Greek Monetary Policy: Issues and Experience*

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I am very pleased to have been invited to join you this afternoon to discuss Greek monetary policy. The second stage of the move towards the European Monetary Union began on January 1, this year, and this is an appropriate time to reflect on our domestic experience with the conduct of monetary policy.

Objectives of Monetary Policy

Let me begin by briefly discussing the objectives of Greek monetary policy. The primary objective of monetary policy in Greece is no-different from that in other OECD countries. Article 4 of the current statutes of the Bank of Greece explicitly provides that safeguarding and securing the value of the currency is the primary objective of the central bank. However, historically, the implementation of monetary policy has not always solely focused on the achievement and maintainance of price stability. Monetary policy had a number of other goals, such as supporting economic activity, or promoting long-term development, meeting the financing needs of the public sector, and channelling credit into desirable uses, from the point of view of the Government's specific social and economic objectives.

During most of the 1970s and until the mid-1980s the main objective of monetary policy was to provide support for economic expansion in Greece, subject to maintaining external balance, although concern with inflation and increasing borrowing requirements of the public sector led the monetary authorities to adopt annual targets for monetary and credit aggregates to ensure that monetary expansion was kept within a predetermined path so as not to fuel inflation. Monetary policy was tightened only or almost only when the external

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* The views expressed here are the author's and are not necessarily those of the Bank of Greece.

balance was threatened. Since the mid-1980s, however, the active use of monetary policy as a counter-cyclical tool was abandoned and reducing the rate of inflation and attaining price stability has become the primary objective of monetary policy.

To a large extent, this development has reflected growing evidence that any positive effects of an expansionary monetary policy on economic activity are of a temporary nature only, and that the main result of monetary policy over the longer run shows up in the rate of inflation. Second, there emerged a disatisfaction with the inability of macroeconomic policy, and in particular monetary policy, to solve the twin problems of inflation and sluggish growth in the 1980s.

But, despite the recognition that achieving price stability is the primary objective of the central bank and that all other objectives should be pursued only in so far as they are not in conflict with the achievement of this primary goal, progress has been slow in reducing the rate of inflation in the past decade (Figure 1).

The average rate of increase of consumer prices in Greece was about 16.5 per cent in 1985-94, against an average of some 18.3 per cent in the preceding decade. Inflation fell to about 11 per cent in 1994 and is expected to decline further in 1995, but the objective of price stability is still far from being attained.

These developments contrast with the remarkable success in bringing inflation down in the industrial world, where consumer prices increased on average by 3.5 per cent per year during the decade ending in 1994, compared with an average of just over 8 per cent in the preceding ten years. The underlying rate of inflation is now less than 2.5 per cent and in a number of these countries price stability is within sight.

There are a number of issues that may be raised as possible explanations for this failure to achieve a satisfactory inflation performance in Greece during the past twenty years. I will restrict myself to three broad issues. First, the absence of strong institutional barriers against inflationary policies. Second, the conflict between fiscal and other economic policies on the one hand, and monetary policy on the other, which undermined the central bank's counter-inflationary objective. And third, the constraints imposed on monetary policy by a strictly regulated financial system, by inadequate and relatively ineffective instruments of monetary control, and by underdeveloped financial and capital markets.

The absence of institutional barriers against inflationary policies

Let me first address the issue of the absence of binding institutional constraints, which may have influenced inflation performance.

Economists and practicioners in the area of monetary policy generally believe that the institutional features of monetary regimes, such as the degree of central bank independence from political influence over its monetary policy decisions can be a fundamental determinant of monetary discipline, and therefore of inflation performance. Although most governments recognise the long-run benefit of maintaining low inflation, other goals often take primacy in the short-run. Assuring price stability, therefore, usually requires ensuring that the central bank is not coerced into an expansionary monetary policy, at least not when it could threaten renewed inflation.

Where the government has strong tendencies to focus on issues other than anti-inflation policy, independence of the central bank from political influence over its monetary policy decisions and a clear mandate to pursue price stability are generally regarded as important institutional devices for ensuring price stability. Central bank independence can therefore be expected to bring about monetary stability and to contribute to lower inflation.

Assessing the existence of a link between the degree of central bank independence and the success of counter-inflationary policy is difficult because actual autonomy of central banks is not an easily measurable variable. However, a number of recent studies (see Grilli, Masciandaro, and Tabellini (1991), and Cukierman, Webb, and Neyapti (1992) and Alesina and Summers (1993) and the references cited therein) find that central bank independence can indeed be associated with better inflation performance.

Figure 2 (taken from the Economist) shows the relationship for a cross-section of countries between the degree of independence and success on inflation. The indicator of independence is based on 15 different features such as whether the bank has a statutory mandate to pursue price stability, or sets short-term interest rates, the length of the governor's term of office, and so on. It is difficult to avoid the conclusion that there is a strong link between the degree of central bank independence and inflation performance. Thus, Germany and Switzerland have the two most independent central banks, and enjoy the lowest inflation rates. The record of inflation in Portugal and Greece, by contrast, where the central bank has traditionally enjoyed less independence than in certain other countries, does appear to have been excessive.

Throughout the post-war period, until 1982, the supreme monetary authority (deciding on monetary, credit, and foreign exchange policies) in Greece was the Currency Committee, an inter-governmental body whose membership comprised five government ministers and the governor of the central bank. Over the years the Committee became a very important instrument for the formulation and the implementation of monetary policy and its composition and credit rules safeguarded the Government's dominance in its decision making. The authority of the Bank of Greece was considerably enhanced by the abolition of the Currency Committee in 1982. But the new institutional arrangements fell short of full independence. Responsibility for the pursuit of monetary, credit, and exchange rate policies is now distributed between the Government and the Bank of Greece. The Government continues to shape the broad outlines of monetary and exchange rate policies, while the Bank of Greece has the responsibility for the development and implementation of these policies.

The lack of independence of the central bank has been a clear limitation in the past, for the conduct of an independent monetary policy. The institutional arrangements that existed in Greece, especially prior to 1982, allowed for governmental involvement in monetary policy decisions with respect to monetary targets, instruments, and implementation procedures. Even when the objectives of the central bank were well defined, the central bank did not always have the power to formulate and implement policies to achieve them. Thus, monetary policy often ended up being conditioned by other policies, and as a consequence the central bank was unable to achieve its objective of controlling inflation. The central bank not only had to finance public sector deficits but also had an explicit obligation to embark on various other activities that compromised monetary policy objectives. Such activities included financing the government at low interest rates, directing credit and granting interest subsidies to specific sectors and providing funds for public enterprises, public entities, and specialised credit institutions. These activities often have implied highly expansionary credit through increases in the monetary base.

