

John Spraos

(A few facts and factual assumptions have not been fully checked at the time of typing. Logistics dictate that checking will have to wait until the day before the presentation of the paper. Some points made in this draft are therefore provisional.)

Since this conference is held to mark 10 years of Greece's membership of the European Community, I will begin with a brief survey of the macroeconomic record of the decade of the 'eighties. I will then discuss two major issues of policy which, in keeping with my assignment, are especially relevant to the open economy aspect of macroeconomic management in the last ten years or so. These issues are important in themselves but they also have a bearing on current and future policies. With this as background, I will offer some comments about current policies and will then conclude with a discussion of macroeconomic management in the run up to European Monetary Union (EMU).

#### The Macroeconomic Record.

It will not be news to this audience that the macroeconomic record of Greece in the 1980s was not impressive. Real GDP per head in the ten years 1980-89 grew at an annual rate of 1.1% against 2.6% in the period 1973-79. Our 1.1% p.a. in the 'eighties compares with 2.1% for the OECD average and 1.9% for the EEC. In the first two years of the 1990s our GDP is still stagnating. So we have been doing worse than we used to and on average only a little more than half as well

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\* Before starting on this paper I had discussions with a number of Greek economists and I have been supplied with data by many more. I have made explicit use of only a small fraction of the data I sought (but the rest has served as essential background) and I have not heeded much of the advice that I was offered, but I am deeply grateful to all of them. None bears any responsibility for what I have written. In alphabetical order they are: . Bibiri, N. Garganas, M. Gyparakis, K. Kossentou, B. Manessiotis, M. Massourakis, N. Paleocrassas, S. Panourgias, I. Sabethai, . Sidiropoulos, Y. Stournaras, P. Tinios, . Valademas, N. Zonzelos

as our partners in Europe and in the wider OECD world. I am not a GDP fetishist. It fails to capture much that is important, and I do not mean just environmental degradation. But with all its limitations, it is still a useful summary statistic. Whereas in the 'sixties and 'seventies we were catching up with Europe, in the 'eighties and early 'nineties we have been dropping back.

Unemployment, which stood at about 4% in 1981 according to survey data of the Greek National Statistical Service, had risen to about 8% by the mid-80s and then receded a little -- roughly to 7% -- still standing, however, considerably higher than at the beginning of the 'eighties.

Prices, as measured by the GDP deflator, rose at an annual rate of 18% between 1979 and 1989 and even faster in the last couple of years. Not only is this higher than in the period 1973-79 (when it averaged 15.5%) but also the deterioration was in contrast to the lowering of inflation in the EEC and the OECD, so that by the second half of the '80s Greece's relative position had worsened materially. (Source for above data, except unemployment: OECD, 1991a)

The current account averaged a deficit of 5.2% of GDP in the years 1980-89 and was about the same in 1990. This is, of course unsustainable. Experience suggests that autonomous capital inflows of the order of 3% of GDP may be expected. So, a current account deficit in excess of 3% must be financed by recourse to external borrowing, which cannot continue indefinitely. Thanks to the sharp and prolonged depreciation of the dollar and a couple of good years in the Balance of Payments (1986-87), Greece's outstanding foreign currency debt has a benign look since the mid-eighties: it constitutes now a lower percentage of GDP than at its peak in 1985. Nevertheless, the rise from 1980 to 1989 is large: from 10.6% to 31%. Some Latin American and African countries have much higher debt ratios but the Latin American debts were incurred in the more lax banking climate of the 1970s and the hardening in the eighties has had disastrous consequences for the countries concerned. To which it must be added that the Greek debt, as officially quoted,

does not include military debt nor the large deposits in Greek banks denominated in foreign currencies. Our foreign debt position, though uncomfortable, is not yet at danger level. We cannot, however, afford a current account deficit averaging 5% of GDP for many more years. This is a sensitive and weak link in our economic relations with the rest of the world.

