

The Medium-term Scenarios

Two scenarios are examined. The first assumes that the primary PSBR is reduced in stages until the ratio of public debt to GDP stabilizes and then declines. In the second scenario, fiscal policy is unchanged in the sense that the ratio of the primary PSBR to GDP remains constant at its value in 1989.

In the scenario with adjustment, fiscal measures are complemented by monetary and exchange rate policy (and implicitly by tough incomes policy). Adjustment is front-loaded and begins in 1990 with a cut in the primary PSBR equivalent to 4 percentage points of GDP, a 5 percent real devaluation of the drachma (through the year), and a rise in drachma interest rates. Real GDP increases by only 1 percent as fiscal stimulus is withdrawn from the economy. The real depreciation of the drachma supports export growth while reducing imports. Both the trade balance and the current account improve. Rising interest rates combine with the revaluation of external debt to boost interest payments by about 4 percentage points of GDP, and the overall PSBR remains broadly unchanged. In addition, higher interest rates on drachma assets help to restore confidence, allowing a larger proportion of the PSBR to be sold to the domestic nonbank public. This reduces the growth of broad money and helps to dampen the price effect of the devaluation.

Fiscal adjustment continues in 1991-94, although at a slower pace than in 1990. Real interest rates on drachma debt continue to rise slightly, while the exchange rate appreciates somewhat in real terms in 1991-92 in order to underscore the authorities' commitment to a nominal path. Growth and investment recover gradually, and there is a slight further reduction in the current account deficit relative to GDP. The ratio of the public sector debt to GDP stabilizes and then begins to decline, albeit slowly. In addition, the growth of broad money decelerates in line with reduced public sector domestic borrowing, and the rate of inflation falls until virtual price stability is established by 1995.

By contrast, the scenario without adjustment shows a deterioration on all fronts. With the primary deficit stuck at its 1989 level of 8.4 percent of GDP, public sector borrowing expands rapidly to cover rising interest payments. The continued real appreciation of the drachma slightly dampens the cost of foreign borrowing, but it also erodes external competitiveness. Real interest rates rise over time as both domestic and foreign creditors demand higher risk premia in response to the unsustainable course of fiscal policy. Despite the sharp increase in interest rates, sales of public debt to the non-bank public remain relatively modest.

Slower growth in invisible receipts and higher interest payments on foreign public debt contribute to a pronounced increase in the current account deficit, which reaches more than 10 percent of GDP by 1993. 1/ In addition, the foreign debt service ratio rises sharply.

Despite the large inflow of foreign financing, the greater reluctance of both foreign creditors and the domestic nonbank public to lend to the Greek government necessitates a reduction in foreign exchange reserves to finance the widening current account deficit. In addition, it forces the public authorities to rely more heavily on domestic bank financing. As a consequence, broad money expands rapidly and the rate of inflation exceeds 40 percent by 1993. 2/ Extended beyond 1993, the scenario becomes quite implausible--that is, it is inconceivable that policies would not be changed to prevent a runaway inflation and an external financial crisis. The scenario, therefore, is ended in 1993.

With the high public debt ratio, the dynamics of the model are very sensitive: it is easy to produce either vicious or virtuous circles. The two scenarios make an overwhelming case for rapid, front-loaded adjustment.

1/ The assumptions on trade, however, are rather generous; in fact the trade balance might deteriorate much more rapidly than is shown in the scenario.

2/ This figure might be too low because of generous assumptions on both velocity and sales of government debt to the nonbank public.

Scenario 1: Full adjustment

[SUMTRD]

1987 1988 1989 1990 1991 1992 1993 1994 1995

(percentage changes)

Nominal GDP	14.2%	19.0%	16.5%	10.7%	14.0%	7.9%	7.9%	7.2%	6.4%
Real GDP	-0.1%	3.9%	2.4%	1.0%	1.5%	1.5%	2.0%	2.5%	3.0%
Broad money	24.7%	22.9%	24.0%	21.0%	18.7%	12.4%	12.4%	11.6%	10.9%
Prices	14.2%	14.5%	13.8%	17.5%	12.3%	6.3%	5.8%	4.6%	3.3%
Export volume (non-oil)	---	---	---	6.6%	6.6%	6.2%	6.2%	6.2%	6.8%
Import volume (non-oil)	---	---	---	0.7%	2.7%	2.9%	4.2%	5.4%	5.9%
Real drachma appreciation	---	---	---	-5.0%	1.5%	0.5%	0.0%	0.0%	0.0%

(in percent of GDP)

Net PSBR	-13.5%	-15.5%	-19.2%	-19.3%	-15.2%	-9.9%	-8.7%	-7.8%	-6.7%
Net PSBR excluding interest	-3.8%	-4.7%	-0.4%	-4.4%	-2.5%	-0.5%	0.6%	0.7%	0.9%
Interest payments	-9.6%	-10.8%	-10.6%	-14.8%	-12.0%	-9.4%	-9.3%	-8.4%	-7.5%
Public debt	93.0%	100.5%	107.3%	109.7%	111.4%	113.2%	113.6%	113.7%	113.5%
Domestic	58.9%	67.7%	76.1%	77.7%	81.2%	84.0%	85.5%	86.8%	87.7%
External	34.1%	32.7%	31.1%	32.0%	30.2%	29.2%	28.0%	26.9%	25.8%
Debt service ratio	-24.9%	-23.3%	-22.1%	-22.1%	-27.9%	-25.9%	-23.9%	-22.1%	-20.4%
Current account deficit	-2.6%	-1.8%	-4.7%	-3.9%	-3.8%	-3.4%	-3.0%	-3.0%	-2.9%
Non-debt capital inflows	3.3%	3.5%	3.1%	3.2%	3.2%	3.2%	3.1%	3.0%	3.0%

Scenario 2: No adjustment

[SUMMARY]

	1987	1988	1989	1990	1991	1992	1993
(percentage changes)							
Nominal GDP	14.2%	19.0%	16.5%	20.6%	27.0%	38.3%	51.5%
Real GDP	-0.1%	3.9%	2.4%	2.2%	2.0%	2.0%	2.0%
Broad money	24.7%	22.9%	24.0%	26.4%	33.1%	44.1%	57.8%
Prices	14.2%	14.5%	13.8%	18.0%	25.3%	35.6%	48.6%
Export volume (non-oil)	---	---	---	3.7%	3.5%	2.9%	2.5%
Import volume (non-oil)	---	---	---	7.3%	7.3%	7.8%	8.3%
Real drachma appreciation	---	---	---	1.0%	1.0%	1.0%	1.0%

(in percent of GDP)

Net PSBR	-13.5%	-15.5%	-19.2%	-23.7%	-29.7%	-36.5%	-43.4%
Net PSBR excluding interest	-3.8%	-4.7%	-8.4%	-8.4%	-8.4%	-8.4%	-8.4%
Interest payments	-9.6%	-10.8%	-10.8%	-15.4%	-21.4%	-28.2%	-35.0%
Public debt	93.0%	100.5%	107.3%	112.7%	117.9%	121.8%	123.8%
Domestic	50.9%	67.7%	76.1%	78.6%	79.4%	77.8%	72.8%
External	31.1%	32.7%	31.1%	34.1%	38.5%	43.9%	51.0%
Debt service ratio	-24.9%	-23.3%	-22.1%	-24.4%	-33.0%	-33.3%	-34.0%
Current account deficit	-2.6%	-1.8%	-4.7%	-7.0%	-8.4%	-9.6%	-11.0%
Non-debt capital inflows	3.3%	3.5%	3.1%	2.5%	2.3%	2.2%	2.0%