March 2001
IMF Country Report No. 01/52

Greece: 2000 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of Greece

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2000 Article IV consultation with Greece, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 21, 2000,** with the officials of Greece on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on January 30, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its February 23, 2001, discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of Greece.

The document(s) listed below have been or will be separately released.

Mission Concluding Statement
Report on Observance of Standards and Codes
Selected Issues and Statistical Appendix paper

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

GREECE

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the 2000 Article IV Consultation with Greece

Approved by Susan Schadler and Jesús Seade

January 30, 2001

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I. Introduction and Key Issues

1. At the **conclusion of the last consultation** on October 20, 1999, Directors commended the authorities for the steady pursuit of stability-oriented economic policies that had yielded impressive economic results and set the stage for euro participation (http://www.imf.org/external/np/sec/pn/1999/pn99102.htm). They saw the main policy challenges as securing low inflation, and enhancing medium-term growth and employment prospects. This called for balancing the euro-entry-related monetary easing with an appropriate fiscal stance; and for wage and structural policies to sustain low inflation and strengthen growth. To an important extent, these considerations also guided the 2000 Article IV consultation discussions, held in Athens during November 9–21, 2000.[1]

2. Imminent euro entry provided a historical opportunity for advancing living standards in Greece. Against this background, and to avert potential risks, the mission focused on:

- **Macroeconomic imbalances and the role of fiscal stabilization policies**: There was broad agreement on the near-term fiscal surplus target, aimed also at containing inflation and a large external current account deficit. The staff argued that competitiveness needed to be strengthened, including through containing future wage increases.

- **Tax and public expenditure policies**: The authorities planned the further lowering of marginal tax rates and a broadening of tax bases. The staff advised deeper revenue cuts, in line with those planned elsewhere in the euro area—complemented by additional primary expenditure measures.

- **Policies to reduce unemployment and strengthen employment growth**: The staff suggested reforms aimed at the weakest segment of the labor market (i.e., job market entrants), including increased wage differentiation at the entry level and improved job market matching. The authorities thought that it would be difficult to garner broad support for these steps. And labor market institutions may hamper a needed strengthening of competitiveness.

- **Structural reforms**: There was a consensus on the need for advancing structural reforms to reap the full benefits of monetary union and accelerate real income convergence—albeit not always an agreement on the urgency and depth of the reforms.

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[1] The mission—comprising Messrs. Krueger, Kieler, Lutz, and Vamvakidis (all European I)—met with Ministers Papantoniou (National Economy and Finance), Giannitsis (Labor and Social Affairs), and Papadopoulos (Health); Governor Papademos; other senior officials; representatives of regulatory agencies and research institutes; and labor and business leaders. Mr. Vittas, Alternate Executive Director, participated in all and Mr. Faini, Executive Director, in some of the meetings.

3. The government of Prime Minister Simitis (Pan-Hellenic Socialist movement, PASOK) narrowly won reelection in April and continues to have an absolute majority in parliament. Greece joined the euro area on January 1, 2001 (Appendix I).

II. Background

A. Recent Economic Developments

Growth, Inflation, and Unemployment in Greece and the Euro Area

	1991-95	1996-2000	2000	2001
GDP growth				
Greece	1.2	3.3	3.9	4.0
Euro area	1.6	2.5	3.4	3.0
Inflation (HICP)				
Greece	13.9	4.5	2.9	3.4
Euro area	3.7	1.7	2.4	2.2
Unemployment				
Greece	8.9	10.7	11.8	11.6
Euro area	10.3	10.5	9.0	8.2

Sources: WEO database; and Fund staff estimates.

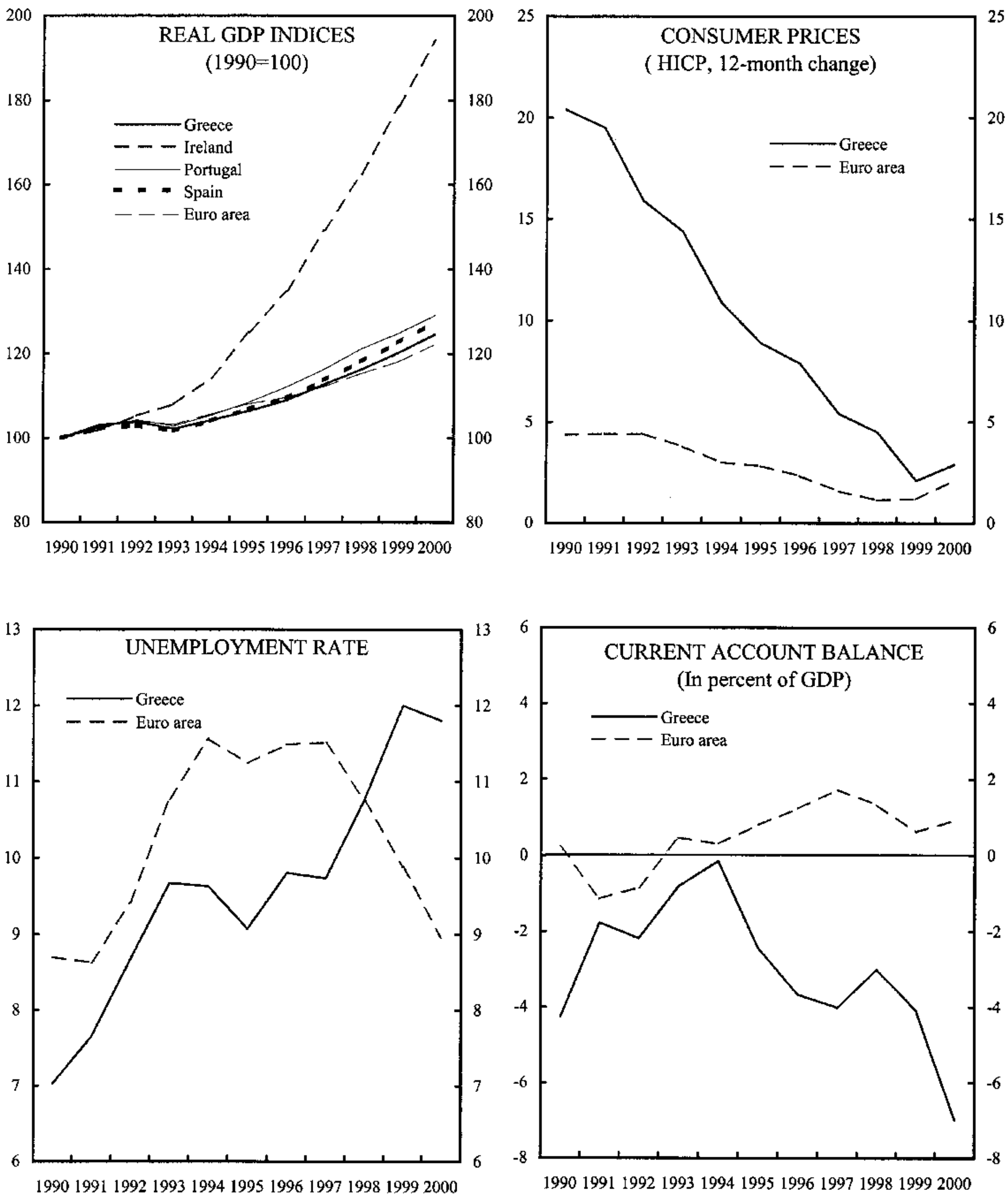
4. **Greece's economic performance improved markedly after the mid-1990s—but persistent structural weaknesses contributed to recently reemerging macroeconomic imbalances.** Following a "lost decade" after joining the EU in 1981, real and nominal convergence progressed over the past five years, reflecting to an important extent stability-oriented monetary and fiscal policies. These policies, which laid the ground for euro entry at the beginning of 2001, contributed to relatively robust growth and disinflation (Table 1; and Figure 1).[2] Nevertheless, the unemployment rate continued to rise, reaching the second highest level in the euro area; and, more recently, core inflation has accelerated again and the external current account deficit has widened considerably (see below).

5. **With euro entry providing an anchor for expectations and monetary conditions turning increasingly accommodative, economic growth rose to some 4 percent in 2000.** Private sector demand responded strongly to the favorable changes in the economic environment (Figures 2 and 3). With entry into the third stage of EMU viewed as more and more likely (and finally approved in June 2000), the effectiveness of relatively high official interest rates became increasingly circumscribed and private investment rose strongly in 2000. Household demand for consumer durables and construction benefited from robust income growth and also from the lower interest rate environment. Moreover, as official interest rates (and short-term market rates) declined by a cumulative 600 basis points (Figure 4), domestic demand was also supported by a strong acceleration of credit growth, with household credit expanding by around 30 percent (Figure 5).

6. **After converging to close to the euro-area average, consumer price inflation (including core inflation) accelerated in the fourth quarter more strongly than in the**

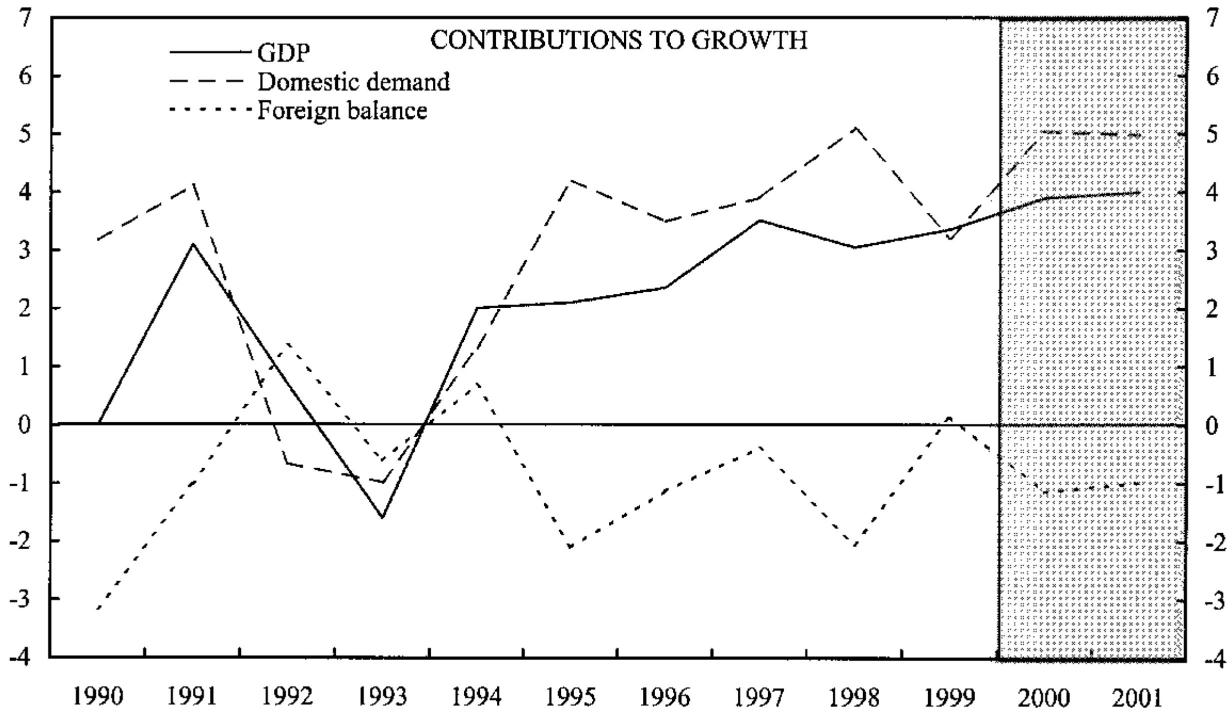
[2] References to the euro area in this report refer to the area excluding Greece, except where indicated otherwise.

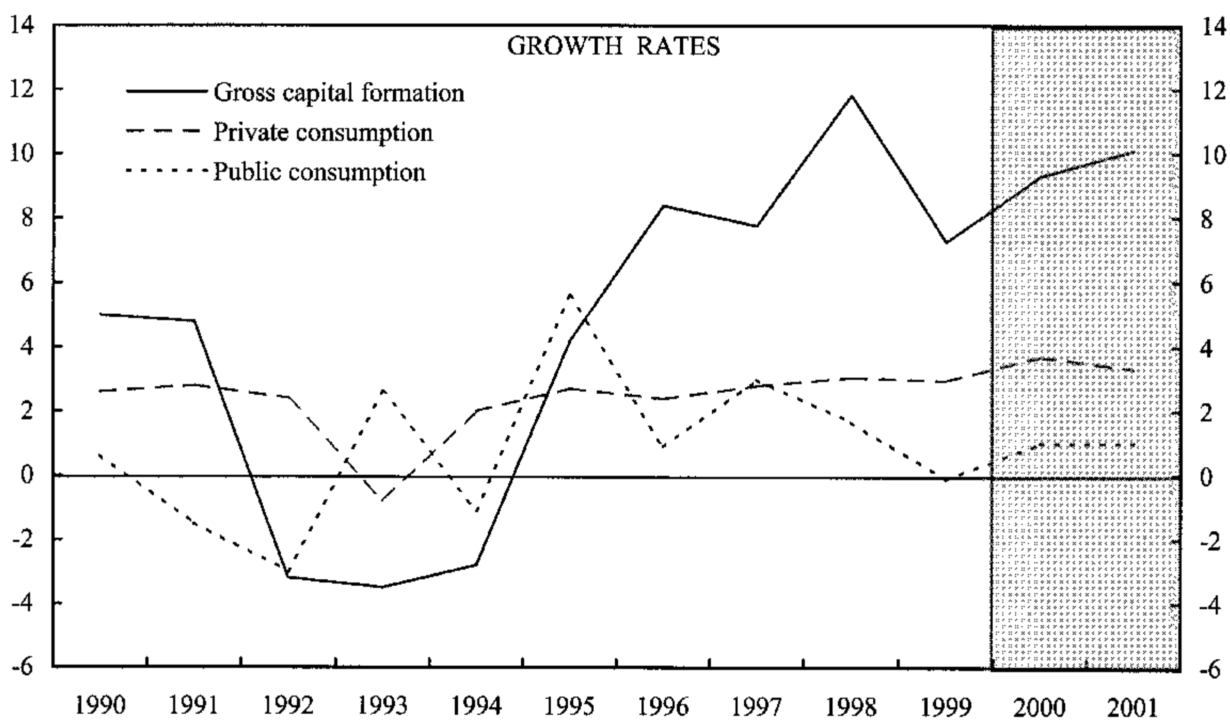
Figure 1. Greece: International Comparisons of Macroeconomic Performance, 1990-2000



Source: IMF, *World Economic Outlook*.

Figure 2. Greece: GDP and Components' Growth and Contributions, 1990-2001 1/
(In percent)

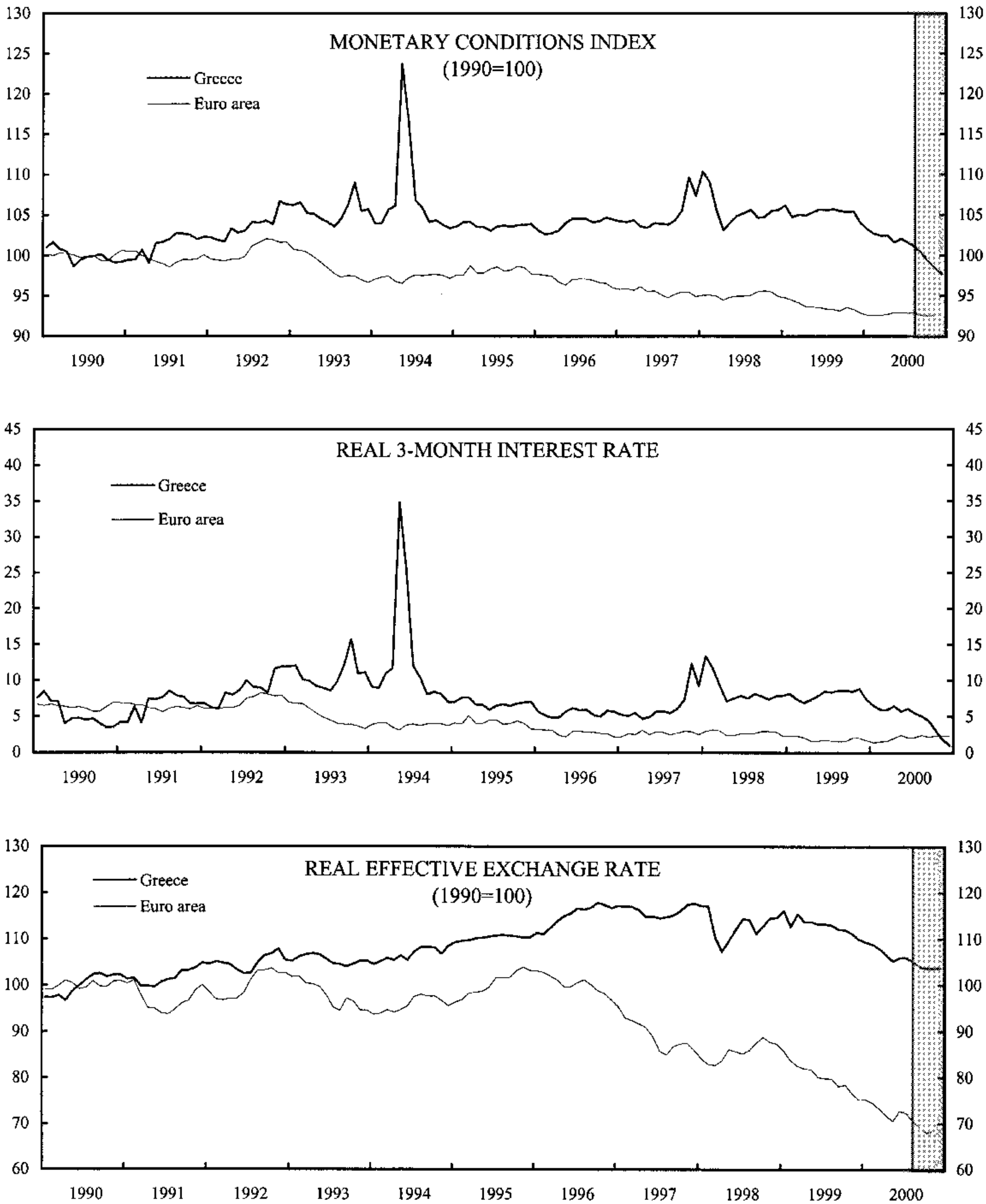




Sources: National Statistical Service; Ministry of National Economy; Fund staff calculations and projections.

1/ Shaded areas show Fund staff projections.

