Mr Garganas looks at the challenges for Greek monetary policy on the eve of euro-zone entry

Address by Mr Nicholas C Garganas, Deputy Governor of the Bank of Greece, at the Euromoney International Bond Congress, held in London on 15 February 2000.

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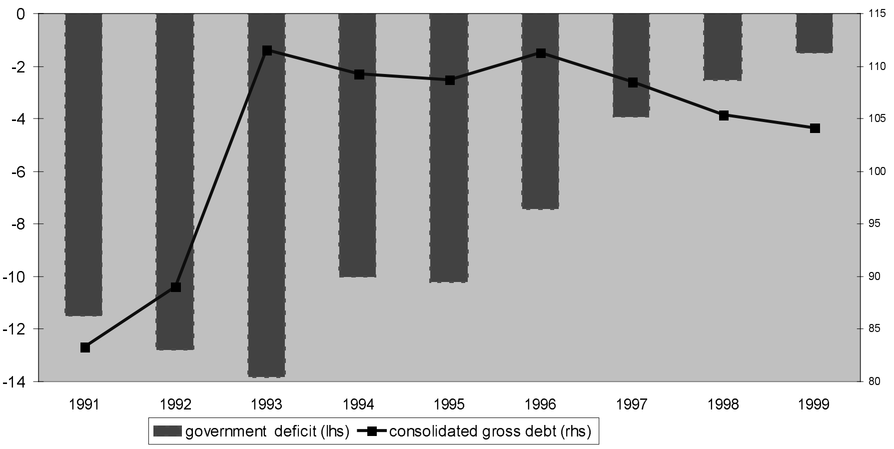
It is a great pleasure on the occasion of the Euromoney International Bond Congress to be given this opportunity to speak to you about recent developments in the Greek economy and I would like to thank Eurobank and Deutsche Bank for having invited me here tonight. I believe that this is a particularly interesting time for Greece as she prepares for entry into the euro-zone on 1 January 2001. I want to begin by looking at the impressive progress made by the Greek economy over recent years before going on to discuss some of the challenges which monetary policy, in particular, faces over the coming months.

In recent years economic policy in Greece has been oriented towards achieving a high degree of sustainable economic convergence and fully satisfying the criteria set by the Maastricht Treaty for participation in the third stage of EMU by the time compliance is examined in 2000. Fiscal and monetary policies were implemented vigorously and the targets of the last two convergence programmes were met, thus placing Greece directly on the road to joining the euro-zone by 1 January 2001.

Three of the four convergence criteria of Article 109j(1) of the Treaty - the government budgetary position and public debt, the exchange rate and long-term interest rates - are already fully satisfied, and the fourth - the criterion on price stability - will be fulfilled by the end of this month.

On 29 November 1999, the Ecofin Council abrogated its decision that an excessive deficit existed in Greece; indeed, the general government deficit reached 2.5% of GDP in 1998, well below the Treaty reference value. In 1999, the general government deficit was further reduced to 1.5% of GDP, below the projection of the 1999 budget. Cyclical adjustment of the government balance shows that the budgetary position of Greece has already been in compliance with the requirements of the Stability and Growth Pact from 1999. As can be seen from Figure 1, left hand scale, in 1993 the deficit was 13.8% of GDP.

Figure 1
Greece: General government finances
(% of GDP)



The debt-to-GDP ratio peaked at 111.6% in 1993 (Figure 1, right hand scale), was broadly stable thereafter, and started to decline in 1997. It was reduced by 3.1 percentage points in 1998 and a further 1.2 percentage points in 1999, despite some additions of below-the-line debits. At about 104% of GDP, its level is still very high, but is now very firmly on a downward path.

With regard to the criterion on exchange rate stability, the Maastricht Treaty stipulates that the criterion will be satisfied if "a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism (ERM) of the European Monetary System without severe tensions for at least two years before the examination" of compliance with the convergence criteria.

The drachma entered the ERM in March 1998 at a central rate of 357 per ECU, just over 12% below the market rate prevailing at the time. As from January 1999, it joined ERM II at a central rate of 353.109 per euro, with the standard fluctuation band of plus or minus 15%.

