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I. RECENT TRENDS, POLICIES AND SHORT-TERM FORECASTS

1. In the past, the conjunctural cycle was broadly synchronised with that of OECD Europe, especially during upswings. In the more recent period, the situation has changed significantly. The recovery in Greece (which began in the first half of 1984) lagged by just over one year. Strong export growth of goods and services since the first half of 1983 was associated with a weak recovery in domestic demand about a year later. On the contrary, the slowdown in export growth since the second half of 1984 was immediately reflected in a marked deceleration in GNP growth. The origin of such assymetrical behaviour is to be found in the existence of large macro-economic imbalances and structural rigidities (analysed in greater detail in Part II of the draft Survey), which have led to a less favourable response of the Greek economy to changes in world demand.

The economy in 1984-1985

Demand and output

2. Booming exports of goods and services were, as in almost all the

southern OECD European countries, the main element of strength in 1984. Merchandise export volume grew by about 12 per cent partly helped by the disappearance of certain supply bottlenecks (following the reactivation of some "ailing" firms in 1984) and buoyant agricultural output. The weakness of domestic demand and more active exchange rate policy since the autumn of 1983 also contributed. Greece gained market shares in both 1983 and 1984, largely offsetting the losses of the two previous years. However, export growth decelerated since the middle of 1984, in line with world trade developments. Given the surge in imports since the end of 1984, net exports may give only a small boost to GDP growth this year. For 1985 as a whole, merchandise import volumes are expected to grow by about 4 per cent or an elasticity with respect to GNP of a little over 2 1/2, broadly in line with longer-term trends.

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Import penetration for certain categories is even more dramatic than suggested by these figures. Whereas manufacturing output has remained broadly stagnant in the three years to 1985, import volume of manufactures may have risen by roughly 13 per cent over the same period.

(Table 1. Demand and output)

3. On the domestic side, public sector investment and consumption were the most expansionary demand components in 1984 and 1985. The steep upward trend of public sector investment over the last few years reflects the urgent need to palliate important deficiencies in the economic and social infrastructure. The growth in government consumption is partly related to an increase in employment. Private consumption growth was fairly modest in 1984-1985 being concentrated on certain imported durables and motor cars. In Greece the purchase of motor cars is considered by many households as an investment. The strong demand for cars since 1982 is also explained by reduced alternative investment opportunities, notably in housing. The significant change in income distribution in favour of farmers and low income categories since around 1980 also made possible for large sectors of the population to become car owners, despite the very high cost of cars (1). The increase in household real disposable income in 1984 was due to a big rise in farm income and in the wage bill, as certain shortfalls in pay in the previous year (delays in the implementation of the automatic wage-price indexation) were made good in 1984. Household real disposable income may have fallen marginally in 1985, largely reflecting a slower real rise in all income categories. Private consumption should, nevertheless, continue to expand somewhat supported by a decline in the saving rate (which would, nevertheless, remain at a

historically high level). 6A 02

(Table 2. Household income)

4. Private fixed investment after a sharp decline in 1984 has probably fallen only slightly in 1985. Private residential investment was the most depressive element in 1984. In spite of some recovery in 1985, the cumulative fall of private residential investment may reach almost 50 per cent between its last peak at the end of the 1970s and 1985. Structural reasons (the end of rapid urbanisation partly resulting from the deterioration of the quality of life in cities), institutional changes (the imposition of a wealth tax on real estate and rent controls) and conjunctural factors (very small growth of household real disposable income and poor employment prospects) are largely responsible for this steep decline. Reflecting the squeeze on profits and the

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1. The price of medium-sized cars in Greece is about twice as high as in most OECD countries and for larger cars three to four times as high. Given the low per capita income, the real value of cars is much higher, which explains that the average life of private motor cars in Greece may be close to 15 to 20 years. For the same reason the second hand price of motor cars is much higher than in most OECD countries. Due to inflation and the devaluation of the drachma, the second hand value of a car is sometimes higher than its price when it was new, which gives an illusion of capital gains.

