Nicholas Garganas: The Greek economy within the euro area

Address by Mr Nicholas C Garganas, Deputy Governor of the Bank of Greece, to the Hellenic American Bankers Association, New York, 23 April 2002.

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It gives me great pleasure to be able to address you today about the transformation of the Greek economy over the last few years. Since the beginning of 2001, Greece has been participating in the euro area as its 12th member. Her entry to the euro area reflects the substantial progress which was made with macroeconomic stabilisation and convergence of the Greek economy to those of the other euro area member states. Disinflation, helped significantly by the monetary and exchange rate policies pursued by the Bank of Greece, alongside fiscal consolidation, ensured that the Maastricht Treaty criteria for euro area entry were all met by early 2000.

Introduction of euro notes and coins

From 1 January 2002, Greece, along with the other countries of the euro area, introduced euro notes and coins. The operation, conducted swiftly and smoothly, and warmly welcomed by the public, has gone remarkably well. The success is all the more remarkable as Greece effectively had two years less than the other euro area countries to prepare for the physical introduction of the euro, since it became a member of the euro area only from the beginning of 2001.

While the cash changeover represented the concluding act of the move to the single currency, many of the benefits of the euro materialized even before joining EMU. The successful cash changeover, which marks a further move towards successful integration with EU partner countries, will reinforce these positive effects.

Sound economic fundamentals

Thanks to the successful nominal convergence process in the second half of the 1990s, which was a condition for joining EMU, Greece can now count on sound economic fundamentals and macroeconomic stability.

Fiscal consolidation was rewarded last year by the general government position being in balance; public debt, although still high at just under 100 per cent of GDP at the end of 2001, has been declining continuously from its peak of just over 111 per cent in 1996.

One of the most remarkable economic developments of recent years has been Greece's success in restoring low inflation. Consumer inflation averaged 17.25 per cent in the twenty-year period to 1994. By mid-1999 it had fallen to about 2 per cent. Rising inflation after the autumn of 1999 can mainly be attributed to higher oil prices and depreciation of the drachma, which, in turn, reflected the weakness of the euro against non-European currencies as well as the drachma's necessary convergence (from an appreciated level) to its central rate within ERM II by the end of 2000. After subsequently subsiding to below 3 per cent in the final three months of 2001, in January of this year inflation again accelerated, largely on account of an increase in domestic unprocessed food prices caused by severe winter weather. After falling by one percentage point to 3.4 per cent in February, it rose again, to 4.0 per cent this time, on account of rising oil prices, renewed pressures from unprocessed food prices, as well as upward rounding of prices (expressed exclusively in euro since March 1st). If we look at the last three years (1999-2001) as a whole, however, inflation averaged 3.1 per cent, a level not experienced since the 1960s. While inflation in Greece has been above the euro-average in recent years, this is to be expected in an economy, which is growing at a relatively fast rate compared with those of its trading partners. This result reflects the so-called productivity bias of fast growing economies.

Macroeconomic stabilisation has been accompanied by healthy growth rates. Since 1996 output growth has exceeded the euro area average. Greek growth has averaged 3.5 per cent compared with 2.4 per cent in the euro area as a whole. The growth rate of real GDP was 4.1 per cent in both 2000 and 2001 (provisional data), significantly higher than the euro area average of 3.3 per cent and 1.5 per cent, respectively.

The growth differential widened considerably in 2001 as economic activity in Greece, benefiting from macroeconomic stability and the euro- entry-related decline in interest rates, held up well in the face of the global slowdown which hit most other euro area countries.

Trends in the labour market have also been relatively satisfactory in recent years. The unemployment rate declined to 10.4 per cent in the first three quarters of 2001, i.e. 2 percentage points than at its peak in late 1999. But unemployment still remains the second highest (after Spain) in the euro area.

Growth prospects

While the forecast for Greek economic growth in 2002 was revised downwards in the aftermath of the 11 September events, real growth is nevertheless projected to be within the range of 3.5 to 3.8 per cent. This strong output performance is expected to continue in the medium term. Output growth should be sustained over the medium term by relatively robust domestic demand, underpinned by improved economic fundamentals, strong private investment spending, expenditures in preparation for the Olympic Games of 2004 and economic infrastructure projects partly financed by EU Community support funds. The growing openness and export orientation of the economy, mainly towards the economies of Central and Eastern Europe and the Balkan countries should also foster growth. In particular the return to stability in the latter countries has benefited Greece significantly. The 2001 update of the Stability and Growth Programme of Greece projects an average annual real GDP growth rate close to 4 per cent in 2003 and 2004.

Higher growth than the rest of the euro area is necessary over the long run if standards of living in Greece (measured by GDP per capita in PPS), which are at present around 71 per cent of the EU average, are to converge on the European average. However, further structural reforms may prove critical to enhance growth over the longer term and accelerate real convergence.

Further economic benefits to be expected from EMU membership

Aside from macroeconomic stabilisation and enhanced growth prospects, there are further economic benefits to be expected from the adoption of the euro.