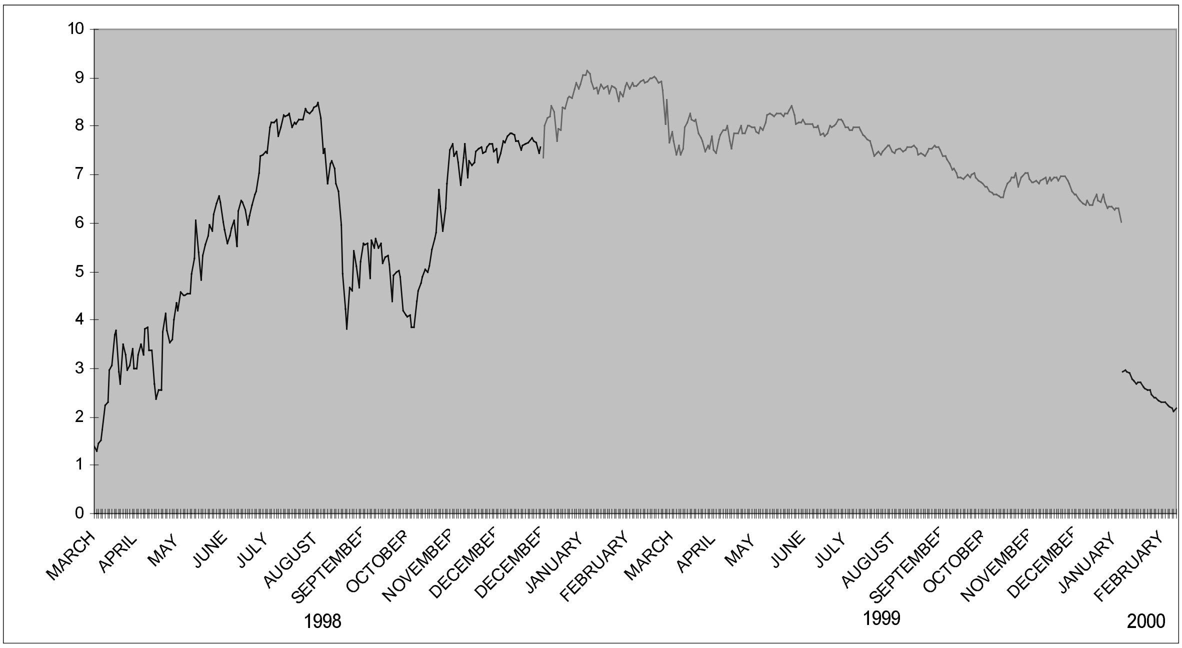
High interest rate differentials and favourable expectations concerning Greece's convergence prospects resulted in large capital inflows. As can be seen from Figure 2, the drachma appreciated (first against the ECU, and since January 1999 against the euro) and traded at around 7% above its central rate for the best part of 1999. The central rate of the drachma was revalued by 3.5% against the euro on 15 January this year. The new central rate of the drachma is 1 euro=340.75 drachma, and the standard fluctuation band of plus or minus 15% continues to be observed around the central rate.

Figure 2

Chart : Exchange rate

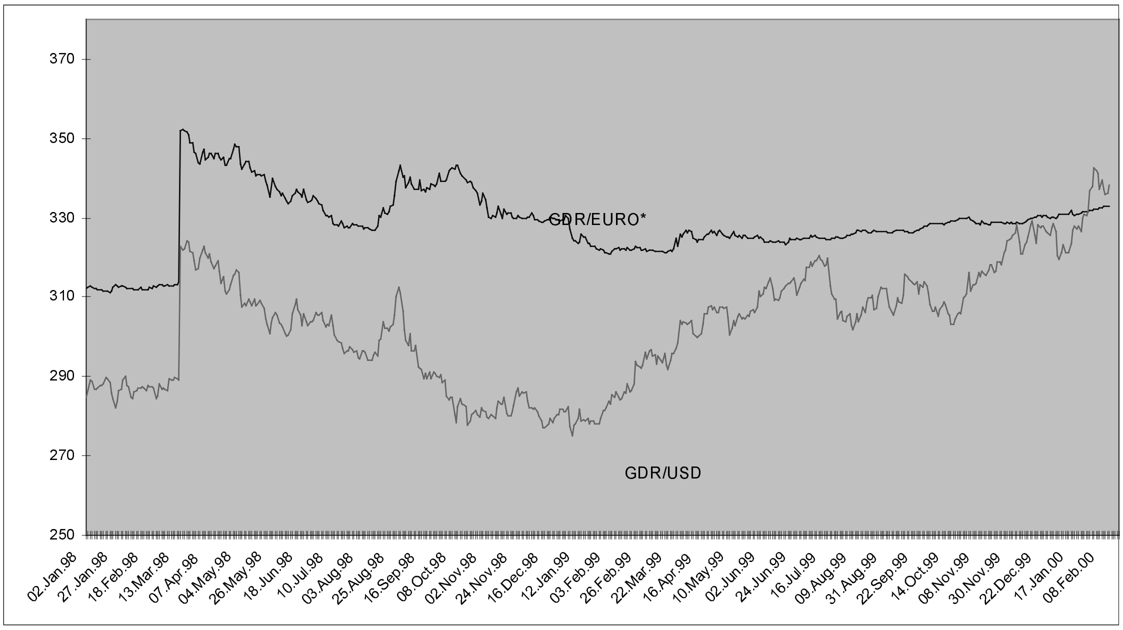
(Per cent deviation of the drachma from its central rate January 1998 - January 1999)

