the OEF results is that the impact of an interest rate reduction on consumption eventually turns negative, reflecting the income effect, especially under the endogenous exchange rate specification. However, in cumulative terms, an interest rate cut is estimated to boost consumption over the simulation horizon. Moreover, and importantly for policy purposes, the income effect does not come to dominate until the fourth year after the shock.

Simulations Using BoI Model
(Percent deviations from baseline)

| Year | Exchange rate exogenous | | Exchange rate endogenous | |
|---|---|---|---|---|
| | Cons. | GDP | Cons | GDP |
| 1 | 0.15 | 0.12 | 0.13 | 0.32 |
| 2 | 0.35 | 0.31 | 0.30 | 0.53 |
| 3 | 0.12 | 0.24 | 0.02 | 0.22 |
| 4 | -0.13 | 0.09 | -0.21 | 0.10 |

In summary, the empirical results presented above suggest the need for caution in relying on the income effect on households to offset the expansionary impact of a reduction in interest rates. For all three southern euro area countries, an interest rate cut boosts consumption (and economic activity), at least over a policy-relevant time horizon: there is a strong likelihood that this would hold for Greece as well. See Selected Issues paper for further details.

the overall disinflationary effort, pointing to the need to rely on other instruments—fiscal, wage, and structural policies—to ensure a sustainably competitive inflation performance in monetary union.

**The contribution of fiscal policy: the need to strengthen fiscal plans**

21. **The authorities' convergence program for 1998–2001 provided the starting point for the discussions on fiscal policy**. Under this program, the general government deficit is targeted to fall from 2.4 percent of GDP in 1998 to 0.8 percent of GDP in 2001, and the primary surplus to rise slightly over the same period (from 6.7 percent to 7 percent of GDP; with the economy operating at or around potential, actual and structural balances are similar). A review of the program's estimates for the interest bill, conducted jointly during the mission, confirmed that these were decidedly conservative, as indeed the program explicitly recognizes (it quantifies the potential overestimation of interest payments at as much as 1.4 percentage points of GDP by 2001). The staff noted that, in these circumstances, adherence to the program's targets for the overall deficit—on which policy is normally focused—would imply a marked deterioration of the primary surplus (by almost 1 percent of GDP in 2000), a development that was unwarranted on both medium term and cyclical grounds.

| | 1999 Staff proj. | 2000 | 2001 |
|---|---|---|---|
| **Implications for Primary Balance of Targeting Convergence Program Overall Balance in 2000-01** | | | |
| | (Percent of GDP) | | |
| Interest expenditures | 8.7 | 7.7 | 6.6 |
| Overall balance | -1.7 | -1.7 | -0.8 |
| Implied primary balance | 7.0 | 6.0 | 5.8 |
| **Implications for Overall Balance of Targeting Convergece Program Primary Balance in 2000-01** | | | |
| Interest expenditures | 8.7 | 7.6 | 6.6 |
| Implied overall balance | -1.7 | -0.7 | 0.4 |
| Primary balance | 7.0 | 6.9 | 7.0 |
| Memorandum item: | | | |
| Convergence program | | | |
| interest expenditures | 9.0 | 8.6 | 7.8 |

22. **The authorities concurred on the advisability of abiding rather to the convergence program's targets for the primary balance** (a surplus of some 7 percent of GDP in both 2000 and 2001). In the staff's calculations, a primary surplus of this magnitude would lead relatively rapidly (by 2001) to fiscal balance or a small overall surplus. The authorities, preferring to maintain their habitual caution in estimating the interest bill and in the announcement of official deficit targets, saw adherence to the primary surplus target as consistent with a somewhat slower

improvement in the overall balance, but still one that would be more rapid than that envisaged in the present convergence program. Indeed, for the update of this program later this year, they were considering—but were not yet officially in a position to commit to—a strengthening of the deficit targets for 2000 and 2001, and achievement of fiscal balance by 2002.[9] In this regard, in endorsing Greece's convergence program in October 1998, the ECOFIN Council remarked that "a significant reinforcement of the pace of fiscal adjustment, if confirmed through the whole period of the program, would be most welcome."

23. While fiscal balance (and, a fortiori, a small surplus) is more than would be required to ensure Greece's observance of the Stability and Growth Pact (SGP), the staff noted that **a proper assessment of the fiscal requirements depended also on an evaluation of the medium- and long-term outlook for both the assets and liabilities of the broader public sector**. Taking this perspective, **a number of considerations argued for an ambitious medium-term fiscal target**. While Greece could count on comparatively large privatization proceeds, it was burdened by a high government debt ratio (a primary surplus of 7 percent of GDP would still leave this ratio at above 60 percent of GDP by 2005, when the number of pensioners begins rising steeply), the highest level of unfunded pension liabilities in the OECD, significant contingent liabilities, and a large debt accumulated by chronically loss-making public enterprises. In this vein, the staff saw merit in, and provided some preliminary suggestions on, developing a broad balance sheet/net worth approach to fiscal policy-making and -reporting, in line with trends in other OECD countries (see the Selected Issues paper, which also reviews the authorities' self-assessment against the *IMF Code of Good Practices on Fiscal Transparency—Declaration on Principles*).[10]

24. Within the above medium-term framework, **the staff considered that it was incumbent on fiscal policy in 1999 and 2000 to play a full role in restraining inflationary pressures arising from current cyclical conditions and the prospective monetary easing**. For 1999, adherence to the budget target (a deficit of 1.9 percent of GDP) would fall short of this requirement, as it would imply a broadly neutral fiscal stance. Developments to date, however, indicated the likelihood of a marked overperformance on the revenue side, with the sustained tax

[9] Initial working assumptions at the time of the discussions implied an overall deficit target of no more than 1½ percent of GDP in 2000 (versus 1.7 percent of GDP in the present program) and ½ percent of GDP in 2001 (versus 0.8 percent of GDP), and of fiscal balance by 2002.

[10] The self-assessment indicates that significant steps have been taken toward improving fiscal transparency, and in its commentary (in a similar form to those for the United Kingdom and Argentina) the staff made a number of specific suggestions for possible further steps, particularly in terms of developing the accounting framework; improving information on various risks associated with the fiscal accounts; a more effective monitoring and analysis of the medium- and long-term effects of below-the-line capital injections to public enterprises (amounting to some 1½ percent of GDP annually), and of the operations of the organization handling the proceeds of privatized assets (DEKA); and developing periodic reports on long-term fiscal sustainability. In general, these suggestions were well received by the authorities, and in some areas were seen as providing useful support to reforms under consideration.

administration efforts of the past years yielding tangible results (as well as significant revenues from a new turnover tax on share transactions). Although the authorities agreed that higher-than-budgeted revenues should largely be devoted to deficit reduction, they also reserved the possibility of using them in part to finance additional indirect tax cuts, which were subsequently undertaken. A better-than-budgeted result nonetheless remains within reach; the authorities' latest estimate is of a deficit of 1½ percent of GDP in 1999.

25. **Looking to the 2000 budget, the staff welcomed the authorities' recognition of the advisability of observing the convergence program's target for the primary surplus (some 7 percent of GDP), rather than its superseded target for the overall deficit**. But it cautioned that—while consistent with the above-noted medium-term requirements—such a target should be seen as a minimum when set against the cyclical and policy mix circumstances that were likely to prevail, and that greater restraint (to be assessed when formulating the 2000 budget) was likely to be needed.[11]

26. In this setting, **the staff advised the authorities to reconsider the tax reduction initiatives being planned for 2000 and 2001; the authorities took note of the staff's concerns but remained committed to their intentions and have since gone forward**. At the time of the discussions, the authorities were preparing a package of tax cuts for 2000–01, in an amount then put at some ¾ percent of GDP over the two years. The staff expressed several reservations in this regard, pointing to the lack of detail on the offsetting expenditure cuts, the risk of higher revenue losses than those anticipated (notably from the intended abolition of the presumptive taxation criteria introduced in the mid-1990s to assess the tax liabilities of the self-employed), the procyclical impulse that would be imparted to the economy, and the untimely signal of relaxation provided—particularly in a situation where the culture of price stability was still fragile and at a time when the negotiations for a new wage agreement would be resuming. The authorities noted the pressing need to address equity issues arising from the sizable fiscal drag of the past years, and wished also to demonstrate to the public tangible benefits from the pursuit of stability-oriented policies—they saw the strong fiscal, and especially revenue, performance as permitting it. As to the abolition of the presumptive criteria, they believed that progress in tax administration was now sufficient to advance to more sophisticated assessment methods.

27. **In early September, the government announced a package of both tax cuts and benefit increases effective as from January 2000.** Main measures include a raising of the level

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[11] In this regard, in response to questions on the required degree of fiscal stringency in light of the prospective monetary easing, the staff estimated (as an illustrative exercise based on a structural VAR model; see Selected Issues paper) that—excluding any contribution from other policies—fully offsetting the inflationary impact of monetary easing would require a cumulative fiscal contraction in the order of 3–4 percentage points of GDP over a two-year period. It recognized such an effort to be unrealistic, and the estimate probably on the high side, but it was seen as suggestive of the broad order of magnitude of the task at hand and indicative of the need to harness other policies (notably wage moderation and structural reforms) to securing sustainable price stability.

of tax-exempt income; higher tax allowances for families with children; a reduction in the corporate tax for small businesses; the abolition of the presumptive criteria; a reduction of social security contributions for new net hires; and an increase in unemployment and selected pension benefits. The package (whose total cost, inclusive of the indirect tax cuts, is officially estimated at 1.1 percent of GDP) is to be partly financed by a doubling (to 0.6 percent) of the tax on stock sales, estimated to raise about ½ percent of GDP. Although the 2000 budget has not yet been elaborated, the authorities see the package as compatible with a further appreciable decline in the overall deficit from the estimated outcome for 1999. The staff is less sanguine, and in particular—in the absence of further offsetting measures—projects a sharp deterioration of the primary surplus (Table 5).

**The contribution of wage moderation**

28. **The current two-year national wage agreement will expire at end-1999 and negotiations on its renewal have yet to start, but early indications appear encouraging.** Some key accords extending into next year (in public enterprises and the banking sector) have been concluded with moderate awards, and the 2000 budget is likely to incorporate wage moderation for civil servants. The staff stressed the importance that, in their negotiations, employers and employees appreciate fully the consequences of the regime change implied by the ERM and, prospectively, monetary union, and queried the continued role of wage catch-up clauses in the new environment.

**The contribution of structural reforms: enhancing growth, disinflation and employment**

29. **The structural reform agenda remains a broad one: the discussions focused on those areas where key additional steps were likely to make a significant contribution to disinflation and growth prospects, notably by strengthening competition and raising productivity.**[12] There was agreement on the primary role that structural reforms would need to play to make the economy more efficient and promote a much more rapid and employment-intensive catch-up process: this was particularly the case with regard to privatization, public enterprise restructuring, liberalization of product markets, and labor market reforms. If sufficiently bold, the staff noted, the structural agenda could relieve the burden on macroeconomic policies.

30. **The authorities expressed satisfaction with the implementation of the privatization program for 1998–99, and with progress in the restructuring of loss-making public enterprises—these were jointly seen as priority areas.** The authorities noted that privatization revenues under the program announced at the time of ERM entry had amounted to some

[12] On the degree of required disinflation, it was noted that the catch-up of productivity in Greece's tradables sector to the levels of main trading partners could be seen as justifying a modestly higher rate of inflation in Greece over the medium term. Box 3 sets out the results of a cross-country quantification of this effect, and confirms—subject to data limitations—the presence of an inflation differential that can be seen as a by-product of Greece's real convergence process.

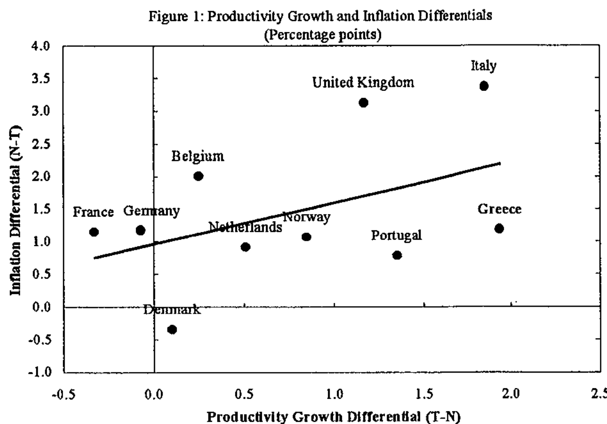
## Box 3. A Cross-Country Quantification of the Balassa-Samuelson Effect

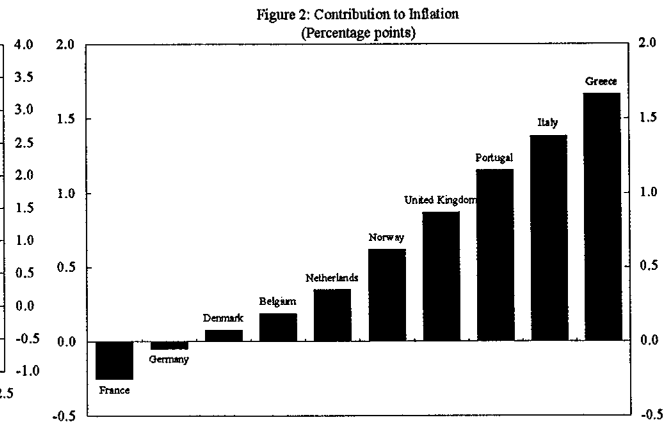
Inflation in Greece is influenced in part by the catch-up of productivity in Greece's tradable goods sector to the productivity levels of its main trading partners. As discussed in several recent staff reports (Finland, Ireland, and Spain), this "Balassa-Samuelson effect" comes about because countries that are experiencing rapid productivity growth in the tradables sector will tend to have higher inflation rates for nontraded goods, and thus higher inflation than would be the case were productivity growth even across sectors. In Greece, the highly centralized system of wage setting ensures that wage growth in nontradables largely keeps pace with that in tradables despite lower productivity growth.

Figure 1 shows that the Balassa-Samuelson relationship holds reasonably well in European countries over 1990–96, with a correlation of 0.58 between total factor productivity growth and inflation differentials across tradable and nontradable sectors.[1] As suggested by the theory, poorer countries tend to have larger productivity differentials reflecting their greater scope for productivity catch-up, and thus larger inflation differentials across sectors. In Greece, however, the 1.9 percentage point productivity differential stems mainly from negative productivity growth in nontradables; productivity growth in tradables, at 0.9 percent, exceeds that in Germany and France, but is below that of the other countries. The inflation differential of 1.2 percent between tradable and nontradable sectors in Greece is less than the corresponding productivity differential, but this is due to faster wage growth in tradables. Greece is less open than the other countries examined, with a smaller share of tradable goods, so that higher inflation in nontradables has a relatively large effect on overall inflation.

Figure 2 shows the prediction of the Balassa-Samuelson model for the contribution of the productivity differentials to overall inflation (non-agricultural production data are used in the calculations, so that the measure of inflation corresponds more closely to the GDP deflator rather than CPI inflation). The contribution to inflation depends on the productivity differential across sectors, the share of labor in each sector, and the share of nontradables in each country's output. Uneven productivity growth accounts for 1.7 percentage points of inflation in Greece over 1990–96, out of an average inflation rate of 14 percent in this period. This compares to a weighted average 0.5 percentage point contribution in the other countries (weighting by each country's share of tradable goods production), so that the Balassa-Samuelson effect potentially accounts for 1.2 percentage points of the inflation differential between Greece and the other countries considered. Taking into account the higher inflation in Greece than in the rest of Europe and the depreciation of the drachma against the ECU, Greece experienced an annual real appreciation of roughly 2½ percent in terms of consumer prices during the above period; the estimated Balassa-Samuelson effect would thus account for nearly half of the real appreciation in terms of relative consumer prices—this portion can be considered as not representing a loss of external competitiveness. This is broadly consistent with the divergence between the CPI-based real exchange rate and the measure based on relative unit labor costs in manufacturing: the latter, which does not reflect Balassa-Samuelson effects, appreciated by 9 percent versus a 15 percent appreciation of the CPI-based real exchange rate in the period examined (1990–96).