Monetary policy had to accommodate whatever higher rate of inflation resulted from pressures arising from high budget deficits, large increases in wage earnings and a weak currency, largely as a result of the ease with which political authorities were able to intervene in monetary policy decisions without being subject to institutional restrictions because the law did not provide the central bank with the powers that would enable it to operate independently.

Given this historical experience, it is important to note that there have been major efforts in recent years to change practices. Among these, the termination of monetary financing of the budget at end-1993, in accordance with the Maastricht Treaty requirements, is paramount.

At the same time Greece, like other member countries of the EU, has started the process of amending the central bank statutes with a view to establishing the functional independence of the Bank of Greece in line with the requirements of the new Treaty.

The incompatibility of fiscal and other economic policies with the counter-inflationary objective of monetary policy

Let me now turn to the conflict between monetary policy and policies of other areas of government, especially fiscal and incomes policies, which have undermined the counter-inflationary objective of the central bank.

Since 1974, monetary policy in Greece has been established within an annual monetary programme, prepared by the Bank of Greece at the beginning of each year, which sets targets for growth in the monetary and credit aggregates. Annual targets were first announced for the rate of growth of M0 (currency in circulation), which accounts for about 70 per cent of M1, in 1976, following their introduction in a number of industrial countries. As M0 and narrow money M1 (defined as currency plus private demand deposits) became less reliably linked to economic developments and inflation pressures in the early 1980s, the Bank of Greece began to place more weight on the broader aggregates especially on M3. In 1982 the Bank of Greece began to announce annual targets (and since 1988 target ranges) for the rate of growth of broad money (M3), along with targets for credit measures. [Broad money (M3), in addition to narrow money (M1), includes private savings and time deposits, bank bonds and repurchase agreements (repos). Repos were introduced at the end of 1990 and have become an increasingly important source of funds for deposit institutions in the last four years. In 1992, M3 was defined to include bank bonds and repos.]

When formulating the monetary targets, the Bank of Greece traditionaly relied on Government projections for real output growth, the Government target for inflation, and policy with regard to borrowing from abroad.

Figures 3 and 4 show the targets and the outcome for the rate of monetary growth and the rate of inflation over the 1976-1994 period. When considering these figures Greek history is very revealing. The data clearly suggest that (a) despite continuous inflationary pressures which would have called for more restraint, through most of the period since the mid-1970's there was generally lack of ambition in the targets for inflation and the targets for monetary growth were relatively lax. Only recently, in 1993 and 1994, did the authorities set an end-year target of single digit CPI inflation and a single digit lower limit of the target range for money growth. (The 1993 monetary programme established a target range for M3 growth of 9-12 per cent and the 1994 programme a range of 8-11 per cent).

(b) As can be seen from Figure 4, in the past 18 years inflation has regularly exceeded announced targets. And Figure 3 shows that, more often than not, actual monetary growth exceeded its target rate, in some years by a significant margin. The expansion of total domestic credit also went beyond targets in 13 of 17 years (Figure 5).

The overshoot of the credit to the Central Government above the initial target (Figure 6) was primarily responsible for the significant excess in domestic credit and the money supply (M3) over the targets set in the monetary programme. This reflected the substantial overruns which were recorded in the borrowing requirements of the Central Government throughout this period (Figure 8).

Excessive rises in real wages - well above the rate of productivity growth - in the ten years to 1984 - and in 1988-1989, when incomes policy was much looser than initially envisaged - also played an important role in this overshooting (Figure 8).

Thus, through much of the period since the mid-1970s, the counter-inflationary objective of monetary policy was severely undermined by the enornous financing needs of the public sector on the one hand, and - in the more distant period - by inadequate income policies on the other.

The lack of effective control over monetary and credit aggreates

Let me now examine the instruments of credit control and issues of monetary management.

As mentioned earlier, the Bank of Greece has the responsibility for overseeing the implementation of the annual monetary programme. During the 1970s and through most of the 1980s, its methods of controlling domestic credit creation differed fundamentally for the commercial banks, on the one hand, and the specialised credit institutions, on the other. For the latter, direct credit ceilings were established at the beginning of each year; in addition the Bank determined the allocation of credit by category of loan, the conditions and terms under which various types of loans were granted, and the sources of the funds required to finance lending programmes.

For the commercial banks, the Bank of Greece influenced the level of credit creation by means of reserve requirements and through management of that portion of reserve money representing liabilities of the Bank of Greece to the commercial banks.

In practice, through most of the 1970s and the 1980s, central bank control over the monetary base was limited, largely reflecting the relatively passive manner in which it accommodated overruns in the public sector borrowing requirements. Specialised credit institutions were often granted large increases above their credit limits which had been set in the annual monetary programme, while excess credit creation of the commercial banks was facilitated both by the large increase in reserve money resulting from public sector overruns, and by the sporadic enforcement of the penalty rate on commercial banks' overdrafts from their current accounts with the Bank of Greece.

Such a mix of policies had deleterious long-term effects as large public sector borrowing requirements became chronic and continuous expansion of monetary and credit aggregates became inevitable.

Until the move to more market-oriented indirect instruments of monetary policy was initiated in recent years, traditional instruments of central bank control over the monetary base had only limited applicability in Greece. In particular, changes in the discount rate of the central bank, while important as a signal of restraint, have traditionally played only a very limited role in the management of commercial banks' liquidity. Furthermore, with no money market to speak of and the absence of secondary markets for securities, open market operations did not exist in any meaningful sense.

It is important to note that until June 1985, treasury bills were not available for sale directly to the non-bank private sector, and the government had relied almost exclusively on the banking system for its domestic financing. The majority of government securities were held by the commercial banks as part of their secondary reserve requirement.

With a view to keeping government borrowing costs down, the yields on treasury bill were artificially held down and were negative in real terms until the mid-1980s (Figure 9).

Throughout this period the prime objective of interest rate policy was not so much to control the overall expansion of credit and monetary aggregates, which were thought to be restrained by direct controls on credit, as to reduce generally interest rate costs and to channel available credit to desired uses.

The role of monetary policy extended beyond quantitative controls over the overall expansion of credit and monetary aggregates. Monetary and credit policies were also employed to channel credit on preferential terms into such priority sectors and activities as small-scale industry, agriculture and export trade, which were thought to be conducive to economic growth and development. Credit was allocated through tightly controlled and highly differentiated interest rates, a complicated reserve/rebate system of bank credit, compulsory investment (or "earmarking") requirements on banks that channeled funds into priority sectors at subsidised rates and tight foreign exchange controls. The overall result was to create an operational infrastructure cluttered by instruments serving subsidiary objectives which often undermined the counter-inflationary policy of the central bank and a non-competitive system of financial intermediation which involved substantial efficiency costs.