1. As I mentioned earlier, the adoption of the single currency has further increased economic integration with the European partner countries, which will stimulate trade and investment. Transaction costs and uncertainty are reduced. The euro contributes to a stable environment that is less exposed to exchange-rate fluctuations. These factors will boost investment and trade. They will also encourage tourism, an important sector of the Greek economy .

2. The euro is contributing to greater efficiency of the European economy by acting as a catalyst for the integration of financial markets. Greek companies will have access to a wider and deeper financial market, which means a lower cost of funds. Indeed, short-term bank lending rates to enterprises fell by almost 7 percentage points in the period December 1999 to December 2001; long-term rates fell by 5.5 percentage points over the same period.

3. Membership of EMU makes low inflation prospects more credible, and thus contributes both to lower interest rates and to moderate wage demands based on lower inflationary expectations.

4. Adoption of the euro is also promoting greater efficiency of the Greek economy by stimulating reforms in product, services and labour markets. Deregulation and a reduction of state intervention, in part through privatization, are important in reforming markets for goods and services. Increased labour market flexibility is also being encouraged.

5. Against these benefits, it could be argued that with EMU membership Greece has lost its independent exchange rate and monetary policies, which could be useful instruments for improving competitiveness and employment. However, it cannot be said that this loss is very great. In small open economies, especially those with strong trade unions, nominal devaluations are quickly offset by wage increases that aim to avoid a cut in real wages. Hence, nominal devaluations do not lead to sustained real devaluations. Greece clearly comes in this category. A similar line of reasoning applies to a monetary expansion leading to temporarily low interest rates.

Challenges for the future

Membership of the euro area brings with it new challenges for economic policy in the years ahead. With independent monetary and exchange rate policies no longer available to target national policy goals, emphasis has shifted towards fiscal policy and to policies to promote labour [and product] market flexibility as a means of restoring strong non-inflationary growth in the face of a negative shock.

Budgetary policy will continue to be geared to maintaining public finances close to balance or in surplus in the medium run, while supporting growth by acting in a counter-cyclical manner (and allowing automatic stabilizers to work fully) as envisaged in the Stability and Growth Pact. This is supplemented by the Greek authorities' goal of reducing the General Government debt-to-GDP ratio to 60 per cent by 2010. The latter target is crucial given Greece's presently high debt ratio and the need to make further progress on fiscal consolidation prior to the onset of expenditure pressures relating to the ageing population.

Prudent fiscal policies will also be crucial to offset the progressively larger negative private savings – private investment gap which otherwise could induce unsustainable movements in the total savings – total investment gap and correspondingly in the current account deficit. In 2002, the general government surplus is expected to be 0.8 per cent of GDP. In 2003 and 2004 the projected budgetary surplus should average 1.1 per cent of GDP, according to the 2001 update of the Greek stability and growth programme. At the same time, the debt ratio is expected to decline from 99.6 per cent in 2001 to 90 per cent of GDP in 2004.

EMU membership is acting as a catalyst for further progress on the structural front and for the reinforcement of macroeconomic stabilization as Greece deepens its economic and financial integration with the euro area. Continued structural reforms will tend to increase total factor productivity, which has been a significant driving force behind growth in recent years.

In this respect, considerable progress has been made with the liberalisation of markets, the safeguarding of competition and institutional changes aimed at ensuring the smooth operation of product and financial markets. Among these, the most important measures taken in 2001 were: the ending of the state monopoly in the electricity sector, the opening-up of the fixed telephony market and the awarding of UMTS licenses and supplementary CGM licenses. The liberalisation of sea transport, an area of major importance, is planned for this year. There has also been an extensive programme of privatisation. Some important companies (like Olympic Airways, the Piraeus Port Authority and the Postal Services) are scheduled to go through privatisation schemes this year. Some publicly-owned companies only recently scheduled for privatisation include the Postal Savings Bank and the General Bank, the Athens Water and Sewage Company (already partially privatized) and the public gas company (DEPA).

The government agenda for structural reform also includes pension reform at the centre of the current policy debate in Greece (social dialogue on this issue was launched last month and is currently underway). Some steps are also being taken to reform the health care system, where there is vast room to improve service delivery and public expenditure control.

The government is also proceeding to an overall tax reform; the proposals of an experts' Commission were made public earlier this month; after public discussion, the government will make its decisions in the summer and new provisions will take effect as of January 2003. The tax reform is expected not only to improve the efficiency of the Greek economy, but also to reduce the administrative costs of collecting taxes and the compliance costs for the taxpayers.

The challenge now is to broaden and deepen the efforts undertaken to date to strengthen competition and efficiency in factor and product markets, efforts which are essential to ensure real convergence. Further progress is required on labour market reform. There remains foremost a need to facilitate labour market entry and to improve training. In product markets, the privatisation progress should be combined with broader measures to ensure competitive market outcomes across the economy. Further efforts to reduce bureaucratic inefficiencies are also required to lift impediments to new businesses - including foreign direct investment.

In conclusion, despite the slowdown in the world economy, the Greek economy continues to perform very well. Real convergence is the clear priority for the coming years and the authorities still face some major challenges to facilitate the process. Nonetheless, the commitment of the authorities to both fiscal reform and policies to improve the operation of product and labour markets augurs well for their likely success in meeting these challenges over the coming years.