While the data do not include the most recent years, the results suggest that some of the present inflation differential vis-à-vis the euro area countries reflects supply-side factors of productivity growth rather than Greece's more advanced cyclical position. Looking forward, the Balassa-Samuelson effect can be expected to remain an influence on inflation, since the level of productivity in tradables in Greece remains substantially below that of its EU partners.




[1] This period was chosen to focus on the latest available data, but the relationship between productivity and inflation differentials becomes stronger when longer time spans are examined. See the Selected Issues Paper for further details.

3½ percent of GDP through the first quarter of 1999. They underscored in particular the ground-breaking nature of the sale of Ionian Bank, and its vital role in enhancing competition in the banking system. The staff concurred, but noted that such benefits now needed to be extended also to other key economic sectors (such as energy and transport) that remained dominated by public enterprises. Experience elsewhere (and, to a limited extent, in Greece itself, e.g., with regard to mobile telephony charges and the rates for certain liberalized airline routes) indicated the significant—and even rapid—contribution that privatization and deregulation could make to lowering prices for consumers and input costs for other sectors, thus aiding disinflation.[13]

31. **The authorities intended to expand the scope of the privatization and flotation program**, to include, inter alia, sales of Commercial Bank, the Industrial Development Bank, and Hellenic Petroleum. However, majority sales of public utilities were not on the agenda; in this regard, the staff pressed for an early opening of these sectors to competition. The authorities felt however that necessary preparatory work still underway would require full use of the EU derogations to liberalization deadlines for fixed telephony and the electricity sector (to early 2001), and the gas sector (2006). In the electricity sector, for example, a resolution of the Public Power Corporation's severe problem of unfunded pension liabilities was deemed an essential precondition to flotation, and steps along the lines proposed by an international consultant have recently been taken. Private participants pointed to various product market rigidities, in the form of barriers to entry and regulatory constraints faced by start-up companies, as thwarting the growth of potentially dynamic sectors (such as information technology) and standing in the way of related efficiency gains. In this area, the discussions suggested the need for a more proactive role of the Competition Commission, which has been hobbled by staffing constraints.

32. **The performance of the labor market during the present recovery was recognized to have been disappointing, but the authorities felt that the measures taken in August 1998 needed time to exert their effects.**[14] These measures had been designed to address some key rigidities (the inflexibility of working time, inadequate wage differentiation, and ineffectiveness of job matching mechanisms under a public monopoly) and had introduced innovations in these areas. However, the measures were subject to a web of implementation difficulties that had rendered them largely inoperative. Thus, there was no evidence that firms had availed themselves of the possibility of annualization of working time, there were no concrete cases of

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[13] The OECD, using a methodology employed in its regulatory reform project (see *The OECD Report on Regulatory Reform*, 1998), estimates that a comprehensive restructuring and deregulation of the sectors dominated by public enterprises would exert an appreciable downward impact on the aggregate price level (1 percentage point off the CPI price level), while the cumulative output gain, including second-round effects in other sectors, would be of the order of 9–11 percent of GDP (see *OECD Economic Survey of Greece*, 1998).

[14] For a review of the Greek labor market and some of the factors underlying the high level of structural unemployment, see Demekas, Dimitri and Zenon Kontolemis, "Unemployment in Greece: A Survey of the Issues," IMF Working Paper 96/91; and "Implementing the OECD Jobs Strategy," in *OECD Economic Survey of Greece*, 1996 (updated in subsequent surveys).

opt-outs from sectoral wage accords in areas of high unemployment, and the bulk of job placement activities remained in the hands of the public bureaucracy, despite the authorization of private employment agencies. While recognizing the slow start, the authorities felt that it was as yet premature to judge the effectiveness of these measures. They furthermore pointed to a series of other initiatives set out in the 1999 *National Action Plan for Employment*, including measures to address the high rate of youth unemployment. There was agreement that the 1999 plan marked a clear improvement from that of 1998: its elaboration had entailed an extensive consultation process, and its comprehensiveness allowed a useful stock-taking of the many facets of employment policy. Nonetheless, the staff queried the plan's heavy reliance on employment subsidy programs, its skepticism regarding the efficacy of reductions in the tax wedge, and the prevalent role assigned to state-run organizations for training and placement services. It urged breakthroughs in reducing the high effective entry wage for first-time job-seekers (who account for almost half of the long-term unemployed), and in improving the quality and job-relevance of vocational training.[15] Staff also called for a review of various anachronistic add-ons to social security contributions (such as those to subsidize low-cost housing loans) that burden labor costs.

### B. Other Policy Requirements

33. **The discussions confirmed a broad recognition of the need for deep-seated reform of the social security system**. The staff was impressed by the scope for savings and increased efficiency arising from the 1998 "mini" package (which included penalties to curtail evasion of contributions, the merger of a sizable number of supplementary social security funds, and a reduction of selected entitlements), as well as from plans to overhaul the organization of the largest basic pension fund (IKA). The authorities were well aware of the need to proceed with the "second phase" of reform that would address the system's basic structure so as to ensure its long-term viability.[16] They intended to do so in the next legislature, with measures including the harmonization of retirement ages across social security funds and of replacement ratios, and the introduction of fully funded supplementary schemes. The staff noted that a broad debate of the reform options in a nonpartisan spirit would be desirable, so as to permit the expeditious enactment of legislation after the elections.

34. **The authorities viewed the Greek banking system as having strengthened considerably since the last consultation**. The banks had taken advantage of the surge in equity

[15] The EU Commission, in its *Joint Employment Report* (September 1999), found that, despite improvements in the 1999 plan, there remained a need to "develop a more comprehensive and integrated employment strategy as well as an effective monitoring and evaluation system."

[16] Many studies have highlighted, and suggested remedies to, the problems of the Greek social security system. Among the more recent, see Mylonas, Paul and C. de la Maisonneuve, "The problems and prospects faced by pay-as-you-go pensions systems: A case study of Greece," Economic Department Working Papers No. 215, OECD: Paris, May 1999; and Committee for the Examination of Economic Policy in the Long Term, "Pensions and the Greek economy: A contribution to the public debate," Athens, 1997.

prices to boost their capital base, and the consolidation of the sector was proceeding at a good pace. In response to the staff's observation that the consolidation to date had been entirely domestic, and that there were few signs that the banks were exploring cross-border alliances to better position themselves in the euro area environment, the authorities noted that domestic consolidation was a necessary first step in the process—early cross-border mergers had been rare in other European countries as well. Banks had continued to make progress in cleaning up their balance sheets. Even though the share of bad loans in total loans, at almost 14 percent in 1998, remained high, the authorities noted that the state-owned Agricultural Bank accounted for a large proportion of such loans, and a restructuring of its balance sheet was well advanced. The recent surge in consumer credit raised concerns about its possible adverse impact on the quality of the banks' loan portfolio, and there were individual cases where the pace of credit expansion was such as to call into question the rigor of the approval process. The Bank of Greece noted that, in the past year, it had defined general criteria governing internal control systems, set out specific actions to be undertaken in this area, and established a quantitative framework for banks' provisioning, along with more frequent and systematic reporting requirements. Looking forward to EMU, there was agreement that banks needed to redouble their efforts to improve efficiency and reduce their still high operating costs. In this regard, the consolidation process had yet to have an appreciable impact on staffing levels or the number of branches.

35. The mission met with representatives of the Ministerial Committee, set up in November 1998, to coordinate all **Y2K-related issues**; the Committee is supported by a Task Force of experts ("Action Group 2000"). The staff was provided with a review of progress to date in all main sectors (energy, transportation, telecommunications, water and sewage, public administration, and large and small private firms).[17] In all, the situation appeared to compare reasonably well with that of other EU countries; this judgement is reflected also in independent assessments (e.g., Gartner Group). In the financial system, Bank of Greece inspectors have been conducting on-site assessments, which have found a generally satisfactory level of preparedness, and identified, at the time, contingency planning as the main remaining shortcoming. The central bank indicated that it would stand ready to provide additional liquidity to the banking sector if necessary to ensure normal operations in credit markets.

## III. Staff Appraisal

36. **The stability-oriented economic policy pursued over the past years has succeeded in placing Greece squarely on the road to joining EMU by the target date of January 1, 2001**—albeit with the recourse to indirect tax cuts to restrain inflation within the Maastricht criterion during the relevant reference period. The achievements to date are impressive: growth is strong, wage increases are moderate, fiscal developments are better than budgeted, and some appreciable advances have been recorded in the structural area.

37. **At the same time, it is also evident that Greece faces both macroeconomic policy challenges and a need for further structural change to ensure the sustainability of low**

[17] Further information can be found on the Committee's website at www.year2000.gr.

**inflation**. The reliance on administrative measures cannot ensure such sustainability. The macroeconomic policy mix would need to undergo a rebalancing, with fiscal policy being called upon to move more decisively to center stage in the disinflationary effort as the effectiveness of monetary policy diminishes and monetary conditions ease significantly—this will require a significant strengthening of current fiscal deficit targets and further measures to offset the costs of the tax and benefit package announced for 2000. On the structural front, the progress to date is beginning to reveal the economy's substantial potential for growth when freed of its shackles, but—given Greece's starting conditions—much remains to be done. Far-reaching structural reforms are also key to the sustainability of price stability.

38. **The tight monetary policy pursued to date has been critical to the disinflation effort, but there are limits to this approach and monetary conditions will ease substantially in the run-up to EMU**. The Bank of Greece's objective of achieving price stability by end-1999, and on a sustainable basis thereafter, implies the maintenance of a tight stance as long as is feasible. In this setting, the Bank's posture of awaiting clear evidence of lower actual and expected inflation on a sustained basis before proceeding with further interest rate cuts is well-placed. Such a stance is also entirely appropriate in light of the economy's cyclical position and other related developments, such as the boom in equity and credit markets. There are however clear limits to this approach (as shown also by the recourse to administrative measures to restrain credit growth, in an evident departure from practices elsewhere in Europe), and the EMU convergence process will progressively constrain the ability of an independent monetary policy to control inflation.

39. **Given the constraints on an already tight monetary policy, there is a need to harness all other policy instruments—fiscal, wage, and structural policies—to the task of ensuring a sustainably low inflation performance in monetary union**. It is, in the first instance, incumbent on **fiscal policy** to offset the effect of prospective monetary easing on inflation. The overall deficit targets of the convergence program for 2000–01 clearly fall short of this requirement. These targets are inadequate from both a cyclical and medium-term perspective: on the first count, they would imply a most untimely fiscal stimulus; on the second count, they unduly postpone the achievement of the stronger medium-term fiscal position—overall balance or a small surplus—that appears advisable and is within reach over the next two years. Though such a position would be more than required for observance of the SGP, a number of considerations regarding the medium- and long-term outlook for the assets and liabilities of the broader public sector, within a balance sheet approach to fiscal policy-making, argue for such heightened ambition.

40. In combining these short- and medium-term considerations, **the better-than-budgeted outcome in prospect for 1999 is welcome and should be consolidated, with fiscal policy aiming to observe the convergence program's targets for the primary balance in 2000–01** (a surplus of about 7 percent of GDP in both years), rather than its superseded targets for the overall deficit. Such a stance would imply no further primary adjustment from the projected outcome for 1999 and should thus be viewed as an absolute minimum from a cyclical perspective and given the large concomitant monetary easing.

41. In this setting, **the tax cut and benefit package announced for 2000 entails risks that will need to be offset by appropriate counter-measures**. The staff maintains its reservations about this package, other than what was required, for equity reasons, to offset the fiscal drag experienced at the lowest minimum bracket. Besides the doubling of the turnover tax on stock transactions, the authorities are encouraged to identify offsetting cuts in current expenditures that are needed if the package is to be consistent with the maintenance of the primary surplus of 7 percent of GDP in 2000 and 2001. As noted, this is a minimum objective, and the situation will need to be monitored carefully, with the authorities standing ready to raise the sights further in elaborating the 2000 budget and to take corrective action promptly as needed in light of developments in the course of the year. It is also important to avoid handing back the hard-won revenue gains of improved tax administration, as may result from the abolition of the presumptive criteria; in order to contain revenue losses from this step, a further strengthening of tax assessment and control capabilities will be required.

42. **The continued contribution of wage moderation to disinflation must be safeguarded in the new national agreement to be negotiated next year**. In deciding wage increases, employers and employees should look to unit labor cost developments in the euro area as a guidepost, and eschew further recourse to wage catch-up clauses, whose existence clearly complicated the conduct of policies in 1998–99.

43. **Progress under the privatization program to date has broken new ground, but it has yet to roll back the dominance of the public sector in key economic activities**. The planned expansion of the reach of the privatization and flotation program is thus welcome, as are some important, albeit gradual, advances in public enterprise restructuring. But substantial benefits could accrue from a bolder and more far-reaching approach to liberalization and deregulation of the economy. In particular, absent majority sales of public utilities, significant early benefits for efficiency and disinflation could be obtained—as illustrated by the experience of other countries—by allowing new entrants into these markets. Wherever feasible, a more rapid liberalization than allowed under EU derogations should be pursued. A strengthening and refocusing of the activities of the Competition Commission could also help reduce the impediments faced by new entrants in many activities.

44. **The benefits of privatization and liberalization have been most evident in the banking sector, though heightened competition raises challenges of its own**. Greek banks have seized the opportunity provided by financial liberalization and the favorable economic cycle to expand their operations, boost their profitability, and strengthen their capital base. But progress has not been uniform across institutions and further efforts to reduce high operating costs remain needed. Furthermore, enhanced competition intensifies the risks faced by banks; the Bank of Greece's steps to induce banks to upgrade their risk management and internal control systems are thus well-placed and their effectiveness will need to be closely monitored.

45. **Despite strong economic growth, labor market performance has been lackluster, highlighting the need for further action**. The measures adopted in August 1998 have been disappointing in their effects to date, and the implementation difficulties that have beset them should be alleviated. The 1999 *National Action Plan for Employment* is a welcome improvement over that of the previous year. It however relies heavily on a range of employment subsidy

programs (whose cost and effectiveness will need to be closely monitored) and on state-run organizations for training and placement services—on the basis of other countries' experiences, the public sector's ability to perform these functions effectively is questionable. Furthermore, the reforms to date do not adequately address two key requirements: reducing the high effective entry wage for first-time job seekers and improving the quality of vocational training.

46. **Greece commendably ranks among the few Fund member countries that have completed a self-assessment in relation to the *IMF Code of Good Practices on Fiscal Transparency—Declaration on Principles*.** The assessment indicates that significant steps have been taken toward improving fiscal transparency in recent years, while also acknowledging areas where further steps are to be taken. In particular, the authorities are encouraged to develop a balance sheet approach to fiscal reporting and policy analysis—which, among other things, would involve enhanced monitoring of below-the-line support of public enterprises and of the operations of the organization handling the proceeds of privatized assets (DEKA)—as well as to improve information on risks associated with the fiscal accounts and develop periodic reports on long-term fiscal sustainability.