Financial liberalisation

The Greek financial system has changed drastically in recent years. The first important steps towards financial liberalisation were taken in 1987-88, following the report of the Committee for the Reform and Modernisation of the Greek Banking System: import related credit had been completely deregulated, interest rates on most categories of bank deposits and on loans were liberalised, and the reserve/rebate system used for allocating bank credit was abolished.

The process of financial reform accelerated after 1990 in the context of preparing for European Monetary Union. Most significantly, the investment requirement for banks in Treasury bills was gradually reduced from 40% of their increase in deposits at the end of 1990 to 15 per cent in October 1992, and was phased out by May 1993.

The requirement on commercial banks to earmark a certain proportion of their deposits for the financing of small-scale enterprises was gradually reduced from 10 per cent of deposits at the beginning of 1991 to 2.5 per cent of the increase of deposits in March 1993, and was abolished in July 1993, while restrictions on consumer credit were removed in January 1994. The minimum interest rate on savings deposits, was also abolished in March 1993.

The termination of monetary financing of budget deficits as of January 1, this year, and of privileged access by the government to financial institutions, in compliance with the provisions of the Maastricht Treaty, was an important step in financial sector reform.

These reforms have improved the efficiency of financial intermediation, and enhanced the ability of the Bank of Greece to implement monetary policy independently.

Deregulation and the removal of almost all controls on external capital movements on May 16 this year, has substantially changed the environment in which monetary policy operates. Money markets have deepened and interest rates on government paper, though still administratively set, largely reflect market forces.

This freeing-up of market forces has entailed a move to market-oriented instruments of monetary control. And interest rates have become the predominant monetary control tool of the central bank.

The Bank of Greece is using daily interventions in the inter-bank market to smooth fluctuations in the interest rate and to meet monetary policy objectives. Two new short-term financing facilities have been introduced by the Bank of Greece recently to provide a corridor system for short-term interest rates. A Lombard facility for short-term financing using government securities as collateral is intended to provide the ceiling and the discount window to provide the floor rate for the corridor[1].

The Bank of Greece has also used foreign exchange swaps to manage the large liquidity shortages created by interventions when the drachma came under pressure last May.

These arrangements extend the range of instruments through which the Bank can control monetary aggregates and provide additional scope for an independent monetary policy. Already there seems to be some evidence of this in recent months when the use of intervention in money markets has played an important role in bringing broad money growth back within the target range.

These reforms alone, however, would not suffice to ensure the operation of a more independent anti-inflationary policy. It would be vital that Greece should also persevere in the period ahead with its programme of fiscal adjustment to ensure that the ambitious but essential inflation targets specified in the revised programme of convergence with EU partners are met.

What is also needed, particularly given present fiscal conditions, is an active secondary market in government securities and deregulation of interest rates on government

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[1] However, over the past 12 months the overnight rate has been below the range defined by the official rates on the Lombard and the discount facilities. Interest rates are thus still, at least for the present, set through by daily operations in the inter-bank market rather than through the new facilities.

paper - currently set by the government, so as to make possible the conduct of open market operations and the strengthening of indirect tools of monetary control.

A decision to speed up the process leading to the independence of the Bank of Greece should also help to increase its credibility, thus reducing the cost of attaining price stability.

References

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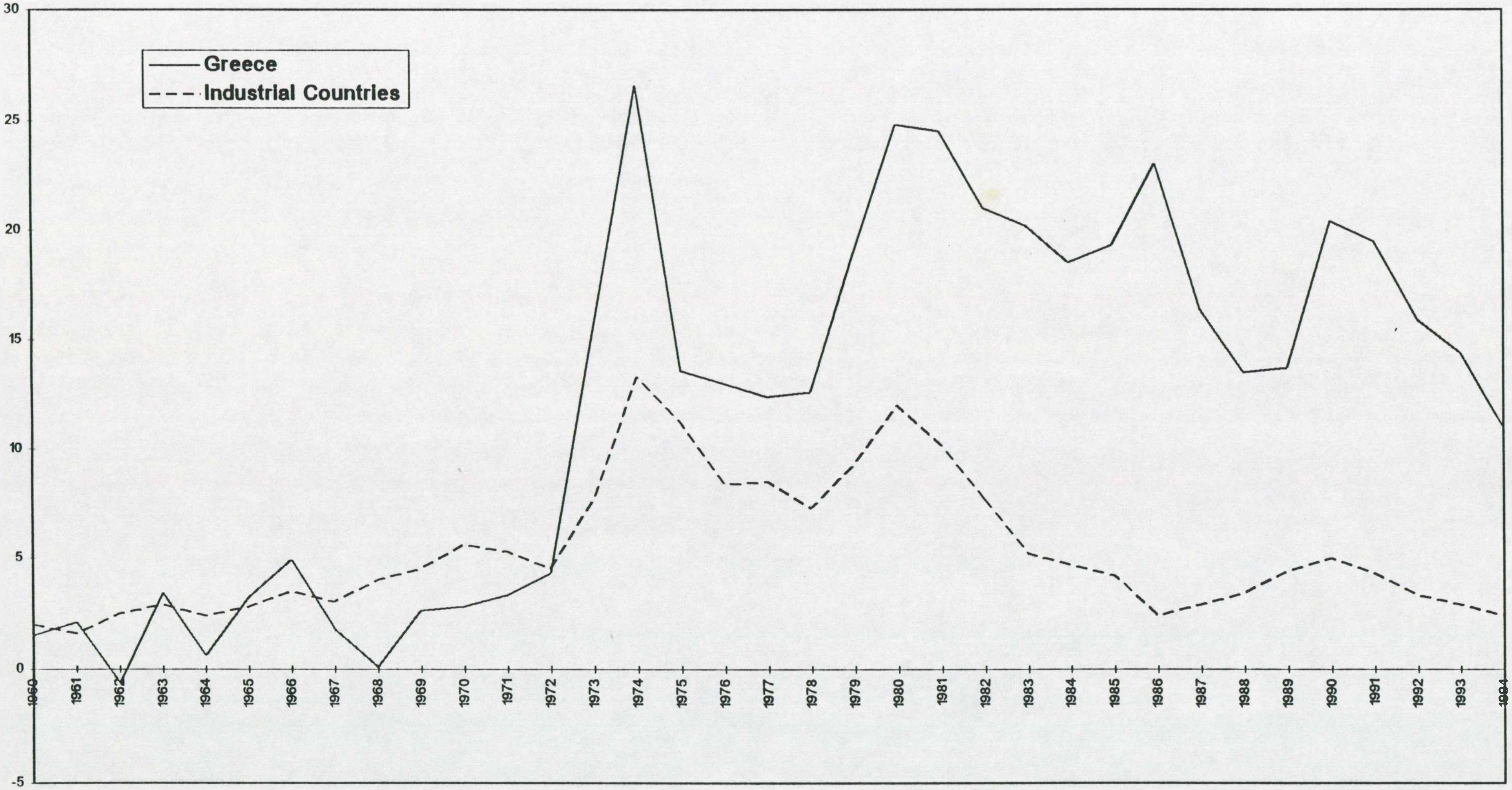
Cukierman, Alex, Steven B. Webb, and Bilin Neyapti, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes", World Bank Economic Review, Vol. 6 (September 1992), pp. 353-98.