(Daily data)



Note :
The Greek drachma entered the ERM on 16.3.1998 at a central rate of 357 drs per ecu. The two straight vertical lines in the Chart indicate the entry of the GRD in ERM II on 1.1.1999 at a central rate of 353.109 drs per euro and the revaluation of the drachma central rate by 3.5% to 340.750 drs per euro on 15.1.2000 respectively.
Source: Bank of Greece

Figure 3
Greece : Exchange rate of the drachma against the EURO* and USD
(Daily data)

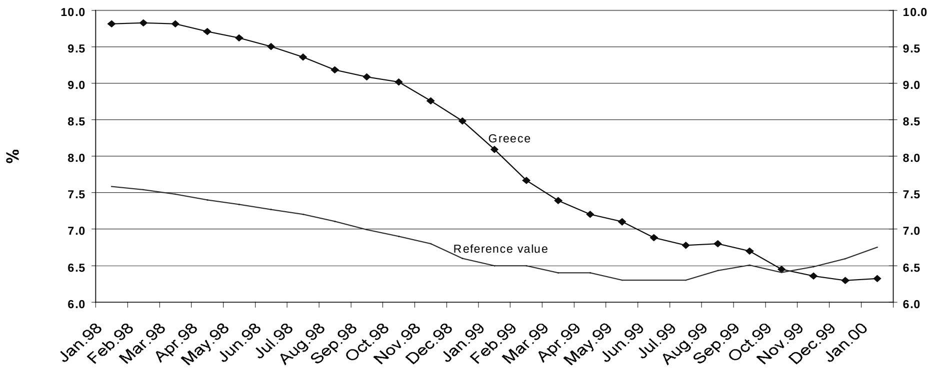


*Based on GRD/DEM in 1998
Source : Bank of Greece

These developments in the exchange rate, presented in Figure 3, indicate that the Greek drachma has successfully participated in the ERM for two years without experiencing any severe tensions during the period under review. Throughout, the drachma has been above its central rate, reflecting the favourable conditions in the Greek economy. Therefore, in my view, Greece fulfils the exchange rate criterion.

Financial markets have reacted favourably to Greece's good convergence prospects and the spread between the 10-year yield on government bonds and German bunds in February was around 98 basis points, compared with 196 basis points in March 1999 and 425 basis points in September 1998. The 12-month moving average of the yield on 10-year government bonds, used to test for convergence, has been below the reference value (derived from the average interest rates in France, Germany and Austria, the three best performing Member States in terms of price stability) since November 1999 (Chart 4), and therefore Greece fulfilled the criterion on the convergence of interest rates.

Chart 4
Greece: Comparison of 10-year interest rate[1] with the reference value[2]
12-month average
Jan. '98 - Jan. 2000



[1] Yield on 10-year government bonds.
[2] Average of long-term interest rates of the three best performing countries in terms of inflation plus 2 percentage points.

Progress towards price stability is also very substantial. The objective of the Bank of Greece is for consumer price increases not exceeding 2%. This target was reached in August 1999. The annual rate of inflation was 2 percent in terms of the national CPI, which corresponds to 1.5% for the harmonised index of consumer prices. Recent price developments (Chart 5) suggest that while the downward trend in headline inflation has been reversed since October 1999, partly as a result of rising oil prices, the underlying trend was still declining in December 1999. Headline inflation eased to 2.6% in January 2000 on an annual basis, from 2.7% in December 1999, while the underlying index edged up marginally from 1.8% in December 1999 to 1.9% in January 2000 (see Chart 5). The harmonised index of consumer prices has been converging rapidly since the beginning of 1999 (Figure 6), exceeding the reference value by only 0.2 percentage points in January 2000, down from 2.5 percentage points in January 1998. Although the increase in oil prices has been slowing down the process of disinflation in recent months, current projections suggest that, in the 12 months ending in February 2000, Greece should have an average rate of inflation, on a harmonised basis, below the reference value (Figure 6).