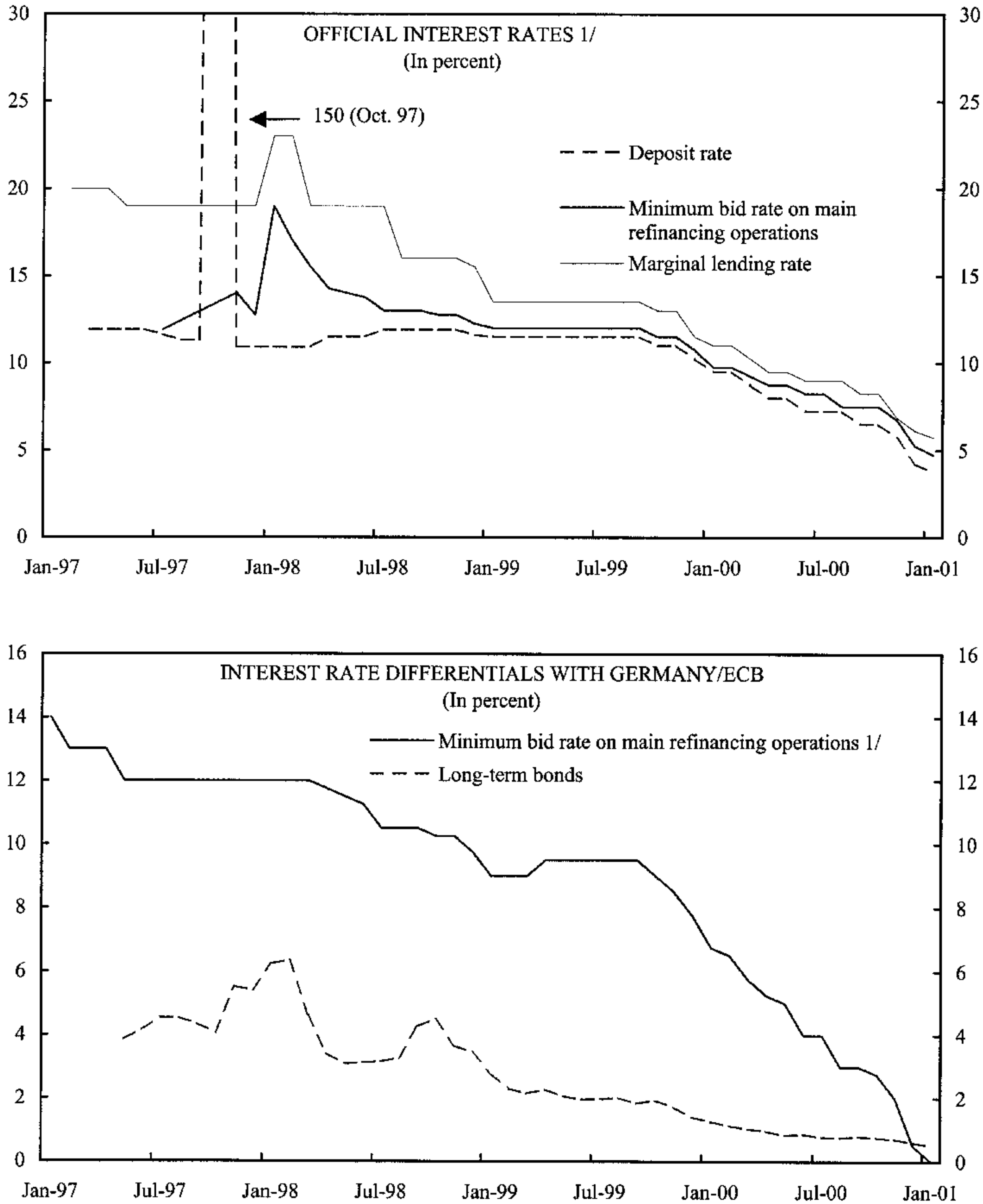
Figure 3. Greece: Monetary Conditions Index, 1990-2000 1/



Sources: Bank of Greece; IMF, *Economic Information System*; European Central Bank; and Fund staff calculations.

1/ Shaded areas show Fund staff projections.

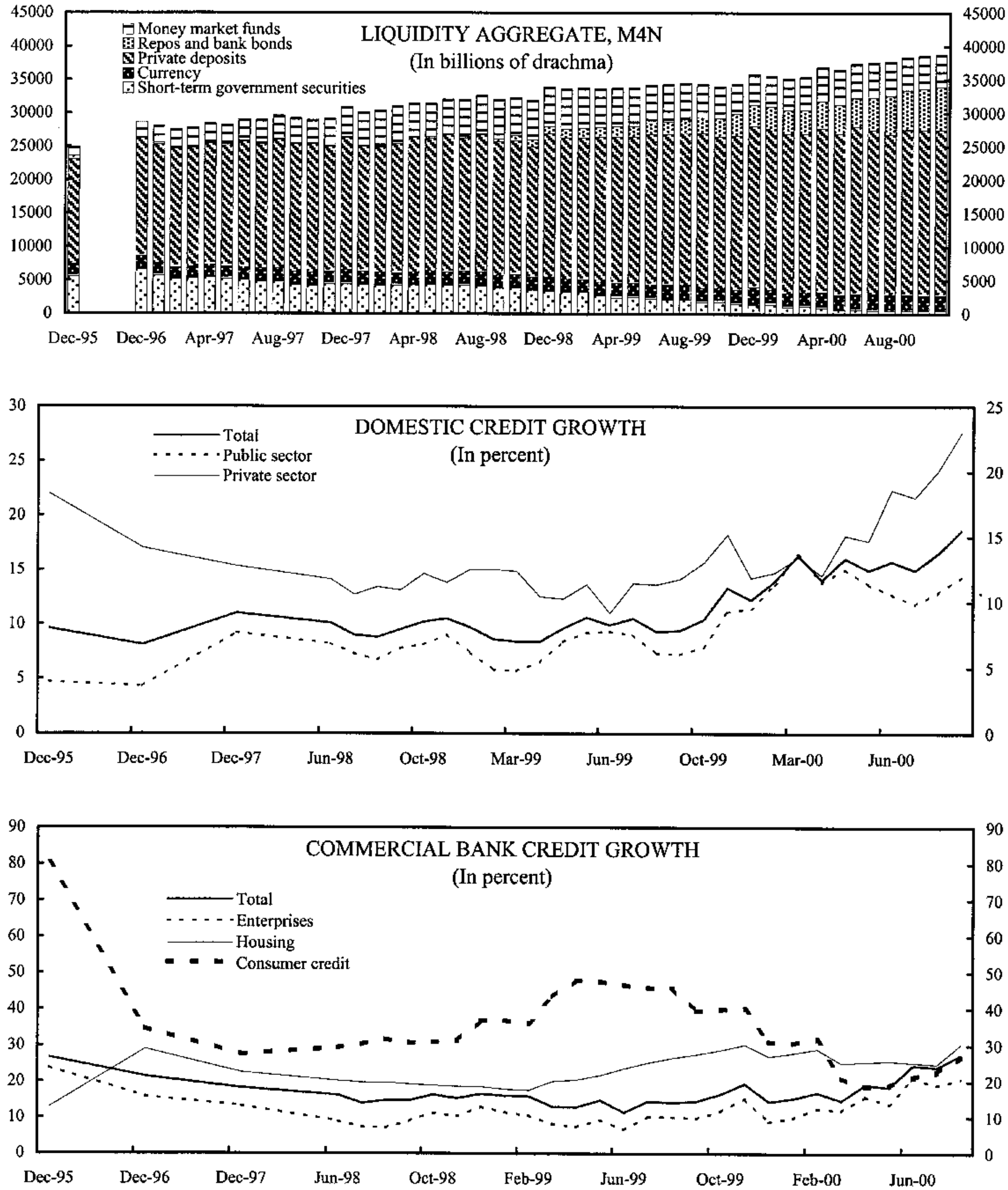
Figure 4. Greece: Official Interest Rates and Differentials with Germany/ECB, 1997-2001



Sources: Bank of Greece; European Central Bank; and IMF, *International Financial Statistics* .

1/ Prior to January 1, 2001, figures refer to official rates of the Bank of Greece.

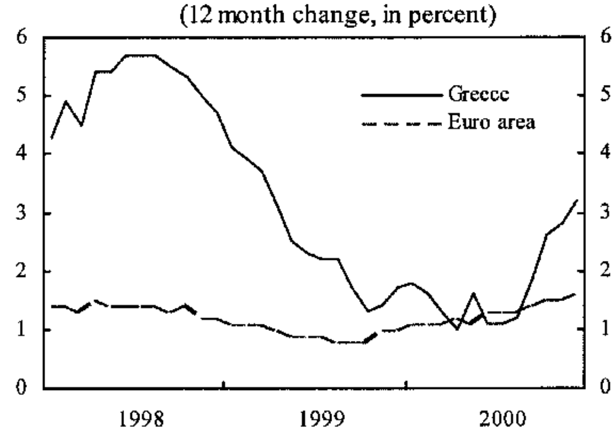
Figure 5. Greece: Money and Credit Developments, 1995-2000



Source: Bank of Greece.

area, amid relatively high wage increases. As elsewhere, rising energy prices added significantly to headline inflation, which rose to close to 4 percent in the fourth quarter of 2000 (based on the HICP; Figure 6). And core inflation in Greece tripled since the summer of 2000, and it reached 3¼ percent by end-year—double the euro-area average. The rise in core inflation was partly due to an unwinding of indirect tax cut effects, which had facilitated meeting the Maastricht inflation criterion and were estimated to have lowered inflation by about 1 percentage point in the year to December 1999. In addition, rising nonenergy price pressure reflected a combination of strong domestic demand, unit labor cost increases above those in the euro area, and higher import prices owing to currency depreciation—the latter reflecting the weakness of the euro as well as the drachma's roughly 4 percent depreciation during 2000 to its central parity rate. On wages, a two-year minimum wage agreement provided for raises of 4.2 percent in 2000 and 3.3 percent in 2001, with only the latter subject to an inflation catch-up clause. Nonetheless, the authorities estimated that private sector compensation growth rose to 5 percent in 2000; as this was not fully matched by stronger productivity growth, unit labor cost increases (2–2½ percent) were again above the euro-area average.

CORE INFLATION 1/
(12 month change, in percent)



1/ HICP, excluding energy and seasonal food.

7. **The unemployment rate continued to rise in recent years, notwithstanding relatively rapid output growth**. Although poor labor market statistics hampered the assessment and no data were available for 2000 (see Appendix II), the authorities thought that the employment intensity of economic growth was considerably lower in Greece than in other EU countries.[3] With rising female participation rates and despite some earlier reforms (see below), the unemployment rate—concentrated among the young and women, and with more than half unemployed for over one year—had increased to 12 percent in 1999 (Figure 7), and little improvement was expected for 2000.

8. **The external current account deficit widened markedly in recent years to one of the highest levels among advanced economies**. With import growth fueled by strong domestic demand, staff estimates that the external current account deficit (including capital transfers) more than doubled over the past two years, reaching 7 percent of GDP in 2000 (Figure 8). About 1¼ percent of GDP of the deterioration in 2000 was attributable to higher

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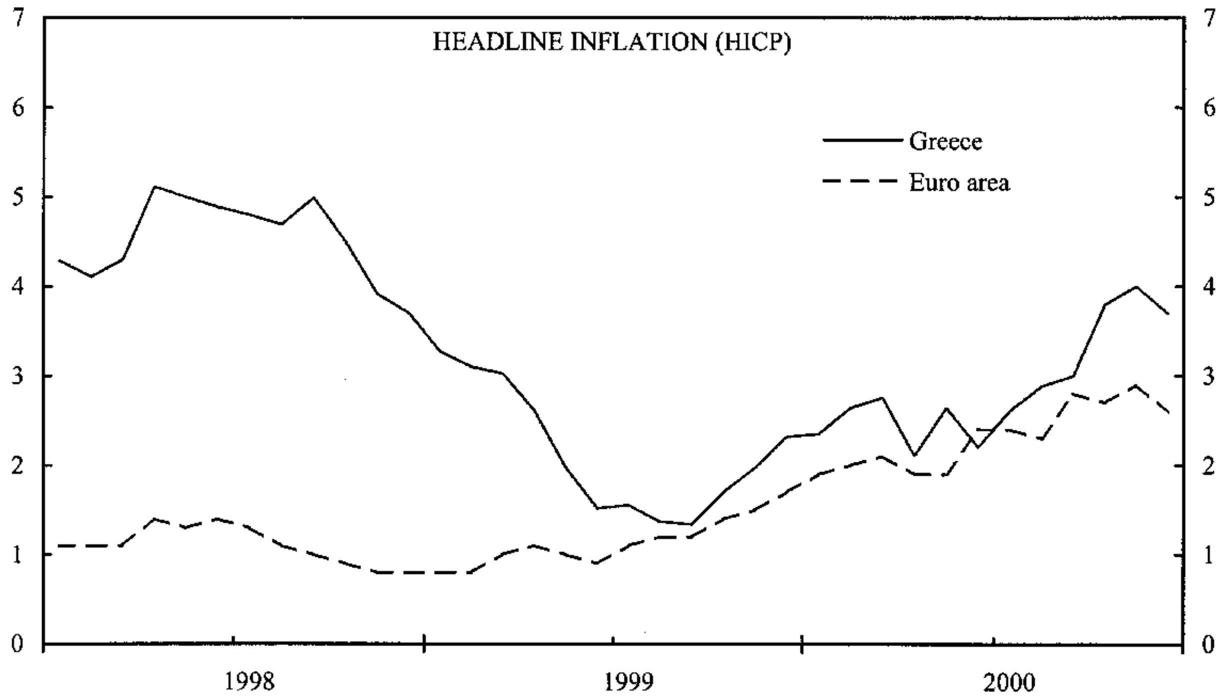
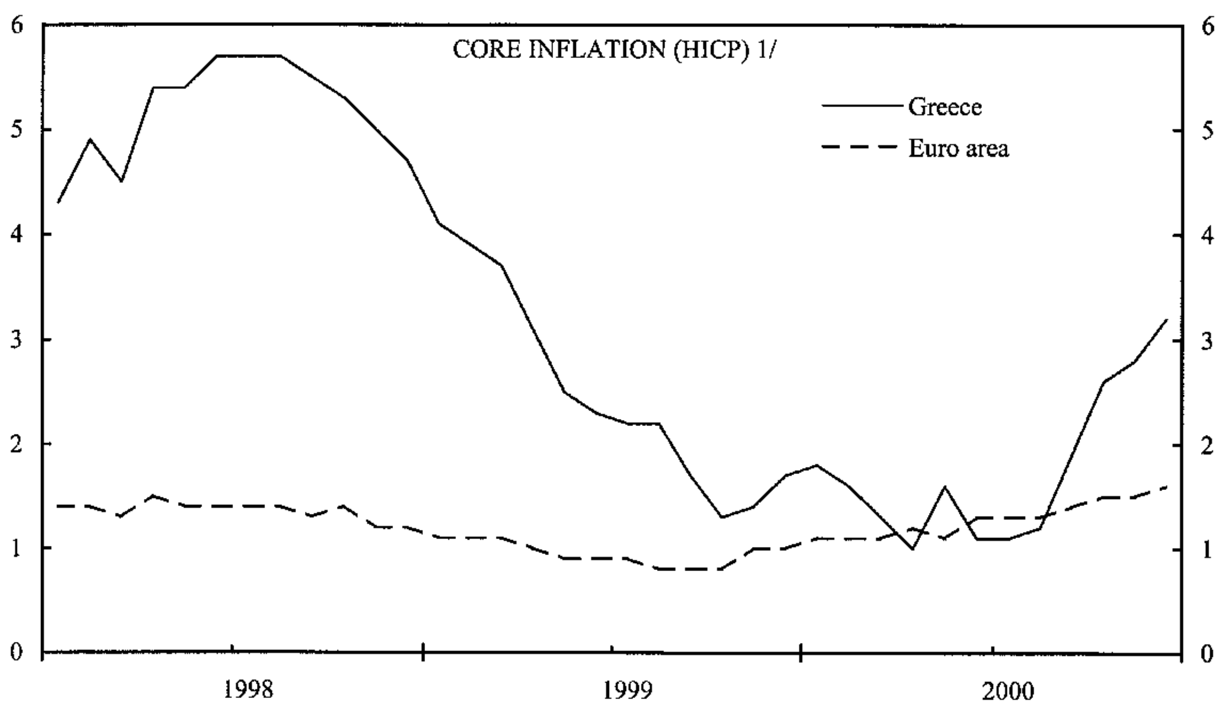
[3] The exception in 1998, when employment rose strongly, was largely due to the regularization of immigrant workers.

Figure 6. Greece: Evolution of Consumer Prices, 1998-2000
(Year-on-year growth rate, in percent)

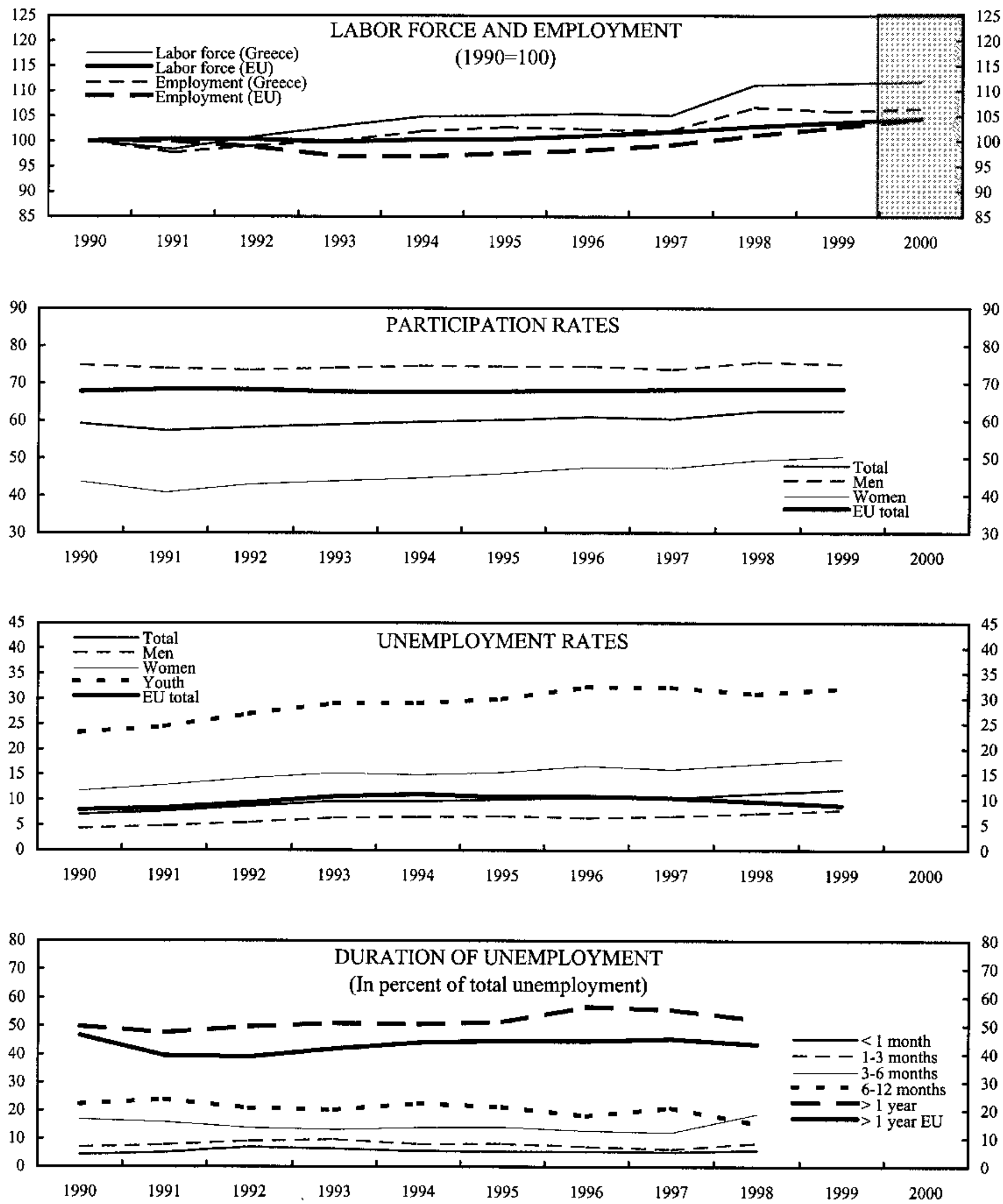




Sources: National Statistical Service; Bank of Greece; Eurostat; and Fund staff calculations.

1/ Excluding energy and sesonal food.