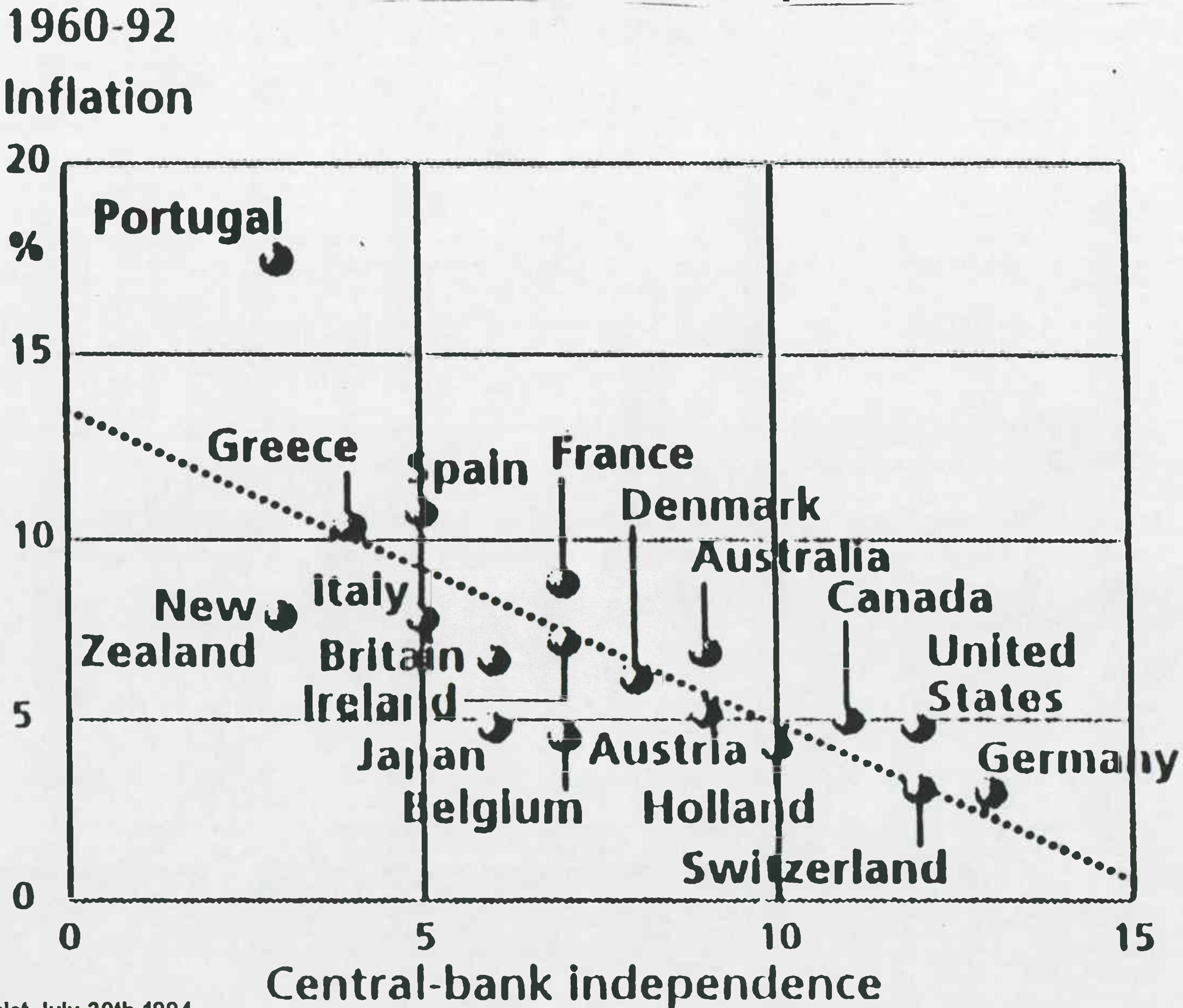
Grilli, Vittorio, Donato Masciandaro, and Guido Tabellini, "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries", Economic Policy 13 (1991), pp. 341-92.

Figure 1
Greece
Comparative Inflation Developments[1]
Percentage change over previous year