47. **Despite improvements in statistical data, there remain areas of weakness that complicate the assessment of economic conditions** (Appendix II). Adoption of the Fifth Edition of the Balance of Payments Manual is in process, and the statistical service has recently issued an advance statistical release calendar for the first time. However, substantial work is needed with regard to the coverage and timeliness of national accounts, and of fiscal and monetary data, before subscription to the Fund's Special Data Dissemination Standard is feasible.

48. It is recommended that the next Article IV consultation with Greece be held on the standard 12-month cycle.

Table 1. Greece: Selected Economic Indicators
(Percentage changes, unless otherwise indicated)

| | 1994 | 1995 | 1996 | 1997 | Est. 1998 | Proj. 1999 | Proj. 2000 |
|---|---|---|---|---|---|---|---|
| **Domestic economy** | | | | | | | |
| GDP | 2.0 | 2.1 | 2.4 | 3.2 | 3.7 | 3.3 | 3.6 |
| Output gap | -1.2 | -1.0 | -0.9 | -0.4 | 0.3 | 0.4 | 0.6 |
| Domestic demand | 1.0 | 4.4 | 3.0 | 3.5 | 3.3 | 3.4 | 3.2 |
| Private consumption | 2.0 | 2.7 | 1.9 | 2.5 | 1.8 | 2.1 | 2.1 |
| Public consumption | -1.1 | 5.6 | 1.0 | -0.4 | 0.4 | 0.0 | 0.0 |
| Gross fixed capital formation | -1.0 | 7.8 | 11.1 | 10.7 | 9.8 | 8.4 | 6.8 |
| Private | -0.1 | 5.8 | 12.4 | 11.7 | 8.4 | 7.5 | 6.0 |
| Public | -4.0 | 14.3 | 7.4 | 7.5 | 13.7 | 11.0 | 9.0 |
| Change in stocks (contribution) | -0.4 | -0.1 | -0.8 | -1.3 | -1.5 | -1.5 | -1.4 |
| Foreign balance (contribution) | 0.9 | -2.8 | -1.0 | -0.8 | -0.1 | -0.3 | 0.1 |
| Exports | 6.6 | 0.5 | 3.0 | 5.3 | 9.2 | 5.5 | 8.8 |
| Imports | 1.3 | 9.2 | 4.9 | 5.4 | 5.7 | 4.7 | 5.4 |
| Unemployment rate | 9.6 | 10.0 | 10.3 | 10.3 | 10.1 | 10.3 | 10.2 |
| Employment | 1.9 | 0.9 | 1.3 | -0.5 | 0.2 | 0.2 | 0.6 |
| Average compensation of employees (economy wide) | 10.8 | 12.9 | 11.8 | 11.0 | 6.3 | 4.3 | 4.0 |
| Unit labor costs (economy wide) | 10.7 | 11.6 | 10.5 | 7.0 | 2.8 | 1.2 | 1.0 |
| Consumer prices, end of period | 10.7 | 7.9 | 6.9 | 4.5 | 3.7 | 2.0 | 3.3 |
| Consumer prices, period average | 10.9 | 8.9 | 8.2 | 5.5 | 4.8 | 2.5 | 2.5 |
| EU harmonized consumer inflation (HICP), period average | ... | ... | 7.9 | 5.4 | 4.5 | 2.3 | 2.2 |
| GDP deflator | 11.2 | 9.8 | 7.9 | 6.9 | 5.0 | 2.3 | 1.6 |
| **External accounts (in percent of GDP)** | | | | | | | |
| Trade balance (national accounts) | -11.9 | -12.8 | -12.6 | -12.3 | -12.7 | -12.5 | -12.9 |
| Current account (national accounts) | -0.5 | -2.4 | -2.6 | -2.6 | -2.7 | -2.3 | -2.4 |
| Current account (settlements) | -0.1 | -2.5 | -3.7 | -4.0 | -3.0 | -2.9 | -3.7 |
| Foreign exchange reserves (US$ billions) | 14.3 | 14.6 | 17.3 | 12.4 | 17.2 | 21.4 1/ | ... |
| Drachma/euro (period average) 2/ | -6.6 | -4.1 | -0.5 | -2.4 | -6.9 | 0.0 3/ | ... |
| NEER | -5.2 | -1.6 | -0.4 | -1.5 | -4.6 | -1.3 4/ | ... |
| REER (consumer prices) | 1.1 | 3.3 | 4.3 | 0.9 | -2.6 | -2.4 4/ | ... |
| REER (manufacturing ULCs) | 2.2 | 6.6 | 3.4 | 3.5 | -4.1 | -1.8 5/ | ... |
| **Public finances (in percent of GDP)** | | | | | | | |
| General government | | | | | | | |
| Current revenues | 36.6 | 37.7 | 38.0 | 38.9 | 39.3 | 39.6 | 39.2 |
| Current expenditures | 43.7 | 44.9 | 43.0 | 40.6 | 40.0 | 39.4 | 38.8 |
| Primary expenditures | 29.6 | 31.9 | 31.0 | 31.0 | 30.9 | 30.7 | 31.1 |
| Interest expenditures | 14.1 | 12.9 | 12.0 | 9.6 | 9.1 | 8.7 | 7.7 |
| Net capital spending | 2.8 | 3.4 | 2.5 | 2.2 | 1.7 | 1.9 | 2.0 |
| Balance | -10.0 | -10.6 | -7.5 | -4.0 | -2.4 | -1.7 | -1.5 |
| Primary balance | 4.1 | 2.3 | 4.5 | 5.7 | 6.7 | 7.0 | 6.1 |
| Structural primary balance | 4.5 | 2.7 | 4.8 | 5.8 | 6.6 | 6.9 | 5.9 |
| Structural overall balance | -9.6 | -10.2 | -7.2 | -3.8 | -2.5 | -1.9 | -1.8 |
| Debt | 109.3 | 110.1 | 112.2 | 109.5 | 106.1 | 102.1 | 98.6 |
| **Financial variables** | | | | | | | |
| M4N 6/ | ... | 13.0 | 15.3 | 7.8 | 9.8 | 7.9 7/ | ... |
| Total credit | 8.7 | 9.6 | 8.3 | 11.4 | 10.0 | 10.3 8/ | ... |
| 3-month treasury bill rate (average) | 18.2 | 14.3 | 11.9 | 10.1 | 11.9 | 9.8 9/ | ... |
| 12-month treasury bill rate (average) | 19.0 | 15.5 | 12.8 | 10.3 | 11.5 | 8.8 10/ | ... |
| Short-term bank lending rate (average) | 26.4 | 21.1 | 20.2 | 19.1 | 17.6 | 14.8 11/ | ... |

Sources: Data provided by the authorities; and Fund staff estimates and projections.

1/ End-August.
2/ Drachma/ECU before 1999.
3/ End-August compared with end-December.
4/ June compared with December.
5/ August compared with December.
6/ M4N is defined as M4 plus foreign currency deposits by residents and investments in money market mutual funds by investors. M4 is the sum of currency, private deposits, bank bonds, and repos (all of which constitute M3), plus private sector holdings of T-bills and government bonds of maturity of up to one year.
7/ 12-month change in July.
8/ 12-month change in May.
9/ Latest auction August 17, 1999.
10/ Latest auction August 30, 1999.
11/ June.

Table 2. Greece: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

| | 1991-94 | 1995 | 1996 | 1997 | 1998 | 1999 | |
|---|---|---|---|---|---|---|---|
| | | | | | | Latest estimate | Date |
| **External Indicators** | | | | | | | |
| Exports (annual percent change, in U.S. dollars) | 4.2 | 10.8 | -0.2 | -6.9 | 3.5 | | |
| Imports (annual percent change, in U.S. dollars) | 0.8 | 22.3 | 5.3 | -2.0 | -1.7 | | |
| Terms of trade (annual percent change) | 4.1 | -0.9 | 0.7 | 1.0 | -1.0 | | |
| Current account balance (settlements basis) | -2.3 | -2.5 | -3.7 | -4.0 | -3.0 | | |
| Capital and financial account balance | 4.6 | 2.8 | 7.0 | 0.1 | 7.1 | | |
| *Of which*: Inward portfolio investment (debt securities etc.) | 0.6 | 0.4 | 1.3 | 1.6 | 6.5 | | |
| Inward foreign direct investment and other investments | 1.9 | 3.7 | 4.2 | 2.6 | 2.0 | | |
| Official reserves (in U.S. dollars, millions, period average) | 7,918 | 14,611 | 17,337 | 12,441 | 17,188 | 21,368 | Aug-99 |
| Central Bank short-term foreign liabilities (in U.S. dollars, millions) | 788 | 860 | 796 | 1,337 | 0.0 | 0.0 | Jul-99 |
| Official reserves in months of imports GS | 4.0 | 6.0 | 6.9 | 5.2 | 6.9 | 9.3 | Aug-99 |
| Total external debt | 32.6 | 34.2 | 32.0 | 33.1 | ... | | |
| *Of which*: General government debt | 24.0 | 23.5 | 22.9 | 24.3 | 26.5 | | |
| Total external debt to exports GS (ratio) | 2.00 | 2.14 | 2.09 | 2.19 | ... | | |
| External interest payments to exports GS (in percent) | 13.3 | 13.5 | 14.4 | 12.6 | 12.9 | | |
| External amortization payments to exports GS (in percent) | 24.4 | 25.9 | 31.7 | 34.9 | 34.0 | | |
| Exchange rate (per U.S. dollars, period average) | 211.2 | 231.6 | 240.7 | 273.1 | 295.5 | 309.7 | 8/18/99 |
| **Financial Market Indicators** | | | | | | | |
| Public sector debt (Maastricht definition) | 98.3 | 110.1 | 112.2 | 109.4 | 106.1 | | |
| Broad money, M4N (percent change, 12-month basis) | 18.5 | 13.0 | 15.3 | 7.8 | 9.8 | 7.9 | Jul-99 |
| Private sector credit (percent change, 12-month basis) | 14.7 | 22.0 | 17.0 | 15.3 | 15.0 | 13.2 | Jul-99 |
| 3-month T-bill yield | 18.2 | 14.3 | 12.0 | 9.5 | 12.0 | 9.8 | Aug-99 |
| 3-month T-bill yield (real) | 2.7 | 4.9 | 3.5 | 3.8 | 6.9 | 6.3 | Aug-99 |
| Stock market index | 827 | 914 | 934 | 1,480 | 2,738 | 5,066 | Aug-99 |
| Share prices of financial institutions | 965 | 1,160 | 1,414 | 2,303 | 5,799 | 9,902 | Aug-99 |
| Spread of 3-month T-bills with Germany (percentage points, end of period) | 14.1 | 12.3 | 10.4 | 8.1 | 9.8 | 6.7 | Aug-99 |
| Spread of 1-year T-bills with Germany (percentage points, end of period) | 10.2 | 10.5 | 9.2 | 7.0 | 8.2 | 6.0 | Aug-99 |
| **Financial sector risk factors** | | | | | | | |
| Foreign Exchange loans to the private sector (in millions of U.S. dollars) | 2,698 | 6,201 | 9,368 | 9,688 | 11,022 | 11,833 | Jul-99 |
| Share of foreign exchange loans in total lending to the private sector | 10.0 | 17.7 | 23.9 | 24.6 | 24.3 | 28.3 | Jul-99 |
| Deposits in foreign exchange (in millions of U.S. dollars) | 16,619 | 21,090 | 21,290 | 29,240 | 38,611 | 33,230 | May-99 |
| Share of foreign deposits in total deposits | 22.7 | 24.1 | 22.6 | 29.4 | 35.1 | 36.0 | May-99 |
| Share of real estate sector in private credit | 15.1 | 14.6 | 16.1 | 17.3 | 18.2 | 19.1 | Jul-99 |
| **Official risk indicators** 1/ | | | | | | | |
| Share of nonperforming loans in total loans 2/ | 10.8 | 19.5 | 19.0 | 16.5 | 13.6 | | |
| Share of nonperforming loans in total assets 2/ | ... | ... | 6.4 | 5.9 | 3.4 | | |
| Risk-based capital asset ratio 3/ | 12.6 | 12.8 | 10.3 | 10.3 | 11.4 | | |
| **Foreign currency debt rating** | | | | | | | |
| *Standard & Poor's* | Mar-90 | Jul-90 | Jan-93 | Mar-94 | Mar-97 | Dec-98 | |
| Long term | BBB | BBB- | BBB- | BBB- | BBB- | BBB- | |
| Outlook | Negative | Stable | Positive | Stable | Positive | Positive | |
| Short term | A-2 | A-3 | A-3 | A-3 | A-3 | A-3 | |
| *Moody* | | Jul-90 | | May-94 | Dec-96 | Jul-99 | |
| Bonds and notes | | Baa1 | | Baa3 | Baa1 | A2 | |
| *IBCA* | | | | Oct-95 | Jun-97 | Jul-99 | |
| Long term | | | | BBB- | BBB | positive alert | |

Sources: Bank of Greece, *Monthly Statistical Bulletin*; data provided by the authorities; and IMF, *International Financial Statistics*.

1/ Data refer to all commercial banks incorporated in Greece.

2/ Nonperforming loans are defined as all loans with interest and/or principal payments in arrears for three months or more, and include all loans classified as doubtful by the banks themselves.

3/ As from 1998, data take also into account market risks.

Table 3. Greece: Credit Indicators, 1994–98

(Outstanding amounts, end-of-year; in percent of GDP)

| | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|
| **Greece** | | | | | |
| Private sector credit | 28.5 | 31.0 | 32.6 | 34.0 | 36.1 |
| Consumer credit | 1.0 | 1.6 | 1.9 | 2.2 | 2.8 |
| Mortgage credit | 4.3 | 4.5 | 5.2 | 5.9 | 6.5 |
| **Portugal** | | | | | |
| Private sector credit | 64.4 | 70.7 | 78.1 | 88.3 | 101.3 |
| Consumer credit | 3.6 | 4.3 | 5.0 | 5.8 | 6.7 |
| Mortgage credit | 16.5 | 19.0 | 22.6 | 27.0 | 33.4 |
| **Spain** | | | | | |
| Private sector credit | 77.7 | 77.1 | 78.2 | 84.2 | 92.5 |
| Consumer credit | 5.7 | 5.7 | 5.6 | 5.9 | 7.1 |
| Mortgage credit | 15.7 | 16.4 | 17.6 | 20.4 | 22.8 |
| **Euro area** | | | | | |
| Private sector credit | ... | ... | ... | ... | 87.5 |
| Consumer credit | ... | ... | ... | ... | 8.1 |
| Mortgage credit | ... | ... | ... | ... | 26.8 |

Sources: Bank of Greece, Bank of Portugal, Bank of Spain, European Central Bank.