uncertain business climate, private business investment seems to have continued to decline in 1984-1985. In addition, weak sales prospects, rising real interest rates and extensive price controls which discourage inventory accumulation (especially speculative) explain the continuous fall in the rate of stockbuilding. Nevertheless, by international standards stockbuilding was still relatively high in 1984-1985, suggesting that there is considerable scope for improving distribution channels and strengthening the cash flow situation of business, by more efficient stock management techniques. Domestic demand may, for the first time in 1985, marginally exceed its previous peak of 1979. Although modest compared with past trends, the 1 1/4 per cent annual rate of growth of domestic demand in the two years to 1985 was probably excessive from the point of view of not impairing the fragile balance of payments situation. The $800 million increase in the current external deficit between 1983 and 1985 to almost 8 per cent of GDP or the highest ratio recorded over a very long period, illustrates the dramatic deterioration in the trade-off between domestic demand and the external position.

(Diagram 1. Investment ratios)

5. On the output side, the swing in agricultural output from a sharp fall in 1983 to a sharp rise in 1984 followed by a more modest increase in 1985 partly explains the sharp recovery in GDP in 1984 (1) and its subsequent slowdown. In both years output from services grew faster than GDP influenced by the expansion of the public sector, the upturn in tourism and the substantial rise in farm incomes. In contrast to what could have been expected in a cyclical upturn and to developments in the rest of the OECD

area, the recovery in manufacturing output was very modest. As a result, its level in 1985 was still about 3 per cent below the 1980 peak, whereas in almost all OECD countries output exceeded its previous peak. Moreover, the recovery was narrow and fragile as many important sectors recorded substantial declines in output reflecting structural weaknesses (discussed in Part II). After benefitting considerably in the past from net factor income from abroad (to the tune of 3 1/4 per cent of GDP in the five years to 1981), this item has been declining rapidly since the early 1980s and is expected to turn negative for the first time in 1985. This has been translated in a markedly slower rate of growth of GNP than GDP in both 1984 and 1985 (by 0.8 and 0.4 percentage points respectively).

6. Greek labour force statistics suffer from important shortcomings making it impossible to assess with accuracy labour market developments. The few data available suggest a modest increase in employment in 1984-1985, as the small decline in the agricultural labour force was more than offset by increases in dependent employment and in the self-employed. The fastest

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1. Agricultural output contributed almost one-third to the growth of GDP in 1984.

growing category was employment in services almost exclusively led by continuing substantial increases in employment in the public sector and in banks (most of which are under public sector control) at around 3 per cent per annum. Traditionally, employment in the public sector is viewed as a means of alleviating unemployment, especially in periods of slack. Dependent employment in the private sector proper is expected to decline in 1985 after remaining broadly flat in 1984. In the three years to 1985 employment in manufacturing declined by around 2 1/2 per cent, a modest increase in 1984 being followed by a renewed fall since early 1985. Unemployment has continued to edge upward to just over 8 per cent of the labour force in mid-1985. However, this figure conceals important differences between regions and age groups. Urban areas, notably Salonika, continued to experience the highest unemployment rate while young age groups (up to 24 years old) account for probably over 60 per cent of total unemployment. The unemployment rate exceeds 10 per cent in urban areas, which is comparable to that of OECD Europe. In a country where there is still a large agricultural sector (one-fourth of employment) and where small to medium size farms is the rule, it is natural for unemployment in rural areas to be relatively small. However, disguised unemployment and underemployment may still be important.

Prices and incomes

7. Reducing inflation (1) has been one of the authorities' major policy objectives over the last few years, but the task was more difficult than originally anticipated. Inflation fell from 23 per cent in 1981 to 18 per cent in 1984. The decline was relatively small when compared with

developments in the rest of the OECD and achieved at a significant cost. 02

Price controls were extensively applied and although in a few areas these were justified because of speculative pressures, in others they led to a severe compression of profits (or aggravation of losses). More recently, some controls were eased without apparently leading to unjustified price increases. Sluggish market conditions combined with growing import competition, especially after Greece's accession to the EEC, also contributed to restraining price rises (and compressing profit margins). Similarly, increases in administered prices were kept artificially small resulting in significant operating deficits in many public sector agencies. Had administered prices risen in line with costs, the annual rate of inflation would have been higher by around 1 percentage point between 1980 and 1984. Energy prices and certain transport fees were raised in the third quarter of 1985 so that price trends will better reflect costs this year. This largely explains the relatively small progress made in 1985, with inflation still expected to be of the order of 18 per cent on average for the year (2).