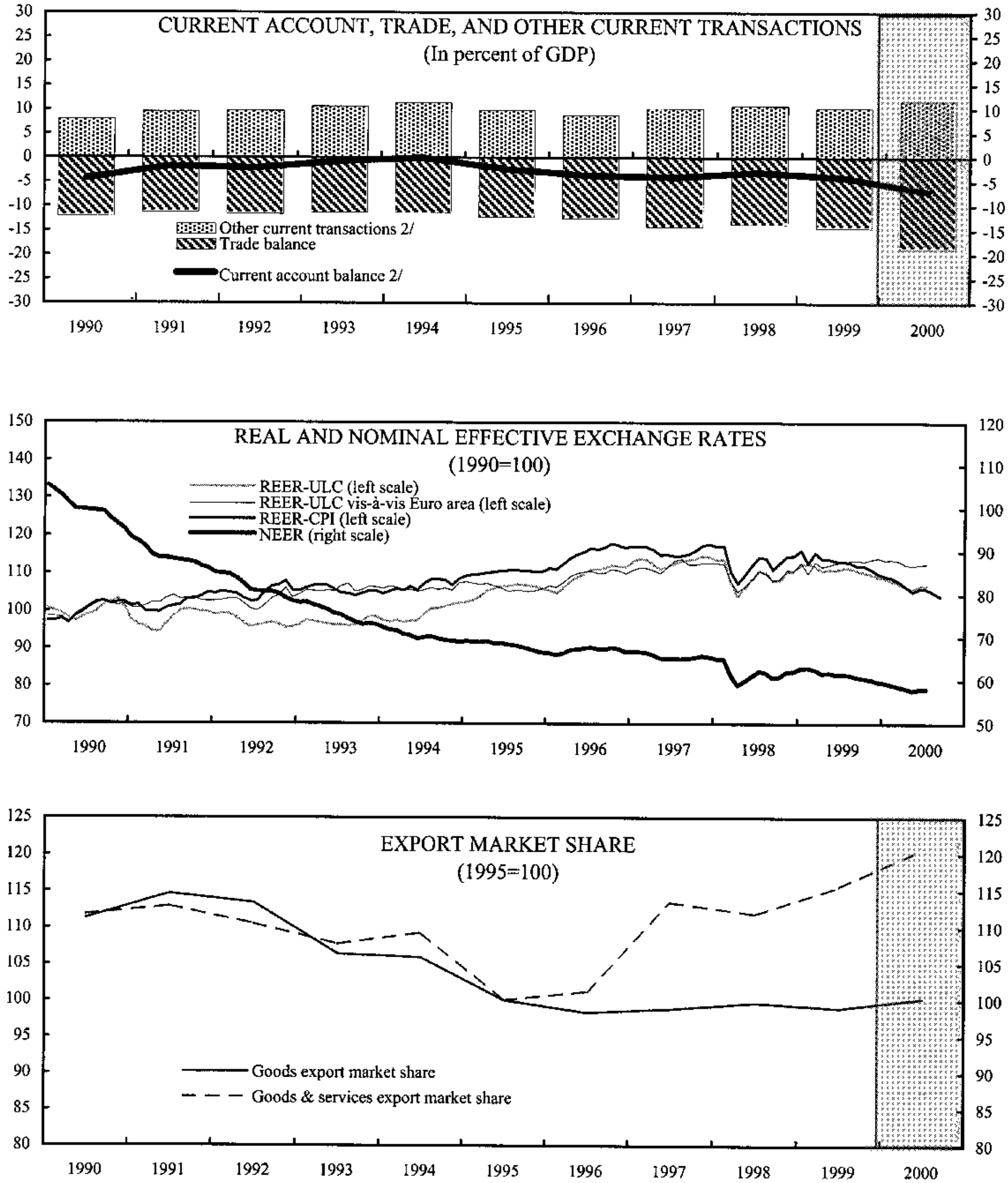
Figure 7. Greece: Labor Market Developments, 1990-2000 1/



Sources: IMF, *World Economic Outlook*; and OECD, *Labor Force Statistics*.

1/ Shaded area shows Fund staff projections.

Figure 8. Greece: External Developments, 1990-2000 1/



Sources: IMF, *World Economic Outlook*; and *International Financial Statistics*.

1/ Shaded areas show Fund staff projections.
2/ Including capital transfers.

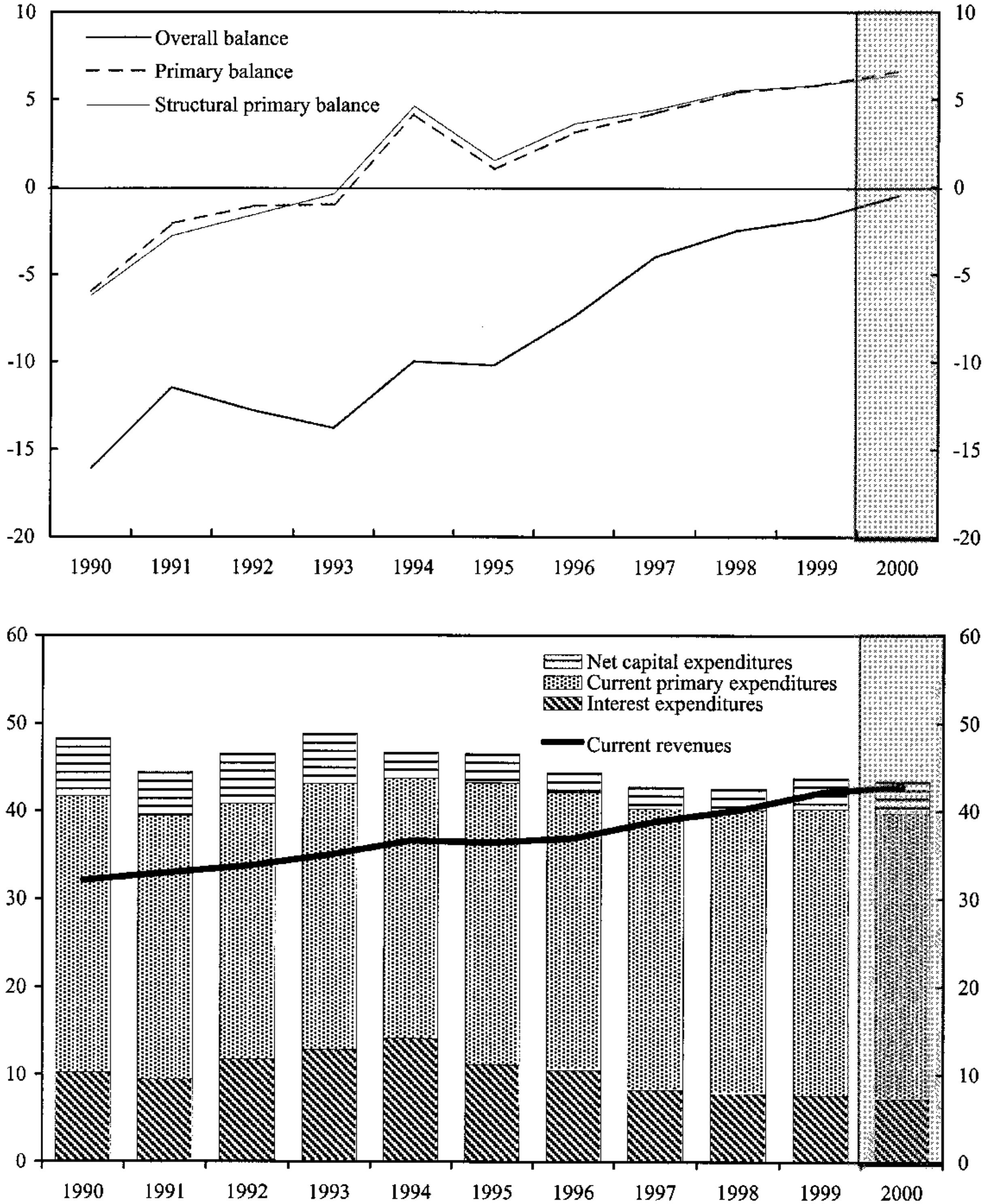
oil prices (Table 2), while a larger portion was accounted for by strong demand for import-intensive capital goods and consumer durables. At the same time, Greek exporters benefited from a depreciating exchange rate, and robust demand among EU partners as well as new trade opportunities in the Balkans. The current account imbalance was financed primarily by foreign portfolio investment inflows. In 2000, the Bank of Greece also reduced somewhat its high foreign reserve asset position to finance the unwinding of convergence trades. The inflow of foreign direct investment (FDI) into Greece remained relatively moderate (around ½ percent of GDP), and with the internationalization of some domestic enterprises raising FDI outflows, the FDI balance turned negative in 2000.

9. **Fiscal consolidation continued in 2000—with staff expecting strong revenue growth to limit the general government deficit to around ½ percent of GDP—and the 2001 budget aimed at a surplus of 0.5 percent of GDP** (Table 3; and Figure 9). The authorities have successively tightened their fiscal targets: for 2000, the original target of 1.2 percent of GDP was lowered to 0.8 percent in the *Stability and Growth Program*, which also introduced a fiscal surplus target for 2001 versus the previously envisaged deficit of 0.2 percent of GDP. The better-than-budgeted outturn for 2000—with staff expecting an even smaller deficit than the authorities—reflected buoyant revenues, due to strong economic activity and marked improvements in tax administration (helped by computerization of tax offices and cross-checking). However, current primary expenditure also exceeded the budgeted levels by a wide margin, boosted by new expenditure initiatives (including fulfillment of election promises to pay contributions to the main pension fund for minimum wage earners) and some slippages, notably on education and health care. The structural primary surplus strengthened by ¾ percentage points, to close to 6½ percent of GDP.

B. Economic Outlook

10. **Near-term prospects point to continued strong output growth, but also to inflation risks and continued high external current account deficits**. Most indicators—such as those for retail sales and industrial production—suggest considerable momentum of domestic demand and activity, supported by the euro-entry-related easing in monetary conditions. There has, however, also been an easing of business and consumer confidence in recent months, pointing to possible downside risks to the staff's projection of 4 percent GDP growth for 2001 (broadly in line with Consensus Forecasts—but well below the authorities' 5 percent, predicated on double-digit investment growth). In all, downside risks to the staff's projection relate mainly to the external side: a more rapid slowdown in world demand than currently envisaged; oil prices above those indicated in current forward contracts; or a relatively sharp appreciation of the euro, which would affect prospects for 2002 in particular. On the upside, construction but also consumer demand may accelerate more strongly than currently projected, notably if the past easing in interest rates were to lead to a considerable rise in liquidity and credit growth, as has been the experience in some euro-area countries. Greece may also benefit from an improved outlook in the Balkan region, following the normalization of trade relations with the Federal Republic of Yugoslavia (Serbia/Montenegro). Risks related to asset prices have diminished with the equity price

Figure 9. Greece: General Government Accounts, 1990-2000 1/
(In percent of GDP)



Source: IMF, *World Economic Outlook*.

1/ Shaded areas show Fund staff projections.

correction since September 1999 (Table 4; and Figure 10). With continued robust output growth, there are some risks that the recent acceleration in inflation will be only gradually reversed, especially if future wage demands attempt to recoup the past oil- and import-price related acceleration of inflation (see below). Over the **medium term**, economic prospects will depend critically on structural reforms and competitiveness. On current policies, staff estimated potential output growth of about 3½–3¾ percent. The authorities' higher projection (of some 5 percent) reflected foremost stronger capital stock accumulation—related to sizable effects attributed to monetary union and future structural reforms—and a sharp decline in unemployment. Should the income prospects and reform expectations ultimately be disappointed, there is a risk of potentially sizable repercussions for the external current account and economic activity—and related policy issues are discussed below.

III. Policy Discussions

11. The discussions in Athens took place amid a well-deserved sense of accomplishment among policymakers over Greece's imminent euro-area entry. Notably, an extended period of stability-oriented macroeconomic policies (supplemented with heterodox anti-inflation measures) had resulted in historically low inflation and contributed to a further acceleration of investment-led economic growth. The staff noted that euro entry provided a unique opportunity for a more rapid advance of living standards in Greece, and the authorities recognized that seizing this opportunity posed substantial economic challenges, not least since there was also a need to ensure the sustainability of price stability within the new monetary policy framework. Moreover, they shared the staff's concern—albeit not always its sense of urgency about implementing major reforms—that not addressing these challenges would, within the constraints of monetary union, risk repeating the weak growth performance that had followed EU entry. Against this background, the discussions focused on:

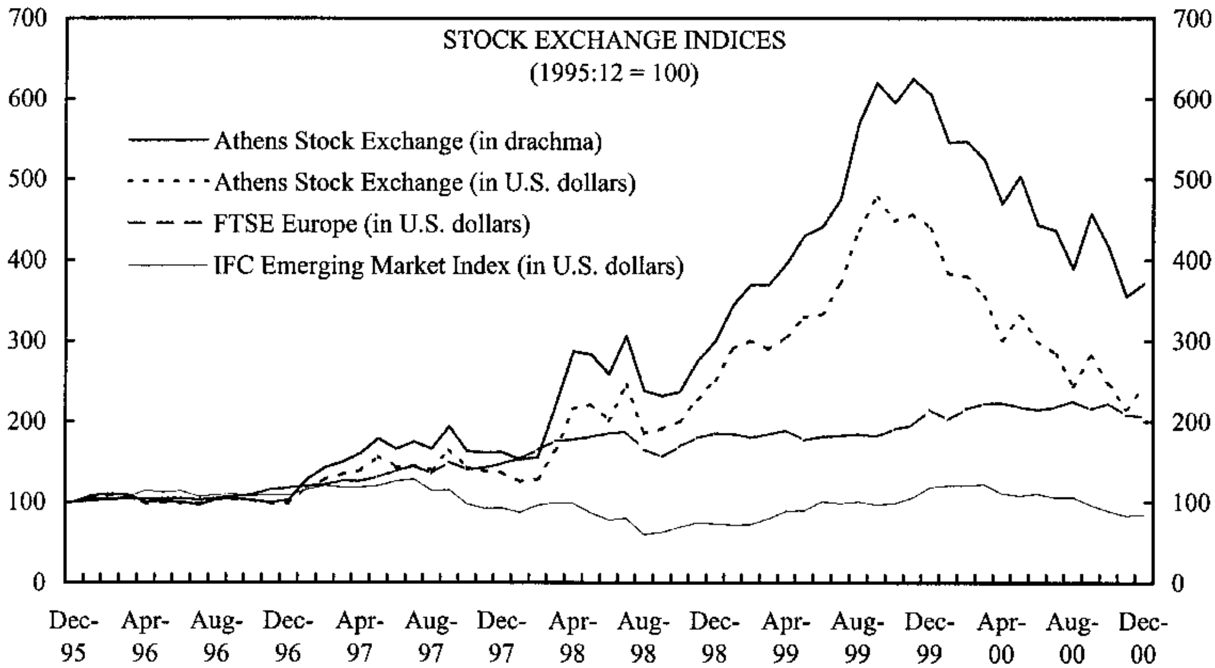
- **Stabilization policies**—policies to secure sustainable rates of low inflation in the new euro environment, and to address the growing external current account deficit;
- **Policies to strengthen growth and accelerate real income convergence**—labor market reforms to reduce high unemployment, and policies to strengthen competition and raise factor productivity; and
- **Policies to safeguard the financial sector**—including reforms of financial sector regulation and supervision, to fully reap the benefits of monetary union.

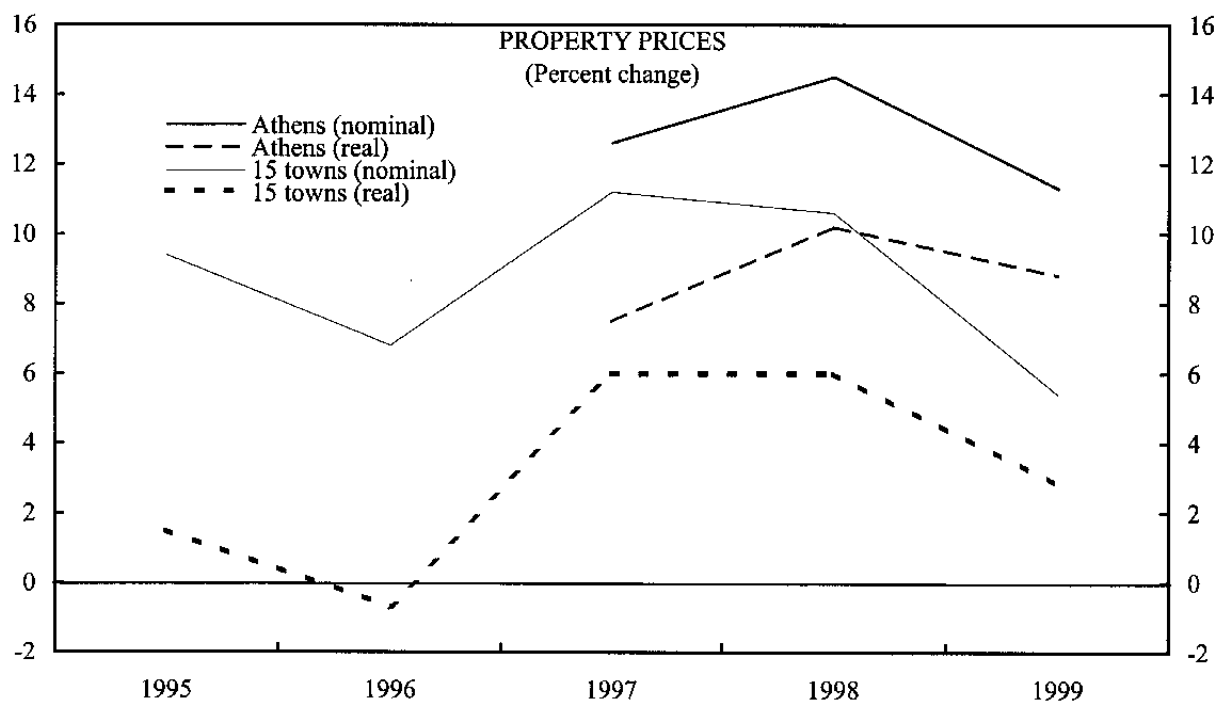
A. Stabilization Issues and Policies

Monetary stance and inflation prospects

12. **The Bank of Greece implemented relatively late the reductions in official interest rates to those of the ECB, with rates declining more than in any euro-area member in the year prior to area entry—a strategy aimed at securing the disinflation gains** (Figures 4 and 11). Full convergence of the main refinancing rate was achieved only in

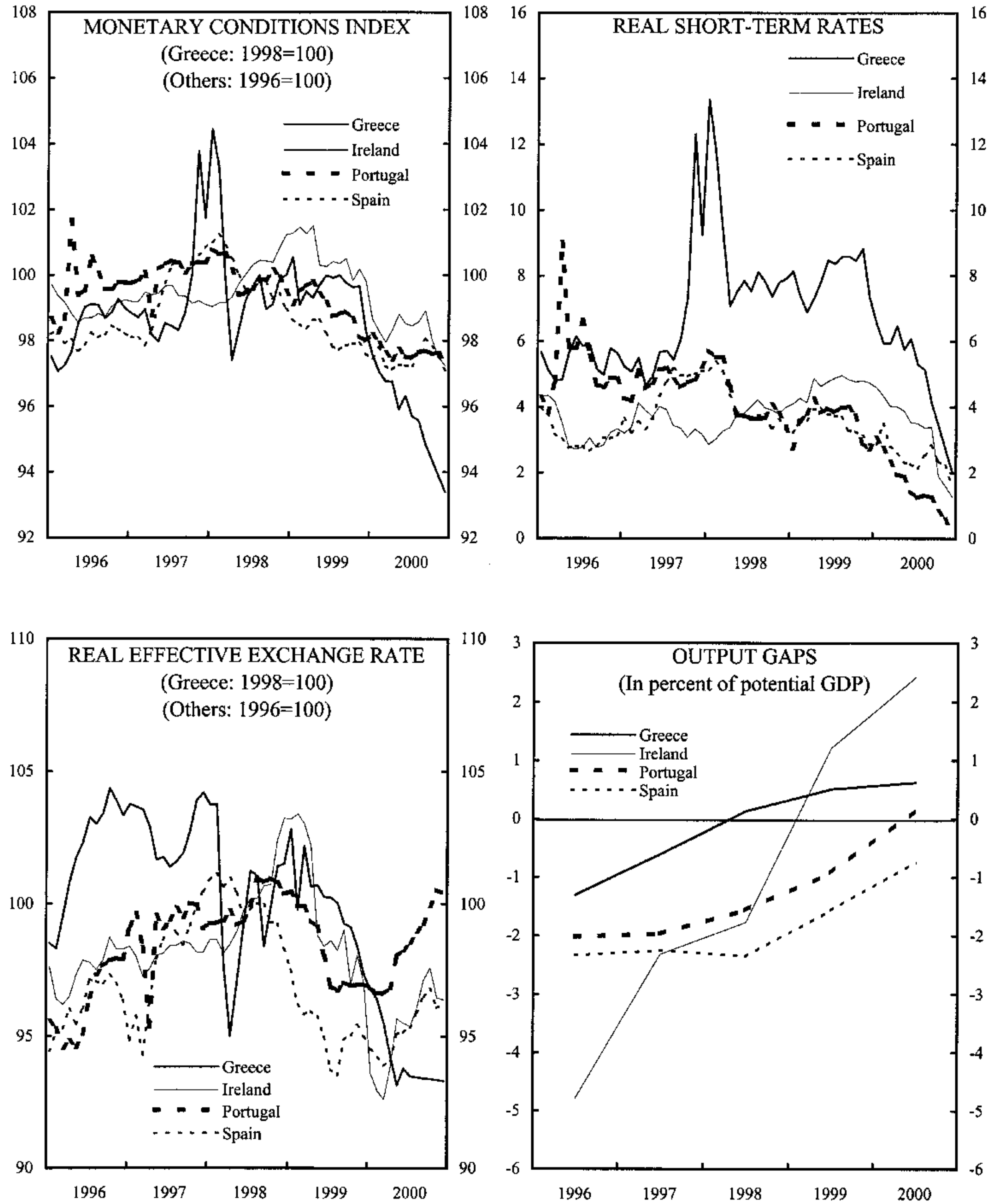
Figure 10. Greece: Asset Market Developments, 1995-2000





Sources: Bank of Greece; and Bloomberg.