The fall in inflation was achieved under conditions of accelerating economic growth and rising real incomes. As can be seen from Figure 7, GDP grew at 3.5% in 1999 - the third successive year above 3% and the fourth year of growth faster than the EU average. Real convergence with our European partners is expected to continue, with growth of 3.8% projected for 2000 and over 4% for 2001.

Chart 5

Greece: Consumer price index and underlying inflation

(Percentage change over 12 months)

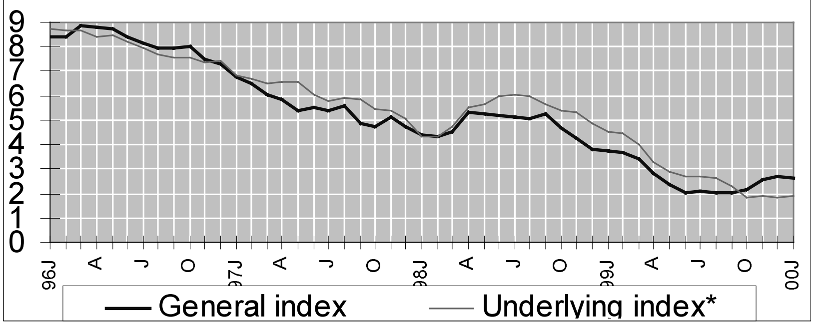


Figure 6

Greece: Comparison of average inflation rate (harmonised basis) with the reference value (%)

(a) Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.

(b) Arithmetic average of the three best performers in terms of inflation plus 1,5 percentage points.

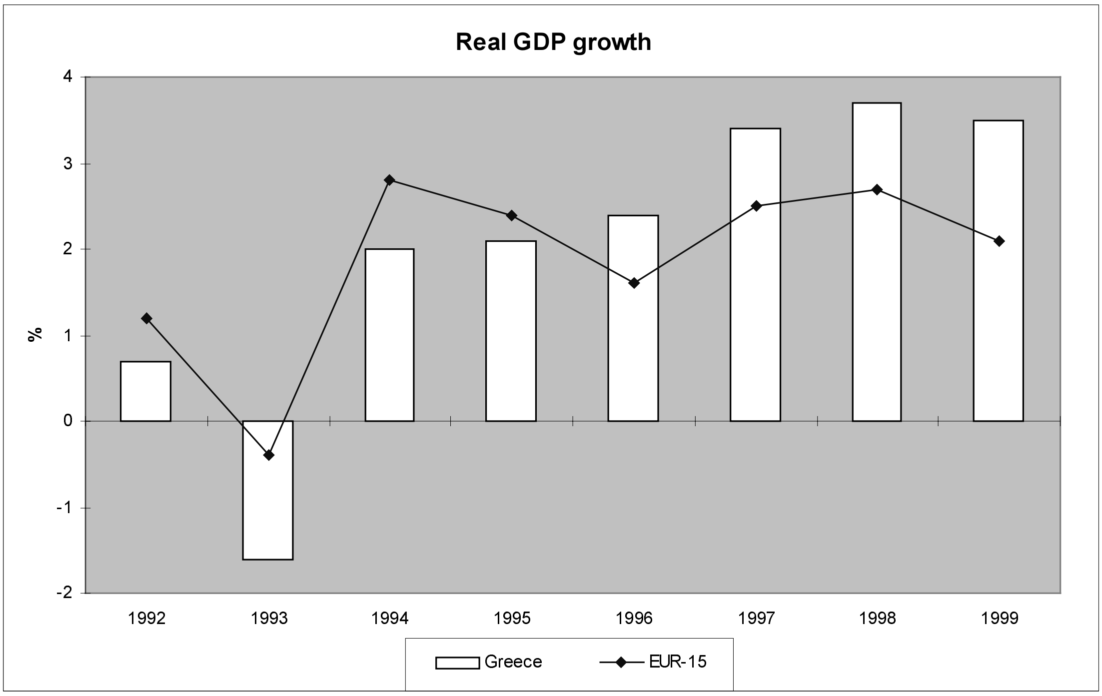
* Partly estimated.

