Mr Garganas gives a speech on integrating Greece into the euro area and the challenges ahead

Speech given by Mr Nicholas C Garganas, Deputy Governor of the Bank of Greece, at the "Athens Summit 1999" on 18 September 1999.

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The adoption of the euro as a common currency by a first group of eleven European Union Member States on 1 January 1999 was rightly described as an historic event since the move to the final stage of Economic and Monetary Union indeed marks a decisive step towards full economic and political integration between the countries participating in this endeavour. The vigorous and credible implementation by Greece of policies aimed at achieving a high degree of sustainable economic convergence and meeting the terms of the Maastricht Treaty for EMU participation have yielded concrete results, thus placing Greece directly on the road to joining the euro area by the target date of 1 January 2001.

Over the past few years, convergence towards price stability has been impressive. The annual rate of inflation in August was 2%. Great progress has also been achieved regarding the general government budgetary position. In 1998, the deficit stood at 2.5% of GDP, and is expected to fall further (to just over 1.5%) this year, continuing the downward path of the debt–to–GDP ratio, which currently stands at 105%. The gradual reduction in budget deficits, together with the entry of the drachma into the Exchange Rate Mechanism, has led to an appreciation of the drachma (first against the ECU and this year against the euro), and lower long-term interest rates. In the first half of this month, the ten-year government bond spread versus Germany was around 163 basis points, compared with 196 basis points in March 1999 and 425 basis points in September 1998.

The remarkable nominal convergence achieved by Greece indicates that its objective of meeting the Maastricht criteria by early 2000 is now becoming a reality.

Although it is widely anticipated that Greece will be admitted into the euro area by June next year so that it can adopt the single currency on 1 January 2001, we should not allow this achievement to dim our view of what remains to be done. As I see it, Greece faces two broad sets of challenges. First, in the remainder of 1999 and in 2000, macroeconomic policy has to remain firmly focused on keeping the EMU process on track and on securing the conditions that will make for a smooth transition and positive performance upon entry. From this point of view, the main challenge is that of sustaining price stability. Second, Greece is faced with the additional challenges of completing the necessary budgetary consolidation and stepping up the structural reforms required to prepare the economy for the demanding competitive environment of monetary union. Let me discuss each of them in turn.

Maintaining price stability

First, there is the issue of establishing conditions that will secure price stability between now and the end of 2000. On current projections, in the remainder of 1999 and early 2000, inflation (as measured by the Harmonised Consumer Price Index) is expected to average close to – or slightly below – 2% – a rate that is consistent with the Bank of Greece's definition of price stability. The benign outlook for inflation reflects a number of important policy choices, most notably the tight monetary policy stance adopted to date, centred on high interest rates and a strong drachma. The reduction in inflation is also supported by a moderation of wage settlements. However, the current favourable inflation prospects reflect, in part, the impact of recent indirect tax cuts and other administrative measures.

Given the need to maintain price stability throughout the year 2000 and beyond, the present tight monetary conditions will have to be maintained as long as is feasible to ensure against unforeseen inflationary pressures. Should there be renewed inflationary pressures, there are evident limits to what monetary policy could do to maintain price stability in the run-up to EMU. I do not have the time to discuss these constraints in detail. I can only mention the fact that the ability of interest rate policy to curb credit growth is being eroded by the public's widespread perception that interest rates will necessarily decline by end-2000 and by firms' recourse to foreign borrowing.

Looking further to 2001, the alignment of Greek interest rates with those in the euro area and the slide of the drachma to its central ERM parity when Greece enters the euro area will, of course, entail a substantial easing of monetary conditions. This prospect for a substantial easing of monetary conditions in early 2001 could result in a reversal of the downward trend in inflation in the course of 2000 and beyond. Against this background, the macroeconomic policy mix will need to undergo a fundamental rebalancing, with other policy instruments – notably fiscal, wage and structural policies – being called upon to offset the effect of monetary easing on inflation and thereby help to maintain price stability.

Let me now turn to the matter of the challenges facing Greece with respect to the completion of the adjustments required to prepare the economy for the exigencies of monetary union. Three interrelated issues are important in this respect. First, the need to sustain efforts to achieve and maintain a sound budgetary position consistent with the Stability and Growth Pact, and a speedy reduction in the still high debt-to-GDP ratio. Second, the need to strengthen Greece's ability to respond to "asymmetric" shocks, i.e. negative shocks affecting the entire national economy and only that economy. Third, the challenge of stepping up the structural reforms required to secure Greece's smooth participation in the euro area and to reap fully the opportunities offered by EMU.

Sound public finances

As I indicated at the outset, Greece has made enormous progress in reducing the large imbalances in its public finances over recent years. However, additional progress is required in order to ensure compliance with the Stability and Growth Pact's medium-term objective of a budgetary position close to balance or in surplus. That will allow Greece to deal with cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP. It will also allow a speedy reduction in the still high public debt ratio and help prepare for the fiscal impact of population ageing.

A sound budgetary position will impart a layer of flexibility into the economy. Since, following entry into the euro area, adjustment to adverse cyclical developments and country-specific disturbances will, to an important extent, rest with budgetary policy, it will be of paramount importance to ensure that the automatic stabilisers will be able to play their role.