Figure 11. Greece: Entering Monetary Union -- A Comparison of Monetary Conditions and Output Gaps, 1996-2000 1/



Sources: IMF, *World Economic Outlook*; *International Financial Statistics*; and *Information Notice System*.

1/ Reflecting their earlier euro entry, data for countries other than Greece are lagged two years (for example, 2000 corresponds to 1998, etc.).

the final week of 2000. The Bank also extended its credit controls (in the form of nonremunerated deposits for an amount equivalent to credit growth above specified rates) through the end of March 2000.[4] Nevertheless, monetary conditions became increasingly accommodative in the run-up to monetary union. This reflected not only the sharp decline in short-term interest rates (by a cumulative 600 basis points during the year), but also the depreciation of the drachma to its central parity, as well as the weakness of the euro itself.

13. **While the authorities agreed that monetary conditions were considerably more accommodative than historically observed for present cyclical conditions, they expected—compared with the staff—a more limited impact on economic activity and inflation.** They pointed to several factors that were likely to contain the impact of easing monetary conditions on inflation: long-term interest rates had already converged earlier in anticipation of euro entry; the effects from rising oil and import prices were likely to wane in the period ahead; lower interest rates reduced household income—a relatively important channel in Greece in view of households' large holdings of public debt; and the authorities thought that the output gap had probably not yet closed. Staff's analysis suggested possibly stronger inflation pressure, in part as it estimated that the economy operated already slightly above potential; and projected important substitution effects from lower interest rates (Box 1). But the authorities and staff agreed that inflation prospects would depend critically on future wage behavior. In this area, however, labor representatives remained unconvinced that import-price-related inflation should not be incorporated into higher wages. These risks are also underscored by a long tradition of private sector wage indexation to past inflation—a practice that has been largely abandoned in the euro area, but was interrupted in Greece for only one year in 2000. If these risks were contained, inflation could end up below the staff's projection for 2001 of an average HICP increase of 3½ percent (well above the approximately 2 percent projected for the euro area)—though inflation may remain considerably higher than indicated in the *Stability and Growth Program* (2.3 percent for the private consumption deflator).

The external current account: implications of monetary union

14. **The authorities attributed the sharp widening of the external current account deficit largely to temporary factors related to monetary union, and to higher oil prices.** Aside from the direct impact of higher oil prices, which accounted for about one-third of the worsened external performance in 2000, the widening external deficit over the past year reflected foremost strong domestic demand growth, concentrated among import-intensive investment and consumer durable goods (especially of automobiles in response to cuts in

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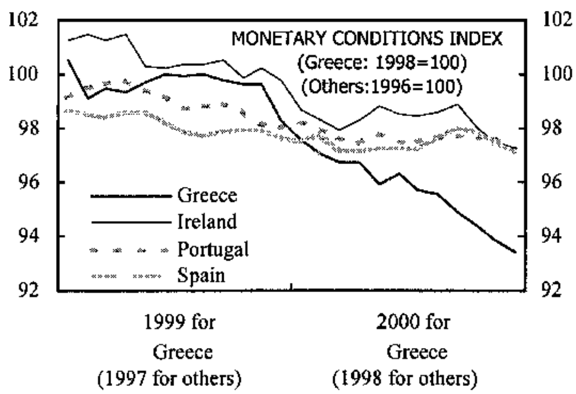
[4] The Bank of Greece took also steps to prevent a surge in liquidity when it reduced reserve requirements from 12 percent to the euro area's 2 percent. The freed-up reserves were converted into blocked interest-bearing deposits at the Bank, to be gradually released until end-2001.

Box 1. Stabilization Challenges in the Wake of Euro-Area Entry: Lessons from First-Round Entrants

In the run-up to joining the euro, monetary conditions in Greece eased by a substantially larger amount than in any first-wave EMU entrant (see chart). For those first-round entrants that were already at a relatively advanced stage of the cycle when they experienced significant euro-related monetary easing—notably Ireland, Portugal, and Spain—the resulting impetus to demand spurred inflationary pressure and worsened external current account positions, in some cases substantially (see table).[1] Although Greece differs in important respects from this group of countries—notably due to the private sector's large interest income from government bonds—the experiences of other EMU entrants highlight the challenges and provide lessons for stabilization policy in Greece. This box focuses on two aspects—inflation prospects, in the light of other euro countries' experience, and external current account prospects, including the extent to which a worsening may be expected in Greece due to euro-entry related changes in fundamentals.

Monetary Conditions in the Run-Up to EMU



Inflation and Current Account Movements in Selected Euro Countries
(In percent, unless otherwise indicated)

	GDP Growth (Annual average)	Core Inflation 1/		External Current Account (In percent of GDP)	
	1996-2000	Dec. 2000	Change 2/	2000	Change 3/
Ireland	9.2	3.9	1.8	-0.6	-1.5
Portugal	3.4	3.1	1.1	-10.1	-5.2
Spain	3.5	3.3	1.7	-3.5	-3.0
Euro area	2.5	1.6	0.4	0.0	-0.7
Memorandum:					
Greece	3.3	3.2	-1.5	-7.0	-4.0

1/ HICP excluding energy and seasonal food.
2/ Change since December 1998.
3/ Change since 1998.

Inflation prospects and risks

Following a long period of disinflation, in which consumer price inflation fell from 20 percent in 1990 to around 2½ percent in the first half of 2000, headline inflation increased to 4 percent by late 2000. Core inflation, excluding energy and seasonal food, reached close to 3 percent, almost twice the euro-area average. Greece could be more exposed to inflationary pressure than most euro-countries on a number of counts: first, wage indexation (with compensation for inflation overruns in 2001 to be paid in 2002) raises the risk of second-round effects of recent external shocks; second, the full effects of recent monetary easing have not yet played out; and third, notwithstanding notorious difficulty in assessing output gaps, the staff estimates output in Greece to be above potential in 2000 and 2001, similar to the situation in earlier euro-area entrants that subsequently experienced a considerable pick-up in core inflation.

In assessing the inflation outlook, the staff has drawn on empirical models presented previously.[2] Inflation projections based purely on econometric relationships often have important shortcomings, especially when the economic policy regime has undergone major changes and important statistical data are lacking, as is the case for Greece. Bearing that in mind, single-equation estimates suggest average inflation could rise to 3¾–4¼ percent in 2001 and 2002. The VAR-specification suggests inflation could accelerate more markedly, at least in the absence of exceptional wage moderation (see table).

Inflation Projections
(Annual average; percent)

	Model-Based		Official Projections	
	Single-Equation 1/	VAR 2/	Authorities 3/	Staff 4/
2000	3.0	3.0	2.7	2.9
2001	4.2	4.4	2.3	3.4
2002	3.8	4.7	2.2	3.3

1/ Model with markup related to output gap; CPI.
2/ Based on five-variable VAR; CPI.
3/ Stability and Growth Program, deflator of private consumption.
4/ HICP.

The experience of earlier euro-area entrants suggests that two key factors could keep inflation lower than indicated by these simulations:

(i) **Monetary union**: euro-membership may change the way that inflationary shocks are propagated through the economy. Indeed, this may already be happening with respect to the speed of exchange rate pass-through. In the past, depreciations of the drachma were often viewed by economic agents as unlikely to be reversed (i.e., persistent); in consequence, they quickly fed through to prices and wages. The recent depreciation of the drachma on account of euro weakness has not yet had the same effect for two proximate reasons: first, the anti-inflation mandate of the ECB has kept inflation expectations in the euro area at bay (as gauged from yields on index-linked vs. nominal bonds); and second, price-setters may not have viewed euro weakness as lasting.

(ii) **Structural change**: deregulation of key sectors (notably, telecommunications) as well as efforts to strengthen competition more broadly is likely to have an appreciable downward impact on prices. While Greece has been lagging behind other EU countries in this respect, the pace of reforms appears to be accelerating (see Box 3) and this could ease price pressure in the period ahead.

Staff's central forecast for inflation, which is informed by historical relationships but not to the exclusion of other considerations, is predicated on moderate improvement on both counts listed above. Nonetheless, inflation and unit labor cost growth in Greece are projected to exceed the euro-area average in 2001–02, and by a margin somewhat above estimated Balassa-Samuelson effects.[2]

Box 1. Stabilization Challenges in the Wake of Euro-Area Entry: Lessons from First-Round Entrants (Concluded)

Monetary Union and the role of the external current account

Greece's current account deficit (on a settlements basis) widened sharply from 3 percent of GDP in 1998 to 7 percent of GDP in 2000, the second-largest deficit among euro-area countries after Portugal. This section discusses whether euro entry may itself justify an increase in the external deficit, and what the imbalance may imply for future adjustment needs.

In the context of surveillance of other euro-area countries, staff has previously considered the policy-relevance of the external current account of individual euro-area members (as opposed to the current account of individual regions within other currency-areas).[3] The analysis suggested that current account positions remain a useful, though less proximate, indicator of macroeconomic imbalances—reflecting the relatively low intercountry mobility of households (which links external debt repayment closely to national income), the absence of a supranational tax and expenditure system, and relatively limited cross-country portfolio diversification. Concerns about large external deficits may arise even when current account positions are driven by private-sector borrowing and investment decisions, as is the case in Greece. If these decisions turn out to have been based on overoptimistic expectations, incorrect information, or distorted incentives, households (and firms) will eventually have to revise their spending downwards to repay their debts, perhaps substantially.

One important channel through which Greece's entry into the euro area may affect its current account is the reduction of risk premia (including the elimination of exchange rate risk premia). Access to capital at euro-area rates is likely to boost investment and lower saving, thus leading to a widening of the current account deficit, which is optimal from the standpoint of lenders as well as borrowers.

To ascertain the extent to which the recent current account widening may be justified by such fundamentals, the potential effects and time profile of a decline in the exchange risk premium was simulated using the IMF's MULTIMOD. The table shows the path of the current account, savings, and investment following a decline in the risk premium of 1 percentage point (for more details, see the background study "Monetary Union Membership and Greece's External Balance"). While it is difficult to pin down precisely the reduction in risk premia, it appears that most of the reduction in the spread of Greek interest rates over euro area rates in recent years reflected the elimination of depreciation expectations. Only a relatively small part (estimated to be in the range of 1 to 2 percentage points) reflected a reduction in the risk premium proper. Using a version of MULTIMOD calibrated to Greek data, the decline in the risk premium is simulated to raise investment as cheaper capital leads to a higher desired capital stock. Consumption is boosted through a wealth effect as asset prices rise and (higher) future incomes are discounted at a lower rate; moreover, consumption is brought forward in time as the interest rate falls. In all, the current account deficit widens by about 1–2 percent of GDP in the short run, as an improvement of the government balance (on account of higher growth) counterbalances only partly the sizeable deterioration in the private sector saving-investment balance. The medium-term current account deterioration is about ½–1 percent of GDP relative to the baseline.

Decline in Risk Premium: Simulated Effects 1/
(Deviations from baseline; percentage points of GDP)

	Year 1	Year 2	Average Years 3-7
Current account	-0.9	-1.1	-0.5
Private Investment	0.4	0.9	1.0
Private savings	-1.3	-1.2	-0.6
Government balance	0.8	1.0	1.2

1/ Simulated impact of 1 percentage point reduction in the risk premium, phased in over three years, using MULTIMOD.

Against this background, the recent widening in Greece's external balance may not be fully explained by changes in fundamentals related to euro entry and other factors, including oil price movements. As a result, the staff estimates that—on unchanged real exchange rates and policies—Greece's external deficit is likely to exceed a "normal" deficit by perhaps some 2 percentage points over the medium term (with the view on the "normal" deficit informed by the specific structure of the Greek economy, including relatively low per capita income compared with most other industrial countries; some of these considerations are also reflected in estimates based on the macroeconomic balance approach—see Isard and Faruqee, 1998—but other other considerations are also taken into account here, including assumptions about the impact of the decline in interest rates). The implications for wage formation and domestic policies are discussed in the main text.

[1] For the initial euro-area entrants, policy issues in the cyclically advanced countries were discussed in "Cyclically Advanced Euro-Area Economies—Consequences and Policy Options" (SM/00/182, 7/27/00). For the purpose of this box, the external current account includes capital transfers.

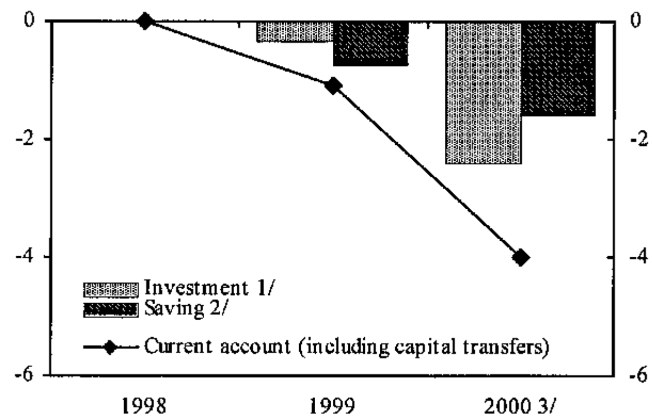
[2] For further details, see the forthcoming background study "Inflation Prospects and Risks in the Wake of Euro Entry;" and Selected Issues papers for the last two consultations (SM/98/194, 7/22/98; and SM/99/255, 10/6/99).

[3] See "Portugal—Staff Report for the 2000 Article IV Consultation" (SM/00/219, 9/28/00); and Jörg Decressin and Piti Disyatat, "Capital Markets and External Current Accounts: What to Expect from the Euro," IMF Working Paper 00/154.

specific taxes and lower interest rates). The authorities explained that this was due in part to stock adjustments to the new monetary environment, in particular to lower interest rates, and that some of the effects would wane over time as the adjustments were completed. They also noted that competitiveness had not deteriorated; in fact—and notwithstanding some appreciation vis-à-vis the euro area (see below)—the multilateral real effective exchange rate had depreciated by about 6 percent in 2000, as the euro had weakened and the drachma in turn fell to its central parity rate.

15. **The staff shared the authorities' view that the external current account would remain a useful, though less proximate, indicator of domestic imbalances in EMU. It noted, however, that the sharp widening of the deficit raised concerns about competitiveness—and staff regretted the lack of a domestic consensus on adequate wage restraint** (see Box 1; and forthcoming background paper). Earlier staff estimates had indicated that the euro-entry rate of the drachma would be broadly consistent with economic fundamentals (SM/99/244, 9/24/99). Since then, however, the drachma's central parity has been revalued by 3½ percent; the 1999 current account deficit exceeded earlier staff estimates by 1¼ percent of GDP; and the 2000 deficit was expected to show a further sharp widening despite a considerably more depreciated euro (and thus drachma) exchange rate. Staff also noted that less than two-thirds of the deterioration in the current account since 1998 was attributable to investment, of which a sizable portion was for infrastructure and housing, with limited near-term gains in export capacity. As a result, it thought the dissipation of temporary factors relating to lower interest rates would leave the current account deficit still some 2 percent of GDP above a "normal" level, as indicated, for example, by estimates informed by the macroeconomic balance approach.[5] This raised concerns about competitiveness, and the ensuing risks would be magnified if the euro were to appreciate markedly—risks highlighted by a unit labor cost appreciation vis-à-vis the euro area, reaching an estimated 6 percent since the mid-1990s (in manufacturing, adjusted for exchange rate changes).

EXTERNAL CURRENT ACCOUNT AND THE ROLE OF SAVING AND INVESTMENT
(Cummulative change since 1998; in percent of GDP)



1/ Negative number indicates increase in investment.
2/ Includes statistical discrepancy between settlements- and national accounts-based current account ratios.
3/ Fund staff projection.

[5] On the macroeconomic balance approach, see Peter Isard and Hamid Faruqee, *Exchange Rate Assessment—Extensions of the Macroeconomic Balance Approach* (Washington, 1998).

16. **The discussions also explored to what extent the financing of the external current account deficit—predominantly in the form of portfolio investment—left the economy vulnerable to sudden shifts in market sentiment.** The authorities thought that these risks would, to an important extent, become limited with euro entry—a view shared by the staff, notably with respect to the near-term outlook and concerning moderate shifts in market sentiment. Nevertheless, the staff noted that the experience in other capital markets—including the United States bond market—suggested that the risk of abrupt liquidity tightening could not be ruled out, including for the euro market. This argued for caution both with respect to the size of the financing needs (and thus the current account deficit) and to the financing instruments (including their liquidity and maturity). In all, while the authorities projected somewhat smaller external imbalances, they agreed that these needed to be addressed by adequate domestic policies.