(Table 4. Wages and salaries)

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1. Inflation is measured by the private consumption implicit price deflator (national accounts basis) unless otherwise stated.

2. According to Secretariat estimates, had the above adjustment in administered prices taken place in 1984, the year-on-year rise in consumer prices would have fallen from about 19 per cent at the end of 1984 to around 17 per cent at the end of 1985.

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8. Rapidly rising labour costs coupled with near stagnant productivity since the early 1980s are the principal factors behind continuing strong inflation. This is reflected in the steady increase in the GNP deflator (which is the most comprehensive indicator of domestic cost trends) at around 20 per cent between 1980 and 1985. The substantial pay rises (both in real and nominal terms) granted in 1982 gave an initial strong push to labour costs, which combined with the indexation mechanism in operation since 1982 (known as ATA) fed the inflationary spiral in the four years to 1985. This system provides for automatic pay adjustments every four months; the majority of employees receive full indexation but those with higher earnings suffer a small loss in real pay. However, this is in turn more than offset by wage drift and considerable real pay rises for those receiving minimum wages and salaries. As a result on average the increase in labour costs per employee has considerably exceeded both that of the GDP deflator and of consumer prices since 1981. Though attenuated, this trend persisted in 1984-1985. Accordingly, both <u>real</u> labour costs in production and <u>real</u> earnings rose appreciably over this period entailing a proportionately stronger decline in profits and investible funds. The public sector and banks (most of which are controlled by the state) have been pacesetters over a long period. The annual rate of increase of average pay in both sectors has exceeded by nearly 4 percentage points that of the private sector since 1981; with the difference narrowing somewhat over the last two years. Pay rises in competing sectors and especially in manufacturing also exceeded the national average contributing to the erosion of Greece's external competitiveness. Given the overall disappointing productivity performance since 1980, it is hardly surprising that underlying inflationary pressures have remained strong. (Despite a small improvement over the last two years in 1985 productivity per

man in manufacturing was still about 4 per cent below its 1979 peak). To sum up, unit labour costs in manufacturing grew by almost 20 per cent on average since 1983 (1) (36 per cent in 1982), or much more than in trading partners. This more than offset the effective depreciation of the drachma.

(Diagram 2. Productivity and labour costs)

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1. Based on a productivity increase of around 2 1/2 per cent, unit labour costs in manufacturing are estimated to grow by just over 17 per cent in 1985. However, the former is largely due to the closure of a number of plants and not so much on genuine productivity gains in plants in operation (because of the government's policy of discouraging labour shake out). Accordingly the underlying rate of growth of productivity is less than 2 1/2 per cent implying a steeper increase than 17 per cent in unit labour costs in plants in operation.

The balance of payments

9. Following a small improvement in 1982 and 1983, largely related to sluggish economic conditions, the current external deficit widened again thereafter. In the first seven months of 1985 it reached a seasonably adjusted annual rate of nearly $3 billion, or about 8 per cent of GDP. All principal items of the current account contributed to this deterioration, which worsened after the end of 1984. In addition to structural and more permanent factors, (inefficient production pattern, reduced external competitiveness since 1982, long-term decline in invisible receipts, etc.) cyclical reasons also contributed to the rising deficit. The revival of domestic demand in 1984-1985 coupled with the strong bias of consumers in favour of imports also played an important role. Capital outflows appear to have increased, reflecting an uncertain business climate and more profitable real and financial investment opportunities abroad (1). Speculation on a sudden and sizeable devaluation of the drachma as well as leads and lags have probably also contributed. Substantial fluctuations in the exchange rate of the principal international currencies have created uncertainties and led to disturbances on the drachma exchange market (2). A more active exchange rate policy and the greater emphasis recently put by the new government on stabilization policies (3) should help to curb capital outflows towards the end of the year.