Greece needs to step up its budgetary adjustment to put its debt ratio firmly on a declining path and to bring it down swiftly below the reference value of 60% of GDP in the near future. A further steady decline in public debt and an appropriate debt management strategy would reduce the vulnerability of Greece's public finances. Moreover, a speedy reduction in public debt is essential because Greece, like other EU Member States, will face increased pension liabilities in the second decade of the next century as a large number of people will retire because of a marked ageing of the population. As a result, public pension spending is likely to increase sharply in relation to GDP, particularly if there is no reform of the social security system.

Reducing the debt-to-GDP ratio to 60% will not be easy. While Greece can count on comparatively large privatisation proceeds, it is burdened by a currently high government debt ratio, significant contingent liabilities and a large debt accumulated by its chronically loss-making public enterprises.

An exercise on the dynamics of the debt ratio carried out under certain assumptions and starting from 2000 onwards suggests that it would take 10-12 years for the debt-to-GDP ratio to be brought down to 60%.[1]

Maintaining Greece's primary budget surplus at its present level (6.7%) for 10-12 years – which is what is assumed in this exercise – would virtually remove the scope for easing the high tax burden on Greek citizens over the next 10-12 years and would imply little room for public spending increases.

It would be more realistic for the government to speed up and expand its privatisation plans, using the proceeds to reduce the debt stock. The government could also press ahead as fast as possible with the reform of the social security system (for example, along the lines implied by the Spraos Committee Report). The government could also intensify its efforts to reduce tax evasion, rationalise public expenditure and reform the wider public sector.

Asymmetric shocks

Let me now turn to the issue of country-specific disturbances. With the date of Greece's entry into EMU approaching, attention should now shift from issues of transition to monetary union to the challenges posed by EMU for Greece.

By definition, EMU implies the loss of national monetary autonomy. One of the criticisms often levied against the EMU project is that member countries will not be able to respond to adverse economic disturbances via changes in national monetary policy or the nominal exchange rate. It is then argued that country-specific disturbances will result in a recession and a surge in unemployment.

In reality, the exchange rate is potentially appropriate for coping with adverse economic developments and country-specific shocks only in a narrow set of circumstances. *Mutatis mutandis*, the same can be said of monetary policy.

Shocks that are truly national are already relatively infrequent. And they will become even more so once Greece joins the euro area: the stability-oriented macroeconomic framework will reduce the likelihood of policy-induced shocks (such as disturbances originating from reckless fiscal behaviour), which in the past have been an important source of country-specific shocks. Moreover, the increasing openness and trade integration of EMU members will further blur the economic importance of national boundaries, thereby reducing the national specificity of economic disturbances.

In the case of Greece, there will be the added benefit to be derived from the process of catching up. A single currency will greatly enhance prospects for bringing in new industries, as the elimination of exchange rate risk will encourage firms to produce closer to their markets. Large infrastructure projects already underway – and financed through the Community Support Programmes – will improve competitiveness and provide a further inducement for firms to move to Greece. It is therefore likely that the conditions after EMU entry will be favourable to growth and employment creation in the Greek economy.

To argue that the incidence of country specific disturbances will diminish is not, however, to say that such shocks will disappear altogether.

In those circumstances, in which a change in the exchange rate or national monetary policy would have been helpful, alternative adjustment mechanisms will have to be provided for responding to macroeconomic disturbances once national authorities have lost monetary and exchange rate independence.

[1] To achieve this it is assumed that Greece would need growth of 3.5% a year, a cost of public borrowing of 5%, and a primary budget surplus of 6.7% of GDP. It is also assumed that the general government takes on contingent liabilities and debt of public enterprises (outside the general government).

At the macroeconomic level, it was argued earlier that, in the case of Greece, public finances will have to regain the necessary room for manoeuvre to cope with adverse economic developments and country-specific disturbances. Where structural adjustment, rather than mere macroeconomic stabilisation, is called for, an improvement in price competitiveness will be needed. This brings me to the crucial role of structural reform.

Structural reform

On the structural front, there has been much progress in several areas over recent years and it is beginning to yield substantial benefits to the economy. But, given the breadth and the magnitude of the structural problems, much still remains to be done.

I focus here only on a few selected issues where I feel that significant breakthroughs would make a major contribution to preparing the economy for the exigencies of monetary union. In particular, more stress needs to be placed on enhancing competition in product markets and improving labour market flexibility. Greater market flexibility will not only allow Greece to cope with country-specific disturbances more easily, but it will also, by reinforcing Greece’s competitiveness, ensure a tension-free macroeconomic growth process and increase the employment-content of growth.

Although legislation was passed in 1998 aimed at addressing some key rigidities in the labour market (the inflexibility of working time, wages, the ineffectiveness of job matching mechanisms), the performance of the Greek labour market has not yet materially improved. This year’s *National Action Plan for Employment* is a well-articulated approach intended to provide an overview of the government’s initiatives and plans in this area. But more stress needs to be placed on improving the quality and job-relevance of vocational training.

The government’s privatisation and flotation programme has been steadily implemented. This has contributed significantly to debt reduction and enhanced competition in the banking system. But privatisation needs to expand into other areas, including key economic sectors that remain dominated by public enterprises.

Tax reform is also needed to alleviate the tax burden, particularly, although not exclusively, on wage earners and to bring the tax structure into line with that in the euro area, thereby preventing the movement of capital and labour to lower-taxed areas.

In concluding, I would note that the achievements to date are impressive and have paved the way for Greece’s forthcoming participation in the euro area. By meeting the challenges of completing the necessary budgetary consolidation and stepping up action across the broad spectrum of structural reforms, Greece will not only be able to join the euro area in a strong competitive position, but will also reap the full benefits from participation in EMU.