Table 4. Greece: Privatization and Restructuring Developments

| Agency or Sector | Action Taken | Date |
|---|---|---|
| Bank of Macedonia-Thrace | Privatization | April 1998 |
| General Bank | Privatization | April 1998 |
| Olympic Airlines | Passage of Reform Bill | April 1998 |
| | Agreement on private management contract | June 1999 |
| Public Petroleum Corporation | Stock Offering | June 1998 |
| Bank of Crete | Privatization | June 1998 |
| Bank of Central Greece | Privatization | July 1998 |
| Postal System | Signing of management contract | July 1998 |
| Athens Urban Transport Organization | Signing of management contract, Relevant bill | 1998 |
| Thermal Bus Company | Signing of management contract, Relevant bill | 1998 |
| Athens-Piraeus Electric Buses | Signing of management contract, Relevant bill | 1998 |
| Hellenic Railways Organization | Signing of management contract, Relevant bill | Nov. 1998 |
| Hellenic Telecommunications Organization | Stock Offering (third tranche) | Nov. 19981/ |
| Athens Stock Exchange | Stock Offering (second tranche) | Nov. 1998 |
| Ionian Bank | Privatization | Mar. 1999 2/ |
| Olympic Catering | Stock Offering | April 19993/ |
| Hellenic Telecommunications Organization | Stock offering (fourth tranche) | July 1999 |
| Corinth Canal | Privatization | early 1999 |
| Saloniki International Fair | Privatization | 1999 |
| National Property Organization | Privatization | 1999 |
| Athens Water Supply Company | Privatization | 1999 |
| Olympic Tourism | Privatization | 1999 |
| Athens Port Authority | Privatization | 1999 |
| Saloniki Port Authority | Privatization | 1999 |
| Saloniki Water Supply Company | Privatization | 1999 |
| Horseracing Organization | Privatization | 1999 |
| Duty-Free Shops | Privatization | 1999 4/ |

1/ Tranche size reduced to 10 percent (from planned 15 percent) of shares outstanding.
2/ Postponed following unsuccessful privatization attempt in August 1998.
3/ Delayed from end-1998.
4/ Unsuccessful in July and December 1998. Majority sold to state-owned Agricultural Bank in August 1999 for subsequent disposal.

Table 5. Greece: Staff Medium-Term Projections 1/

(In percent of GDP, unless otherwise indicated)

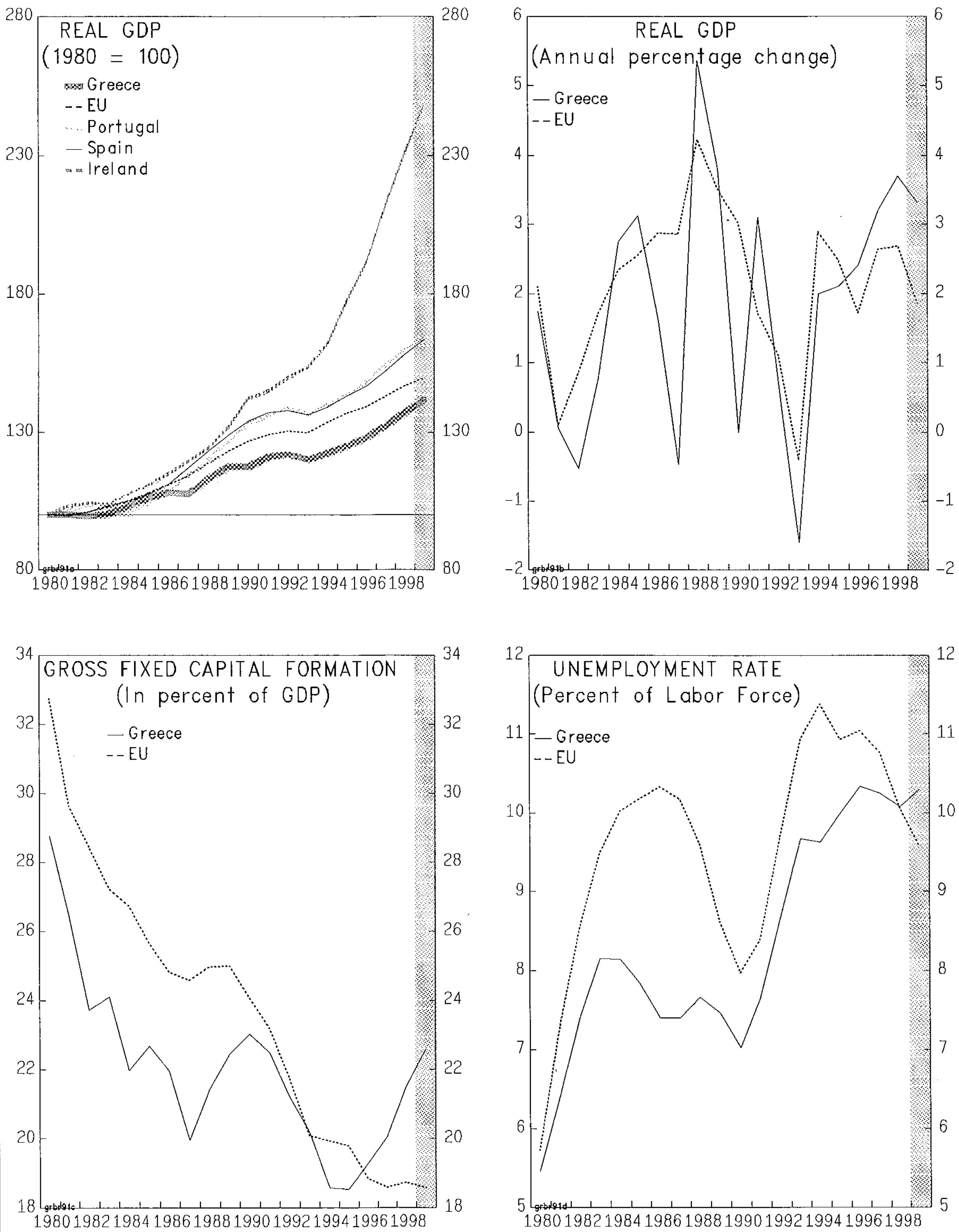
| | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|
| **Staff projections** | | | | | |
| Real GDP growth (in percent) | 3.7 | 3.3 | 3.6 | 3.5 | 3.3 |
| Inflation (HICP period average; in percent) | 4.5 | 2.3 | 2.2 | 2.8 | 2.4 |
| Unemployment rate | 10.1 | 10.3 | 10.2 | 10.1 | 10.0 |
| General government | | | | | |
| Balance | -2.4 | -1.7 | -1.5 | -1.0 | -0.8 |
| Primary balance | 6.7 | 7.0 | 6.1 | 5.7 | 5.3 |
| Structural balance | -2.5 | -1.9 | -1.8 | -1.2 | -1.0 |
| Structural primary balance | 6.6 | 6.9 | 5.9 | 5.4 | 5.1 |
| Debt | 106.1 | 102.1 | 98.6 | 94.0 | 89.7 |
| Saving and investment | | | | | |
| Gross domestic investment | 21.8 | 22.8 | 23.7 | 24.5 | 25.3 |
| *Of which:* capital formation | 21.5 | 22.6 | 23.4 | 24.3 | 25.1 |
| Gross national saving | 19.1 | 20.5 | 21.3 | 22.4 | 23.2 |
| Foreign saving (current account) 2/ | 2.7 | 2.3 | 2.4 | 2.1 | 2.1 |

Source: Fund staff projections.

1/ Projections are based on the standard assumption of announced policies, including the tax and benefit package announced in September 1999, and known structural measures (e.g., liberalization of the telecommunications and electricity sectors in 2001). The projections are also based on the return of the drachma to its ERM2 central parity rate by end-2000 and on short-term interest rate convergence to euro levels by that time.

2/ Data on a national accounts basis, excluding EU transfers to the investment budget.

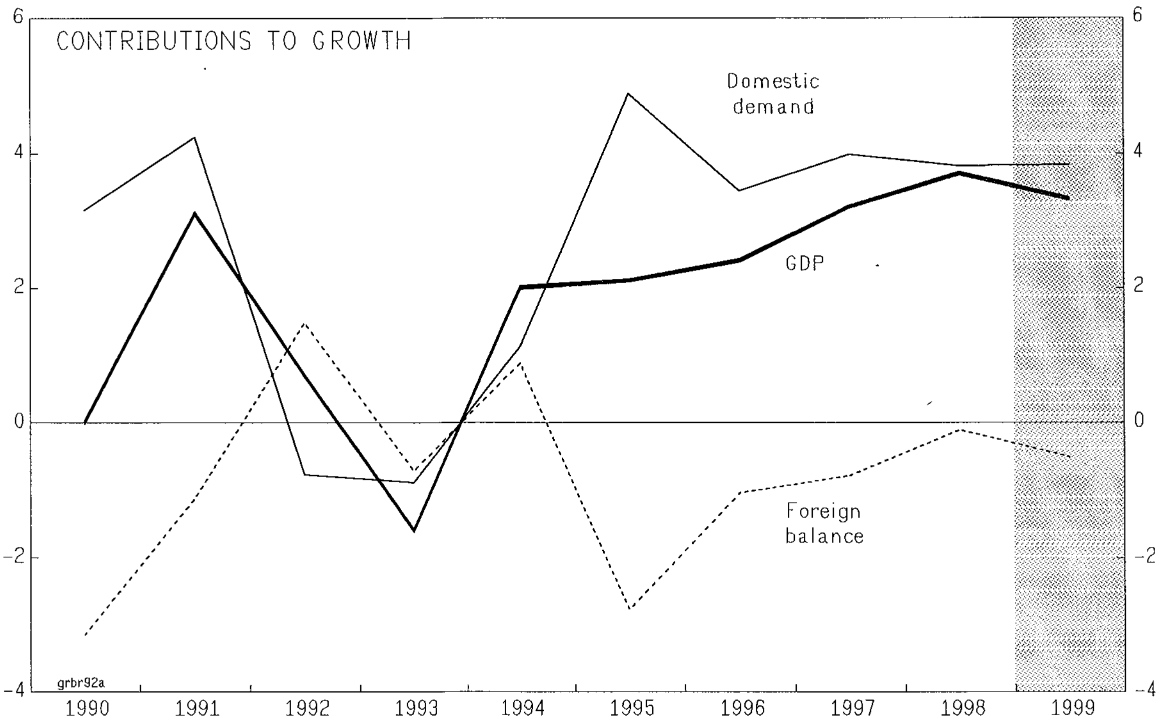
Figure 1. Greece: International Comparisons of Macroeconomic Performance 1/

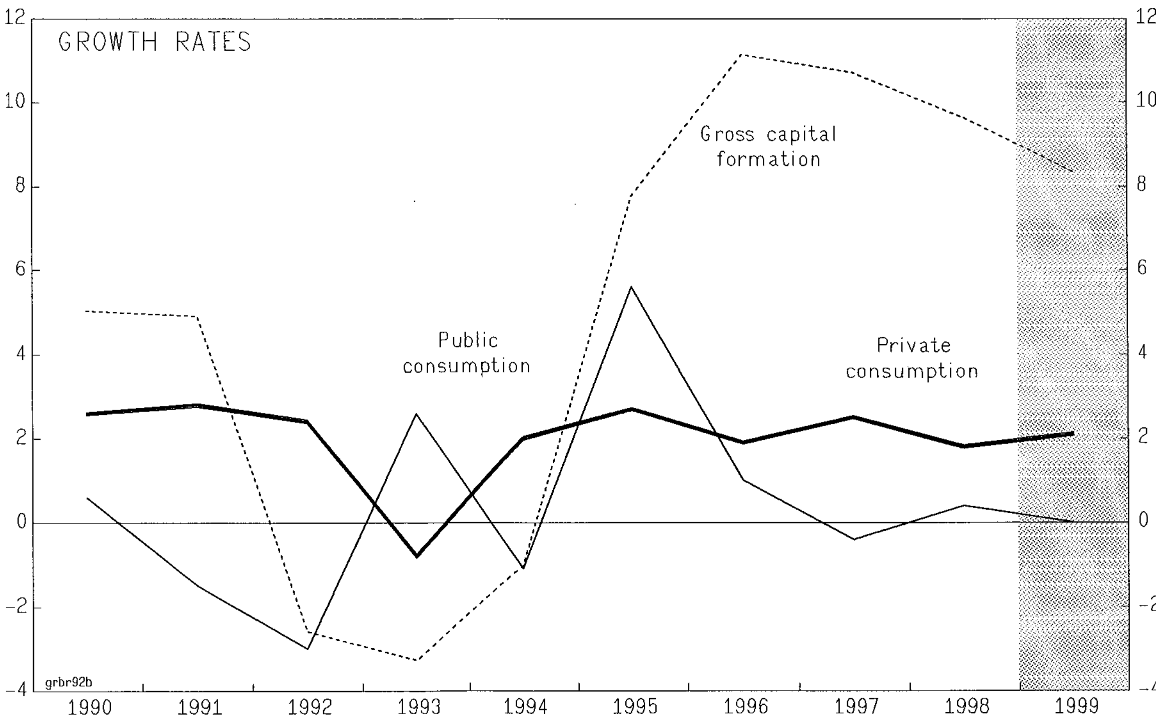



Source: IMF, World Economic Outlook.

1/ Shaded areas show staff projections.

Figure 2. Greece: GDP and Components' Growth and Contributions 1/

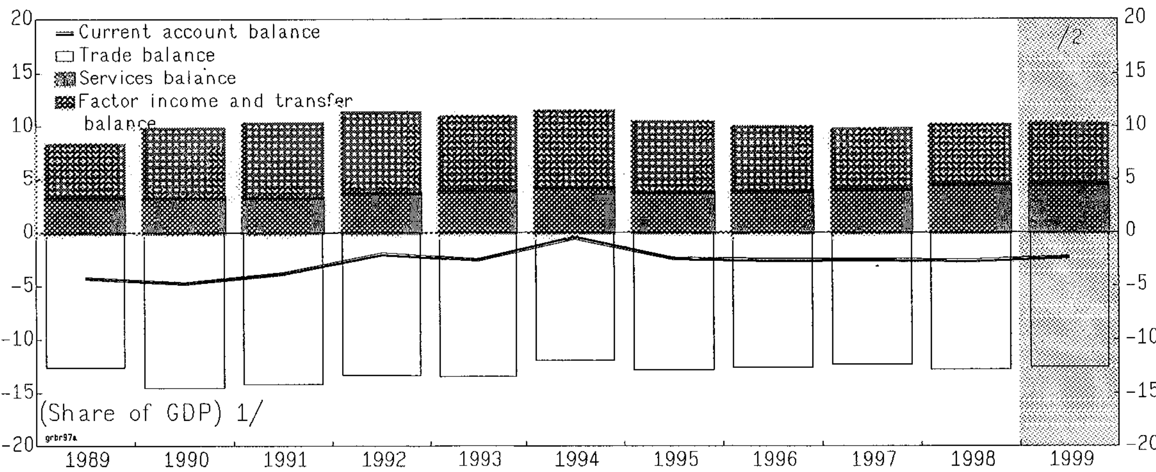


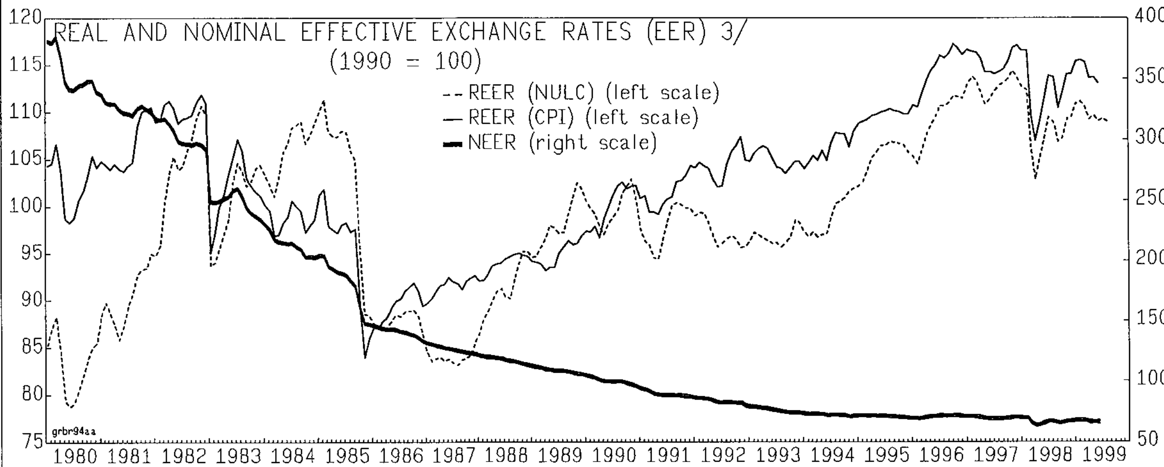



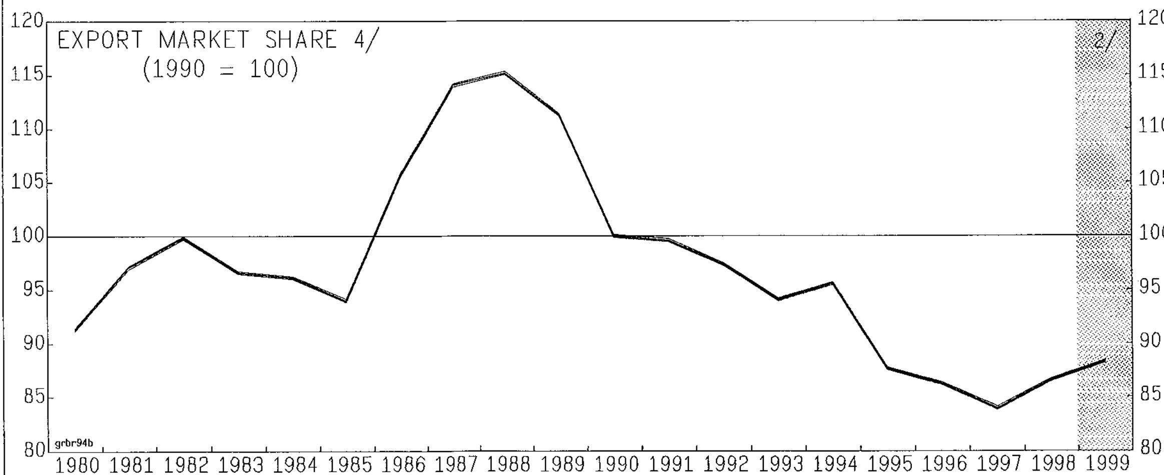

Source: IMF, World Economic Outlook.

