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Foreign Exchange continued

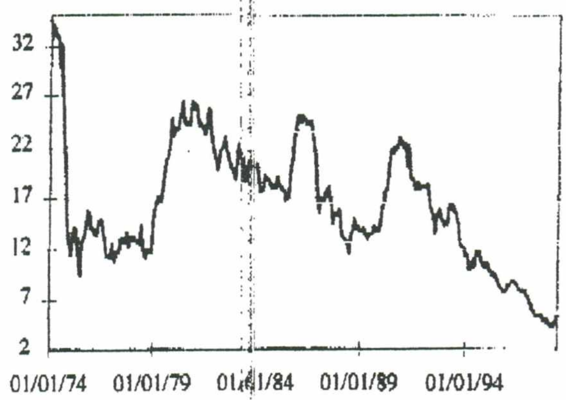
FX Focus: Hot Summer For The Drachma

One of the remarkable features of the recent period of stress in emerging markets has been continued appreciation of the drachma, regardless of external events. However, this robustness is not an indication that the drachma is now secure, but simply that domestic events are now key. Although we feel on balance that the drachma will stay on the EMU path and so remain strong, there are a number of important obstacles that have to be overcome this summer before EMU entry in 2001 is achievable.

Greece is still some way away from EMU convergence...

Assuming that the Maastricht criteria will be applied to future EMU entrants, Greece still has some distance to go, both on inflation and on government deficit/debt criteria. Inflation is still running at 5.3%, the 1997 government deficit was 4% of GDP and debt was 108.6%. Also, as far as inflation is concerned, the devaluation of the drachma in March will make further reductions even more difficult than before, when the reduction of inflation expectations was the only concern (historically inflation has been high: since 1973, the y-o-y rate has averaged 16%).

Greek inflation
(% y-o-y)



...structural reform and tight money are key policies...

Despite the devaluation, which we estimate could add up to 4 percentage points to inflation this year, our analysis suggests that the combination of tight monetary policy and a strict incomes policy can offset the inflationary impact of devaluation.

Inflation impact of devaluation, monetary and incomes policy (simulation minus base)

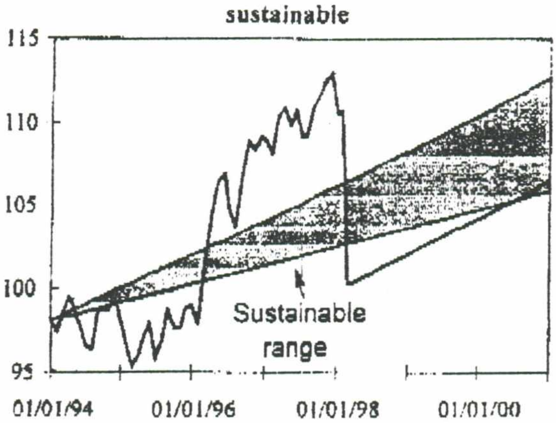
	End 1998	End 1999
-10% exchange rate	+4.4%	+1%
+ 1% on interest rates (with ex-rate effect)	-2%	-0.7
+1% on interest rates (w/out ex rate effect)	-0.5%	-0.4%
-1% off real wages	-0.3%	-0.7%

Notes: Difference from base forecast based on simulations of our model of the Greek economy. Shocks occur at 98:3

Added to this, with the drachma now around 5% above its ERM parity, the inflationary impact of the currency is now somewhat muted. So far, the central bank has kept liquidity tight and has only decreased interest rates slightly from its pre-devaluation crisis levels. Moreover, Greece's largest labour union (GSEE) has struck a collective wage agreement for 1998 and 1999, with 4.7% and 2.8% increases respectively.

... but the implementation of reforms remains uncertain

DM/GRD real exchange rate: predicted and sustainable



Notes: The chart shows a sustainable range for the real exchange rate should structural reform be undertaken, compared with the actual and projected level of the DM/DR real exchange rate.

However, containing inflation is not the whole story: Greece also needs to implement a rapid programme of structural reform to ensure EMU entry. These reforms are needed, not only to help reduce the public sector deficit, but also to help raise productivity to a point where the economy can compete successfully in Europe. The chart above shows our estimates of the likely increase in the sustainable real exchange rate should structural reform take place at a similar pace to that which occurred in Portugal and Italy in the early stages of their ERM entry. Note that without structural reform, the Greek economy will become less and less competitive, making a further devaluation likely and so derailing the EMU entry process.

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Given that the privatisation programme is the most visible aspect of these reforms, we have listed the announced DEKO (public companies for common benefit) privatisation programme. The government plans to raise DR 850bn from the planned privatisations, with three-quarters (2% of GDP) used to reduce government debt. This programme is concentrated in the next four months, since the planned privatisations by the end of this September aim to raise more than DR 700bn. The main events to watch are: the 15 June 20% sale of the public petroleum company (DEP), the July 80% sale of Duty Free Shops, and, most importantly, the September 10-15% sale of the state telecommunication company (OTE), which is expected to raise DR 450-500bn.

Separately, the government is determined to proceed with the privatisation of the fourth largest bank (Ionian). The decision has been met with strikes and support protests from various sectors of the economy, but to date the government has remained firm on its commitment to proceed. On 19 June Commercial Bank (another state bank that owns 60-62% of Ionian) will decide in its annual shareholders' meeting to privatise Ionian. The government has stated the sale will be completed by the end of the summer. Developments on Ionian must be watched carefully, since traditionally implementation of stated policy has been a weak spot of Greek governments.