At this point it should be said that in the first two years of the 'eighties, during which a different party was in power than in the rest of the decade, the performance of the economy was no better than in the decade as a whole. The growth rate of GDP per head was zero in the first two years while in the decade as a whole it was 1.1% p.a. Inflation (GDP deflator) proceeded at an annual rate of 18.7% in the first two years against 13% in the decade. The current account deficit averaged 6.0% of GDP in the first two years against 5.2% in the decade. (Allowing for the stock accumulation of petroleum in 1981, the last two numbers become virtually equal.) It would be crude in the extreme to use these numbers in order to rank the economic performance of the respective governments. Other things were not equal. The point of quoting the numbers is simply to indicate that poor performance in the 80s extended across the parties in power.

Not all was unmitigated gloom, however. Greece has done better than the EEC on the score of unemployment. On a comparable basis the unemployment rate in Greece in 1989 was 7.5% of the labour force against 8.9% in the EEC (Eurostat, Unemployment, a monthly bulletin). This is a positive point even though the position does not look so good for the under 25s, especially the females.

There is also a bright side on the income distribution front. I am one of those who consider certain aspects of income distribution as a legitimate macroeconomic concern and so I do not feel I stray outside my terms of reference in bringing this matter to your attention. The evidence available in Greece on income

distribution is meagre. But the national accounts show that the share of wages in non-agricultural GDP rose from 53.5% in 1980 to 55.4% in 1989 and this on top of a steep rise from 45.2% to 53.5% between 1974 and 1980. Even in the trough year of 1987, when the then operating stabilisation programme was biting hardest, the wage share was fractionally higher than at the beginning of the decade. Within the wage-earning population, equality also increased. On the assumption that wages and salaries changed exactly in the proportions prescribed by the wage indexation scheme (known by its acronym as ATA) plus the "corrective" wage increments of I.I.1982, the rise of nominal wages from 31.12.81 to 31.12.89 was for a typical low wage (15000 drs on 31.12.81) 407%, for a typical middle wage (36500 drs) 297% and for a typical high wage (30000 drs) 202%. The underlying assumption is not realistic and it exaggerates the degree of equalisation. But the direction is unmistakeable and the extent of equalisation was undoubtedly substantial. Mainly as a side-effect of this, there was also a substantial improvement of women's wages relatively to men's. For anybody with egalitarian leanings this was a positive development of the 80s, though not all the side-effects of greater equality were benign (see Spraos, 1989).

Lastly, let me put the decline in our rate of GDP growth in recent years in perspective. I said earlier that in the 'eighties we were losing ground relatively to the EEC whereas earlier we had been gaining. But in 1973-79 our lead was small (2.6% against 2.1% for the EEC in respect of GDP per head) and all the difference can be accounted for by a transitory element in our growth that was destined to die. It was the result of the large movement of the economically active population from low value added occupations in agriculture to higher value added employment in industry and services. This translated into growth of gross output per head, growth which would have taken place even if labour productivity in each sector remained constant. As urbanisation (inevitably) slowed down, so this growth component withered. So, our present position, though relatively worse does not contrast as sharply as it first appears with earlier years. In terms of sustainable growth,



the years 1973-79 were not a golden age when we were catching up with the advanced countries. And even before 1973, half the growth differential in our favour was also attributable to the same transitional phenomenon, which was then more pronounced.<sup>1/</sup>

I can now conclude this section. Even after all the qualifications have been made, the verdict must still be that the microeconomic performance of the 'eighties was a poor one. My purpose in making the qualifications was not to deny this fact but to counter a little the newspaper syndrome that only bad news are news, a syndrome which is demoralising and cynicism-inducing.