1/ Shaded areas show staff projections.

## Figure 3. Greece: External Developments



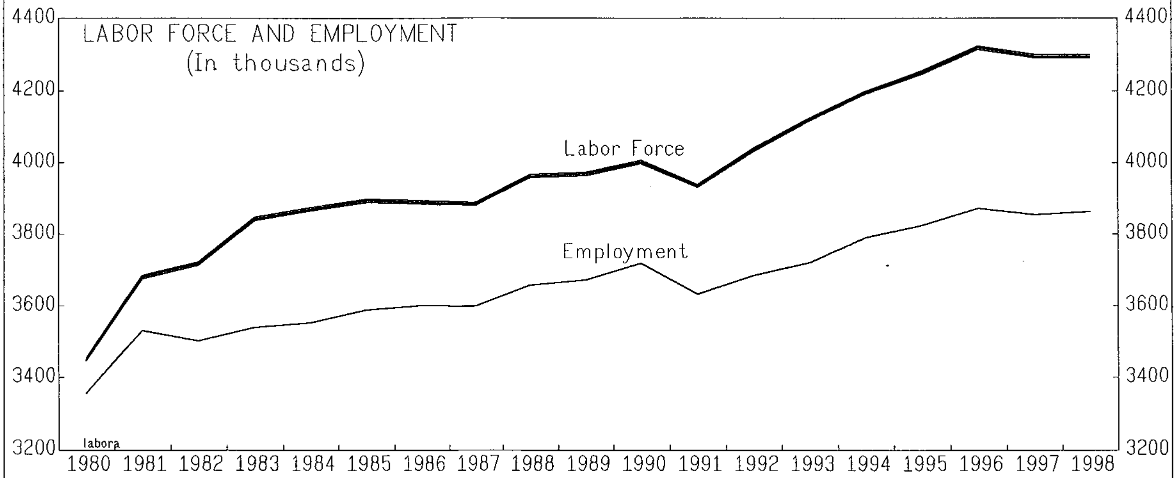



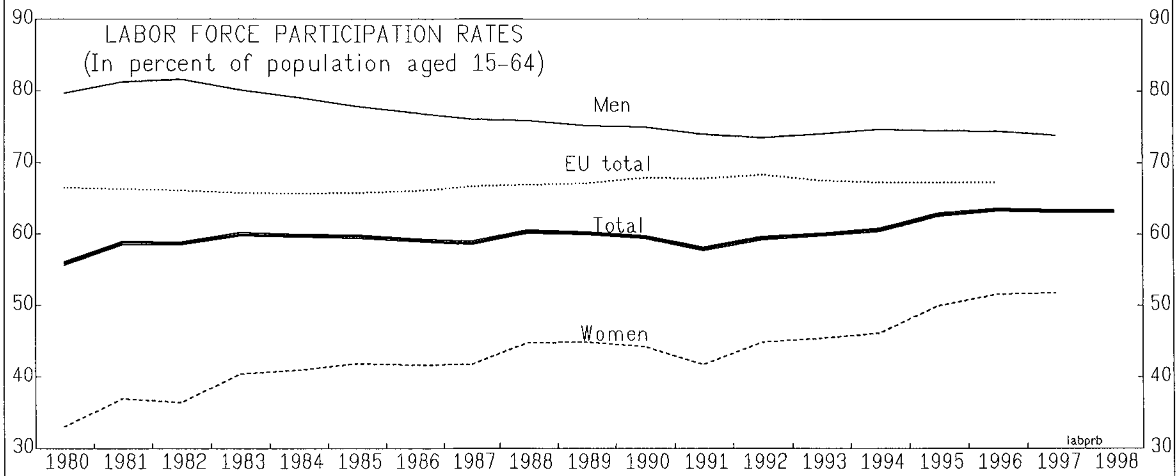



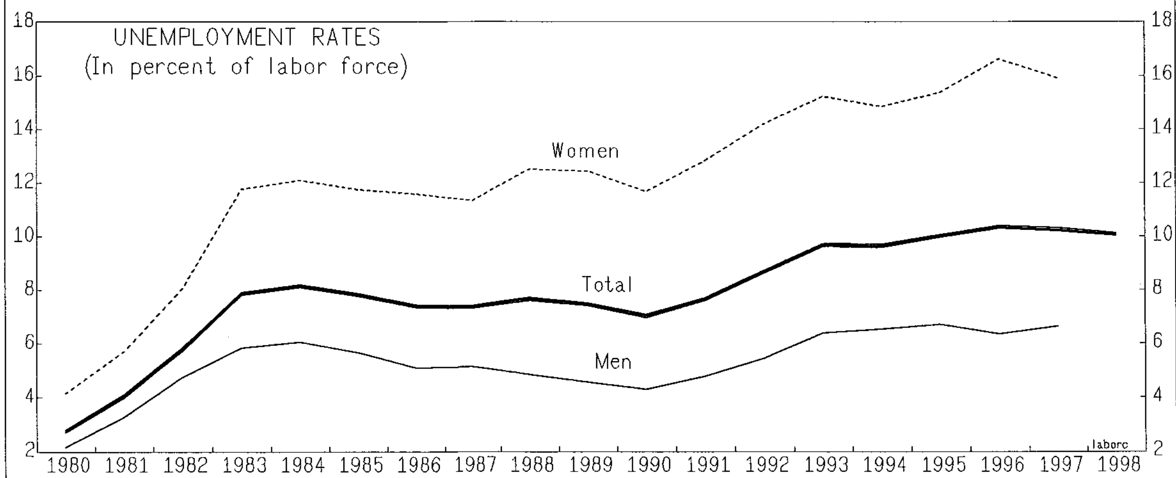

Sources: National Statistical Service of Greece; and Bank of Greece.

1/ National accounts basis.
2/ Shaded area shows staff projections.
3/ Normalized unit labor costs (NULC) refer to the manufacturing sector.
4/ Exports of goods and services (national accounts basis) relative to trading partner demand.

# Figure 4. Greece: Labor Market Developments

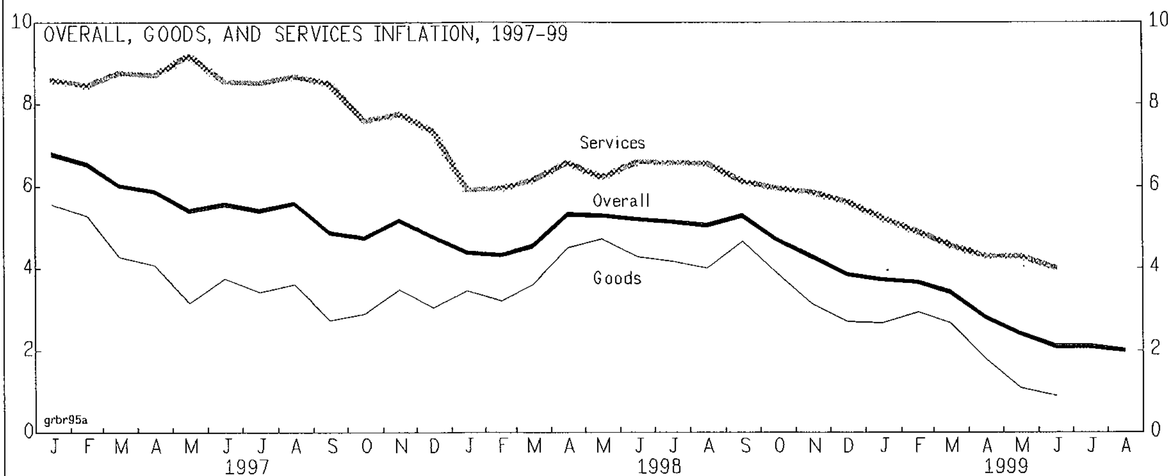


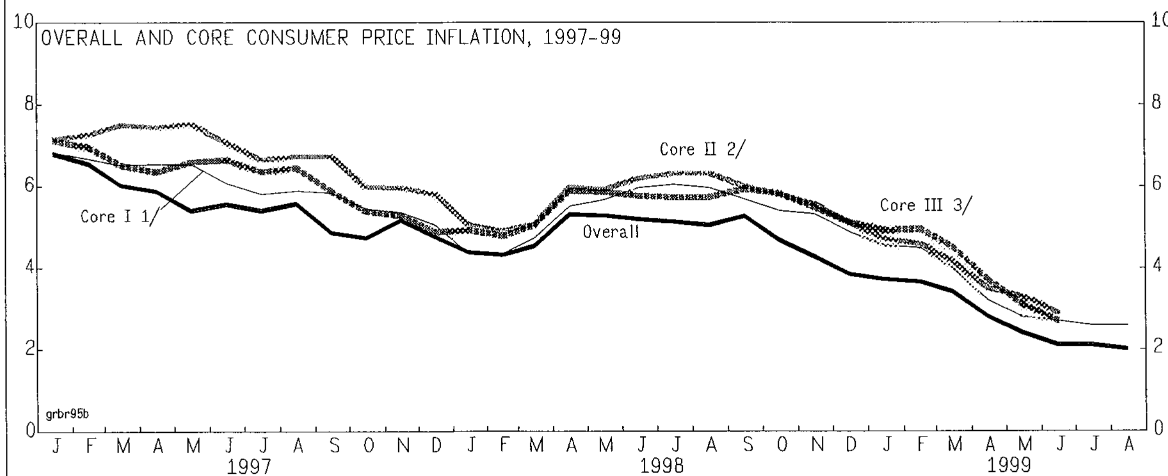



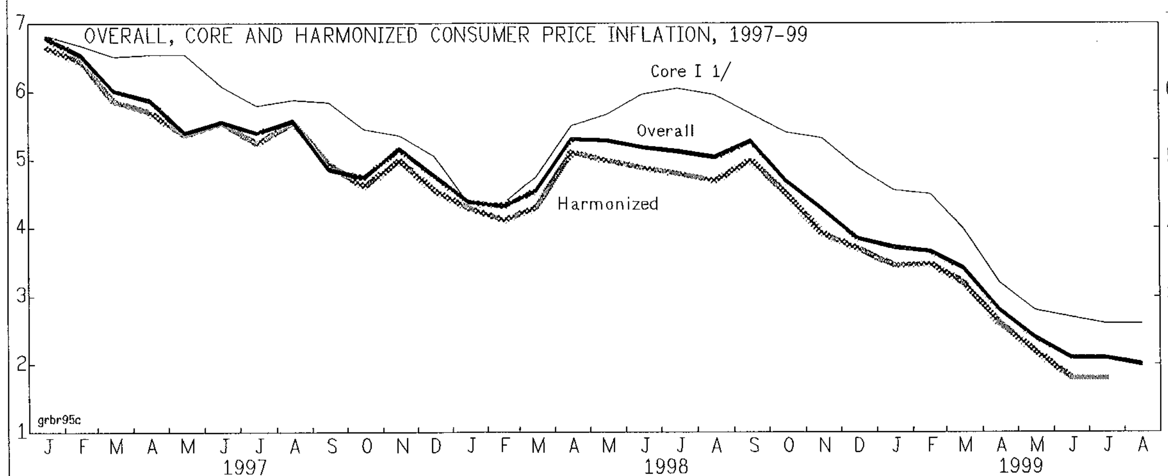




Sources: NSSG; MNE; OECD; and staff calculations.

## Figure 5. Greece: Consumer Price Inflation



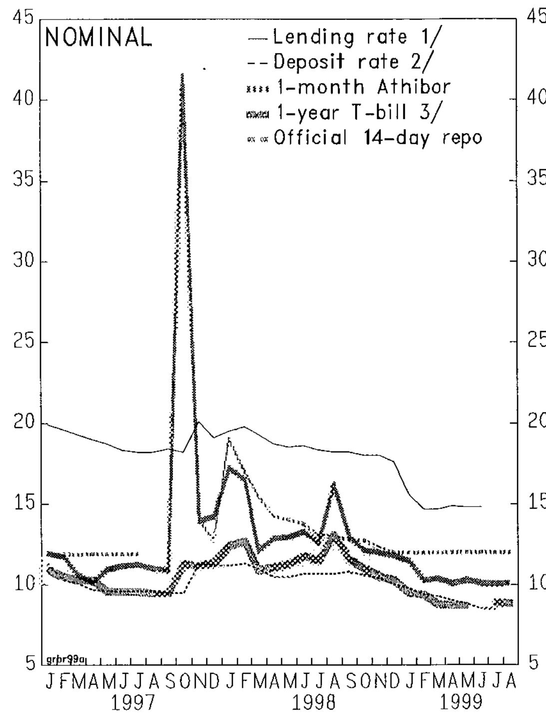



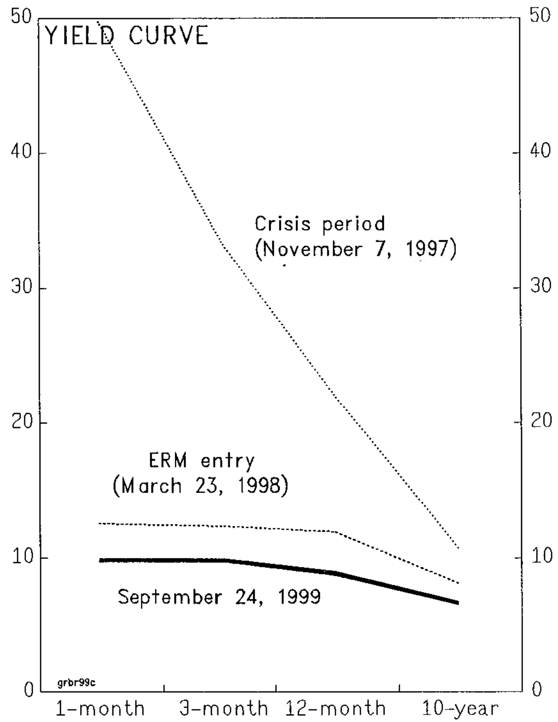



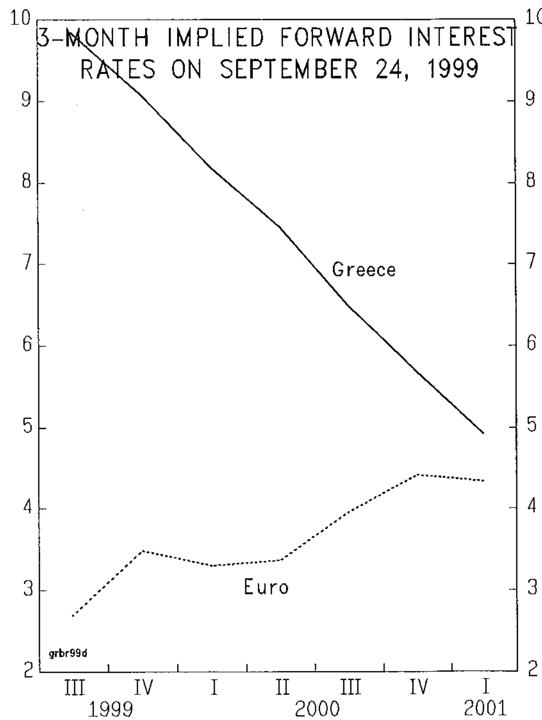

Sources: NSSG; Bank of Greece; EUROSTAT; and staff calculations.