(Diagram 3. Exchange rates)

(Table 5. Balance of payments)

10. After remaining broadly unchanged in 1984 the trade deficit on a

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settlement basis increased significantly in the seven months of 1985. The oil

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1. Though the differential has been reduced since the middle of 1984, real interest rates on deposits are still considerably lower in Greece than in the Eurocurrency markets.

2. In evaluating exchange rate changes the Greek public attaches primordial importance to the dollar/drachma rate and pays considerably less attention to the change of the effective rate of the drachma. Accordingly, when the dollar rises in world markets sometimes the authorities, in order not to unsettle market sentiment, feel more prudent not to let the drachma depreciate substantially. This explains its effective appreciation in real and even sometimes in nominal terms for short periods.

3. General elections were held in June 1985. PASOK (the Socialist Party) retained the absolute majority in Parliament. However, there were important changes in the new government formed after the elections, notably many ministers and secretaries of state dealing with economic affairs were changed. The new Minister of National Economy has announced that one of the principal short-term government objectives is to reduce the excessive balance of payments deficit and already measures have been introduced to this end.

bill rose further despite the reduction in oil dollar prices suggesting continuing strong volume growth. It seems that arrangements concerning oil imports did not permit Greece to benefit as much as other OECD countries from the fall in the international price of oil. After a small improvement in 1984 the non-oil trade deficit widened markedly in the first seven months of 1985, due to a decline in exports and to an increase in imports. Exporters curbed the rise in prices in order to remain competitive and also due to a marked slowdown in volume growth. The structural decline in the invisible surplus is a matter of concern. After reaching a peak in 1980-1981, shipping remittances have fallen by almost one half to an annual rate of less than $1 billion in the first half of 1985. The world shipping crisis and the contraction of the Greek owned fleet largely explains this trend. The growing external debt has been accompanied by rising servicing charges -- interest payments more than doubled in five years to over $1 1/4 billion (annual rate) in the first seven months of 1985. After a substantial increase between 1981 and 1983 net EEC transfers have stagnated since then, at around $700 million annually. The only favourable trend is the recovery in tourist receipts, but at about $1.4 billion (annual rate) in the first seven months of 1985 they were still $400 million below their 1980-1981 peak. Autonomous non-financial capital inflows have remained broadly flat over the last three years at about $700 million, down by about one-third since 1980-1981. Public sector compensatory borrowing filled the widening basic balance deficit. In 1985, net public sector borrowing will probably exceed $2 billion compared with $1 1/2 billion in 1984 and $3/4 billion in 1980-1981 (1).

Economic policies

11. The policy stance was planned to be moderately restrictive in 1984 with a view to alleviating inflationary pressures and reducing imbalances. The PSBR (net public sector borrowing requirement) was officially projected to decline slightly, monetary expansion to slow down, inflationary pressures to ease and the balance of payments deficit to roughly stabilize at its 1982-83 levels. In the event, policies were considerably relaxed in the course of 1984 so that the stance turned out to be fairly expansionary. Instead of declining, the PSBR surged to 15 1/2 per cent of GDP (the highest rate for over 30 years), monetary targets were overshot, underlying inflation remained unchanged at about the high rates of 1983 and the balance of payments situation deteriorated. Developments in 1985 are also unsatisfactory; in most sectors the outturn will be worse than initially forecast by the authorities. These trends may be explained by the following factors: insufficient coordination; lack of consistency among certain targets (and

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1. Gross borrowing by the public sector will be around $3 billion in 1985 compared with just over $2 billion in 1984. The Bank of Greece is the principal borrower in 1985 (about two-thirds of the total) followed by public corporations and enterprises. Central government borrowing is relatively unimportant.

also between targets on the one hand and policy instruments on the other); the propensity of many government and public sector agencies to overspend; lack of adequate institutional mechanisms and of efficient administration to ensure close adherence to stated policies and targets.