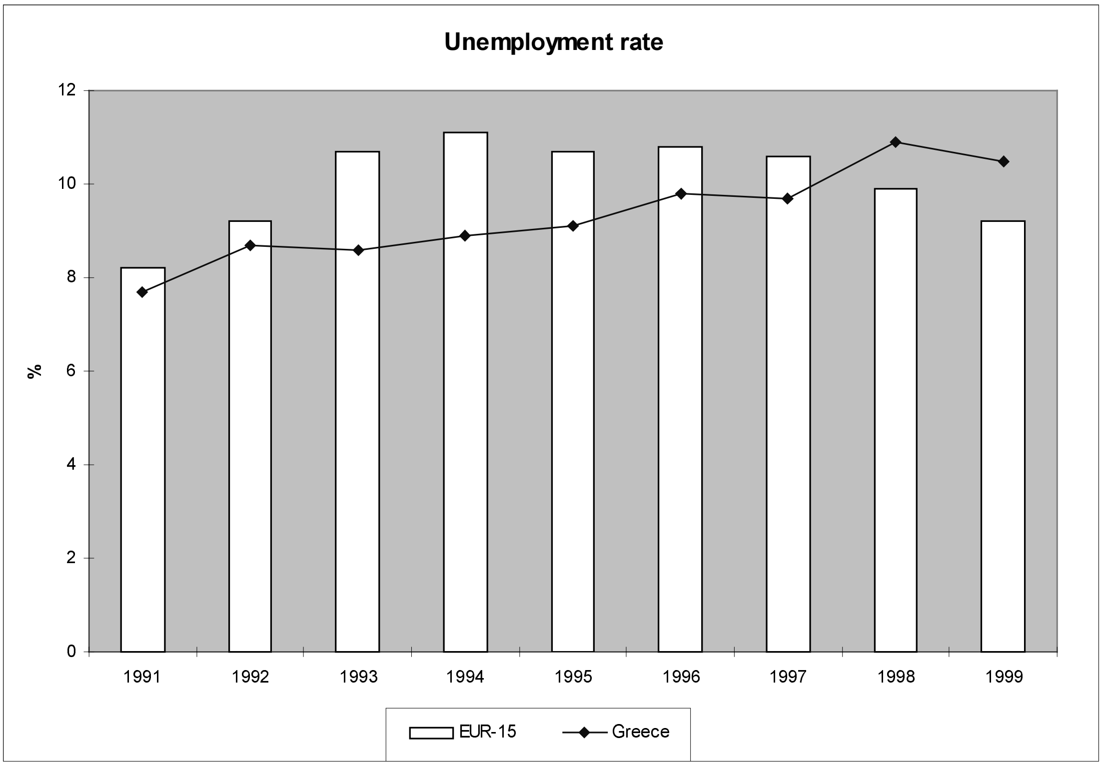
Source: Commission services and Bank of Greece.

One area in which performance is not satisfactory is the labour market. Unemployment is at about 10.5% of the labour force, above the EU average (Figure 7).