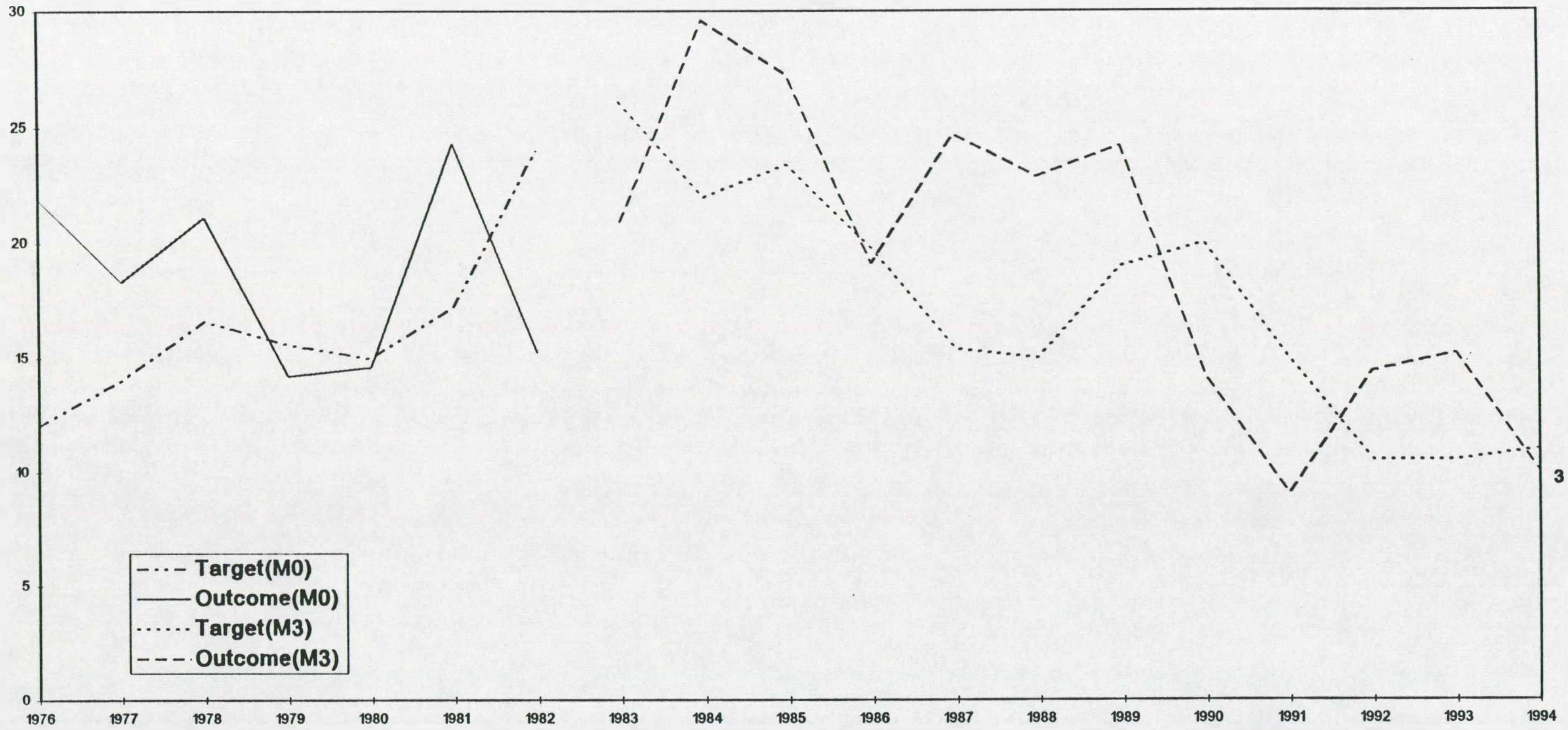
Source: IMF, *International Financial Statistics*
1 Measured by the consumer price index

Figure 2
Inflation and Central Bank Independence



Source: The Economist July 30th 1994

Figure 3
Greece
Growth of Monetary Aggregates: Targets and Outcome[1,2]
In percent over December of preceding year



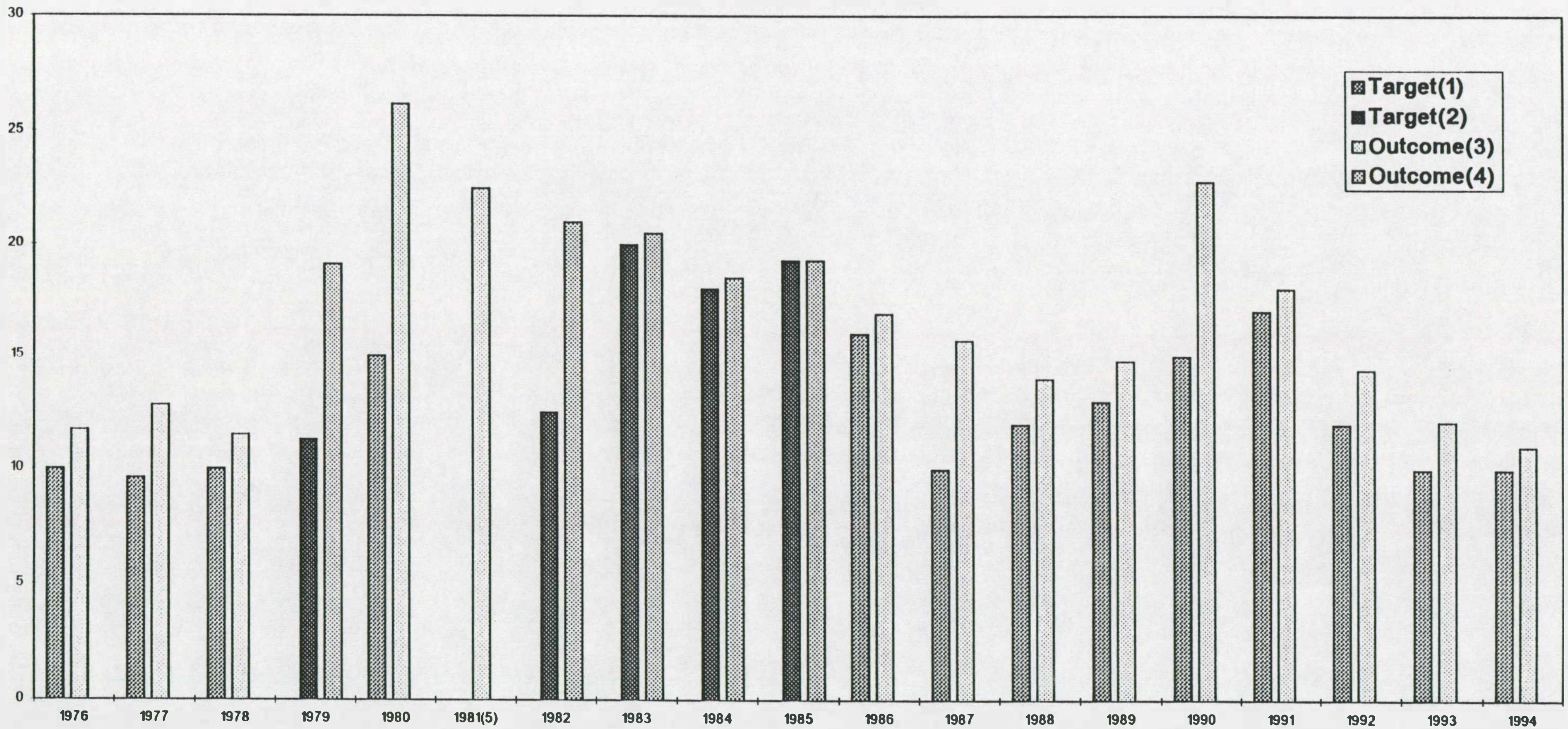
Source: Bank of Greece

1 1976-1982: Currency in circulation (M0); 1982-1994: Broad-money supply (M3)