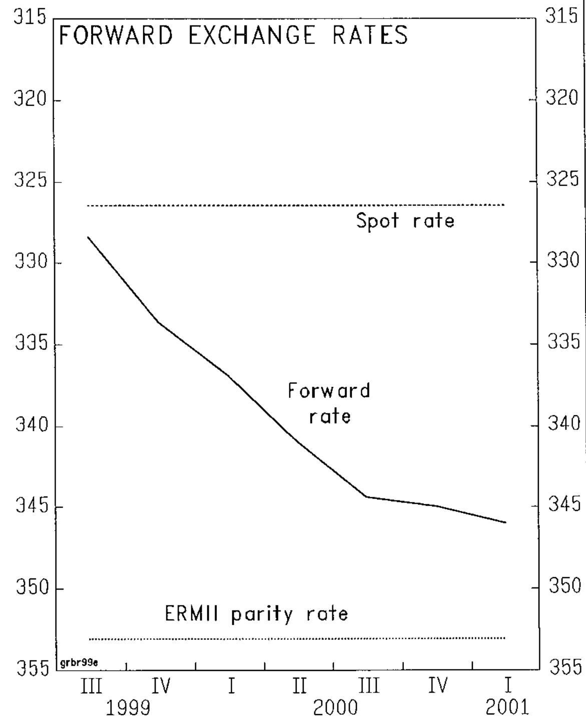
1/ CPI excluding fresh fruits and vegetables and fuels.
2/ CPI excluding food and fuels
3/ CPI excluding public utilities and fuels.

## Figure 6. Greece: Interest and Exchange Rates



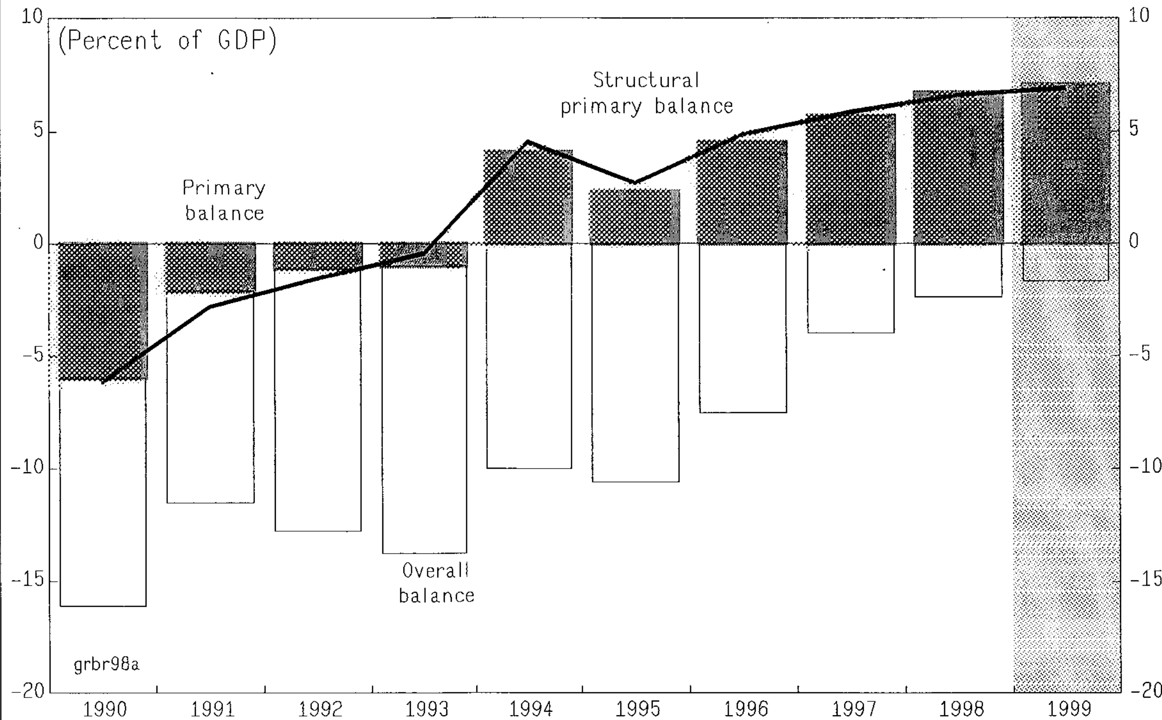



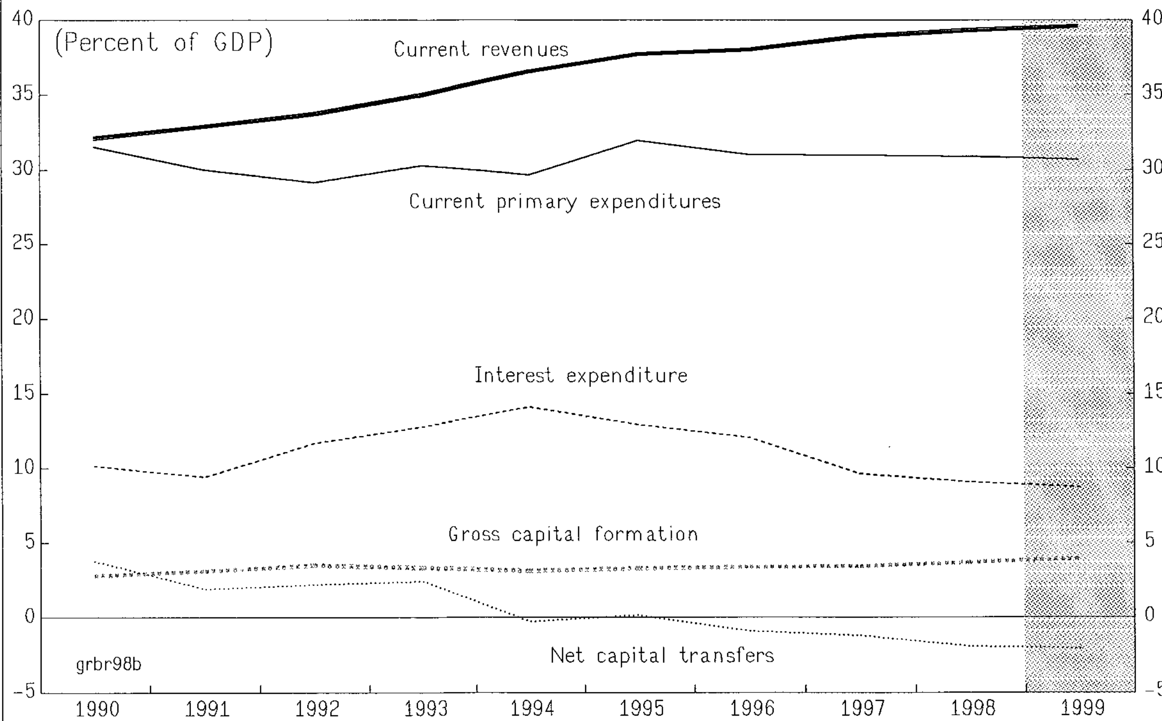




Sources: Bank of Greece; Bloomberg; Reuters; and staff calculations.

1/ Maximum rate charged by commercial banks on working capital loans to industry.
2/ Rate offered by deposit money banks on three- to twelve-month drachma deposits.
3/ Prior to 1997, treasury bill returns were tax free, whereas those for other assets shown are subject to withholding tax. The treasury bill withholding tax was 7.5 percent in 1997 and is 10 percent since 1998.

## Figure 7. Greece: General Government Fiscal Developments 1/

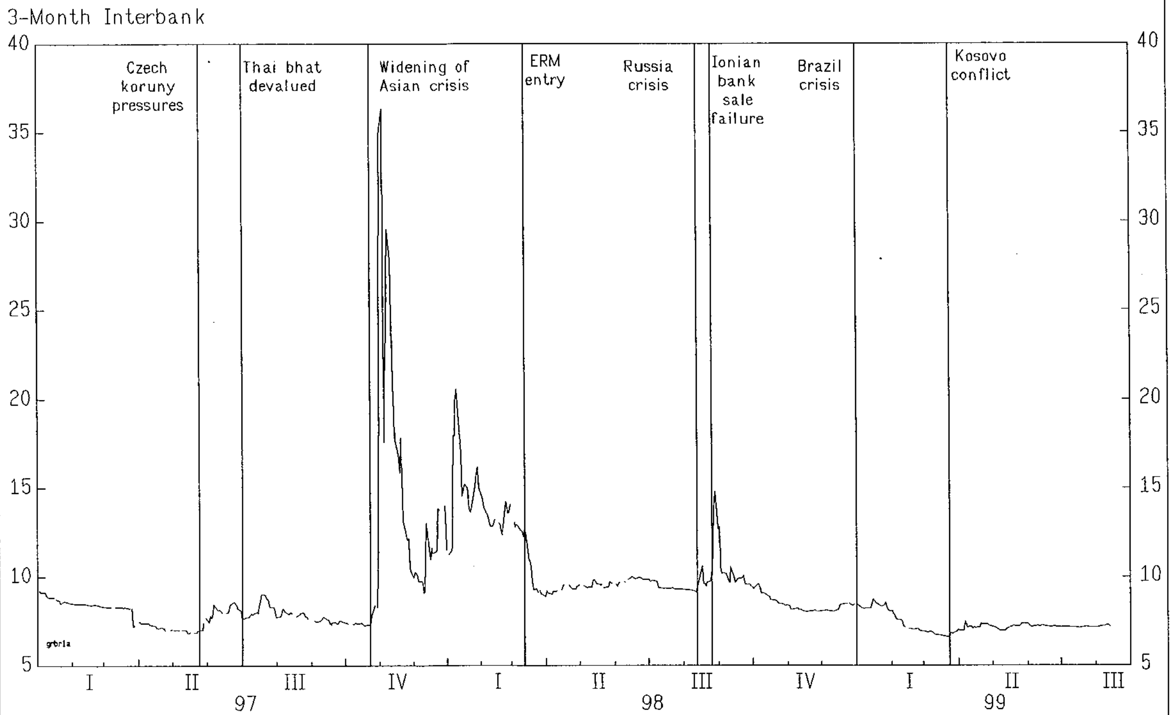


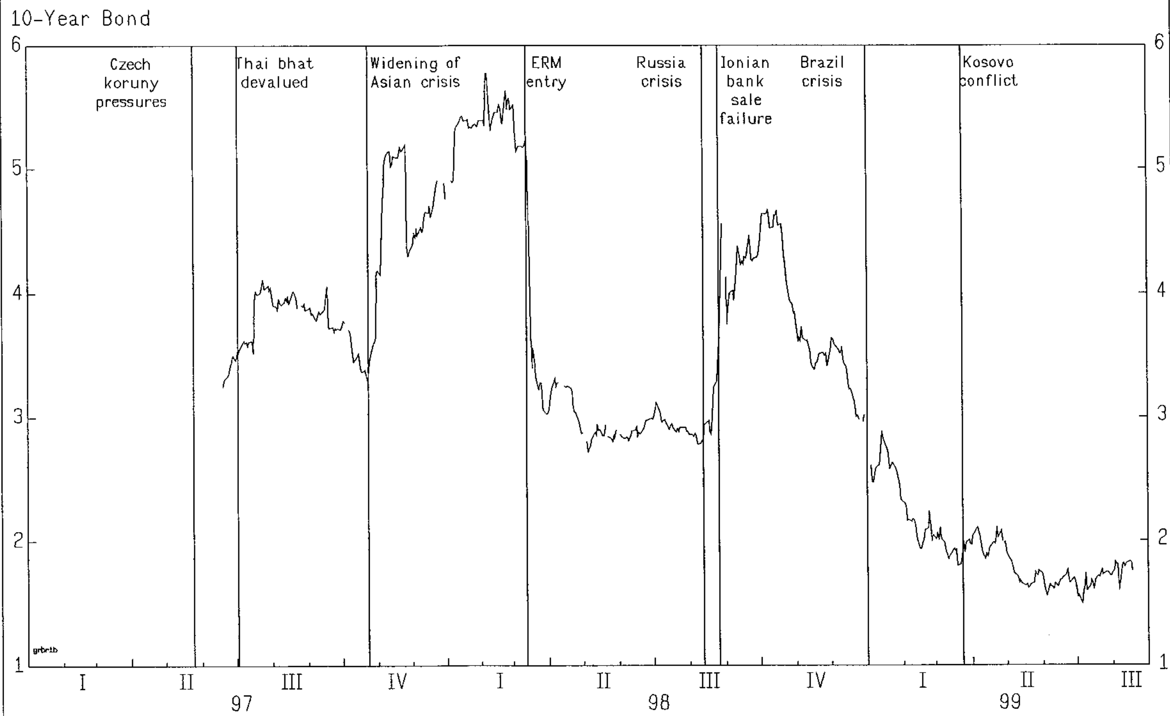




Sources: Ministry of National Economy; IMF, World Economic Outlook; and staff calculations on offic

1/ Shaded areas show staff projections.