(Table 6. Public sector accounts)

Fiscal developments

12. The implementation of the central government budget for 1984 (on an administrative basis, Table 7) proved more difficult than expected. There was a shortfall on personal income tax receipts mainly because measures against tax evasion did not produce as much as had been estimated. The endemic problem of tax evasion cannot be solved in the short-run as the legal and institutional apparatus as well as public conscience is not adequately developed to cope with such an important problem. Indirect taxes increased more than budgeted, almost exclusively due to the higher yields from the rise in taxes on oil and motor cars, reflecting the strong increase in oil consumption and private car purchases. Expenditure was broadly contained within budget limits; a somewhat faster increase in current expenditure was roughly offset by a slower rise in investment (1). The former is due to a marked overshooting in interest payments, largely caused by higher interest rates (mainly domestic) and, to a lesser extent by the appreciation of the U.S. dollar. The increase in the deficit of the "oil account" (to about 1 1/4 per cent of GDP in 1984) and of the combined deficits of public sector corporations and enterprises is due, on the one hand to the policy of keeping the rise in charges and fees below that of costs and on the other hand, to the

fast growth of investment expenditure (about 15 per cent in real terms in 1984). The deficits (excluding central government transfers) of the Social Security and of the Local Authorities continued to increase in 1984 (mainly due to the growth of the pension bill and investment expenditure respectively). Not only did the PSBR rise appreciably in 1984 but also in contrast to 1983, the Bank of Greece financed a substantial part of it. The monetisation of the public sector deficit strengthens inflationary trends over the medium term. External borrowing financed a smaller share in 1984 but in absolute terms foreign loans almost doubled between 1983 and 1984 reaching record levels (4 1/4 per cent of GDP).

(Table 7. Ordinary and investment budgets)

13. The 1985 Budget is expansionary: general government expenditure is planned to increase in nominal terms by almost 2 percentage points to about 47 per cent of GDP. The general government deficit and that of public corporations and enterprises is also expected to rise slightly (due to a steep rise in investment). The Budget provides for an appreciable increase in direct taxes (50 per cent) due to expected progress against tax evasion and more importantly to an acceleration in the collection of tax arrears. On the other hand, tax allowances were raised and tax rates lowered so that the real

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1. The 1983 and 1984 budgets projected cumulative increases in investment of 85 per cent in nominal terms (about 23 per cent in real terms) which could not be easily achieved following four years of near stagnation (in real terms). This explains the shortfall in investment expenditure.

tax burden on household income earned in 1985 (especially on employment income) is expected to decline significantly (1). The steep rise in current expenditure (28 1/4 per cent) is again led by interest payments (50 per cent up on 1984), investment (27 per cent) and the wage bill (25 per cent). The latter implies an increase in real average pay of about 3 1/2 per cent, mainly accounted for by the introduction of the unified salary system a new grading and salary system) in the civil service and the conversion of extraordinary and other categories of government employees into permanent civil servants. The level of expenditure and the PSBR are again likely to exceed budget projections. When the 1985 budget was prepared, the authorities had overestimated the growth of GDP for 1985 so that the cyclical component of the deficit will tend to be higher, fiscal trends for 1984 also looked better than they actually turned out to be (so that the carry-over from 1984 will be worse than originally expected). Finally, inflation will be higher than had been assumed. The increase in the tax rate on selected oil products last August will have a limited impact on fiscal aggregates this year. Overall, the PSBR may reach almost 17 per cent of GDP in 1985. Under these conditions the central government debt will rise further to nearly 59 per cent of GNP, compared with 35 per cent in 1982 and 27 per cent in 1979. The increase in the total public sector debt was probably somewhat slower but still significant, and at about two-thirds of GDP it is one of the highest in the OECD area.

(Table 8. General government accounts)

Monetary policy

14. Major reforms have been introduced by the Bank of Greece over the last

few years, with the aim of improving the functioning of the financial market and the efficiency of monetary management. So far, these reforms do not seem to have had a significant influence on monetary conditions. This may be due to: the heavy demands to finance the growing public sector deficits; the underdeveloped state of the financial system and of the capital market; the growing policy emphasis on maintaining a high level of employment through a rapid expansion in bank credit; the external constraint and large fluctuations in the foreign exchange markets and interest rates abroad. The monetary stance has remained accommodating in 1984-85 with developments strongly influenced by the need to finance the sizeable and growing PSBR. Domestic credit expansion reached 25 1/2 per cent in 1984, exceeding by about five percentage points both the 1983 outcome and the initial official projections. Credit to the public sector grew by 32 per cent and that to the central government at a somewhat faster rate. In order to finance the PSBR,

(Table 9. Domestic credit expansion)

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1. The 1985 reduction of the tax burden may raise real take home pay of an average employee by about 1 1/2 per cent compared with a fiscal drag of about 1 per cent in 1984.