Fiscal stabilization policy and medium-term deficit targets

17. **Against the background of the large monetary easing and concerns about inflation and external current account deficits, the discussions revealed a broad agreement on the need for a tight fiscal policy stance, to secure an appropriate policy mix.** Following the lower-than-budgeted deficit in 2000, the authorities had accordingly tightened the budget target for 2001—aiming at a surplus of 0.5 percent of GDP versus the previous *Convergence Program* objective of a 0.2 percent deficit. In terms of the structural general government balance, achieving these targets would—under the staff's

Fiscal Developments and Prospects, 2000-04 1/

(In percent of GDP)

	2000		2001		2004	
	Budget	Staff Estimate	Stability Program	Staff Projections	Stability Program	Staff Normative Scenario
Revenues	44.4	45.8	45.7	45.8	44.2	43.4
Excluding capital revenues	41.4	42.8	42.5	42.7	41.4	40.6
Expenditure	45.7	46.4	45.2	45.3	42.2	41.1
Of which: interest	7.1	7.2	6.5	6.5	4.9	4.9
Overall balance	-1.2	-0.5	0.5	0.5	2.0	2.3
Primary balance	5.9	6.6	7.0	7.0	6.8	7.2
Memorandum items:						
GDP growth	3.8	3.9	5.0	4.0	5.5	3.3
Structural balance 2/	-1.4	-0.7	-0.4	0.1	...	2.1
Structural primary balance 2/	5.7	6.4	6.2	6.7	...	7.0

Sources: Ministry of National Economy, *Stability and Growth Program* (December 2000); and Fund staff estimates.

1/ Figures incorporate statistical revisions in the fiscal and national accounts, but exclude UMTS receipts that are expected to be realized in 2001.

2/ Fund staff estimates.

macroeconomic scenario—imply a fiscal withdrawal of close to1 percent of GDP in 2001, following a broadly similar withdrawal in 2000; the structural primary surplus would strengthen marginally in 2001 to 6.7 percent of GDP.[6]

18. **With broad agreement on the fiscal deficit objectives for 2001, the discussions focused on potential risks to meeting the targets, and on corrective measures.** Potential risks to the budget targets were mainly related to its macroeconomic framework and to expenditure overruns. On the framework, GDP growth was assumed to reach 5 percent (some 1 percentage point above the staff's projection). Nevertheless, the budget's expected growth in the nominal revenue base was broadly in line with the staff's, reflecting the budget's lower inflation projection. The budget also assumed some further gains from tax administration, due to additional computerization of tax offices and improved tax auditing. On the expenditure side, the authorities intended to pursue a strict incomes policy for civil servants' wages (with base wage increases of 2.2 percent),[7] and limit the growth of primary current expenditure to less than nominal GDP. Within the deficit objectives, this was to still leave room for a considerable increase in expenditure priority areas, including public investment and outlays related to the 2004 Olympics. Staff noted, however, that steps to limit expenditure growth had frequently met with little success in the past, and it welcomed the authorities' commitment to implement primary expenditure cuts should the 2001 deficit target be jeopardized. The staff saw also room for allowing the operation of the automatic stabilizers should growth fall below its current projections. Furthermore, there was agreement that some additional expenditure tightening would be called for if signs of macroeconomic imbalances were to become more pronounced, including a further acceleration of inflation and substantial widening of the external current account deficit.

19. **The new *Stability and Growth Program* aimed at further increases in the general government surplus, reaching the target level of 2 percent of GDP by 2003—broadly consistent with the staff's normative scenario, although staff argued for targeting the structural primary, rather than the overall, budget balance.** The authorities' *Program* envisaged initially a further rise in the primary balance to 7¼ percent of GDP by 2002, but a small deterioration afterwards, with the overall balance continuing to benefit from declining interest payments. By contrast, the staff argued for maintaining the structural primary surplus at roughly the level projected for 2002 (7 percent of GDP). Over the medium term, this would result in an accelerated reduction of public debt and push the public debt-to-GDP ratio below 60 percent of GDP around 2007; in later years, this could allow some fiscal easing to cushion the most adverse impact of population aging. Provided that sufficient progress was

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[6] Given widespread public debt holdings, the estimated demand effect of lower government interest payments to residents is broadly similar to cuts in primary expenditures (the overall effect is somewhat weaker as about one-third of the debt is held by nonresidents).

[7] Although with wage drift, the authorities projected civil servants' average earnings would increase by 4½ percent, compared with an estimated 7½ percent increase in 2000.

made in addressing old-age-related fiscal pressures (see below), the staff saw room—and, indeed, a useful role—for allowing the full and symmetric play of the automatic fiscal stabilizers. The authorities preferred at this stage to stay with surplus objectives unadjusted for the cycle, which had the advantage of providing a benchmark that was well understood by the public. However, they acknowledged the potential merits of a primary target that would take into account the economy's cyclical position—a step that might be considered after an adequate fiscal surplus had been achieved.

B. Structural Policies

20. **With an extended history of, at best, relatively limited structural reforms, the authorities considered major progress in this area as pivotal for successful integration into monetary union and rapid income convergence.** Product and labor market liberalization had progressed more slowly than in most EU countries and, notwithstanding some gains in recent years, Greece's income gap vis-à-vis the EU average had essentially remained unchanged over almost two decades since EU entry. The discussions focused on several key areas—namely fiscal policy, the labor market, deregulation, and policies to strengthen competition.

Structural fiscal policies

21. **The authorities explained that a fundamental review of the tax system was underway, with reform implementation expected for 2003.** Expert groups were studying a comprehensive reform of a tax system that the government and market participants viewed as overly complicated and inefficient. The reforms would aim at broadening tax bases while reducing tax rates, and at aligning effective tax rates across different activities. In the meantime, the 2001 budget already incorporated several steps consistent with the general reform intentions, including the reduction of top marginal direct tax rates and elimination of many minor, but administratively costly, indirect taxes and stamp duties.[8]

22. **While the staff welcomed the general intentions underlying the planned tax reform, it explored whether these should not also aim at lowering the overall revenue burden (in terms of GDP) in coming years, as planned in other euro-area countries** (Table 6). The staff noted that the revenue burden had increased considerably faster in recent years than in any euro-area country (Figure 12), and was expected to reach the area's average in 2001. The authorities argued, however, that surplus objectives and expenditure priorities provided little room for more decisive reductions in revenues. Moreover, they stressed the critical role of marginal tax rates, with base broadening expected to allow considerable

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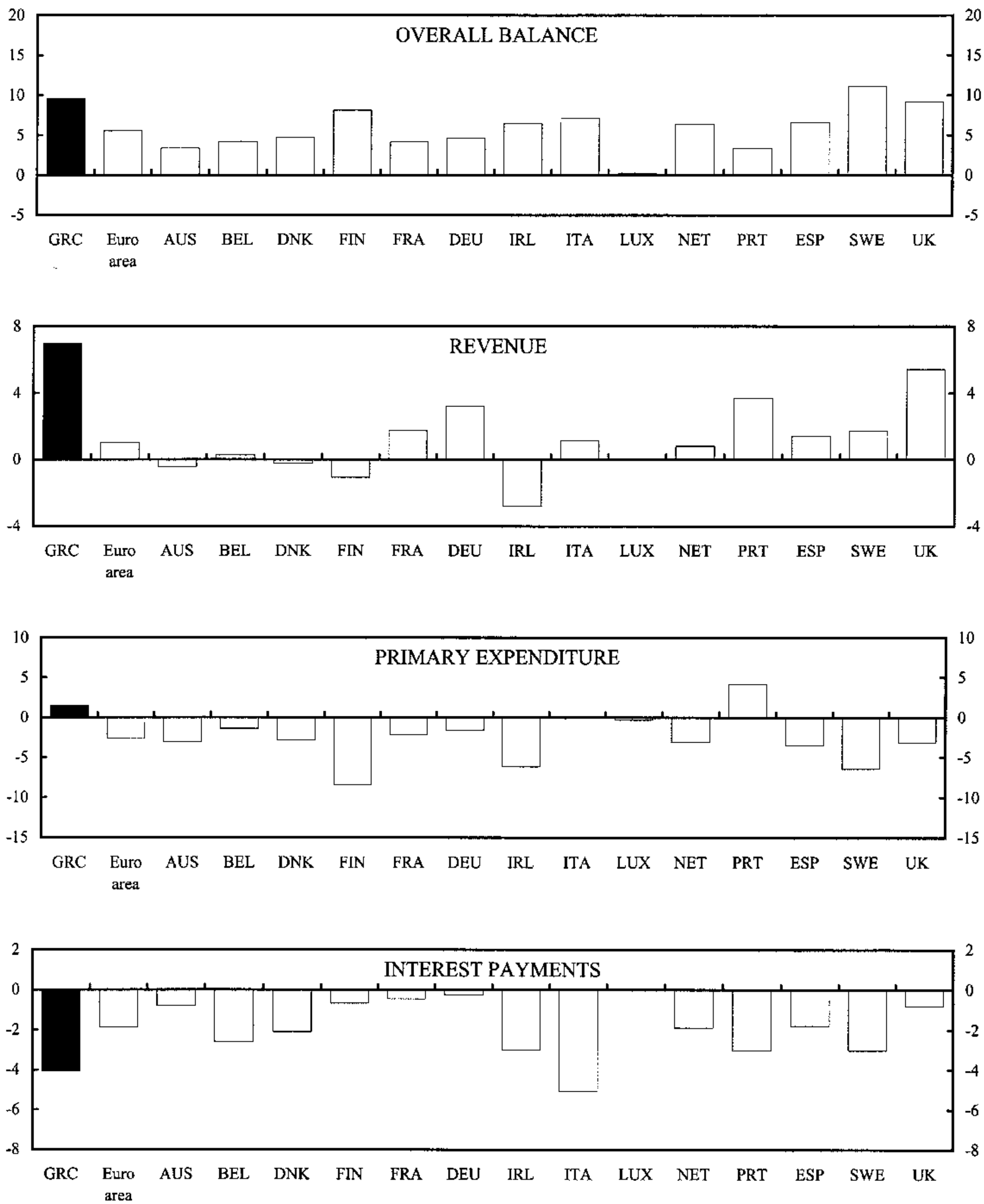
[8] For the personal income tax, the zero bracket was doubled and the top marginal tax rate was reduced by 2.5 percentage points; the same tax rate reduction was extended to firms not listed on the stock exchange, and to personal companies.

Figure 12. Greece: Composition of Fiscal Adjustment, 1995-2000
(Cumulative change, in percent of GDP)



Source: IMF, *World Economic Outlook*.

reductions. Even so, the authorities were prepared to consider lowering the revenue burden more decisively over time, should competitive disadvantages emerge vis-à-vis the euro area. Indeed, the *Stability and Growth Program*, released after the consultation discussions, included more sizable reductions in the revenue burden in later years (by 1¼ percent of GDP during 2003–04).

23. **Public expenditure reform was seen as an important element of the government's structural reform agenda—a view shared by the staff, although it saw the need for more decisive steps in several areas.** With respect to the *public administration,* past reforms had restrained employment growth in parts of the public sector. However, civil servant wage and employment growth well above estimated economy-wide averages in 2000 underscored, in the view of the staff, the need for more decisive steps—not least to address widespread inefficiencies in the sector. In contrast, the authorities saw mainly some room for limiting hiring, but were not considering more far-reaching initiatives that could undermine current public sector employment practices; this included some reforms taken in several advanced economies, such as fixed-term, performance-based contracts for senior public service managers. With respect to other expenditure areas, the discussion focused mainly on steps to address the future impact of population aging on the budget. On *pensions*, the government had commissioned a pension reform study, to be completed by early 2001; following discussions with social partners, implementation of the reforms was to begin in 2002. Awaiting the results of the reform commission, the authorities were not yet ready to discuss reform alternatives with the staff—who emphasized that the reforms needed to resolve the issue of unfunded public pension liabilities, among the highest in advanced economies. As with pensions, the *health care* system would face severe pressure from an aging population. The government introduced a broad reform at the end of 2000, decentralizing health care administration, aimed at reducing wasteful spending and better matching of local health care needs. The staff expressed concern, however, that the new system provided expenditure devolution without corresponding revenue responsibilities. The authorities acknowledged the risks, but argued that improved monitoring would safeguard fiscal responsibility. More broadly, they recognized that achieving a sizable reduction of primary current expenditures (in terms of GDP), as envisaged in the *Stability and Growth Program*, would test their resolve and require additional expenditure measures.

24. **A comprehensive system for budgeting, monitoring, and evaluating public expenditures was under preparation—aimed at strengthening efficiency and transparency.** Medium-term budgeting was to be introduced over a period of three to four years, drawing on lessons in several other countries. In the meantime, and building on earlier reforms (as discussed in the authorities' updated self assessment against the *IMF Code of Good Practices on Fiscal Transparency*; see Supplement 1), the latest budget reported public ownership stakes in enterprises (a step toward providing a public sector balance sheet and sustainability analysis); and expanded fiscal information has become available electronically.

Labor market reform

25. **The Greek labor market continues to be characterized by very high unemployment—viewed by the authorities, at least partly, as inevitable in the face of major structural changes, while staff considered it to an important extent symptomatic of structural weaknesses that needed to be addressed.** The authorities noted that employment growth in Greece had been similar to the euro area in recent years. Rising unemployment reflected foremost two major structural changes: rising female participation rates, and a sectoral decline in agricultural employment—a sector that was still relatively large in Greece. Combined with immigration, this posed challenges to the labor market that were, in important respects, larger than in many euro-area countries. While the staff acknowledged these developments, it pointed out that many EU countries had faced similar challenges in the past, including the sectoral shift out of agriculture and immigration, without commensurate increases in unemployment.

26. **Against this background, the staff explored comprehensive labor market reforms, involving steps by the social partners as well as the government that aimed especially at reducing exceptionally high unemployment rates for job market entrants.** Such reforms could be geared toward improving job matching through educational and training reform; reducing relatively severe firing restrictions; a limited expansion of well-targeted state support; and increased wage differentiation for all job market entrants (Box 2). Such differentiation was an especially important element that had been missing in earlier reforms. For example, the possibility for "opt outs" from sectoral wage accords in high unemployment areas had remained largely unused, as it was subject to onerous consensus requirements. The authorities, who were somewhat divided in their assessment of the staff's proposal, noted that it would be difficult to build a consensus for these more far-reaching labor market measures. The government had itself been unable to secure support among employers and employees for more limited proposals. In the event, it settled for reform steps that included a focus on redistributing work more equally (including restrictions on overtime). Based on the experience in other countries, the staff was skeptical that this could result in a decisive turnaround of the labor market's performance.

Policies to strengthen competition and deregulate product markets

27. **Mindful of Greece's poor track record on competition and deregulating product markets, the new government has expanded several initiatives—which staff welcomed as steps toward more far-reaching reforms that could foster competitiveness and potential growth** (Box 3). On privatization, where progress slowed in 2000 partly because of adverse market conditions, the government announced an extended list of enterprises, including the majority stakes of some utilities. The authorities also expected important benefits from lessening the pervasive regulatory and administrative burden; and market participants saw considerable room for further easing these burdens and regarded them as major impediments for a more dynamic business environment, including the new economy (whose status in Greece is reviewed in a background study). The authorities had increased

Box 2. Greece's Labor Market—Grappling with High Unemployment

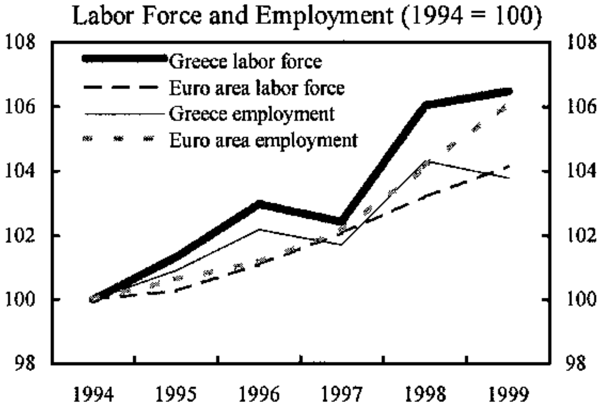
Greece's cumulative employment growth during 1995–99 was only 3.8 percent, compared with 6 percent on average in advanced economies—notwithstanding broadly similar GDP growth. A job-scarce expansion emerges also vis-à-vis the euro area, where labor force and employment growth has been broadly comparable despite Greece's more rapid economic growth. Moreover, in contrast to the projected decline in the euro-area unemployment rate to around 9 percent in 2000, Greece's unemployment rate has continued to increase, to 12 percent in 1999 (data for 2000 are not yet available). Accelerating the process of real convergence of Greece's economy to euro-area levels depends fundamentally on improving its labor market performance.

A combination of rigid labor market institutions and a series of adverse shocks is likely to have been a key factor behind rising unemployment in Greece (as discussed in more detail in a background paper). Of particular importance were relatively limited wage differentiation, including a high ratio of the minimum to the average production wage; backward-looking wage indexation in the private sector, contributing to real wage rigidities; a high and rising labor tax wedge (due mainly to rising social insurance contributions); and relatively strict employment protection legislation. Moreover, part-time employment contracts played only a minor role—in part the result of legal impediments, which were eased only recently; the educational system is not well attuned to matching the skill needs of the economy; and active labor market programs are relatively underdeveloped compared with other EU countries. As a result, half of all unemployed in Greece have never been previously employed, which contributes to the fact that more than half of all unemployed have been jobless for over one year. In the face of these labor market characteristics and institutional settings, the market was ill-equipped to cope with a number of adverse shocks. These included a sizable decline in agricultural employment, a sector that still accounts for almost 20 percent of employment; large immigration, which affected mainly lower-skilled labor market segments; and a relatively rapid rise in female labor force participation rates, albeit from low levels (as in some other Mediterranean countries). Finally, the public sector stopped its role as "employer of last resort," with hiring restrictions imposed on the civil servants and declining public enterprise employment.

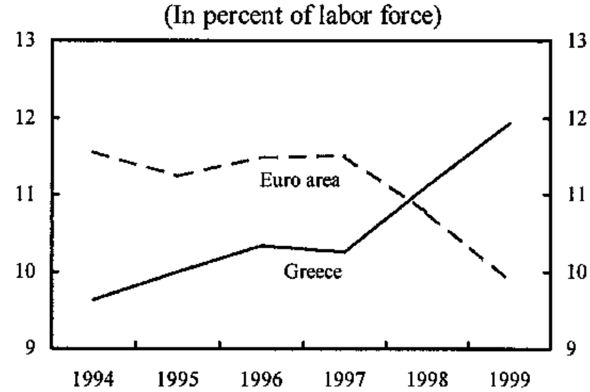
In view of the poor labor market performance, the authorities, in 1998, introduced several measures to: encourage net new hires; remove disincentives for part-time employment; facilitate more flexible working hours; provide opportunities for additional wage flexibility (through "opt-outs" from sectoral wage accords in high unemployment areas); and legalize private employment services. Some of these measures, including the implementation of more flexible working arrangements and "opt-outs," were conditional on social partners' consent, which proved difficult to reach. The EU Commission (in the context of reviews of its National Action Plans for Employment) has pressed for more ambitious efforts, and Parliament adopted a new labor market initiative in late 2000. It included a decrease in maximum weekly overtime hours and a rise of the overtime premium (to encourage new hires); alternatively—and subject to consensus among a firm's employer and employees—an annualization of working hours while reducing the working week from 40 to 38 hours; the continued payment of partial unemployment benefits for long-term unemployed obtaining part-time employment; and a slight reduction in firing restrictions. Both employers and employees opposed various aspects of the measures. For minimum wage earners, the government took over also part of employees' social insurance contributions; and it cut employers' contributions for low-wage earners by 2 percentage points. In addition, the manpower placement services were reorganized and active labor market programs were expanded.

The recent initiatives fail to address some of the key structural weaknesses described above, and they are therefore unlikely, in the staff's view, to achieve a major reduction in unemployment. Notably absent are measures directly addressing the root causes of exceptionally high unemployment rates among new labor market entrants—an area where a comprehensive strategy, involving steps by the social partners as well as the state, is required. This would need to include increased wage differentiation for all job market entrants—combined with adequate safeguards for minimum family income levels; improved education and job training, to facilitate job market matching; and further reductions of still severe firing restrictions. In addition, the labor market would benefit from reforms in other areas, including product markets, which are discussed in the main text.

