Panayotis Thomopoulos: Anti-inflationary exchange rate policy in Greece in the 1990s

Speech by Mr Panayotis Thomopoulos, Deputy Governor of the Bank of Greece, at the Euro-Mediterranean Seminar, Eurosystem and Mediterranean country national central banks, organised by the Bank of Italy and the European Central Bank, Naples, 14-15 January 2004.

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I would like to thank the ECB and the Bank of Italy for the successful organization of this meeting. Greece has been for more than three thousand years at the cross-roads between North, South and Eastern Mediterranean countries and, we Greeks have been able to enrich our culture and ideas from our relationship with all the nations around the table and I am sure that to-day's exchange of experiences will be to the mutual benefit of all present. I look forward to an even closer cooperation in the future between the Eurosystem, with the ECB taking the appropriate initiative, and the rest of the Central banks from the other regions of the Mediterranean.

When the Maastricht treaty was signed, Greece was meeting all the criteria of a country in crisis. Stagflation, with mounting macro-economic imbalances, were the main characteristics of the economy. In the 15 years up to 1993, average inflation was almost 17%, GDP growth was barely 1% per annum, while the fiscal deficit was creeping upwards reaching some 13,5% of GDP by 1993 and pulling up the debt - to - GDP ratio to over 110%. It was, therefore, not surprising that the government's commitment to prepare Greece for the satisfaction of the Maastricht criteria in 1999 and membership of the Euroarea by 2001 (2 years after its creation) was received with disbelief by almost all foreign and domestic observers. From the beginning of 1994, when the new stability oriented policy was initiated, a managed exchange rate was a key policy plank in the stabilization process and contributed importantly to disciplining economic agents and setting in motion wage and price restraint, which brought the rate of inflation down to some 2% on average in the twelve months to early 2000 thus making possible our Euroarea membership.

Between end 1994 and early 1998, i.e. in the period preceding our ERM I membership, the Bank of Greece and the government had decided to follow a policy of managing the exchange rate by not allowing the drachma to depreciate as fast as was needed to compensate for the inflation differential vis-a-vis our trading partners. This was done purposefully in order to put a break on inflation and inflationary expectations, which in the past were strongly fed by the recurrent devaluations of the drachma, which, sometimes, more than fully accommodated the excessive wage and price rises. While there was some real appreciation of the drachma, the resulting disequilibrium was not as large as some argued, especially participants in the financial markets. Studies conducted by the Bank of Greece indicated that the real overvaluation of the currency was of the order of 10 percent after taking into account the Balassa-Samuelson effect and a number of other factors. This anti-inflationary exchange rate policy started having its impact on inflation after less than one year and was accompanied by other policy measures, with the result that domestic disequilibria were narrowing and our policy was gradually gaining credibility.

This permitted the government to persuade the labor unions to abandon the backward looking wage indexation scheme, which by its nature had perpetuated the inflationary spiral for years and instead to move to forward looking wage increases, based on the continuously declining annual inflation target set by the government. Lower inflation was, in turn, facilitating fiscal consolidation as a result, of (a) the progressive narrowing of the very high interest rate risk premia on government debt and, (b) the actual decline in interest rates in line with inflation. As a consequence, government expenditure on interest payments fell from 13% of GDP in 1993 to less than 7% in 2001, when Greece joined the European Union. Falling inflation was also making our managed exchange rate easier to operate. However, we were conscious that an exchange rate adjustment would have to take place at the time of joining the ERM I, so as to offset the loss of external competitiveness reflecting the previous few years of real appreciation of the drachma. We had fixed 10% as an upper limit for the real appreciation, because, first, a moderate appreciation would not frighten the markets and, second, the subsequent necessary correction of the exchange rate would be limited. We were aiming at a limited correction that would not impact unfavorably on other macroeconomic variables, in particular inflation and would not generate expectations for further depreciations. Indeed, central banks which follow a managed exchange rate policy have to be very careful not to allow a big appreciation of the real exchange rate, that would subsequently open the stage for big speculative attacks, which because of the usual overreaction of markets could trigger capital flight. Indeed, there are numerous examples, starting with Argentina and going backwards, that capital flight on the one hand, deprives the domestic economy of much needed investable funds and, on the other hand, drives the exchange rate to abnormally low levels, which immediately set the stage for a wave of price rises and drive the economy into recession. If this situation is allowed to develop the original anti-inflationary exchange rate policy would ultimately cause much more damage than if a pure free floating policy was followed.

Anti-inflationary exchange rate policies, which aim to eliminate imbalances and disequilibria, so as to improve domestic economic performance, inevitably entail a cost. There is no free lunch in a global and competitive world, especially when market makers are, sometimes, enticed by speculators and wild rumors. Indeed, for almost 4 years the cost, borne by the Bank of Greece, of sterilizing the excessive short-term capital inflows attracted by the high interest rate policy, in combination with the exchange rate policy amounted to almost ½% of GDP per annum. Furthermore, the government proceeded with fiscal consolidation and structural reforms as well as other measures which were introduced (notably extensive privatization) as a necessary complement to the anti-inflationary exchange rate policy. These policies underpinned the improvement in the functioning of the economy and gave a significant boost to business confidence. The determination with which the three Cs were pursued - consistent policies, continuity in policies and confidence building, after two to three years of hesitation, swayed the labor unions, businessman and the public at large to back the stabilization policies with the aim of entering the Euroarea as soon as possible. In addition to targeting the exchange rate, the Bank of Greece always kept a close watch on the growth of M3 and domestic credit expansion and through open market operations absorbed any excess liquidity, which, if it had been allowed to reach the real economy, could have aggravated inflationary pressures. Moreover, when necessary, we also imposed stricter terms on banks' obligatory reserve requirement deposited at the bank of Greece, which were already relatively tight (an amount equal to 12% of deposits with the banking system and it can be noted that they were remunerated at a negative real interest).