...and politics could derail the process

In the end, the success or failure of the convergence attempt will probably be determined by political factors, both domestic and foreign. Domestic factors involve the strong power of the trade unions, which will naturally oppose the privatisation process, either because they will be affected or because they will be the next "victims" if the attempt gains enough momentum. The ruling socialist party, PASOK, is uniquely equipped to introduce reforms, given that trade unions traditionally have supported it. Nevertheless, the "backlash from within" the party has been gaining momentum and cannot be ignored. Therefore, we will have to await the implementation of the proposed privatisations and evaluate the procedure as it unfolds. In particular, comments from potential challengers to Mr Simitis, (the defence minister, Mr Tzohatzopoulos, and the education minister, Mr Arsenis, stand out) must be watched closely. Municipal elections in September will offer more information regarding the standing of Mr Simitis within his own party, and vis-à-vis the opposition New Democracy party.

The second political problem is external and involves the relationship between Turkey and Greece. The particular event that will become progressively more important in the summer is the scheduled delivery of the surface-to-air Russian-made S-300 missiles to Cyprus. Turkey has threatened that it will undertake a limited strike if this goes ahead as planned and Greece's defence minister has responded that such an action will be viewed as *casus belli* . The convergence process cannot afford a war, and even a mobilisation of the Greek army could be costly enough to derail the whole process. The US and Britain have stated openly that they disapprove of the delivery, and a number of possible solutions have been put forth to resolve the stand-off. One possibility involves the imposition of a moratorium of Greek and Turkish fighter planes over Cypriot air space,

The road to 2001: key dates in Greece's convergence process

Date	*Event*
15 June 1998	DEP (Public Petroleum Company): 20% sold, expected proceeds: DR 80bn.
Mid-June	Labour market reform bill submitted to parliament (aims to decentralize wage bargaining and introduce a more flexible working hours scheme).
19 June	Commercial Bank annual shareholders' meeting: decision on sale of majority stake in Ionian Bank taken. Alpha Bank and Ergo Bank expected to submit bids on Ionian Bank soon thereafter.
June 29	Bank of Crete: 97% sold.
July	80% of XAE (Hellenic Duty Free Shops) to be sold, DR 130bn expected.
August-December	Russian-made S-300 missiles due to be delivered to Cyprus.
August	Ionian Bank privatized (51-60%).
September	Municipal elections
September	Helexpo and 10-15% of OTE (state-owned telephone company) sold.
November	Corinth Canal (100%) and Olympic Catering (25%) sold.
December	Athens Stock Exchange (up to 49%).
1999	Different smaller-scale privatisations (DEKOs).
September-2000	Parliamentary elections.
1 January 2001	Planned EMU entry

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with the missiles not being delivered at all. A second scenario involves the cancellation of the order and the beginning of negotiations between the Greek and Turkish Cypriots. A third proposal is for the missiles to be delivered to Cyprus, but stored for two years, under either UN or Cypriot supervision. If progress is made for resolving the conflict, the missiles will be resold to a third country (other than Greece).

However, none of these solutions appears plausible at this point: a moratorium is agreed upon by neither party. The cancellation of the order and the beginning of negotiations will suit the Greek Cypriots, but will not be agreed upon by the Turkish Cypriots, who have said they will want to be recognised as an independent state before recommencing inter-communal negotiations. And the proposition of storing $680m worth of missiles for two years in the hope of "progress" in resolving a conflict that has lasted for at least 24 years lacks credibility.

At this point, it is hard to see how the conflict will be resolved. But what is clear is that Greece cannot afford foreign policy adventures in the midst of a major economic overhaul, whose largest part is scheduled to be implemented in the coming summer. The 80% scenario is that nothing serious happens and a face-saving way is found for the Greek Cypriots to cancel the delivery. However, there is a 20% probability that the deadlock is not resolved, in which case economic convergence would halt.

Conclusion

We conclude that Greece has the potential to follow Portugal's EMU convergence example and that this summer will prove especially crucial in that attempt. The implementation of the proposed economic plans must be monitored closely, while on the foreign policy front, the looming S-300 missile crisis could be a cause of volatility, but will derail the process if military mobilisation is required.

FX Technical Perspective

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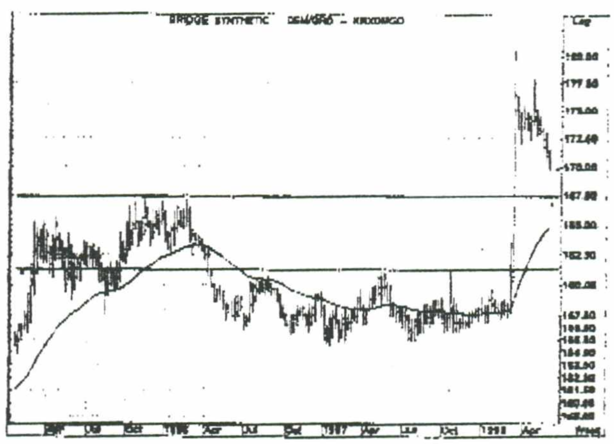
MARK-GREEK DRACHMA:

Weekly Bar Chart with 40-week moving averages



The intermediate-term trend remains up for DM following the vertical advance in March that tagged the 180/180.60 level. Following this explosive move we see the DM trading weaker as a retracement process to the overall 1997-1998 advance begins. First support target is off the old 1996 highs, 167.50/167. The second target will be 165/164, which is where the rising 40-week exponential moving average sits. Once we see probes of these support areas, a new round of DM strength should attempt to retest the highs. Normally following very sharp directional moves we see large range bound consolidations. Before our support targets are seen, look for resistance/DM selling at 172.50, 174. After the big retracement supports are tested raise resistance targets towards the 176/177 area.