Figure 7

Unemployment and real output growth
Comparison of Greece with the EUR-15

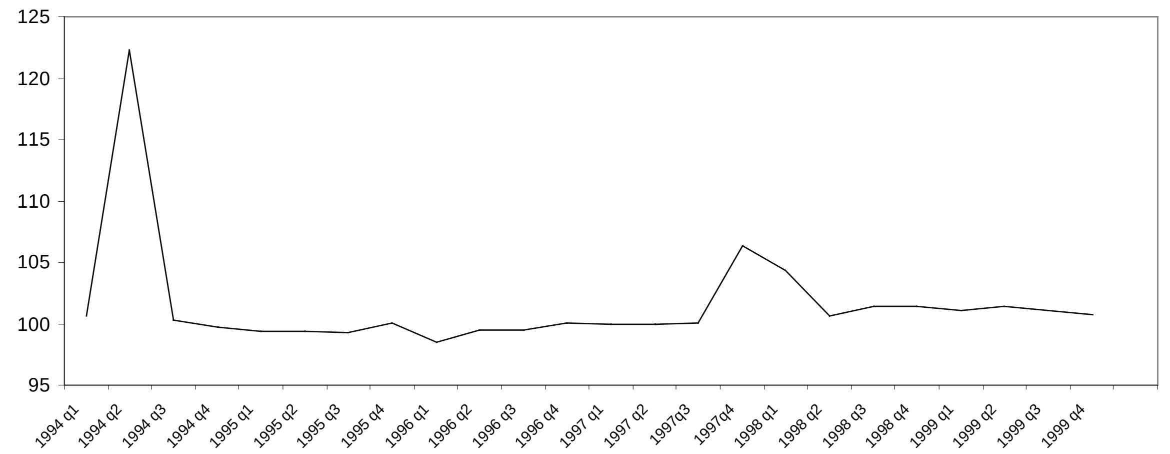




Sources:
Greece: Ministry of National Economy and Updated Convergence Program(Dec.1999)
EU-15: Eurostat / DG EcFin.

Although employment has been growing steadily, the labour force is also growing fast as a result of large immigration and increasing participation. Last year, the government adopted a National Action Plan for Employment, which relies on a range of intensive employment - enhancing measures. However, it is somewhat too early to assess the effectiveness of these measures.

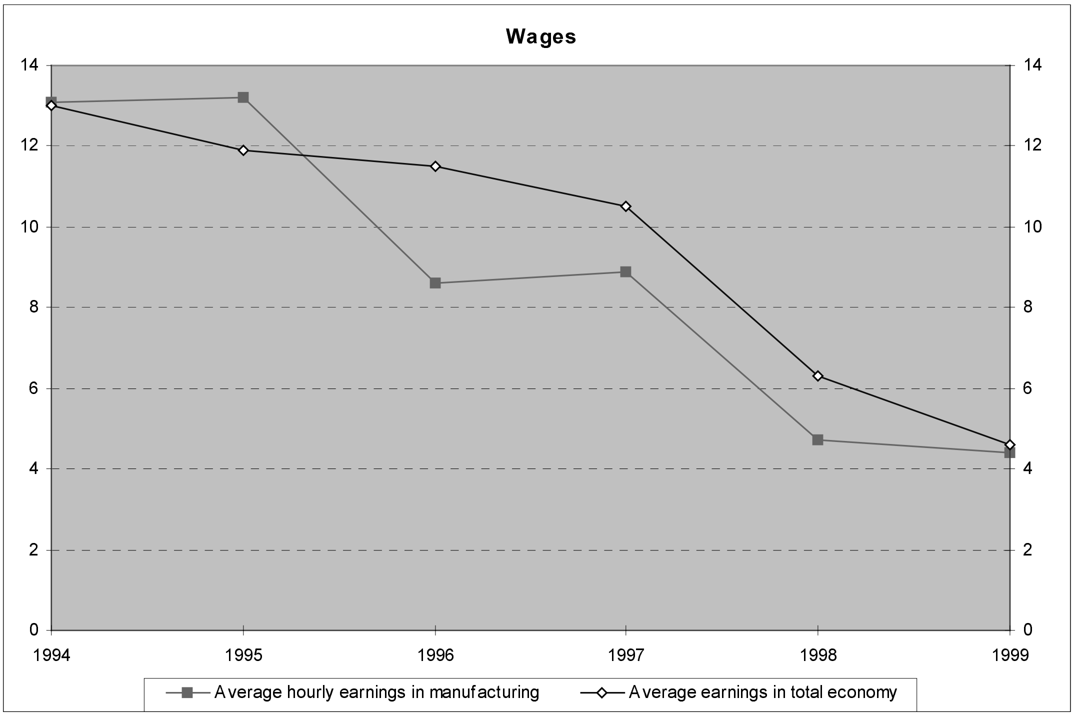
Figure 8
Greece: Monetary Conditions Index, 1994-1999 /1
(1997 q1 = 100)



Notes:
1/ The index is defined as the weighted average of the percentage change in the real short term interest rate and the percentage change in the real effective exchange rate. Relative weights of 3 to 1 are used.

The peaks in the second quarter of 1994 and the fourth quarter of 1997 are due to high interest rates because of speculative pressures against drachma in May 1994 and October 1997.

Figure 9
Greece: Wage and unit labour cost trends
(annual percentage change)



So much for recent developments and the results that Greece has already achieved in the convergence process. Let us now look at the challenges ahead.