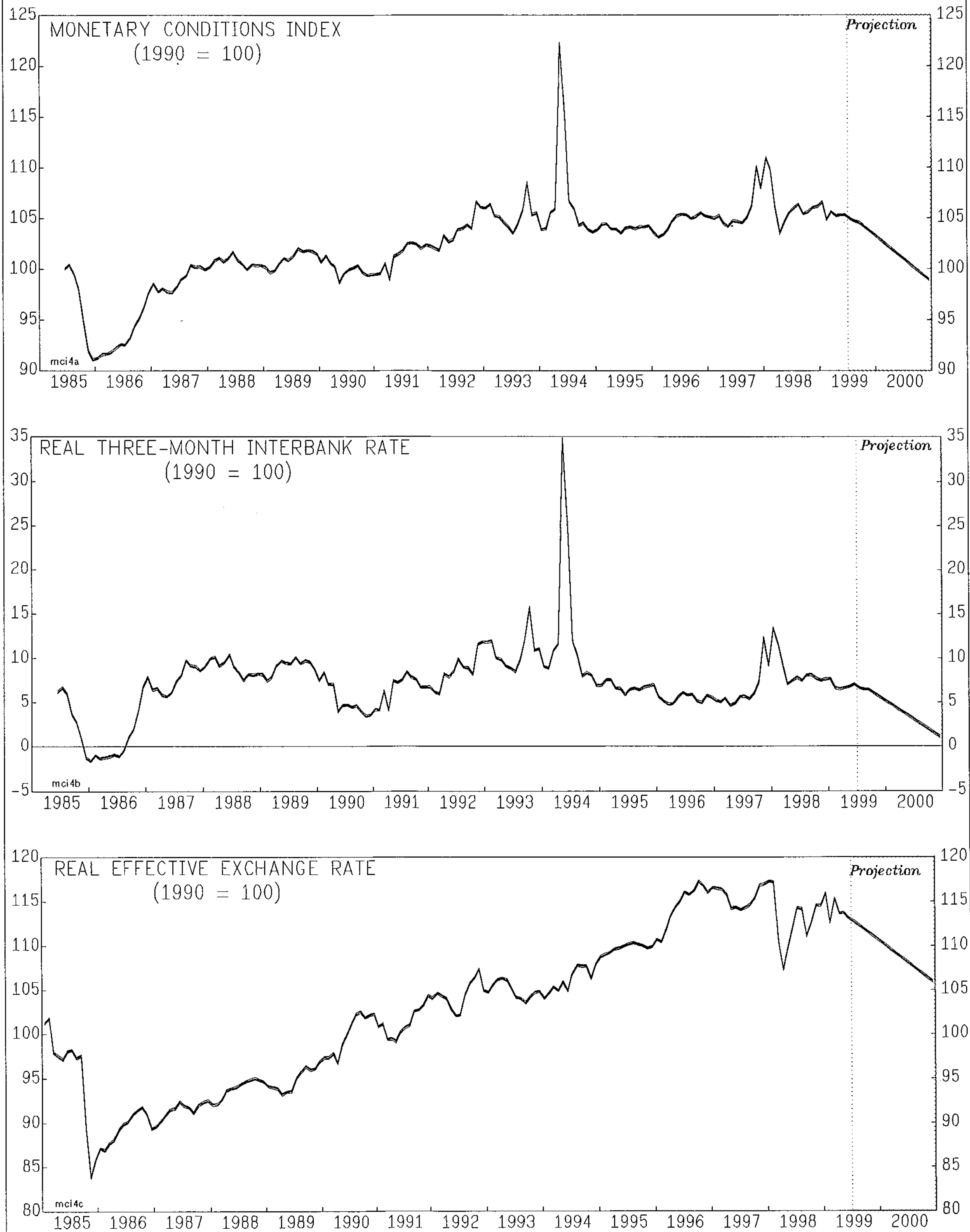
## Figure 8. Greece: Short- and Long-Term Interest Rate Spreads
(Against comparable German securities)



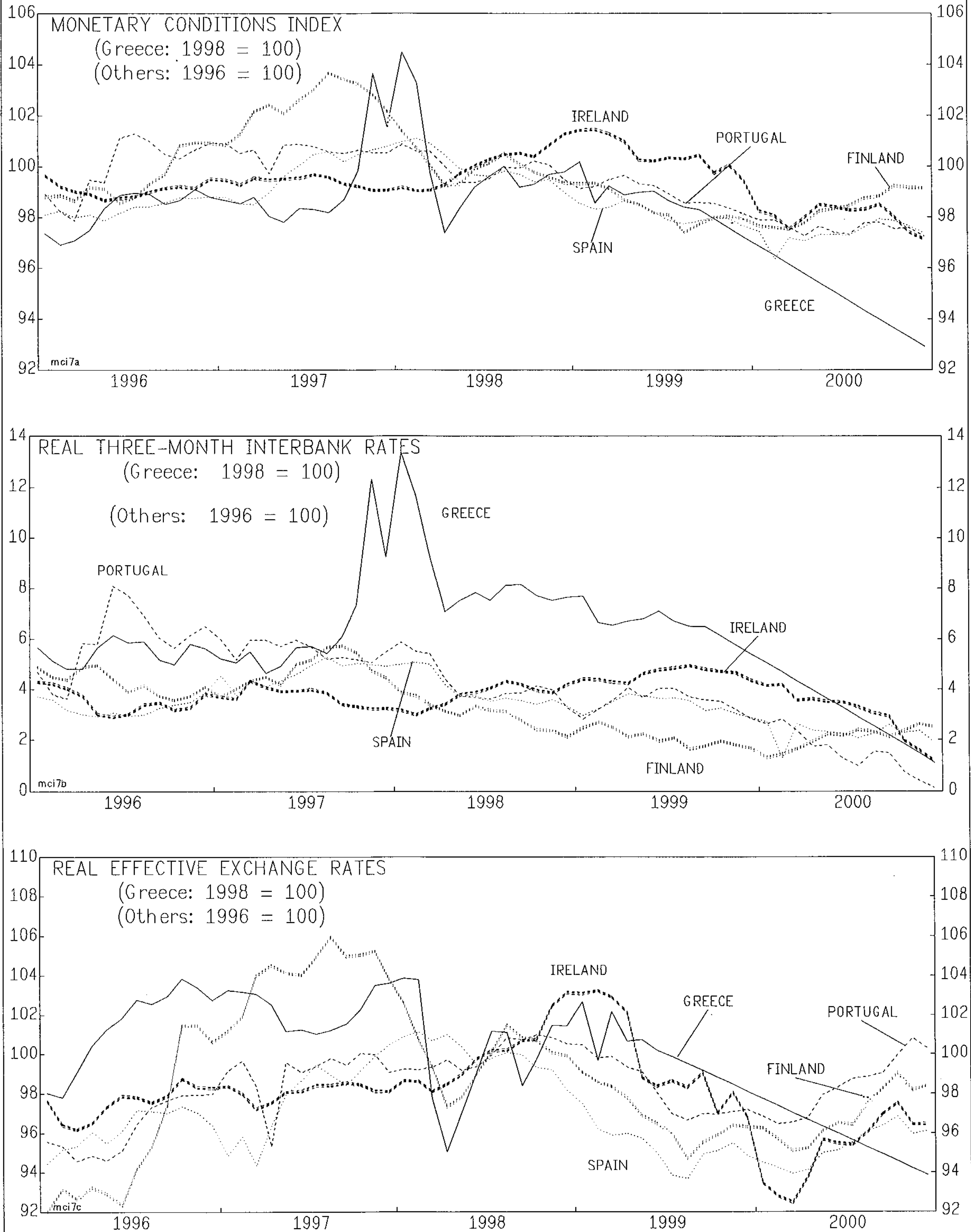

Sources: Bloomberg; Reuters; and staff calculations.

# Figure 9. Greece: Monetary Conditions Index




Source: Staff calclulations.

Figure 10. Greece: Monetary Conditions Index Convergence Implications 1/




Source: Staff calculations.
1/ Data for countries other than Greece are lagged two years.

## Greece - Fund Relations
(As of August 31, 1999)

I. **Membership Status**: Joined 12/27/1945; Article VIII

| II. **General Resources Account**: | **SDR Million** | **% Quota** |
|---|---|---|
| Quota | 823.00 | 100.0 |
| Fund holdings of currency | 529.66 | 64.4 |
| Reserve position in Fund | 293.34 | 35.6 |
| Operational budget transfers (net) | 20.00 | |

| III. **SDR Department**: | **SDR Million** | **% Allocation** |
|---|---|---|
| Net cumulative allocation | 103.54 | 100.0 |
| Holdings | 2.50 | 2.4 |
| Designation Plan | 9.00 | |

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund** (SDR Million; based on existing use of resources and present holdings of SDRs): None

VII. **Exchange Rate Arrangements**: Effective March 16, 1998, Greece devalued the drachma by 12.3 percent against the ECU and joined the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS). Effective January 1, 1999, Greece joined the successor ERM2 Mechanism.

Greece maintains restrictions on the making of payments for current international transactions vis-à-vis Iraq. These restrictions were notified to the Fund under Decision 144-(52/51) in EBD/90/304, 9/21/90.

VIII. **Article IV Consultation**: Greece is on a 12-month consultation cycle; the last Article IV consultation discussions were concluded on August 5, 1998 (EBM/98/86).

IX. **Technical Assistance**:

| **Year** | **Dept.** | **Purpose** | **Date** |
|---|---|---|---|
| 1993 | FAD | Treasury Reform | June |
| 1993 | MAE | Central Bank Independence in the Context of the Maastricht Treaty | June |
| 1994 | MAE | Development of Primary and Secondary Markets in Government Securities | September |

X. **Resident Representative**: None

## Greece: Statistical Issues

Efforts have been under way for several years to improve the quality and timeliness of Greece's economic data. While there has been some progress, important weaknesses persist in a number of areas. The authorities have an open publication policy and have indicated their intention to subscribe to the SDDS. However, an STA mission in September 1997 found that a significant amount of work remained before subscription and posting of metadata to the DSBB would be feasible. This Appendix highlights problem areas and planned remedial actions.

### National accounts

National Accounts data produced by the National Statistical Service of Greece conform to the 1979 European System of Accounts (ESA79), but are available only on an annual basis. Data in current prices exist for 1960–97, while data in constant prices of the previous year are available only for 1988–97 (the Ministry of National Economy produces estimates for 1998). The Statistical Service has provided data for 1960–97 in constant 1988 prices. Rather than working to introduce data on a quarterly basis, for which Greece has a derogation through 2002, attention has focused on producing annual regional accounts by 2000 (with EUROSTAT assistance), as a basis for determining certain EU transfers. Work is also underway to adopt ESA95.

### Balance of payments

Balance of payments data on a settlements basis are available with a lag of about five months, while customs data on merchandise trade (upon which national accounts estimates are based) have longer lags. The former, however, are less reliable because of the effects that financial and capital account liberalization, and the rise in drachma-denominated trade with Balkan countries have had on traditional data collection and classification methods. The gap between the two measures of the trade accounts has widened since 1994, with the exception of 1998, especially with respect to exports. Settlements data seem to underestimate imports to a lesser extent, which, given their much larger magnitude relative to exports, leads to a biased picture of the trade balance compared to the customs data. The customs-based trade data are also not without problems, a feature common to customs statistics in other EU economies following adoption of the Single Market in 1993. Moreover, national accounts estimates appear to understate the current account deficit, as they do not include private drachma transfers abroad by foreign workers in Greece—which presumably finance part of the drachma-denominated export activity.

In cooperation with EUROSTAT and a number of European central banks, the Bank of Greece has been engaged for a number of years in a comprehensive revision of the settlements statistics, with a view to ensure consistency with the fifth edition of the *Balance of Payments Manual*. The new "closed" statistical system (followed by many other European countries) has been introduced by nearly all large commercial banks with smaller banks slated to join the system in the next year. The Bank of Greece and the Statistical Service are both aiming to reduce the production lag for settlements and customs data to less than 45 days.

Greece provides annual and quarterly balance of payments data, but these data are still in the presentation of the fourth Manual. In addition, the latest data pertain to December 1997. (No international investment position has been provided yet).

**Government finance**

Reliable data exist for the central government, but the quality and timeliness of the data on public entities, including social security funds and local governments, are poor. As a result, the quality of the data for the general government is affected. The problem arises from inadequate accounting practices and weaknesses in reporting. In 1995, the authorities started addressing this issue through an attempt to clarify the financial relations between the central government and peripheral entities. A law adopted in 1997 introduced penalties for agencies that do not supply the required data on a timely basis, but no fines have yet been imposed.

**Monetary accounts**

There is a need for improving the timeliness of data for publication in the *International Financial Statistics*. At present, data for the accounts of deposit money banks and other banking institutions are reported with a lag of about ten months, and data for the monetary authorities' accounts are usually available with a lag of about four months.

**Labor force survey**

A new quarterly labor force survey, in place since Fall 1998, uses a larger sample size and more detailed questionnaire, and allows data to be compiled on an EU-harmonized basis. There is no formal target date to shift to monthly surveys, which is the standard in other EU members.

**Advance release calendars**

The Statistical Service has announced an advance publication schedule for most statistical releases. However, this calendar is not always followed, with a substantial number of releases—including market sensitive data such as consumer price inflation—appearing before the scheduled date.

**Internet**

Some statistical data are available on the internet, and the Statistical Service is working on providing broad access, possibly with some fee-based services.

Greece: Core Statistical Indicators
as of September 15, 1999

| | Exchange Rates | International Reserves | Central Bank Balance Sheet | Reserve/ Base Money | Broad Money | Interest Rates | Consumer Price Index | Exports/ Imports | Current Account Balance | Central Government Balance | GDP/GNP | External Public Debt/Debt Service |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Date of Latest Observation | 9/15/99 | 7/30/99 | 1/31/99 | May 99 | May 99 | 9/15/99 | August 99 | Jan. 99 | Jan. 99 | Oct. 98 | 1998 4/ | 1998 |
| Date Received | 9/15/99 | 8/12/99 | 5/13/99 | 8/11/99 | 8/11/99 | 9/15/99 | 9/7/99 | 7/7/99 | 7/7/99 | 8/11/99 | Sept. 99 | June 99 |
| Frequency of Data | daily | daily | monthly | monthly | monthly | Daily | Monthly | monthly | monthly | monthly | annually | annually |
| Frequency of Reporting | daily | monthly; or when requested | monthly | when requested | monthly | daily | Monthly | monthly | monthly | monthly | when updated | monthly |
| Source of Update 3/ | Reuters/ Bloomberg | BoG | BoG | BoG | BoG | Reuters/ Bloomberg | Bloomberg/ Reuters/ MNE | BoG | BoG | BoG | MNE | BoG |
| Mode of Reporting | electronic | fax/phone | fax/mail | fax/mail | fax | electronic | Electronic/ Fax | fax | fax | mail/ Statistical Bulletin | fax | mail |
| Confidentiality | none | None | none | none | none | none | None | none | none | none | none | none |
| Frequency of Publication | daily | monthly | monthly | monthly | monthly | daily | Monthly | monthly | monthly | monthly | when updated | monthly |

1/ Estimates exist with shorter lags.
2/ Estimates can be produced on a daily basis with a lag of two days.
3/ BoG = Bank of Greece; MNE = Ministry of National Economy.
4/ Provisional.

INTERNATIONAL MONETARY FUND

GREECE

**Staff Report for the 1999 Article IV Consultation**
**Supplementary Information**

Prepared by the Staff Representatives for the 1999 Consultation with Greece

Approved by Susan Schadler

October 18, 1999

1. This supplement to the staff report on the 1999 Article IV consultation discussions with Greece (SM99/244, 9/24/99) provides an update of recent economic developments and describes the authorities' preliminary intentions regarding the 2000 budget, to be presented to parliament in the coming weeks. The information presented here does not alter the thrust of the staff appraisal.

**Recent economic developments**

2. Consumer price **inflation** in September remained at 2 percent (12-month change, national index), as in August, as rising foodstuff prices offset the effect of the lowering of the excise tax on automobiles. Core inflation (excluding fresh fruits, vegetables, fuels, and public utility prices) fell by 0.3 percentage points in September, to 2.7 percent. The harmonized inflation index (HICP) declined to 1.5 percent, with the 12-month average used for the Maastricht criterion down to 2.8 percent from 3.1 percent. Although EU-wide HICP data for September are not yet available, it is presumable that the distance from the Maastricht reference value narrowed by a broadly commensurate amount (namely, to around 1 percentage point).