Labor Force and Employment (1994 = 100)



Unemployment Rate
(In percent of labor force)



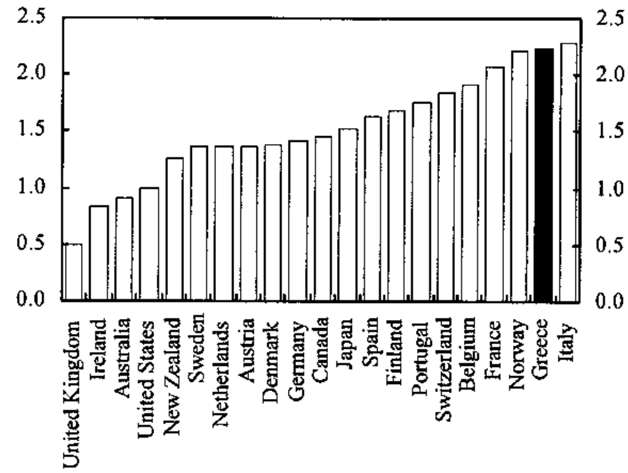
Box 3. Product Market Reform in Greece: Progress and Policy Challenges

With participation in monetary union achieved, the focus of economic policymakers in Greece is shifting toward structural reforms—an area where progress has, in the past, lagged behind that in most other industrial countries. The absence of an exchange rate adjustment mechanism under EMU brings to the fore the need for sufficient market flexibility, adding urgency to address policy challenges in this area. Moreover, implementing a "critical mass" of reforms would also strengthen Greece's competitiveness. This box reviews recent reform steps of the government and identifies selected policy challenges.

Privatization. Privatization slowed in 2000, partly because of the government's reluctance to sell state assets in what it deemed to be adverse market conditions, and partly because investors were wary of the attractiveness of some assets. Of the 17 state-owned companies that were on the government's list for (part-) privatization in 2000 and 2001, stakes have been sold in only a few—the most important being the part-flotation of Cosmote (the mobile phone subsidiary of OTE, the national telecom utility) and the disposal of Commercial Bank in 2000. Companies still on the privatization list include Olympic Airways, OTE Telecom, Public Power Corporation, as well as several banks, water companies, and port authorities. In an important development, the new government has announced its willingness to privatize majority stakes in key utilities.

Improving the administrative and regulatory environment. A recent OECD study[1] argued that Greece had one of the most burdensome administrative and regulatory business environments among advanced economies (see chart). The government is planning to cut back the number of required certificates for new businesses by about one-fourth and streamline approval processes through the introduction of "one-stop shops." Enhanced cooperation between authorities at various levels (different ministries and local governments) and reduced response times are needed to make the initiative effective. The authorities also stressed ongoing efforts to make information on regulation more easily accessible via the Internet. In addition, efficiency gains could be achieved through opening up sectors where competition may be hindered by unnecessarily restrictive entry regulations, including for many professions (e.g., accountants, lawyers, notaries, realtors, and many others) and in some transportation sectors, as well as through accelerated implementation and better enforcement of EU internal market rules (e.g., in public procurement).

Summary Indicator of Product Market Regulation, 1998 1/



1/ Higher numbers indicate more restrictive regulations.

Strengthening competition policy. Enforcement of competition rules received a boost in 2000 when the financial independence of the Competition Committee was strengthened, its resources increased, and its obligation to vet relatively small mergers with little consequences for competition—which had taken up most of its time and efforts in preceding years—were eased. The Committee is to attack sectoral as well as horizontal issues, including alleged widespread price-fixing agreements.

Liberalization of network industries. The liberalization of the telecommunication sector was fully aligned with the rest of the EU at the beginning of 2001. It has led to steep declines in tariffs and improvements in service. Much less progress has been made in the energy sector. As for electricity, true competition may require breaking up the power generation capacity of the incumbent vertically integrated former monopoly, and consideration should be given to creating separate ownership of the national grid. Moreover, the regulatory authority would need to be fully independent with adequate capacities, in line with those recently bestowed on the telecommunications authority. The gas sector, where Greece has a derogation from EU liberalization directives until 2006, would also benefit from accelerated deregulation.

[1] G. Nicoletti, S. Scarpetta, and O. Boylaud, "Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation," OECD Economics Department Working Paper 226 (1999).

the resources and strengthened the mandate of the Competition Committee in 2000, and expected the Committee to advance more competitive pricing behavior, with potential benefits for the country's overall competitive position. On deregulation, however, progress was mixed. While the telecommunications sector was, by early 2001, fully liberalized in line with other EU markets—contributing to sharply lower prices and improved quality—progress had been slow in other sectors (including electricity, gas, and transport). The staff regretted that liberalization was often limited to meeting minimum EU requirements, at times using extensive derogations, but the authorities viewed this as useful where enterprise restructuring was needed, for example, in the energy sector. Nevertheless, they would consider the staff's suggestion to strengthen the supervisory framework in these sectors.

C. Financial Sector and Other Issues

Financial sector

28. **Greece's financial markets were in the process of far-reaching restructuring, with further impetus expected from monetary union**. In the banking sector (as detailed in a background study), privatization had facilitated consolidation and, with increased competition, interest rate spreads narrowed. Together with the general decline in interest rates, this contributed to rapid credit expansion, with private sector credit growth exceeding 25 percent (year-on-year) in early fall, a doubling of the growth rate since the lifting of credit restrictions in April 2000. Despite the stock market's weakness in 2000, it continued to grow in importance as a source for firms' capital, rivaling bank credit. On the other hand, a corporate bond market remained largely dormant; the cross-border interbank market is small; almost 40 percent of outstanding bank credit is still to the public sector; and consumer and mortgage loans, while accelerating rapidly, constitute a relatively small share of household income.

29. **Against this background, the focus was on steps to safeguard the financial sector, through appropriate reform of financial supervision and regulation**. The authorities pointed out that the financial sector was sound on available indicators. They agreed with the staff, however, that these indicators were generally backward looking and that the evolving financial system had not yet been tested in a major economic slowdown. Moreover, personnel costs and the share of nonperforming loans remained high in comparison with many other countries, even if these as well as other standard indicators had generally strengthened in recent years. The authorities recognized that the current juncture provided a potent mix for a rapid credit growth, reflecting the confluence of the decline in interest rates, elimination of credit restrictions, future releases of bank liquidity following the reduction in reserve requirements, and the integration into the interbank euro market. While a considerable credit increase should be expected in response to the changed economic environment under monetary union, the discussions explored how financial supervision and regulations needed to adapt to the new economic environment. Drawing on lessons from other countries—including the credit boom in Portugal (see SM/00/219, 9/28/00)—the staff argued for increased monitoring of qualitative aspects of banks' activities, notably their

credit management processes and procedures, through stress testing and scenario analysis. The authorities were exploring these options as well as suggestions to enhance market discipline through more public disclosure, as recommended by the Basel Committee on Banking Supervision. Concerning financial market supervision, the authorities agreed that, notwithstanding recent progress, there was room for further improving coordination among supervisory agencies; and for strengthening the independence of the capital market and insurance supervisors. It was agreed that some of these issues should be analyzed in more depth in future discussions, including possibly in the context of a Financial Sector Assessment Program (FSAP).

Other issues

30. **The authorities were sympathetic to accelerating the liberalization of least developed countries' imports, except in areas viewed as critical for Greek producers, such as textiles and some agricultural products.** In the latter cases, they supported liberalization to proceed in line with current multilateral agreements.

31. **The authorities acknowledged that improvements in the statistical database had been slow, but expected progress over the coming year.** With further delays subsequent to the mission, Greece's statistics remain poor by advanced economy standards—including on labor markets and national accounts—and there were no immediate plans to meet the subscription requirements for the Special Data Dissemination Standards (see Appendix II).

IV. Staff Appraisal

32. **Monetary union provided a formidable challenge but also a welcome spur to policies in Greece.** Given the starting conditions, the authorities are commended for the road traveled—achieving a transformation of Greece's macroeconomic landscape. Already, inflation and interest rates have declined to historically low levels, GDP growth has exceeded the euro-area average during the past five years, and fiscal adjustment led to large primary surpluses.

33. **Looking forward, the task is to build on these achievements and take advantage of the historic opportunity provided by EMU—mindful that Greece's integration into the euro area and increased competition from other partner countries in the region also add urgency to addressing the remaining formidable economic challenges.** This foremost requires steps to:

- Secure stabilization gains, where wage increases and the fiscal stance need to be consistent with safeguarding low inflation and adequate competitiveness; and

- Implement a broad range of far-reaching structural reforms, an area where Greece has, in the past, lagged behind progress in most other industrial countries.

34. **Securing stabilization gains within EMU will, to an important extent, depend on labor cost developments, which need to restore an adequate level of competitiveness.** The waning effects of earlier tax cuts and the euro-entry-related easing of monetary conditions have brought to the fore underlying inflation pressure well above the euro-area average. This reflects in part relatively sizable wage increases, not matched by higher productivity growth. For domestic wage increases, a consensus needs to be forged to take into account wage settlements elsewhere in the euro area, securing not only low inflation but also adequate competitiveness, consistent with a gradual decline in the external current account deficit.

35. **Achieving the strengthened 2001 fiscal surplus target would result in a broadly appropriate policy mix—counterbalancing monetary conditions that, in view of Greece's advanced cyclical conditions, have become very accommodative.** Following a considerably smaller-than-budgeted deficit in 2000, the 2001 budget envisages the first general government surplus in decades. Some risks, notably on the expenditure side, argue for cautious budget implementation early in the year. Moreover, additional expenditure tightening would be called for if there were signs of widening macroeconomic imbalances, notably rising inflation and external current account deficits. Over the medium term, maintaining on average over the cycle the general government surplus, excluding interest payments, at roughly the 2001 target level (7 percent of GDP) would be a minimum to secure an adequate reduction of public debt ahead of the most adverse impact of population aging.

36. **Taking full advantage of the propitious juncture of monetary union requires far-reaching structural reforms, overcoming a long legacy of subpar progress.** The areas where measures are most urgently needed—and some welcome progress is underway—include the fiscal sector (notably, tax and expenditure reform); labor markets (aimed at reducing unemployment and accelerating employment growth); and product markets and deregulation (targeted at strengthening competition and efficiency). Additional steps should also improve the efficiency and resilience of the financial sector.

37. **On taxation, the government has already lowered some marginal tax rates and its plan for fundamental reform is expected to result in a more equitable tax system; nevertheless, the economy would benefit from more ambitious reductions in the tax burden in coming years.** While recent cuts in tax rates and improvements in tax administration are welcome, the revenue burden has continued to increase, reaching the high EU average. This raises concerns about future growth prospects, particularly at a time when many partner countries are implementing sizable tax reductions. As a rough guidepost, and subject to safeguarding the surplus objectives, consideration should be given to reductions in the tax burden apace with those in the euro area.

38. **Public expenditure reform will be critical not only for securing stabilization gains and creating room for reducing the tax burden, but also for raising overall economic efficiency.** In this context, public administration reform will be a prerequisite for limiting the growth of primary expenditure and preventing a repetition of past expenditure slippages. There remains room for reducing public sector employment and curtailing its wage

bill, inter alia by taking full advantage of savings arising from new technologies and of redeployment within the sector to the areas of greatest need. Fundamental reforms of public administration incentives should also be considered, including performance-based fixed-term contracts for senior managers. Limiting future primary expenditure growth will depend foremost on steps to contain old-age-related fiscal expenditure. The pending pension reform needs to address the large unfunded liabilities of the public pension system; and consideration could be given to supplementary, fully funded pension schemes, building on the experience in other countries. In the health care sector, the government's proposed reforms contain useful steps for improved service targeting; it will be crucial, however, that the accompanying devolution to local entities be buttressed by incentives to strengthen fiscal responsibility. The government's plan to establish a multiyear budgeting framework should provide a useful vehicle for planning and implementing these and other reforms, and it should include a full analysis of fiscal risks and sustainability issues.

39. **The high unemployment rate remains a blemish on Greece's economic record and symptomatic of pervasive structural rigidities; its decisive reduction will require comprehensive reforms targeted at the most affected labor market segments.** The government's recent reform proposals are unlikely to address the root causes of high unemployment. In particular, high unemployment rates for the young and women suggest that future reforms should include steps to make entry level wages more flexible—providing increased wage differentiation for all job market entrants, combined with adequate safeguards for minimum incomes. Better aligning the education system and job training with the skills needed in the labor market, including those required for the new economy, as well as reducing relatively severe firing restrictions and lowering social security contributions for the weakest segments of the labor market should also be considered. Moreover, the experience of other countries strongly argues for abandoning backward-looking wage indexation.

40. **Expanding on recent government initiatives would hold out the promise of overcoming Greece's relatively poor record in deregulating product markets and strengthening competition, with potential benefits for growth and competitiveness.** Recent steps to strengthen the Competition Commission, expand privatization, and deregulate the telecoms market are particularly welcome. Bolder steps to liberalize other sectors, covering electricity, gas, and transportation, are now needed, supported by further regulatory reform in these sectors. In addition, there remains considerable room for easing the administrative burden and streamlining the regulatory business environment, with important benefits also for the new economy sectors. The planned simplification of administrative rules, including one-stop shops, should be helpful in this regard.

41. **In the financial sector, rapid credit expansion and evolving activities in an increasingly integrated and open market environment pose challenges for supervision and regulation.** In the banking sector, it would be appropriate to focus on banks' risk management and internal control systems, and require scenario analysis and stress testing, as recently proposed by the Basel Committee on Banking Supervision. Consideration could also

be given to strengthen market discipline by greater public disclosure. With the boundaries between different market segments in the financial sector increasingly blurred, coordination among the different financial market supervisors should be further strengthened, building on welcome recent initiatives—steps that could usefully be reviewed in the context of a FSAP.

42. **The authorities are encouraged to support the full liberalization of imports from the least developed countries, and to raise Official Development Assistance (ODA)—the second lowest (in percent of GDP) among advanced economies—toward the UN target.**

43. **Statistical data weaknesses persist, hampering the assessment of economic developments and some aspects of Fund surveillance.** A substantial effort is needed to improve labor market, national accounts, fiscal, and balance of payments data, and the authorities are encouraged to accelerate steps for meeting the SDDS requirements (Appendix II).

44. 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, 1995-2001
(Percentage changes, unless otherwise indicated)

	1995	1996	1997	1998	1999	Est. 2000	Proj. 2001
Domestic economy							
GDP	2.1	2.4	3.5	3.1	3.4	3.9	4.0
Output gap	-1.4	-1.3	-0.5	-0.4	-0.1	0.5	0.8
Domestic demand	4.4	3.3	3.6	4.7	2.9	5.0	4.8
Private consumption	2.7	2.4	2.8	3.1	2.9	3.7	3.4
Public consumption	5.6	0.9	3.0	1.7	-0.1	1.0	1.0
Gross fixed capital formation	7.8	8.4	7.8	11.8	7.3	9.3	10.1
Private	5.8	9.7	7.3	12.1	5.8	9.4	11.0
Public	14.3	2.0	10.4	10.5	14.7	8.8	6.0
Change in stocks (contribution)	-0.1	0.1	-0.1	0.2	-0.5	0.0	0.0
Foreign balance (contribution)	-2.1	-1.1	-0.4	-2.1	0.2	-1.1	-1.1
Exports	0.5	3.5	18.2	5.9	6.5	9.2	6.3
Imports	9.2	7.0	13.9	11.3	3.9	10.0	7.6
Unemployment rate	9.1	9.8	9.7	11.2	12.0	11.8	11.6
Employment	0.8	-0.4	-0.3	3.4	-0.7	1.3	0.9
Average compensation of employees (economy wide)	13.4	8.8	13.5	6.0	4.8	4.6	4.6
Unit labor costs (economy wide)	11.9	5.9	9.3	6.4	0.6	2.0	1.8
Consumer prices, end of period	7.9	6.9	4.7	3.9	2.7	3.9	3.5
Consumer prices, period average	8.9	8.2	5.5	4.8	2.6	3.2	3.6
Consumer prices (HICP), period average	...	7.9	5.4	4.5	2.1	2.9	3.4
GDP deflator	9.8	7.4	6.8	5.2	2.9	2.9	3.0
External sector							
Trade balance (in percent of GDP, settlements basis)	-12.3	-12.5	-14.3	-13.7	-14.4	-18.8	-19.0
Current account (including capital transfers; in percent of GDP, settlements basis)	-2.4	-3.7	-4.0	-3.0	-4.0	-7.0	-7.2
Foreign exchange reserves (US$ billions)	14.6	17.3	12.4	17.2	17.7	14.2 1/	...
Drachma/euro (period average) 2/	-4.1	-0.5	-2.4	-6.9	1.8	-3.0 3/	...
Nominal effective exchange rate	-1.6	-0.4	-1.5	-4.6	-0.6	-5.5 4/	...
Real effective exchange rate (consumer prices)	3.3	4.3	0.9	-2.7	0.0	-5.5 4/	...
Real effective exchange rate (manufacturing ULCs)	6.5	3.6	3.5	-3.5	1.6	-3.2 5/	...
Public finances (general government, in percent of GDP) 6/							
Current revenues	36.4	36.9	38.8	40.1	42.1	42.8	42.7
Current expenditures	43.3	42.2	40.4	40.1	40.1	39.6	38.7
Primary expenditures	32.1	31.6	32.2	32.3	32.6	32.5	32.2
Interest expenditures	11.1	10.5	8.2	7.8	7.6	7.2	6.5
Net capital spending	3.3	2.2	2.5	2.5	3.7	3.7	3.5
Overall balance	-10.2	-7.4	-4.0	-2.5	-1.8	-0.5	0.5
Primary balance	1.1	3.1	4.2	5.4	5.8	6.6	7.0
Structural primary balance	1.5	3.6	4.4	5.5	5.8	6.4	6.7
Structural overall balance	-9.6	-7.0	-3.8	-2.3	-1.7	-0.7	0.1
Debt	108.7	111.3	108.3	105.5	104.6	103.9	98.2
Financial variables							
M4N 7/	13.0	15.3	7.8	9.8	5.6	12.6 8/	...
Total credit	9.6	8.1	11.0	9.7	12.2	18.6 9/	...
3-month treasury bill rate (average)	14.3	11.9	10.1	11.9	9.8	5.7 10/	...
12-month treasury bill rate (average)	15.5	12.8	10.4	11.6	8.9	4.6 11/	...
Short-term bank lending rate (average)	23.1	21.0	18.9	18.6	15.0	11.1 12/	...

Sources: National Statistical Service; Ministry of National Economy; Bank of Greece; and Fund staff estimates and projections.

1/ End-November.
2/ Drachma/ECU before 1999.
3/ End-November compared with end-December.
4/ September compared with December.
5/ November compared with December.
6/ For 2001, fiscal projections are based on unchanged policies.
7/ M4N is defined as sthe sume of base money, private sector deposits in domestic and foreign currencies, repos, banks bonds, money market funds, and private sector holdings of Greek government securities with an initial maturity of up to one year.
8/ 12-month change in November.
9/ 12-month change in September.
10/ Latest auction November 21, 2000.
11/ Latest auction December 19, 2000.
12/ November.