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not only had the banks to increase their obligatory investment in Treasury bills and loans to public corporations by one percentage point (for each of them), but also after an interruption in 1983 the central government resorted again to Bank of Greece finance.

15. Domestic credit expansion to the private sector was considerably slower in 1984 than that to the public sector and only marginally above the target of the monetary programme. The excess was due to the rapid expansion of housing loans (partly reflecting a backlog of demands not cleared in 1983) and to the failure to curb the high rate of growth of credit to agriculture. The continuing steep increase in agricultural investment since 1982 (to a record level of 1 3/4 per cent of GDP in 1984) partly explains the rapid rate of growth of this credit category. However, round-tripping was also probably taking place as deposit rates are considerably higher than interest rates on agricultural loans. This distortion needs to be corrected not only in order to avoid round-tripping but also to ensure a better allocation of scarce resources. Credit to handicraft increased rapidly, albeit less than provided under the monetary programme, as demand was weaker than originally expected. Sluggish demand for investment in manufacturing also contributed to the relatively slow growth of credit to manufacturing (at an underlying rate (1) of about 16 per cent in 1983 and 1984). Since a significant part of this credit was channelled to "ailing" firms (see Part III), the growth of credit to other manufacturing branches and firms with better prospects for expansion seems to have been even slower. This underlines not only the loss of dynamism due to structural and other reasons (see Part II) but also the aversion of entrepreneurs to take risks in the uncertain business climate that has prevailed since the end of the 1970s.

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(Table 10. Monetary indicators) 02

(Diagram 4. Interest rates)

16. The overshooting of the credit targets led to an excessive growth of the principal monetary aggregates. M3 grew by nearly 30 per cent in 1984 and on average at an annual rate of about 29 per cent in the four years to end-1984. Such high underlying rate constantly above the growth of nominal GNP has led to excessive liquidity of the economy. This steep growth is only to a limited degree due to the more widespread use of the financial system for transaction purposes. The main reasons are to be found in the marked reduction of alternative investment opportunities (due to the depressed state of the stock exchange (2) and real estate market) and the shift in income

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1. The small acceleration in the growth rate of credit to manufacturing between 1983 and 1984 is due to temporarily stopping production in certain industries in 1984 and to the restoration of production in 1984.

2. See Part III, Financial Reforms.

distribution in favour of low income categories with less capability to undertake direct investment. Indeed, the majority of households have no alternative choice than putting their savings in bank deposits. It seems that the money illusion is weakening and the structure of private sector deposits is becoming more sensitive to changes in real interest rates. Allowing for two specific factors, which inflated M1 in December 1984 (1), the shift in favour of time deposits in 1983 was confirmed in 1984 as real interest rates continued to edge up. "Special time deposits", for relatively large sums carrying interest rates of up to 20 per cent, increased by about 50 per cent in 1984. The adjustment towards a more unified interest rate structure and more realistic interest rate levels continued in 1984 and 1985. Interest rates on many deposits were raised by up to 1 1/2 per cent in 1984, (there were no significant changes in 1985), which combined with slower consumer price increases led to a rise in real interest rates of roughly three percentage points between 1983 and 1984. However, most categories of deposits still carry negative real interest rates. Lending rates for most categories of loans did not change although there was a substantial increase for loans to certain public agencies and for certain categories of agricultural loans with a view to discouraging unnecessary and sometimes speculative stockpiling.