3. The **drachma** has weakened slightly in recent weeks, to between 7 and 7½ percent above its ERM2 central parity rate, possibly in anticipation of a reduction in official short-term interest rates and/or in reaction to volatile equity market performance. Money market rates have trended up in recent weeks, with one-month rates some 30 basis points higher (to 10.3 percent), while the yield spread over German ten-year government bonds widened marginally. The Bank of Greece has kept official interest rates unchanged and intervened periodically to smooth day-to-day currency fluctuations.

4. Greek **equity values** have displayed some volatility in the recent period. By mid-September, the Athens Stock Exchange composite index had increased by over 130 percent compared to its end-1998 value. In the wake of increased supervision over trading in smaller capitalized firms, stricter controls for brokers, and official remarks interpreted as suggesting a possible market overvaluation, the index declined by 17 percent in late September. It had

subsequently rebounded, but fell again in the wake of downward pressures in U.S. and other European markets, and was in mid-October some 15 percent off its peak value.

5. The Bank of Greece has announced that it will allow unrestricted access to credit via its Lombard facility to provide liquidity as needed to ensure the normal operation of credit markets at the end of 1999–early 2000 in response to any **Y2K**-related problems.

6. Ordinary **budget** revenues continued to overperform through September, increasing by 10.9 percent in the first 9 months of the year, compared to a 5.8 percent annual target. Primary expenditures grew by 4.3 percent in the first 8 months of 1999 compared to the same period in 1998, lower than the 5.5 percent budgeted increase. All in all, the authorities estimate that the general government deficit will decline to 1.5 percent of GDP in 1999 (versus a budget target of 1.9 percent of GDP and the convergence program's original target of 2.1 percent of GDP). The general government primary surplus is expected to increase to 7.2 percent of GDP, about ½ percentage point of GDP above the 1998 outcome.

7. The government confirmed its intention, at the latest ECOFIN meeting on October 8, to present its request for EMU membership in early March 2000, with a possible decision to be taken at the June 2000 European Council meeting in Lisbon.

8. The authorities have communicated to staff their readiness to publish the results of their self-assessment against the Fund's ***Code of Good Practices on Fiscal Transparency—Declaration on Principles***, as contained in Chapter IV of the Selected Issues paper (SM/99/255, 10/6/99). In separate developments, Greece has accepted the Fourth Amendment to the Fund's Articles of Agreement, and is participating in the enhanced HIPC initiative by transferring as a grant its entire Second Special Contingent Account (SCA-2) balance and making an additional contribution such as to bring its total contribution in line with its quota share.

**The 2000 budget**

9. The 2000 budget is to be sent to parliament in late October or early November; at this stage, the authorities have indicated their preliminary intentions regarding its main parameters. The target for the general government overall deficit is put at 1.2 percent of GDP, compared to 1.7 percent of GDP in the convergence program. Targets for 2001–02 have yet to be submitted as part of an update to the convergence program, but are anticipated to reflect improvements of a similar order of magnitude.

10. In the authorities' figures, the overall deficit target for 2000 implies a primary surplus of 6.8 percent of GDP—below the 1999 estimated outcome and marginally less than the convergence program target. However, in discussions with the staff during the Annual Meetings, the authorities stressed that tax revenues continued to be estimated very conservatively (including in particular with regard to the likely yield from the recently increased tax on equity transactions), with thus appreciable scope for further revenue

overperformance. The staff would also view the authorities' estimate of the interest bill as remaining on the cautious side. At all events, the authorities emphasized their intention to maintain a tight fiscal stance in 2000.

**Staff assessment**

11. The staff welcomes the better-than-budgeted fiscal outturn anticipated for this year, as providing much-needed fiscal withdrawal. While details on measures to restrain primary expenditures in 2000 are not yet publically available, and their definition will need to be an important element of the upcoming budget, the broad targets indicated for 2000 appear to provide scope for maintaining the primary surplus at least at the 7 percent of GDP indicated in the staff report as a minimum. It remains important that the macroeconomic situation be monitored carefully, with the authorities standing ready to raise the fiscal sights further in light of developments in the course of the coming year. In this regard, their recognition of the importance of a tight fiscal stance in 2000 is well placed.

INTERNATIONAL MONETARY FUND
*Public Information Notice*

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 99/102
FOR IMMEDIATE RELEASE
November 8, 1999

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

# IMF Concludes Article IV Consultation with Greece

On October 20, 1999, the Executive Board concluded the Article IV consultation with Greece.[1]

## Background

**Growth** is relatively strong, with the economy in the sixth year of an expansion that is estimated to have brought output back to potential. GDP growth is projected at roughly 3½ percent in 1999, a rate in excess of the EU average for a fourth consecutive year. Activity is being led by high rates of investment, and consumption has been sustained by brisk consumer lending. Export performance has also strengthened, reversing a protracted decline in market shares, and contributing to a projected slight improvement in the current account deficit. The prolonged recovery has failed, however, to dent still high unemployment. The staff anticipates that growth will strengthen further, to some 3¾ percent, in 2000.

Following the drachma devaluation and ERM entry in March 1998, **inflation** persisted at high levels through the summer. In response, the government introduced a series of indirect tax cuts (and other administrative measures) in the fall of 1998, and again more recently. These measures are projected to succeed in containing inflation within the likely Maastricht criterion for the relevant reference period (the year to early 2000). The other reference values required for EMU membership by January 1, 2001 are also expected to be observed. But the staff projects an appreciable pickup in inflation in the latter part of 2000 and in 2001, given the end of the effects of the indirect tax cuts and the impact of the pre-EMU monetary easing.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

The **monetary policy** stance—centered on high interest rates and a strong drachma within the ERM—has remained tight, aiding the anti-inflationary effort. Financial markets have reacted favorably, with a sharp fall in long-term interest rates and a booming equity market. But the effectiveness of monetary policy is diminishing in the run-up to EMU. In particular, lending to households has been boosted by the expected convergence of interest rates to euro area levels and by intense competition within the banking system. In this setting, the Bank of Greece introduced temporary administrative measures to restrain credit growth in mid-April 1999, tightening them further at end-July.

The 1999 **fiscal deficit** is set to come in under target (at some 1½–1¾ percent of GDP, compared to a budget target of 1.9 percent of GDP), thanks to strong revenue performance. On the basis of this performance, the authorities announced a tax cut and benefit package for 2000 (for a total net cost, inclusive of the indirect tax cuts, put at slightly over ½ percent of GDP), which they see as compatible with a further decline in the overall deficit (the 2000 budget is currently under preparation). However, in the absence of further offsetting measures, the staff projects a deterioration of the primary surplus. The debt-to-GDP ratio is expected to decline further in 1999-2000, dipping below 100 percent of GDP.

Progress with **structural reforms** has been most visible with regard to privatization, and important steps are being taken in public enterprise restructuring, but broad social security and labor market reforms remain on hold. The detailed privatization and partial flotation program announced upon ERM entry has, with a few delays, been essentially implemented. While sales in the banking system have generated intense competitive pressures, other key sectors continue to be dominated by public enterprises, with liberalization being deferred as long as possible under EU derogations. The restructuring of loss-making public enterprises has made some ground-breaking advances. Labor market measures taken in August 1998 have faced a web of implementation difficulties. Fundamental reform of the social security system has been deferred to after the 2000 elections; nonetheless, measures taken under a "mini" package hold the promise of both appreciable savings and increased efficiency.

**Executive Board Assessment**

Executive Directors commended the authorities for the steady pursuit of stability-oriented economic policies that had generated the virtuous circle essential to the success of Greece's drive to EMU participation by January 1, 2001. Directors noted that the achievements to date were impressive: growth was strong, nominal wage increases were moderate, fiscal developments were better than budgeted, and inflation had declined considerably. Looking ahead, the main policy challenges were to secure a low inflation performance on a sustainable basis and to enhance Greece's medium-term growth and employment prospects.

Directors recognized that EMU qualification was a demanding goal to be realized within a limited time span. They noted that the macroeconomic policy stance adopted together with indirect tax cuts and other administrative measures that had been taken appeared likely to succeed in containing headline inflation below the Maastricht criterion for the relevant reference period. Some Directors agreed that the indirect tax cuts could produce more durable effects on

inflation through lower inflationary expectations and wage agreements. Several Directors, however, expressed the view that these measures were likely to have only a transitory impact on inflation, and were in any case not a substitute for more fundamental measures: they stressed the need to achieve a sustainable reduction of inflation through an appropriately tight fiscal policy, continued wage moderation, and far-reaching structural reforms that would strengthen competition and raise productivity.

Directors endorsed the tight monetary policy that had been pursued to date, and welcomed the intention of the authorities to maintain this policy stance for as long as feasible in the run-up to EMU. They felt that such a stance was well advised in light of the economy's cyclical position and other related developments, such as the boom in equity and credit markets. However, they noted that there were evident limits to this approach, and that the eventual alignment of domestic interest rates with those in the euro area and the depreciation of the drachma toward its central ERM2 parity would entail a relaxation of monetary conditions. While a number of factors that could attenuate the extent of monetary relaxation were noted by a few Directors, there was broad agreement that the monetary easing in prospect was sizable and would need to be countered by other policy instruments—fiscal, wage, and structural policies—to ensure a sustainable competitive inflation performance in monetary union. Directors welcomed the authorities' intention to remove the administrative measures to restrain credit growth as soon as feasible, given the commonly recognized drawbacks of such measures.

Directors commended the Greek authorities for the better than expected fiscal performance this year in providing needed macroeconomic restraint, and in supporting monetary policy in pursuing disinflation. They endorsed the strengthening of the convergence program target for the overall deficit for 2000, and the intention to do likewise for the 2001–02 targets in the update of the convergence program later this year. Most Directors recommended maintenance of the current primary surplus at around 7 percent of GDP in 2000–01, both from a cyclical perspective and in view of the concomitant monetary easing. They welcomed the authorities' intention to aim at this order of magnitude in the primary surplus next year. A number of Directors saw the tax cut and the benefit package for 2000 as entailing some risks in this respect, and they encouraged the authorities to remain vigilant and to stand ready to take offsetting measures to ensure continued progress in fiscal consolidation over the medium term.

Directors recognized the contribution that wage moderation had made to disinflation. In looking to the next round of negotiations, they stressed the importance that employers and employees appreciate fully the consequences of the regime change implied by Greece's planned participation in EMU. In this regard, Directors noted that unit labor cost developments in the euro area should be seen as a guidepost in deciding wage increases. They recommended that the authorities continue to actively promote nominal wage moderation, and some suggested elimination of wage catch-up clauses.

Directors emphasized the importance of far-reaching structural reforms, especially in liberalizing and deregulating the economy, so as to help sustain price stability, reduce structural unemployment, and allow Greece to fully realize its growth potential. They welcomed the progress that had been achieved with regard to the privatization and public enterprise

restructuring programs. Directors pointed, however, to the burden imposed by inefficiencies in key state enterprises, and advocated the extension and quickening of the liberalization process. While recognizing the positive effects of privatization and liberalization in the banking system, they remarked that the heightened competition intensified the risks faced by banks, and that further efforts to reduce their high operating costs were needed. Directors welcomed the steps taken by the Bank of Greece to improve banks' risk management and internal control systems, and recommended that their effectiveness be closely monitored.

In noting the still high level of unemployment, Directors welcomed the measures taken in order to improve labor market performance, but regretted that they had remained largely unapplied and had yet to elicit the desired response. In this regard, they stressed the desirability of reducing the high effective entry wage for first-time job seekers, and recommended a greater role for the private sector in vocational training and job placement services. Directors welcomed the recent progress made in improving the efficiency of the social security system. They encouraged the authorities to proceed rapidly to the next phase of the reform process, so as to ensure the long-term viability of the system.

Directors commended Greece's completion of a self-assessment against the IMF Code of Good Practices on Fiscal Transparency—Declaration of Principles, as well as its readiness to publish the results. They also welcomed Greece's participation in the pilot project for the voluntary release of Article IV staff reports.

While noting the improvements that had been made to the statistical system and in data provision to the Fund, Directors urged the authorities to strengthen their efforts, particularly in the areas of national accounts and balance of payments data, and recommended that they seek to satisfy the requirements for subscribing to the Special Data Dissemination Standard.

***Public Information Notices (PINs)*** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 1999 Article IV consultation with Greece is also available on the IMF's website (http://www.imf.org).

## Greece: Selected Economic Indicators

| | 1995 | 1996 | 1997 | 1998 | 1999 1/ |
|---|---|---|---|---|---|
| Real economy (change in percent) | | | | | |
| GDP | 2.1 | 2.4 | 3.2 | 3.7 | 3.3 |
| Domestic demand | 4.4 | 3.0 | 3.5 | 3.3 | 3.4 |
| EU harmonized consumer inflation (period average) | ... | 7.9 | 5.4 | 4.5 | 2.3 |
| Unemployment (in percent) | 10.0 | 10.3 | 10.3 | 10.1 | 10.3 |
| Investment 2/ | 18.7 | 19.4 | 20.1 | 21.8 | 22.8 |
| Saving 2/ | 16.2 | 16.7 | 17.5 | 19.1 | 20.5 |
| Public finance (general government, in percent of GDP) | | | | | |
| Overall balance | -10.6 | -7.5 | -4.0 | -2.4 | -1.7 |
| Primary balance | 2.3 | 4.5 | 5.7 | 6.7 | 7.0 |
| Debt | 110.1 | 112.2 | 109.5 | 106.1 | 102.1 |
| Of which: external debt | 23.5 | 22.9 | 24.3 | 26.5 | ... |
| Money and credit (end-period, percent change) | | | | | |
| Broad money (M4N) 3/ | 13.0 | 15.3 | 7.8 | 9.8 | 7.9 |
| Domestic credit 4/ | 9.6 | 8.3 | 11.4 | 9.9 | 10.3 |
| Interest rates (year average) | | | | | |
| 3-month treasury bill rate 5/ | 14.3 | 11.9 | 10.1 | 11.9 | 9.8 |
| 12-month treasury bill rate 6/ | 15.5 | 12.8 | 10.3 | 11.5 | 8.8 |
| Balance of payments (national accounts, in percent of GDP) | | | | | |
| Trade balance | -12.8 | -12.6 | -12.3 | -12.7 | -12.5 |
| Current account balance | -2.4 | -2.6 | -2.6 | -2.7 | -2.3 |
| Foreign exchange reserves (US$billions) 7/ | 14.6 | 17.3 | 12.4 | 17.2 | 21.4 |
| Exchange rates | | | | | |
| Exchange rate regime | Member of the European monetary system | | | | |
| Present rate (September 21, 1999) | Dr 327.0 to 1 euro | | | | |
| Nominal effective rate (1990=100) 8/ | 71.1 | 70.8 | 69.1 | 66.5 | 66.3 |
| Real effective rate (1990=100) 8/ | 110.2 | 115.0 | 116.1 | 112.9 | 113.1 |

Sources: Data provided by the Greek authorities; and IMF staff estimates and projections.

1/ IMF staff projections, except where noted.
2/ In percent of GDP.
3/ Data for 1999 correspond to the 12-month change to end-July.
4/ Data for 1999 correspond to the 12-month change to end-May.
5/ Data for 1999 correspond to the auction of August 17, 1999.
6/ Data for 1999 correspond to the auction of August 31, 1999.
7/ Data for 1999 correspond to end-August.
8/ Data for 1999 correspond to June.

**Statement by John Spraos, Executive Director**
**for Greece**
**October 20, 1999**

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.