However, at the Bank of Greece we knew that this was not sufficient to ensure a smooth run up before entering first the ERM I and subsequently the Euroarea. Speculators are always waiting round the corner and, sometimes, markets may wish to test the country's resolve to maintain its exchange rate targets. Therefore, we followed throughout the six years before entering the Euroarea a high interest rate policy so as first to keep foreign investors happy and keep their confidence but also in order to build a high level of foreign exchange reserves so as to be able to have sufficient reserves to thwart speculative attacks. Indeed, when the 1997 south-east Asian crisis spill over effects reached Greece in September-October and american hedge funds started speculating heavily (up to $2 billion daily) against the drachma and the word was spread that the drachma would devalue by as much as 28% we were able to defend our parity by drawing on our foreign exchange reserves and by raising interest rates temporarily, for a couple of days at a time. We were, however, concerned not to scare the markets, which might have perceived our moves as resulting from panic, and, therefore, we were very careful about how the policy tightening was presented. Instead of raising our intervention rate (lombard rate) from 19% to 330% we temporarily put a surcharge of 0,4% daily at the end of October. This move looked innocuous and passed smoothly, while penalizing heavily banks' cost of borrowing. Accordingly, we sent the right signal to the market and this permitted us to eliminate the surcharge within a few days, so a quasi-normal situation was soon restored. We were also very careful in the way our foreign exchange interventions were executed. In most cases, we wanted to show our determination to defend the parity and, therefore, the Bank of Greece's foreign exchange department intervened directly in the market but, sometimes, we judged that an intervention through a friendly foreign bank could be more persuasive and influence market sentiment better.

Both the government and the Bank of Greece knew that our fundamentals were rapidly improving and our economy had entered a virtuous cycle of rapid growth, falling inflation and fiscal deficits and with relatively small current account deficits by past standards, so we did not hesitate even for a second, regarding our policies and goals. We became even more determined than before to continue our stabilization policies and defend the exchange rate so as not to delay our entry in to the Euroarea. Our determination paid off and foreign exchange markets after a few months of turbulence calmed down in early 1998. Conditions were then considered propitious to achieve our intermediate goal, ***to enter ERM I in calm waters*** accompanied by a small devaluation to correct the previous real appreciation. We succeeded in catching the markets by surprise and not being forced to make a devaluation under duress, with all its destabilizing effects. Moreover, the new ERM parity agreed with our EU partners was broadly consistent with Greece's fundamentals and costs and productivity levels and satisfied the markets. And judging from Greece's record of the last 6-7 years: an annual growth of GDP 3.9%, inflation at the end of 2003 at 3.1% only 1 percentage point above the Euroarea average, and a fiscal deficit at 1.5% of GDP in 2003, the exchange rate with which the drachma entered the ERM in 1998, and the subsequent conversion rate into the euro in 2001, were appropriate and reflected Greece's overall competitive conditions. I would like to tell you how markets behave or rather misbehave: in the heat of speculation, many investment banks were spreading the word (even via the monthly bulletins they circulated and one of them through a teleconference in London) that there would be a devaluation of the drachma of up to 28%. We disproved the pessimistic views and the actual devaluation upon entering ERM I was 12,3%. Immediately afterwards market sentiment changed and the drachma traded at well above its central parity. As a result, the central parity was revalued later in January 2000 and the total devaluation by the time the drachma entered the Euro area was only 7,9%.

The lesson that can be drawn from the greek experience is that a managed exchange rate policy needs to be consistent with the other policy planks, notably fiscal and structural policies which, in turn boost markets' confidence and, therefore, facilitate the exchange rate policy. Confidence is crucial for the successful realization of the policy goals. As I mentioned above, the cost of sterilizing the excessive short term capital inflows (almost ½% of GDP) may appear at first sight too high, but the benefit of stabilization, notably the resulting sustainable investment-led high rate of GDP growth of almost 4% since 1997, which is expected to continue well into this decade, far outweigh any temporary sacrifice the economy incurred in order to fulfill our stabilization goals.

The road to the Euro was not strewn with roses, it was not smooth and I don't want to underestimate the difficulties. With regard to the sequence of policies and priorities, we took a calculated risk starting our stabilization policies by adopting a policy that allowed for a moderately appreciating real exchange rate. We walked on a tightrope, sometimes for months in a row, as there were occasional bouts of jitters based on market expectations, even until the last moment, that our Euroarea entry would be deferred or that we would join at a significantly depreciated rate. Accordingly, whereas our goals were ambitious, our policies erred on the side of caution. We made gradual adjustments and, as an insurance, always had at hand a sufficient large cushion of foreign exchange reserves and a relatively high interest rate differential vis-a-vis Euro rates, even until the last few weeks before entry into the Euroarea.