(Table 11. Monetary Programme for 1985)

17. The Monetary Programme for 1985 projects continuing fast domestic credit expansion (23 per cent), with the growth of credit to the public sector again exceeding that to the private sector (27 per cent and 18 per cent respectively). M3 is planned to rise by about 22 1/2 per cent pointing to a further increase in the liquidity of the economy. The Programme forecasts new

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issues of bonds and for the first time the public will be allowed to directly purchase Treasury bills (some Dr.100 billion are expected to be raised in this way). A further big rise in external funds is also projected for 1985 reflecting the growing reliance on foreign borrowing to finance domestic activity. Monetary and credit aggregates are again expected to overshoot their targets, largely due to excessive growth of demand for credit by the public sector and to a lesser extent to an increase in agricultural credit. During the first five months of 1985 private sector deposits were rising by about [30 per cent] (almost twice as fast as projected in the Monetary Programme). A markedly slower growth in deposits is expected in the second half of the year because households had to draw on their savings in the summer to pay tax arrears, but also reflecting some policy tightening by the new government. New credit (in billion drachmae) to the public sector is expected to be twice as large in 1985 as that to the private sector, suggesting some crowding out. As in 1984, due to sluggish investment long-term credit to handicrafts and to industry may fall short of the target. But ex-ante demand for short-term credit by business seems to have remained strong and is unlikely to be satisfied.

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1. A bank strike at the end of the year and accounting adjustments by public enterprises led to an excessive growth of sight deposits in December 1984, which was subsequently made good in January 1985.

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The Outlook for 1986

18. Prospects for 1986 are subject to an unusual margin of uncertainty due to possible large exchange rate fluctuations, unsettled conditions in the oil and raw material markets, and to important policy measures likely to be announced after the draft survey is finalised. The new government formed after the June elections has shifted the focus of policies towards stabilization, with a view to reducing the most urgent imbalances and laying the ground for structural adjustment of the economy. The few measures already introduced confirm this new orientation. Certain administered prices were raised, with an increase in some urban transport fees of as much as 50 per cent. The Bank of Greece has also, over the last few months, allowed the drachma to depreciate in effective terms more than price differentials would have suggested, permitting to recoup part of the previous years' loss of competitiveness. The forecast for 1986 takes account of the latest measures but assumes no further policy changes. This may not be entirely realistic but there is as yet no detailed information on the forthcoming package of measures (1) and the 1986 Budget. Accordingly, it is assumed that the wage-price-indexation system (ATA) will be kept unchanged. Monetary and credit policies are expected to accommodate the public sectors' demand for finance, with detrimental consequences for private sector activity. The downward trend in the exchange rate is assumed to persist, so as to roughly offset price differentials vis-à-vis trading partners.

19. Fiscal policy is assumed to rmain expansionary, the implementation of the 1985 measures and the carryover from 1985 pointing to continuing rapid growth of government expenditure and a further increase of the general

government deficit. A major factor contributing to the steep rise in expenditure in 1986 as well, is the new unified salary scale in the civil service (introduced in the spring of 1985), under which substantial pay rises were accorded to most civil servants. Interest payments are also expected to increase rapidly. The general government deficit is, therefore, projected to rise to about 12 per cent of GDP in 1986. However, given the recent increases in administered prices and the fall in the price of oil, the deficit of the rest of the public sector is expected to be contained and may even fall marginally. Overall, the PSBR may stabilize at around 17 per cent of GDP in 1986. After two years of strong stimuli the public sector as a whole may therefore have a broadly neutral impact on the growth of GDP in 1986. Tight credit conditions for private borrowers will again have a depressive effect on business activity. It is, moreover, assumed that price controls will be maintained, so that apart from the effect of the large adjustment in administered prices, other price increases may decelerate somewhat in 1986.

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1. It is hoped that the Greek authorities will be able to inform the EDRC of the new policies in detail. The Secretariat will in turn prepare a new forecast for publication.

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Moderation in farm prices and producer costs should also contribute. For the second year running, the growth of unit labour costs in manufacturing may decelerate to some 17 per cent reflecting both lower wage increases and rising productivity. Inflation is expected to continue to edge downward in 1986, but at around 17 1/2 per cent, would still remain considerably higher than in the rest of the OECD (1).