In the coming months, the main challenge for economic policy in Greece will be to secure the sustainability of the ongoing disinflation process so as to ensure a smooth transition to the common currency within a healthy growth environment.

Progress towards price stability reflects a number of important policy choices, most notably the tight stance of monetary policy adopted to date, centered on high short-term interest rates and a strong drachma (Figure 8). The reduction in inflation is also supported by the tight stance of fiscal policy and by the slowdown in the growth rate of unit labour costs (Figure 9). Unit labour costs registered a substantial deceleration following the two-year wage agreement, signed in the private sector in May 1998. Unit labour costs in the whole economy increased by 2.5% in 1999, down from 5.5% in 1998 and 8.4% in 1997. In the manufacturing sector the deceleration was more pronounced as a result of improving productivity (Figure 9).

As the changeover to the euro approaches, so domestic short-term interest rates will have to align with those in the euro-zone and the exchange rate converge to its central ERM parity. Table 1 provides some indication of the gap between official interest rates in Greece and those in the euro-zone. The consequence of convergence is that monetary conditions will inevitably loosen. The question which clearly arises therefore is the extent to which this development represents a possible threat to the sustainability of price stability.

A useful point which can be made at the outset is that the impact of monetary policy loosening on inflation may well be diminished by the openness of the financial system in Greece, the dampening effect on household incomes of decreasing yields on financial assets and the fact that economic agents have already anticipated the fall in domestic short-term interest rates. However, this is not to say that the Bank is not taking the issue seriously. On the contrary, we are carefully monitoring the situation.

Table 1

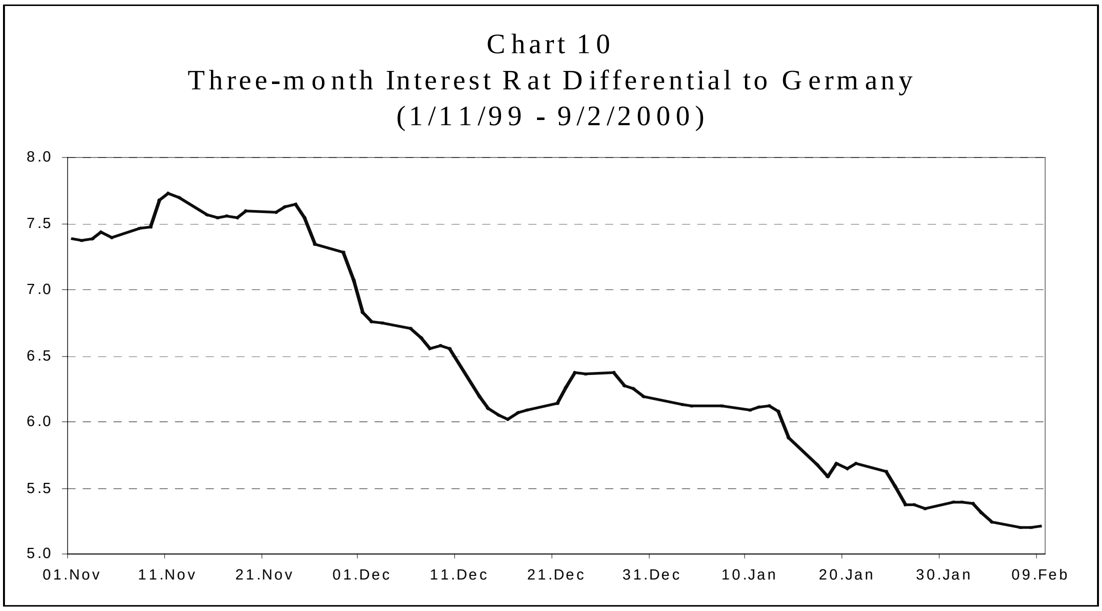
Bank of Greece		**European Central Bank**	
Overnight deposit facility (first tranche)	9.50	Deposit facility	2.25
Overnight deposit facility (second tranche)	8.50		
14-day deposit rate	9.75		
Lombard rate	11.00	Main refinancing rate	3.25
		Marginal lending rate	4.25

Sources: Bank of Greece, European Central Bank

Indeed, the Bank supported fully the recent 3.5% revaluation of the drachma central rate within ERM II. By reducing the amount of exchange rate convergence required, this step will considerably reduce the foreseeable negative effect on domestic inflation. It is now expected that the depreciation that will occur until the end of this year will have little impact on inflation. Last week the drachma traded at around 2.25% above its new central ERM parity. The impact of a depreciation of the drachma towards its central ERM parity is negligible: given that the share of imports in consumption is about 22% in Greece, the depreciation of the drachma required for it to reach its central parity is estimated to imply an acceleration in consumer price inflation of not more than 0.4 of a percentage point.