2 1988-1994: upper limit of target range

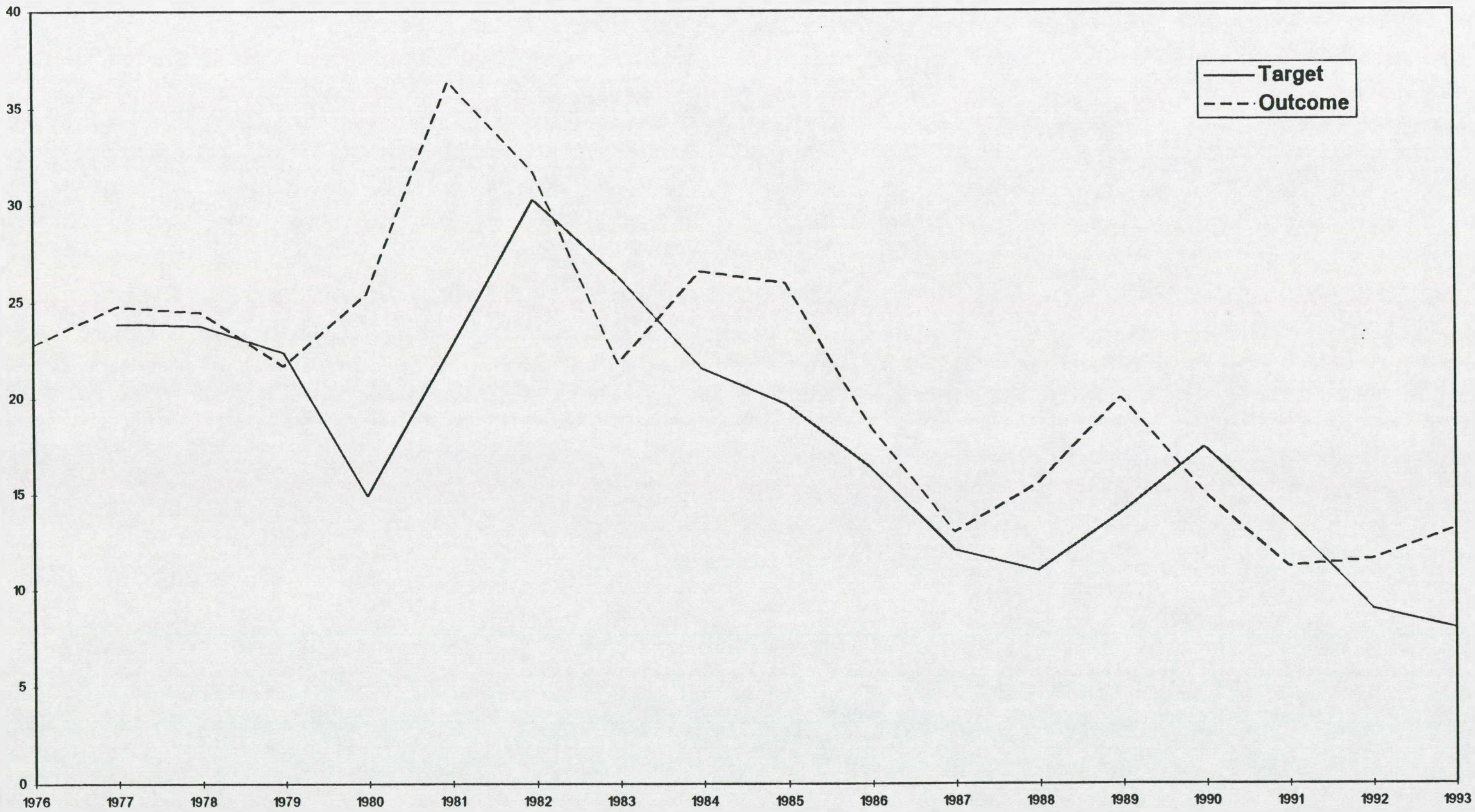
3 12 months to September 1994

Figure 4
Greece
Inflation Targets and Outcome
Percentage changes



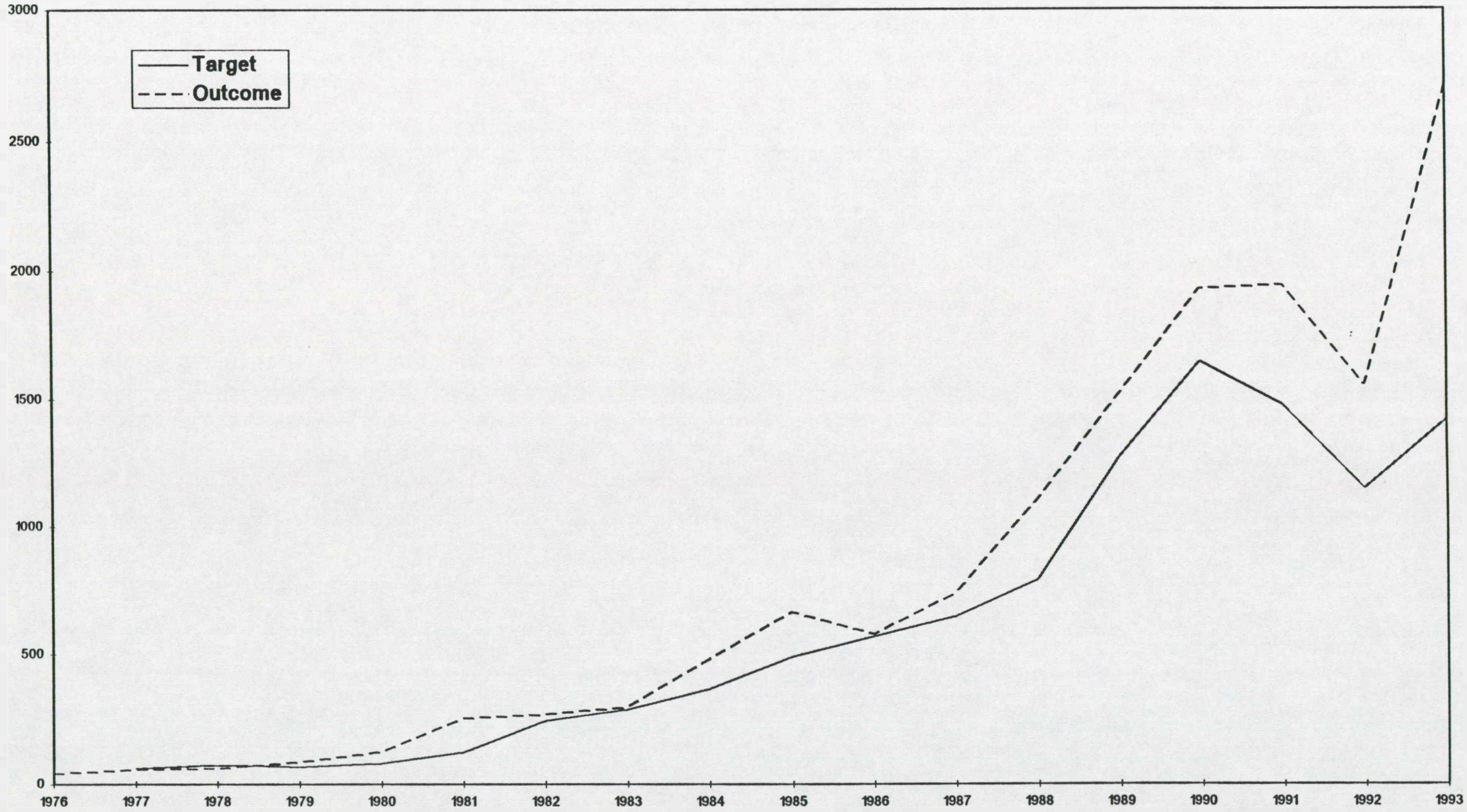
1 December on December
2 Year on year
3 December on December
4 Year on year
5 Target not available