20. Household real disposable income should again fall marginally next year, influenced by below average growth in income from agriculture and from property and entrepreneurship but also due to a further increase in income tax. The wage and salary bill is expected to continue rising markedly in real terms largely reflecting significant increases in real average earnings in the government sector. Despite the projected small fall in employment, the growth in the wage and salary bill in the non-government sector will be moderate, but still positive in real terms. Relatively large pay rises in public corporations and enterprises and in banks (mainly explained by the promotion and graduation system) will be largely responsible for the rise in private sector average earnings. In total, supported by a small decline in the savings ratio private consumption is projected to continue growing, at a rate of about 1 per cent. Following a steady and substantial decline over the last six years, private investment is predicted to pick up in 1986 but would still remain substantially below its 1979 peak. Private residential investment may continue growing moderately financed by bank credit. For the first time since 1979 business investment (2) may also rise marginally in 1986, almost exclusively due to new projects undertaken at the initiative of the public sector (3).

21. Government consumption and investment are projected to remain the most

expansionary domestic demand components. Nevertheless, a significant deceleration is expected in 1986 largely reflecting the greater attention paid by the authorities to domestic and external imbalances. Exports should be an important element of strength, positively influenced by moderate gains in competitiveness (reflecting the more dynamic exchange rate policy since mid-1985) and continuing slack in domestic demand. Nevertheless, this may not prevent a small loss of market shares. Import volume growth should remain somewhat slower than that of exports, whereas tourism, which

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1. The introduction of VAT, initially planned for January 1986, has been delayed due to technical reasons. This would certainly have had a detrimental impact on prices.

2. Firms in competing sectors of the economy which are directly controlled by the state or indirectly by state controlled banks, are also included in private business.

3. It is assumed that work on a new alumina plant (whose value is estimated at $450 million) will begin in 1986. This new project will be responsible for the small rise in business investment.

accounts for about one fourth of total exports of goods and services, is expected to display relative buoyancy. Overall, with a moderate boost to activity from the real foreign balance GDP may rise by around 1 3/4 per cent and GNP by just less than 1 1/2 per cent implying a further rise in net factor income payments abroad. For the first time after seven years, the growth in manufacturing production may exceed that of GDP. Total employment is projected to remain broadly unchanged in 1986. A modest decline in self-employment (including employers) may be roughly offset by a small increase in dependent employment. The fall in self-employment should exclusively be due to the retirement of old-age farmers. The increase in the number of civil servants will be responsible for the small growth of total dependent employment. Dependent employment in the private sector should decline, led by falling employment in manufacturing. On the assumption that present policies hampering lay offs will continue to operate, the decline in employment in manufacturing will largely reflect retirements (i.e. there will not be any significant shake-out). Unemployment will remain on a moderate upward trend, the increase being concentrated on younger age groups.

22. After its marked increase in 1985, the current external deficit may decline somewhat in 1986 to around $2 1/2 billion. Export volume growth may be more vigorous, helped by a faster expansion of markets; some fall in the oil bill is also predicted following the steep rise in administered oil prices, which should help to stem the growth of consumption; finally there may be some unwinding of this year's leads and lags (1). Capital flight appears to have gathered strength in 1985 and a return to more normal levels seems also probable in 1986. Nevertheless, the reversal of these trends will greatly depend on business sentiment and on the credibility of government

policies. The projected small improvement in the balance of payments position should not, as in 1982-83, be interpreted as a fundamental change. Underlying conditions may still continue to deteriorate, albeit at a slower pace than earlier, reflecting unfavourable terms of trade developments. Exporters may be expected to hold back price increases while importers will pass them on to retail prices because of low price elasticity of demand for most merchandise imports. Shipping receipts will also continue to decline reflecting the prolonged world shipping crisis and the appreciable contraction (one-third) of the greek fleet since 1981. In addition, the invisible account will negatively be influenced by rising interest payments associated with the growing external debt. Overall, the trade deficit may decline by around \$1/4 billion in 1986 to some \$5.6 billion while the invisible surplus may rise to just over \$3 billion, (a fall of roughly one-fourth from the average level between 1979 and 1983). A current external deficit of about \$2 1/2 billion would imply net compensatory financing of the order of \$2 billion and gross official borrowing of nearly \$3 billion.

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1. Widespread expectations of a sizeable devaluation of the drachma would seem to have influenced economic agents in 1985, with importers speeding up their payments and exporters (including tourist agents) delaying the rapatriation of export earnings.