Table 2. Greece: Balance of Payments, 1995–2000
(In billions of Greek drachma)

	1995	1996	1997	1998	1999	2000 Proj.
Current account 1/	-663	-1,096	-1,360	-1,145	-1,570	-2,856
(In percent of GDP)	-2.4	-3.7	-4.0	-3.0	-4.0	-7.0
Trade balance	-3,342	-3,732	-4,723	-4,937	-5,507	-7,669
Exports	1,371	1,418	1,751	1,962	2,617	3,514
Oil	...	...	165	215	355	745
Non-oil	...	...	1,586	1,747	2,262	2,768
Imports	4,713	5,150	6,474	6,900	8,124	11,183
Oil	...	...	764	598	825	1,684
Non-oil	...	...	5,710	6,301	7,300	9,499
Services	1,213	1,230	1,760	2,007	2,231	2,761
Receipts	2,225	2,250	2,766	3,302	5,078	7,145
Travel	958	896	1,414	1,829	2,704	3,419
Transportation	87	91	510	640	1,590	2,951
Other services	1,180	1,263	842	833	785	775
Payments	1,012	1,020	1,006	1,295	2,847	4,384
Travel	306	291	364	518	1,226	1,763
Transportation	277	305	101	143	740	1,614
Other services	428	424	541	634	881	1,007
Income	-390	-525	-433	-458	-204	-311
Receipts	304	278	341	451	786	1,036
Compensation of employees	70	45	77	111	188	207
Investment income	234	234	265	340	599	829
Payments	694	803	774	910	990	1,347
Compensation of employees	69	77	93	107	75	88
Investment income	625	726	681	803	915	1,260
Transfers	1,855	1,931	2,036	2,244	1,910	2,364
Receipts	1,862	1,938	2,047	2,389	2,198	2,895
Official	1,151	1,217	1,248	1,414	1,384	1,811
Other sectors	711	721	799	975	814	984
Payments	7	7	11	144	288	430
Official	0	0	3	4	62	87
Other sectors	7	7	8	141	226	343
Financial account	738	1,070	1,598	1,012	1,558	2,626 2/
Direct investment	244	255	446	103	2	-467 2/
Portfolio investment	0	0	426	3,491	1,848	2,771 2/
Other investment	489	1,829	-921	-1,162	-164	-1,114 2/
Reserve assets	5	-1,014	1,647	-1,419	-128	1,436 2/
Errors and omissions	-74	27	-238	132	12	-570 2/

Sources: Bank of Greece; and Fund staff projections.

1/ Includes capital transfers.
2/ January-October 2000.

Table 3. Greece: Summary of General Government Accounts, 1995-2001

(In percent of GDP)

	1995	1996	1997	1998	1999	Budget 1/ 2000	Staff Proj. 2000	Budget 2001
Current Revenues	36.4	36.9	38.8	40.1	42.1	41.4	42.8	42.5
Direct taxes	7.4	7.1	7.8	9.5	10.5	8.7	10.7	10.7
Indirect taxes	13.5	14.0	14.3	14.4	15.2	14.9	15.4	15.2
Social insurance contributions	12.6	12.9	13.3	13.5	13.7	13.8	13.9	13.9
Other current revenues	2.9	2.9	3.4	2.7	2.7	4.0	2.7	2.7
Current expenditures	43.3	42.2	40.3	40.1	40.1	38.9	39.6	38.5
Primary expenditures	32.1	31.6	32.2	32.3	32.6	31.8	32.5	32.0
Interest expenditures	11.1	10.5	8.2	7.8	7.6	7.1	7.2	6.5
Current balance	-6.8	-5.2	-1.5	0.0	2.0	2.5	3.1	4.0
Capital balance	3.3	2.2	2.5	2.5	3.7	3.8	3.7	3.5
Capital transfers received	2.7	3.7	3.4	3.5	3.1	3.0	3.0	3.2
Gross fixed capital formation	3.2	3.2	3.5	3.7	4.2	4.3	4.2	4.5
Other capital expenditures	2.7	2.6	2.3	2.2	2.5	2.5	2.5	2.2
Overall balance	-10.2	-7.4	-4.0	-2.5	-1.8	-1.2	-0.5	0.5
Memorandum items:								
Structural balance 2/	-9.6	-7.0	-3.8	-2.3	-1.7	...	-0.7	-0.4
Structural primary balance 2/	1.5	3.6	4.4	5.5	5.8	...	6.4	6.2
Primary balance	1.1	3.1	4.2	5.4	5.8	5.9	6.6	7.0
General government gross debt	108.7	111.3	108.3	105.5	104.6	103.5	102.5	98.9

Sources: National Statistical Service; Ministry of National Economy; and Fund staff estimates and projections.

1/ Ministry of National Economy projection consistent with 2000 budget.

2/ Fund staff estimates.

Table 4. Greece: Indicators of External and Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1991-94	1995	1996	1997	1998	1999	2000/01 Latest estimate	2000/01 Date
External indicators								
Exports (annual percent change, in U.S. dollars)	4.2	10.8	-0.2	11.4	3.8	28.1	15.1	Nov-00
Imports (annual percent change, in U.S. dollars)	0.8	22.3	5.3	-1.9	-1.5	13.7	16.2	Nov-00
Terms of trade (annual percent change)	4.1	-0.9	0.7	1.0	-1.4	1.7	...	...
Current account balance (settlements basis)	-2.3	-2.4	-3.7	-4.0	-3.0	-4.0	-6.8 1/	Nov-00
Capital and financial account balance	4.6	2.8	7.0	4.8	2.8	3.7	6.5 1/	Nov-00
Of which : Inward portfolio investment (debt securities etc.)	0.6	0.4	1.3	1.3	9.7	5.4	8.9 1/	Nov-00
Inward foreign direct investment and other investments	1.9	3.7	4.2	1.3	0.3	0.4	0.8 1/	Nov-00
Official reserves (in U.S. dollars, millions, period average)	7,918	14,611	17,337	12,441	17,188	17,726	13,116	Dec-00
Central Bank short-term foreign liabilities (in U.S. dollars, millions)	788	860	796	1,337	0.0			
Official reserves in months of imports GS	4.0	6.0	6.9	5.2	6.9	6.0	6.0	Dec-00
Total external debt 2/	32.6	30.7	29.9	30.9	31.5	33.8	...	...
Of which : General government debt	24.0	24.2	24.2	25.2	25.5	24.8	...	...
Total external debt to exports GS (ratio) 2/	2.0	2.3	2.4	2.3	2.1	1.7	...	...
External interest payments to exports GS (in percent)	13.3	13.5	14.4	12.6	12.9	5.5	...	...
External amortization payments to exports GS (in percent)	24.4	25.9	31.7	34.9	34.0	12.4	...	...
Exchange rate (per U.S. dollars, period average)	211.2	231.6	240.7	273.1	295.5	305.6	365.4	1/26/01
Financial market indicators								
Public sector debt (Maastricht definition)	98.3	108.7	111.3	108.3	105.5	104.6	103.9	Dec-00
Broad money, M4N (percent change, 12-month basis)	18.5	13.0	15.3	7.8	9.8	5.6	12.6	Nov-00
Private sector credit (percent change, 12-month basis)	14.7	22.0	17.0	15.3	15.0	14.2	28.5	Dec-00
3-month T-bill yield	18.2	14.3	12.0	9.5	12.0	9.4	5.7	Nov-00
3-month T-bill yield (real)	2.7	4.9	3.5	3.8	6.9	6.6	1.4	Nov-00
Stock market index	827	914.2	933.5	1,480	2,738	5,535	3,072	1/26/01
Share prices of financial institutions	965	1,160	1,414	2,303	5,799	10,165	6,720	1/26/01
Spread of 3-month money market rate with Germany (percentage points, end of period)	14.1	12.3	10.4	8.1	9.8	7.6	0.1	Dec-00
Spread of 10-year bond with Germany (percentage points, end of period)	...	...	...	4.1	3.8	1.8	0.5	1/26/01
Financial sector risk factors								
Foreign exchange loans to the private sector (in millions of U.S. dollars)	2,698	5,685	8,785	9,138	10,398	10,989	13,312	Dec-00
Share of foreign exchange loans in total lending to the private sector	10.0	22.8	30.3	30.6	29.8	32.0	32.7	Dec-00
Deposits in foreign exchange (in millions of U.S. dollars)	16,619	21,090	21,290	29,240	38,611	31,118	32,299	Dec-00
Share of foreign deposits in total deposits	22.7	24.1	22.6	29.5	35.2	30.9	32.8	Dec-00
Share of real estate sector in private credit	15.1	14.6	16.1	17.3	18.2	20.0	20.4	Dec-00
Share of nonperforming loans in total loans 3/	10.8	19.5	19.0	16.5	13.6	14.7	...	...
Share of nonperforming loans in total assets 3/	...	...	6.4	5.9	5.4	5.8	...	...
Risk-based capital asset ratio 4/	12.6	12.8	10.3	10.3	10.2	16.2	15.7	Jun-00
Foreign currency debt rating								
Standard & Poor's	Mar-90	Jul-90	Jan-93	Mar-94	Mar-97	Dec-98	Nov-99	
Long term	BBB	BBB-	BBB-	BBB-	BBB-	BBB-	A-	
Outlook	Negative	Stable	Positive	Stable	Positive	Positive	Positive	
Short term	A-2	A-3	A-3	A-3	A-3	A-3	A-1	
Moody		Jul-90		May-94	Dec-96	Jul-99	Jan-00	
Bonds and notes		Baa1		Baa3	Baa1	A2	A2	
IBCA				Oct-95	Jun-97	Oct-99	Jul-00	
Long term				BBB-	BBB	BBB	A-	

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

1/ Data for January-November in percent of annual output.

2/ Public sector.

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

4/ Data refer to all commercial banks incorporated in Greece. Starting in 1998, data take also into account market risks.

Table 5. Greece: Stability and Growth Program and Staff's Medium-Term Scenario, 1999-2004
(In percent of GDP, unless otherwise indicated)

	1999	Projections 2000	2001	2002	2003	2004
Stability and Growth Program						
GDP (percent change)	3.4	4.1	5.0	5.2	5.5	5.5
Private consumption deflator (percent change)	2.4	2.7	2.3	2.2	2.3	2.4
Gross domestic investment	22.3	23.8	25.7	27.1	28.6	29.9
General government balance	-1.8	-0.8	0.5	1.5	2.0	2.0
General government primary balance	5.8	6.5	7.0	7.3	7.3	6.8
General government debt 1/	104.6	103.9	98.9	96.0	90.5	84.0
Staff Projections (Unchanged Policy Scenario)						
GDP (percent change)	3.4	3.9	4.0	3.7	3.6	3.6
Output gap (percent of potential output)	-0.1	0.5	0.8	0.8	0.7	0.6
Consumer prices (HICP, period average, percent change)	2.1	2.9	3.4	3.3	3.2	2.9
Gross domestic investment	22.3	24.3	25.5	25.9	25.8	25.8
Current account balance (settlements basis)	-4.0	-7.0	-7.2	-7.2	-6.5	-5.9
General government balance	-1.8	-0.5	0.5	1.4	1.7	2.0
General government primary balance	5.8	6.6	7.0	7.1	7.0	7.0
General government debt 1/	104.6	103.9	98.2	92.4	86.6	81.2

Sources: Ministry of National Economy *The Stability and Growth Programme: 2000-2004* (December 2000); and Fund staff estimates and projections.

1/ The staff assumes that the amount of "below the line" capital injections, net of privatization receipts used to retire government debt, equals 1.7 percent of GDP, while the Greek authorities implicitly assume a larger amount.

Table 6. Greece: Comparison of Stability Programs for 2000-04
(General government, in percent of GDP) 1/

	1999	2000	2001	2002	2003	2004	Change 1999-2003
Revenue							
Greece	45.2	45.6	45.7	45.5	44.9	44.2	-0.3
Portugal	45.9	48.0	48.2	48.1	47.9	47.7	2.0
Ireland	35.5	35.0	34.1	33.6	31.9	...	-3.6
Spain	40.1	40.1	40.0	39.9	39.8	...	-0.3
Euro area 2/	47.1	46.5	45.8	45.5	45.3	...	-1.8
Expenditure							
Greece	47.0	46.3	45.2	44.0	42.9	42.2	-4.1
Portugal	47.9	49.6	49.3	48.8	48.2	47.7	0.3
Ireland	32.3	31.7	31.3	30.7	30.7	...	-1.6
Spain	41.3	40.8	40.4	39.8	39.5	...	-1.8
Euro area 2/	48.4	47.6	46.7	46.1	45.3	...	-3.1
Primary expenditure							
Greece	39.4	39.1	38.7	38.2	37.6	37.3	-1.8
Portugal	44.5	46.4	46.0	45.6	45.2	44.8	0.7
Ireland	29.5	29.3	29.3	29.0	29.3	...	-0.2
Spain	37.5	37.2	36.8	36.3	36.1	...	-1.4
Euro area 2/	44.0	43.4	42.7	42.1	41.5	...	-2.5
Overall balance							
Greece	-1.8	-0.8	0.5	1.5	2.0	2.0	3.8
Portugal	-2.0	-1.6	-1.1	-0.7	-0.3	0.0	1.7
Ireland	3.2	3.3	2.8	2.9	1.1	...	-2.1
Spain	-1.2	-0.7	-0.4	0.1	0.3	...	1.5
Euro area 2/	-1.4	-1.1	-1.0	-0.5	0.0	...	1.4
Structural balance							
Greece	-1.8	-0.9	0.1	1.1	1.7	1.7	3.4
Portugal	-2.3	-1.9	-1.4	-1.1	-0.3	0.0	2.0
Ireland	0.9	1.2	0.8	1.3	1.1	...	0.2
Spain	-1.1	-0.9	-0.5	0.1	0.3	...	1.4
Euro area 2/	-0.5	-0.4	-0.4	0.0	0.0	...	0.5
Primary structural balance							
Greece	5.8	6.3	6.6	6.9	7.0	6.6	1.1
Portugal	1.1	1.3	1.9	2.1	2.7	2.9	1.6
Ireland	3.7	3.6	2.8	3.0	2.6	...	-1.1
Spain	2.7	2.7	3.1	3.6	3.7	...	1.0
Euro area 2/	3.9	3.8	3.7	3.9	3.8	...	-0.1

Sources: National authorities; and Fund staff estimates.

1/ Figures for some years for France, Ireland, and the Netherlands were estimated or projected by Fund staff. See SM/00/48 (4/27/00) for more details on individual country stability programs; except for Greece, data for the 2001 stability programs were not yet incorporated.

2/ GDP at PPP exchange rates weigthed average excluding Luxembourg.

Greece - Fund Relations
(As of January 26, 2001)

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	595.18	72.3
Reserve position in Fund	227.82	27.7
Operational budget transfers (net)	-3.00	

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	103.54	100.0
Holdings	9.19	8.9
Designation Plan	8.00	

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**:

Greece entered the final stage of European Economic and Monetary Union on January 1, 2001, at a rate of 340.750 Greek drachma per 1 euro.

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 October 20, 1999 (EBM/99/117).

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 eventually to the SDDS. However, a significant amount of work remains to be done, particularly in the areas of quarterly national accounts, labor market data and balance of payments statistics before subscription to the SDDS would be feasible.

National accounts

National Accounts data produced by the National Statistical Service of Greece (NSSG) based upon the ESA95 system of accounts are available only for 1995–99, and only on an annual frequency.

Balance of payments/external trade

The Bank of Greece (BoG), in cooperation with several European central banks, had been engaged for a number of years in a comprehensive revision of balance of payments data on a settlements basis consistent with the fifth edition of the *Balance of Payments Manual*. Data for 1999 were the first available under the new system, with the BoG also providing estimates for 1997–98 (collected under the previous system, but compiled in the new categories). Reporting lags remain considerable, at about 3–5 months on average. Data on gross and net asset and liability positions are not available, excepting public sector external debt. Despite the new settlements-based reporting system, significant differences remain in comparison to national accounts-based current account data, with sizable differences in changes (and even in direction) of the current account and its components in recent years. Customs-based external trade statistics are prepared by the NSSG, but with significant lags (there is no detailed implementation timetable regarding their EMU commitment of shortening the time lag to 40 days).

Government accounts

Reliable data exist for the central government, but the quality and timeliness of the data on other public entities, including social security funds and local governments, are poor. This also affects the quality of the data for the general government. The problem arises from inadequate accounting practices and weaknesses in reporting. 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 (IFS).* Data for the accounts of deposit money banks and other banking institutions are current through end-1999 in the January 2001 issue of IFS. In preparation for

Greece's entry into the euro area in January 2001, data reporting to the Bank of Greece by banking institutions has been revised recently in accordance with a report format that is compatible with the European Central Bank Implementation Package. After this revised reporting system has been tested and established, issues related to data reporting to the Fund will be addressed accordingly.

Labor force survey

A new more detailed labor force survey, with an enlarged sample size and capable of generating data on an EU-harmonized basis, has been used since the fall of 1998. However, the timeliness of the data needs to be improved (no data are presently available from 2000 surveys).

Short-term data

In the absence of quarterly national accounts, reliance on high-frequency indicators for economic surveillance takes on increased importance. Unfortunately, many indicators (including retail sales, industrial production, wholesale prices, and other indices) are based on out-of-date samples and component weights. In addition, reporting delays seriously undermine the usefulness of these data.

Advance release calendars

The NSSG has announced an advance publications schedule for most statistical releases. However, this calendar is not always followed.

Greece: Core Statistical Indicators
as of January 26, 2001

	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	1/26/01	12/31/00	12/31/00	12/31/00	11/30/00	1/26/01	Dec. 2000	October 2000	October 2000	September 2000	1999	1999
Date Received	1/26/01	1/17/01	1/17/01	1/17/01	1/11/01	1/26/01	1/11/01	1/9/01	1/9/01	11/9/00	November 2000	November 2000
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	When requested	When updated	Monthly
Source of Update 3/	Reuters/ Bloomberg	BoG	BoG	BoG	BoG	Reuters/ Bloomberg	Bloomberg/ Reuters	BoG	BoG	BoG	MNE	BoG
Mode of Reporting	Electronic	Fax	Fax	Fax	Fax	Electronic	Electronic	Electronic	Electronic	Electronic/ statistical bulletin	Electronic	Electronic/ statistical bulletin
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.

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

IMF Concludes Article IV Consultation with Greece

On February 23, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Greece.[1]

Background

Economic growth strengthened further in 2000 and GDP expanded at about 4 percent, the seventh year of expansion. Activity was led by robust domestic demand, with a further acceleration of investment, while private consumption was buoyed by sizable wage increases and by a rapid acceleration of credit growth. The strong growth performance failed, however, to reduce the unemployment rate through 1999 (the latest year for which data are available), which is the second highest among European Union countries. Exports were boosted by vigorous demand from trading partners. Nevertheless, the demand for import-intensive capital goods and consumer durables fueled import growth and resulted in a further widening of the external current account deficit, which is estimated by the staff to have reached 7 percent of GDP in 2000—one of the highest levels among advanced economies.

After converging to close to the euro-area average, consumer price inflation, including core inflation (i.e., headline inflation, excluding energy and seasonal food prices), accelerated in the closing months of 2000 more strongly than in the euro area. As elsewhere, rising energy prices added significantly to headline inflation. However, core inflation rebounded since the fall of 1999, to 3.2 percent at end-2000. This was partly due to an unwinding of indirect tax cut effects, which had facilitated meeting the Maastricht inflation criterion. In addition, rising nonenergy prices reflected a combination of strong domestic demand, unit labor cost

[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. This PIN summarizes the views of the Executive Board as expressed during the February 23, 2001 Executive Board discussion based on the staff report.

increases above those in the euro area, and higher import prices owing to currency depreciation—the latter reflecting the weakness of the euro as well as the drachma's depreciation during 2000 to its central parity rate.