Figure 5
Greece
Domestic Credit Expansion: Targets and Outcome
(Annual percentage change; end of year)



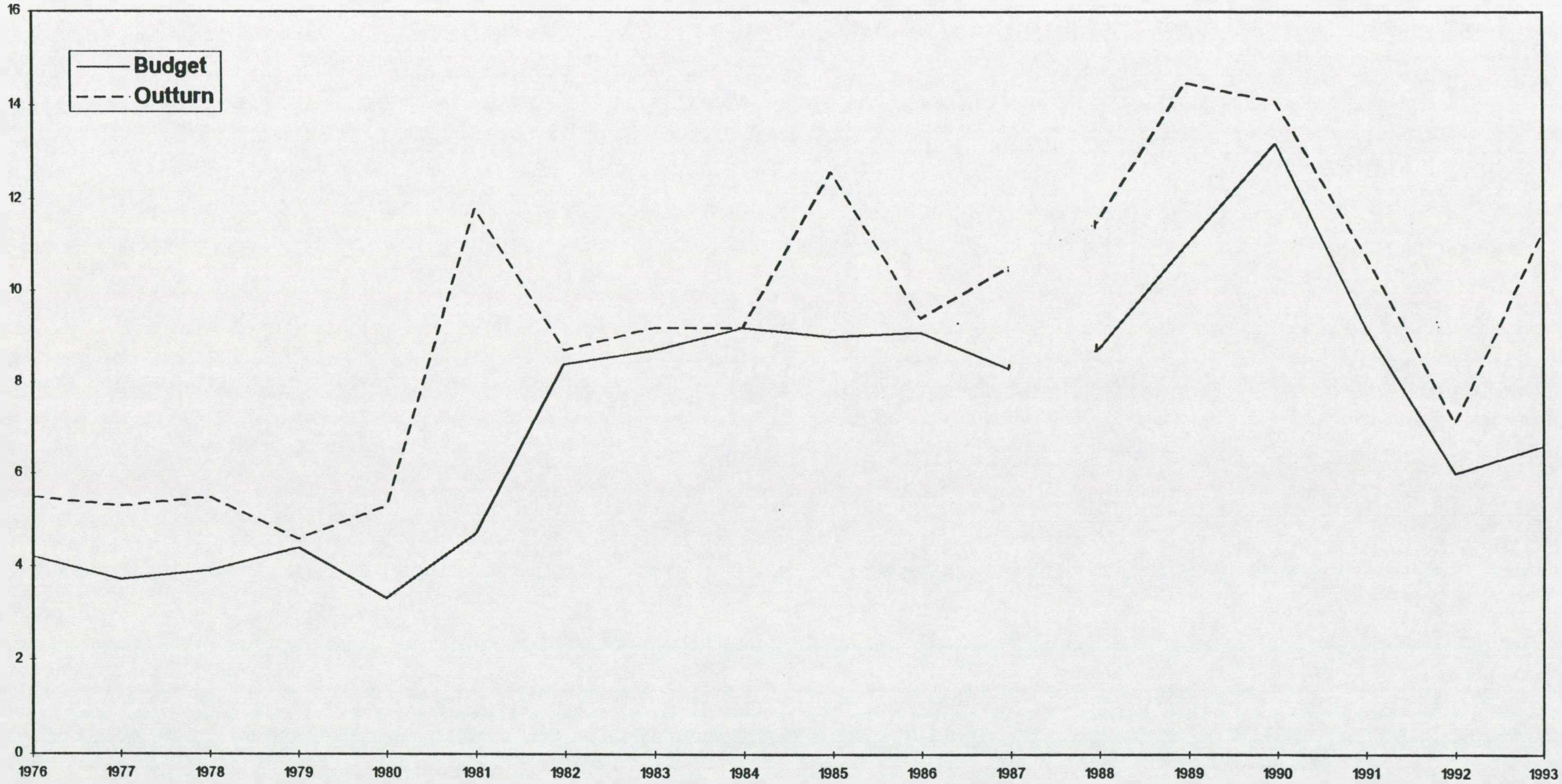
Source: Bank of Greece

Figure 6
Greece
Credit Expansion to Central Government (Net)
(End of year change in billion Drs)



Source: Bank of Greece

Figure 7
Greece
Central Government Net Deficits[1,2]
(In per cent of nominal GDP)