Developments after the March 1998 devaluation provide evidence of Greece’s ability to absorb external shocks and to implement non-accommodating policies when required. Aggregate demand slowed down as a result of restrictive fiscal and incomes policies, though a tight stance of monetary policy still had a central role in containing pressure on prices.

The revaluation has facilitated some convergence of interest rates by allowing a reduction without implying a loosening of the overall stance of monetary policy.



Developments in interest rates and the exchange rate since the revaluation of the central parity suggest that markets largely discounted the effects of the revaluation (Chart 10). A downward trend in the 3-month Athibor-Euribor differential was noticeable from the third week of November onwards. Developments in the foreign exchange market were broadly similar, with concerns about whether a central rate adjustment would occur and, if so, its extent, along with seasonal factors, causing some weakening of the drachma in December. Following the revaluation, the market adjusted quickly with the implied December 2000 forward rate moving to the new central rate of 340.75 drachmas per euro.

Thus the revaluation, in combination with the fact that interest rate declines have already been largely discounted, suggest that the impact of the monetary policy “shock” will be considerably less than initially anticipated. Overall, it is not now expected that it will be very significant. That having been said, however, interest rate policy in the remainder of the year will proceed cautiously. The timing and magnitude of changes in interest rates by the Bank of Greece will be dictated by developments in inflation and the evolution of the exchange rate. We intend to ensure a smooth transition to euro-zone membership in both money and foreign exchange markets.

In view of the forthcoming easing of monetary policy, other policies - notably, fiscal policy, but also, wage and structural policies - will become the pre-eminent instrument available to counter possible inflationary pressures and ensure sustainability of low inflation.

The new convergence programme which was recently presented to and accepted by the Ecofin Council envisages a further tightening of fiscal policy, targeting a general government deficit of 1.2% of GDP for this year and a primary surplus of 6.7%. For 2001, the target deficit is 0.2%, followed by a small surplus in the following year. The general government primary surplus is projected to rise again to 7% of GDP for both years. Maintaining the level of the primary surplus may become the most reliable policy instrument available to hold back demand and ensure price stability.

As regards wage developments, the updated Greek convergence programme implies moderate wage increases in the public sector in 2000 and beyond. The conditions of the renewal of the two-year wage agreement for the private sector that has just lapsed are of particular importance. As I mentioned earlier wage moderation was a key factor that contributed to lowering inflation and inflationary expectations in the aftermath of the 1998 devaluation, suggestive of an incipient culture of stability that will be essential in the forthcoming wage negotiations. A credible targeting of inflation and the maintenance of the announced target in all circumstances have also created a favourable climate that may positively affect the outcome of the impending wage agreement. The behaviour of economic agents might also be influenced by awareness of the consequence of a regime change: the exchange rate instrument will no longer be available as a solution to competitiveness losses once Greece has become a full member of the euro-zone.

Finally, deregulation and structural reform aimed at enhancing competition and improving the functioning of individual markets (the goods, services, capital and labour markets) are also helping price stability. In this context, it is important to mention that key sectors of the economy, such as electricity and fixed telephony, are programmed to be opened to competition as from 2001 in accordance with an EU timetable. Additionally, conditions on the supply side of the economy have been improving in recent years. The acceleration of private capital formation, the improvement in infrastructure and the structural reforms (including privatisations) implemented so far have most likely increased the productive potential of the economy.

To conclude, the Greek economy has come a long way over the recent past. Tight monetary and exchange rate policies have been instrumental in fighting inflation. The inevitable reduction in interest rates implied by participation in the euro-zone and a return of the drachma to its central ERM rate would represent an easing of monetary conditions with a foreseeable impact on inflation. I have tried to argue today that the inflationary impact of gradual interest rate and exchange rate convergence should not be very significant. The support of other policies, in particular, further fiscal consolidation, persisting wage moderation and continued progress towards structural reform should prevent any significant inflationary pressure resurgence when monetary policy eases and ensure a smooth transition to the euro on 1 January 2001. The outlook for Greece once in the euro-zone is good, suggesting that in the long run she will be in a position to reap the full benefits of EMU membership.