Turning to monetary policy, continued concerns about inflation led the Bank of Greece to reduce official interest rates relatively gradually toward corresponding ECB rates, with full convergence only achieved in the final week of 2000. Nevertheless, the effectiveness of monetary policy diminished in anticipation of euro-area entry. With official interest rates declining by 600 basis points during 2000 and short-term market rates falling by broadly similar amounts, private sector credit growth accelerated and, by the fall, was expanding at a rate above 25 percent (year-on-year).

Fiscal consolidation continued in 2000, with staff estimating that strong revenue growth limited the general government deficit to around ½ percent of GDP, against an original budget target of 1.2 percent of GDP. The revenue overperformance reflected strong economic activity and improved tax administration, which more than offset current primary expenditure overruns. The *Stability and Growth Program* aims for a 2001 budget surplus of 0.5 percent of GDP. The staff estimates that achieving the 2001 surplus target would result in an improvement of the structural balance by almost 1 percentage point of GDP, similar to the improvement recorded in 2000. The authorities' *Program* targets an overall budget surplus of 2 percent of GDP by 2003.

The near-term outlook points to continued strong growth, with domestic demand benefiting from the euro-entry related easing of monetary conditions. Moreover, investment demand should continue to respond favorably to the stable macroeconomic environment. The staff projects GDP growth of around 4 percent in 2001, with downside risks mostly related to the external environment (a more marked economic slowdown in partner countries or a sharp appreciation of the euro). On the other hand, growth could be higher than projected should domestic demand respond more strongly to past interest rate declines. Inflation prospects depend critically on the second round effects of earlier import price increases (including for energy); these could lead to only a gradual reversal of inflation rates from current levels.

Executive Board Assessment

Executive Directors commended the Greek authorities for the impressive economic gains achieved in recent years, crowned by entry into the Economic and Monetary Union (EMU). The economic benefits were visible in many areas: inflation and interest rates, which have declined to historically low levels; a roughly balanced fiscal position; and GDP growth substantially above the euro-area average during the past five years.

Looking forward, Directors saw the main objective as building on these achievements, taking full advantage of the historic opportunity provided by EMU. They stressed that Greece's integration into the euro area and increased competition from partner countries add urgency to addressing the remaining formidable economic challenges. These include securing the stabilization gains and implementing a broad range of structural reforms to boost growth and support a rapid convergence in living standards with those of Greece's euro-area partners.

Directors expressed concern about the rise in core inflation and the considerable widening of the external current account deficit, which put at risk the stabilization gains. They regretted that unit labor cost increases continue to exceed the euro-area average, contributing to core inflation rising faster than the area average. In addition, they noted that wage developments make it difficult to stem a rising external current account deficit, although the rise in the deficit, as several Directors noted, reflected also the surge in the price of oil and temporary factors related to EMU entry. Directors therefore called for wage restraint and stressed the need for developing a consensus on wage settlements so as to improve competitiveness. A few Directors suggested that the inflation catch-up clauses still prevalent in wage agreements in the private sector, should be phased out.

Directors emphasized that the accommodative monetary conditions stemming foremost from the substantial drop in interest rates prior to Greece's entry into EMU, needed, in view of Greece's relatively advanced cyclical position, to be counterbalanced by a tight fiscal stance. In this respect, they welcomed the strengthened 2001 fiscal surplus target and expected that, if met, it would result in a broadly appropriate policy mix. Nevertheless, they cautioned that some risks, especially on the current expenditure side, argue for cautious budget implementation early in the year, and that additional spending restraint would be required, if signs of widening macroeconomic imbalances emerge. For the medium term, Directors called for maintaining, on average over the cycle, the general government primary surplus roughly at the level targeted for 2001. This would ensure an adequate pace in reducing the very high public debt before the impact of an aging population becomes severe.

Directors emphasized that taking full advantage of monetary union would require far-reaching structural reforms. While recognizing some progress, they called for more sweeping reforms—in particular, on taxes and public expenditure as well as labor and product markets.

With respect to taxation, Directors argued that the economy would benefit from more ambitious reductions in the tax burden, noting that many partner countries are implementing sizable tax cuts. In this regard, and subject to safeguarding the primary surplus objective, they suggested that reductions in the tax burden should keep pace with those in the euro area. This objective could be incorporated into the authorities' plans for a fundamental tax reform. In this context, Directors welcomed the intention to create a more equitable tax burden, building on past tax rate reductions and other reforms, which have already made some progress in this direction.

On the expenditure side, Directors noted that reforms in public administration are necessary to limit the growth of primary spending, and that benefits could accrue from adopting more flexible personnel policies and new technologies, and employing a multiyear budgeting framework. Directors welcomed reform efforts underway in health care, but stressed that incentives to strengthen fiscal responsibility are crucial. Directors urged the authorities to move ahead with a fundamental reform of the pension system—placing the public pension system, plagued by large unfunded liabilities, on a sound footing; and possibly introducing a supplementary fully funded private pension scheme.

Directors pointed with concern to the high unemployment rate in Greece, notably among the young and women, and saw it as a major challenge. While welcoming some of the authorities' recent reform efforts, Directors urged the authorities to consider comprehensive reforms targeted at the root causes of the problem. These reforms could include increased wage differentiation for job market entrants (with adequate safeguards for minimum incomes), and better alignment of the education system and job training system with the skills demanded by employers.

Directors welcomed recent progress in liberalizing product markets, but emphasized the benefits for growth and competitiveness from further, comprehensive reforms. Notable progress is underway with respect to privatization and the deregulation of the telecommunications market. Building on these steps, Directors called for bolder efforts in other sectors, including electricity, gas, and transportation. They noted that considerable room remained to ease administrative burdens and streamline the regulatory environment.

In light of rapid credit growth and an evolving financial sector in the new environment, Directors stressed the challenges posed for supervision and regulation. This calls for steps to ensure the adequacy of banks' risk management and control systems, and to strengthen cooperation among different financial market supervisors. Directors urged the authorities to lend support to the liberalization of imports from developing countries, and to raise official development assistance toward the UN target.

Directors also called on the authorities to strengthen efforts in improving Greece's statistical system—where persistent weaknesses are hampering the assessment of economic developments—and encouraged accelerating steps for meeting the SDDS requirements.

Greece: Selected Economic Indicators

	1997	1998	1999	2000	2001 1/
Real economy (change in percent)					
GDP	3.5	3.1	3.4	3.9	4.0
Domestic demand	3.6	4.7	2.9	5.0	4.8
EU harmonized consumer inflation (period average)	5.4	4.5	2.1	2.9	3.4
Unemployment (in percent)	9.7	11.2	12.0	11.8	11.6
Public finance (general government, in percent of GDP)					
Overall balance	-4.0	-2.5	-1.8	-0.5	0.5
Primary balance	4.2	5.4	5.8	6.6	7.0
Debt	108.3	105.5	104.6	103.9	98.2
Of which: external debt	25.2	25.5	26.7	...	...
Money and credit (end-period, percent change)					
Broad money (M4N) 2/	7.8	9.8	5.6	10.4	...
Domestic credit 3/	11.0	9.7	12.2	17.3	...
Interest rates (year average)					
3-month treasury bill rate 4/	10.1	11.9	9.8	7.2	4.2
12-month treasury bill rate 5/	10.4	11.6	8.9	5.9	4.2
Balance of payments (settlements basis, in percent of GDP)					
Trade balance	-14.3	-13.7	-14.4	-18.8	-19.0
Current account balance (including capital transfers)	-4.0	-3.0	-4.0	-7.0	-7.2
Foreign exchange reserves (US$billions)	12.4	17.2	17.7	13.1	...
Exchange rates					
Exchange rate regime		Euro area member			
Present rate (March 7, 2001)		US$0.93 per 1 euro			
Nominal effective rate (1990=100) 6/	69.7	66.5	66.1	60.5	...
Real effective rate (1990=100) 6/	116.0	112.9	113.0	104.5	...

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

1/ IMF staff projections, except where noted.
2/ Data for 2000 correspond to the 12-month change to end-December.
3/ Data for 2000 correspond to the 12-month change to end-November.
4/ Data for 2001correspond to the auction of February 20, 2001.
5/ Data for 2001 correspond to the auction of February 20, 2001.
6/ Data for 2000 correspond to end-November.

Statement by Hari Vittas, Alternate Executive Director for Greece February 23, 2001

1. On behalf of my authorities, I wish to express our appreciation to staff for the stimulating discussions in Athens and for the comprehensive set of documents they have prepared for this year's Consultation. Although our assessment of recent developments and prospects differs from that of the staff, in some important respects, there is no major disagreement on the policies that need to be pursued to meet the difficult challenges that still lie ahead. As on previous occasions, the staff has put forward a number of constructive policy recommendations to help address outstanding issues. These will be carefully considered by the authorities in shaping policies in the years to come.

2. The past year witnessed the realization of Greece's aspiration to join the European Economic and Monetary Union. This event marked the culmination of our efforts, sustained over a long period of time, to achieve nominal convergence with our partners in Europe and, more specifically, to comply with all the criteria of the Maastricht Treaty for accession to the EMU. But it also signaled the beginning of a new era during which the predominant economic policy objective will be to accelerate progress in narrowing, and eventually eliminating, the gap in real per capita income relative to the EU average. My authorities are well aware that meeting this objective will require not only the consolidation of macroeconomic stability but also the upgrading of the country's economic infrastructure and the speedy implementation of deep structural reforms to increase the economy's efficiency and flexibility.

Recent Economic Developments

3. Greece's economic performance continued to gain strength in 2000. The main features were a further acceleration in real GDP growth, which was driven by very large increases in investment and exports and, for the fifth year in a row, was distinctly higher than the EU average; and a continued strengthening of the public finances, which once again surpassed expectations. The rate of inflation remained on a downward trend in the early part of the year but has since accelerated, largely (though not entirely) on account of the surge in the price of oil and the depreciation of the euro vis-à-vis the US dollar. These factors also contributed to a marked widening of the external current account deficit.

4. The Staff Report rightly points out that the recent acceleration of inflation was more pronounced than in the rest of the euro area. However, it is important to stress that the difference is accounted for by two factors of a one-off nature. First, in the run-up to the EMU the drachma had to depreciate by about 4 percent relative to the euro in order to reach its central parity rate. This depreciation, which exacerbated the impact of imported inflation on consumer prices, would have been higher were it not for the authorities' decision, made in agreement with our European partners, to revalue the then central parity of the drachma by 3.5 percent. Second, since last September there was an upward **blip** in the Greek CPI (and all other measures of consumer price inflation), equivalent to about 0.8 percent. This blip

reflected the fact that the indirect tax cuts introduced a year earlier to ensure that the Maastricht inflation criterion would be met ceased to exert any direct impact on the year-on-year rate of inflation.

5. If these two factors are properly accounted for, then the recent pickup in *underlying* price pressures can hardly be said to be out of line with that observed in the rest of the euro area. In particular, although wage drift was somewhat higher than expected, the behavior of wages remained moderate, with little attempt to recoup reductions in purchasing power stemming from currency depreciation and/or the surge in energy prices. In fact, the increase in unit labor costs (estimated by staff to have been 2 percent) exerted, if anything, a slight dampening effect on the rate of inflation.

6. The Staff Report also draws attention to the sharp widening of the external current account deficit. My authorities recognize that this development cannot be viewed with equanimity. However, they do not agree with staff that it can be attributed in any meaningful way to "competitiveness" problems. To begin with, all the indicators of external competitiveness have shown a trend *improvement* over the past several years, as illustrated in Figure 8 of the Staff Report. Thus, competitiveness cannot credibly be blamed for any part of the increase in the external deficit. In addition, in recent years export performance has been satisfactory, with Greece's share in its markets for exports of goods and services being some 20 percent higher in 2000 than five years earlier. Most importantly, as already noted, in the period since the mid-1990s economic growth in Greece has consistently outstripped the EU average. It is unlikely that this would have been possible in the absence of a satisfactory competitive position, especially considering that the period in question was also characterized by the pursuit of very restrictive fiscal and (until very recently) monetary policies aimed at achieving the needed fiscal consolidation and disinflation.

7. The authorities attribute the increase in the current account deficit to a combination of factors, including the steep rise in the price of oil, the surge in investment and the exceptionally strong growth of passenger car imports (which reflected mainly the effects of recent cuts in specific taxes, but also the effects of lower interest rates and other measures taken to reduce pollution). While investment is expected to remain buoyant for several years to come, the impact of the other factors is likely to gradually disappear. Thus, the current account deficit is likely to narrow, even though during the transitional period in which Greek living standards catch up with those in the rest of the euro area it can be expected to remain above its long-run sustainable level.

8. All in all, the authorities do not share the judgment that competitiveness has deteriorated and needs therefore to be "restored." This said, however, they agree that a further strengthening of competitiveness will be desirable in the future, in order *inter alia* to facilitate the real convergence process and, in the longer term, compensate for any reduction in EU transfer payments. In this regard, the importance of continued wage moderation is well appreciated not just by the authorities but by the social partners as well (even if the rhetoric is not always reassuring). However, as the reform efforts proceed and bear fruit, it is expected that competitiveness gains will reflect to an increasing extent a comparatively high rate of

productivity growth, rather than a compression of wage income.

Short-term Prospects and Policy Challenges

9. Short-term prospects for economic growth are favorable, reflecting the strong momentum of domestic and foreign demand and the ongoing improvement in the economy's supply potential. There are of course downside risks and it is acknowledged that these may have increased since the conclusion of the discussions in Athens, mainly on account of the more subdued global economic outlook. In addition, the sustained weakness of equity prices in the Athens Stock Exchange may have begun to exert a dampening effect on domestic spending. Nevertheless, the authorities remain confident that the increase in real GDP will at least match, and probably exceed, the 4 percent growth rate forecast by staff (which incidentally is at the low end of available forecasts and about one-half a percentage point below the recently published OECD projection).

10. The authorities agree that the main policy challenge in the near term is to contain the price and balance of payments pressures associated with the recent (EMU-related) sharp easing of monetary conditions. In order to help meet this challenge, a cautious fiscal policy is being pursued this year, with the budget aiming to achieve a surplus of 0.5 percent of GDP. This will be the first time that the general government accounts have been in surplus in modern history and underscores the dramatic transformation in the state of the public finances over the past few years. The fiscal withdrawal embodied in this year's budget is expected to broadly offset the demand effects of the monetary easing (which are more modest in Greece than elsewhere). The authorities are determined to ensure that the budget target be met and they stand ready to take additional action to curb spending, if needed.

11. In addition to the tight fiscal policy, the effort to contain inflationary pressures is being assisted by the ongoing liberalization of markets and by the favorable 2-year wage agreement reached last May; the latter envisages moderate pay increases and does not provide for any catch-up clause in 2001. With energy prices easing and the euro on a recovery path, the year-on-year rate of inflation has already begun falling and (on a harmonized basis) is expected to drop to about 2½ percent or less by the end of 2001. At that level, it would remain above the euro area average but the difference would no longer be higher than can be ascribed (according to staff estimates) to Balassa-Samuelson effects. Nevertheless, the authorities will aim to lower inflation further in 2002 to bring it within the ECB's target range.

Medium-term Projections and Policy Challenges

12. The official Stability and Growth Program (SGP) for the period 2000-2004, which was endorsed by ECOFIN last week, aims to achieve an average rate of economic growth slightly in excess of 5 percent, coupled with a low rate of inflation and a substantial reduction

in unemployment. The target for economic growth may be viewed as ambitious, but the authorities are confident that it can be attained, provided that the external environment remains propitious, wage moderation persists, and the government's efforts to improve public administration and the functioning of product and labor markets meet with success. Fiscal policy will remain prudent, with the overall government surplus targeted to rise to 2 percent of GDP and the primary surplus to stabilize at about 7 percent of GDP. Although the primary surplus is higher than required to satisfy any notion of long-term fiscal sustainability, the authorities intend to keep it broadly at that level, in order to rapidly reduce the public debt and make it easier, later on, to meet fiscal challenges stemming from population aging.

13. In view of the underlying strength of the public finances, the automatic stabilizers will be allowed to operate fully and annual decisions on the fiscal stance will continue to take into account the cyclical position of the economy. However, the staff proposal for the adoption of targets in terms of the **structural** primary, rather than the overall, budget balance is not feasible, given that the structural balance cannot be measured with the degree of accuracy that is needed to make it operationally useful. Staff also favors a faster reduction in the revenue ratio than envisaged under the SGP. This recommendation will be kept under review. It is worth pointing out, however, that thanks to the substantial progress made in strengthening tax administration and revenue collection it has already proved possible to effect significant cuts in tax rates. As a result, the tax system is already more equitable than before and the true tax burden has become less onerous. Progress in combating tax evasion is expected to continue. Together with the planned broadening of tax bases and the restraint on public spending, it will provide room for further cuts in tax rates, thereby facilitating wage moderation and enhancing overall economic incentives.

14. It is recognized that in the field of structural policy, reforms are not as advanced in Greece as in many other EU countries. However, the pace has recently picked up considerable momentum and the authorities are determined to accelerate it further in the period ahead. Among the main priorities in the next few years will be the overhaul of the tax system, the promotion of far-reaching reforms in public expenditure management, and the implementation of long-overdue reforms of the health and pension systems. In the meantime, despite adverse market conditions, the government is making steady progress in pushing forward its privatization program. The liberalization of the telecommunications and energy markets is also proceeding on schedule and is to be followed by the deregulation of coastal shipping and the opening up of several hitherto closed shop professions. In many of these areas preparatory work (including the indispensable dialogue with the social partners) has already begun and in some cases is at an advanced stage. Overall, major benefits (in terms of productivity growth and downward pressure on prices) can be expected to accrue from the

implementation of these reforms, even though the pace of change is unlikely to fully satisfy the purists.

15. The authorities also recognize that the performance of the labor market has not been satisfactory. In particular, the level of unemployment, notably among women and the young, remains unacceptably high. One of the most important reasons for the rise in unemployment has been the mismatch between the demand and supply of labor, which in turn can be traced primarily to weaknesses in the education system. Major steps have been taken to address these weaknesses but their results will unavoidably emerge only gradually. The authorities have also taken action to expand and rationalize spending on training schemes, lower social security contributions for the weakest segments of the labor market, and ease firing and hiring restrictions. Moreover, wage differentials have widened steadily over the last decade and backward-looking wage indexation has all but disappeared. By and large, these policies and developments are consistent with staff advice. However, the staff recommendation for lowering further the minimum wage for first-time job seekers is unlikely to do much to address high unemployment among women and the young, even if it were to be accepted by the social partners. The reservation wage for these two groups is in effect well above the minimum wage on account of the "safety net" provided by close family ties. This explains why most of the low paying jobs are taken up by immigrants (whether legal or not), rather than the unemployed natives, and also contributes to the oddity of the unemployment rate being higher, rather than lower, among high school and university graduates than among the unskilled.

16. The financial sector has been among the most dynamic sectors of the Greek economy and its performance has improved markedly in recent years. Although some weaknesses have not yet been fully addressed and there is probably room for further consolidation, the sector is in general well placed to cope with the new challenges stemming from Greece's entry into the euro area. Nevertheless, the supervisory authorities are aware of the need to remain vigilant, notably in light of the heightened risks associated with the rapid growth of credit, and will continue to take steps to strengthen market discipline and the regulatory framework.

Conclusion

17. Accession to the EMU has fulfilled Greece's main economic policy objective of the past decade. But neither the authorities nor the people at large are under the illusion that they can rest on their laurels. Greece has now embarked on the more ambitious challenge of eliminating the disparity in living standards relative to its EU partners, while also endeavoring to improve the quality of life and to address the problem of high unemployment. Attainment of these goals will require strong policies and social cohesion and will, at any rate, take time. But the authorities are confident that the effort will again meet with success.