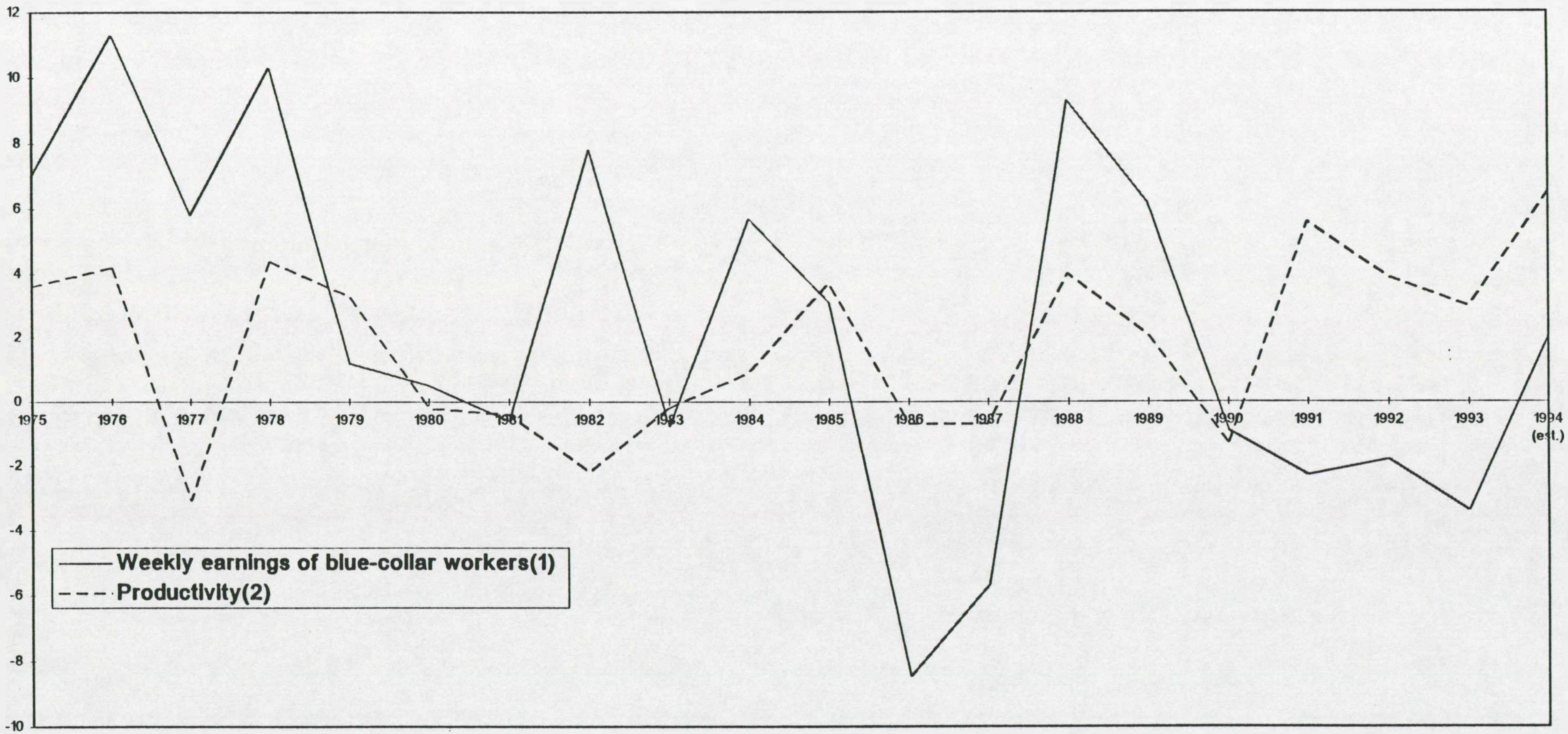


Source: Ministry of Finance, *Annual Budgets*

1 Accrual basis

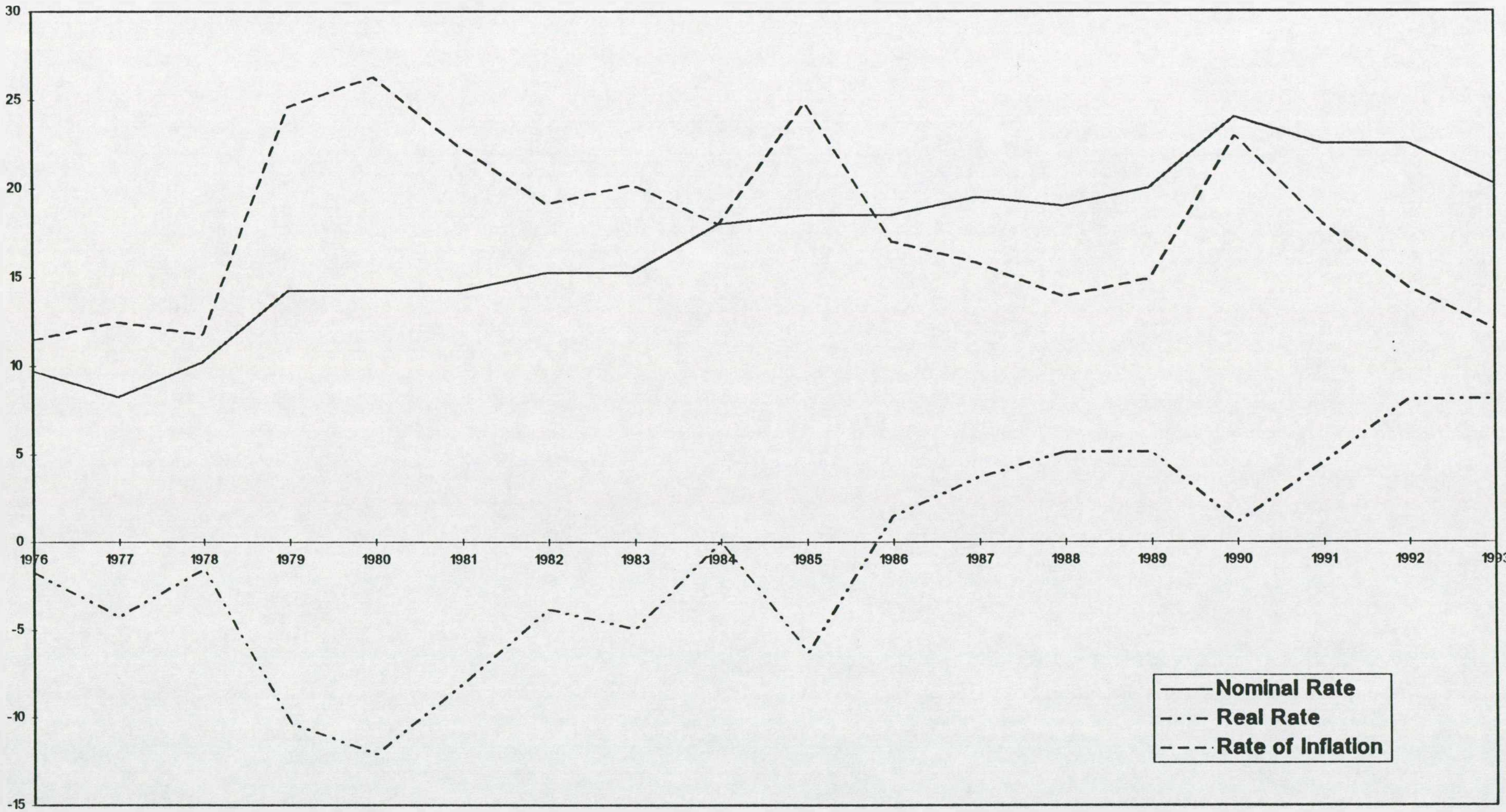
2 For the 1988-1993 period the Central Government net deficits are expressed in terms of the new nominal GDP, based on the European System of Integrated Accounts

Figure 8
Greece
Real Earnings and Productivity in Manufacturing
Percentage change per man



Source: National Statistical Service of Greece, Monthly Statistical Bulletin, and Bank of Greece estimates
1 In real terms
2 Output per worker

Figure 9
Greece
7-Month Treasury Bills Interest Rate and Inflation
(End of year)



Source: Bank of Greece