#### Absorption and Competitiveness in the 'Eighties.

The openness of the economy, which is emphasised in my assigned title, is something that a policy maker in Greece overlooks at his peril. For when the current account of the balance of payments is sick, poor macroeconomic performance turns into a crisis.<sup>2/</sup>

A thousand and one influences affect the current account. But from the macroeconomic standpoint the major influences are grouped under two headings -- absorption and competitiveness -- and I will follow this schema. Competitiveness is used in its common sense, every day meaning. I shall concretise it by measuring it in terms of a relative unit labour cost index. It is not a perfect measure and it is not the only measure. But the other measures are seriously flawed in that they register as improved competitiveness developments which damage competitiveness.<sup>3/</sup> Absorption is a concept very familiar to economists. For the benefit of non-economists here I explain that it refers to the aggregate demand for goods and services emanating from sources resident in the country relatively to the total flow of the country's output. Excess absorption spells trouble because it is reflected in a current account deficit. Growing uncompetitiveness spells trouble because we are increasingly undersold by foreigners in both the domestic market and the foreign markets, which

is again reflected in a current account deficit (unless the so-called Marshall-Lerner condition fails to be satisfied).

The challenge of adjustment to EEC membership is most directly manifested in the area of competitiveness. Competitiveness had to improve to compensate for the elimination of tariff and tariff-like import barriers and the abolition of export subsidies vis a vis fellow members. For a country which protected its industry, subsidised its exports and used tariffs for revenue-raising as much as Greece did, the adjustment required was not a mean one. The urgency and the size of the compensating response was to be cushioned by EEC transfers and these had reached 5% of GDP by 1990 (as recorded in the balance of payments accounts, as distinct from pure transfers) but they were not meant to obviate the need for adjustment to EEC membership, only to offset the burden of adjustment.

There was also another major development that in the 'eighties needed adjusting to by improvement in competitiveness. I refer to the shrinking contribution to our foreign currency revenue made by what I will call the "big three" -- travel, shipping and emigrants' remittances.

The big three had a profound influence on Greece's economic development. Let me draw the parallel with the so-called Dutch Disease. As many of you know, this refers to the deindustrialisation induced in the Netherlands and, especially, Britain by the discovery of North Sea gas and oil. This discovery effected deindustrialisation via the appreciation of the exchange rate which it brought about. The big three were Greece's oil. At their peak they accounted for more than half our foreign currency proceeds on current account. We did not have a big manufacturing base to be shrunk by the influence of the big three as it was shrunk in Britain by the influence of oil, but by sustaining the real exchange rate at levels otherwise unsustainable, the big three constrained Greek manufacturing to

an unusually low share of GDP and thwarted the development of middle and large scale manufacturing enterprises despite the aspiration for greater industrialisation of all governments and all major political parties for many decades. And manufacturing is just one part of the wider sector of tradeables which was held back by the big three, an efficient and export-oriented agriculture is another. Not having had a large manufacturing base before the (partially) exogenous expansion of the big three, we were spared the pain of deindustrialisation. The expansion of the big three was, therefore, unambiguously beneficial while it lasted. But now we have entered the reverse phase. Under exogenous influences, the share of the big three in total current earnings (excluding EEC transfers and fuel exports) has declined steadily from an average of 49% in 1977-79 to an average of 39% in 1987-89. (Source: Bank of Greece, Monthly Statistical Bulletin.) Adjustment to this phenomenon is unavoidable and cannot be painless, just as the adjustment needed when North Sea oil runs out will not be painless for Britain. And an essential element of that adjustment is greater competitiveness of our entire tradeables sector.<sup>4/</sup>

Thus, both EEC membership and the decline of the big three invisible exports point towards the need for greater competitiveness. Yet, while this receives attention from time to time, discussions of macroeconomic policy have been dominated by absorption. We have been absorbed by absorption, if you will permit a pun which has the merit of being translatable.

The public sector deficit, which is at the heart of the absorption issue, has grown so large, when conventionally measured, that it has taken the dominant position -- the mother of policy failures, to coin a phrase -- and has pushed into the sidelines other major issues. The PSBR (public sector borrowing requirement), from an average of 5% of GDP in 1973-80, jumped to 11% in 1981 and went on to reach 19% in 1989 and again in 1990. As others before me have observed (Manessiotis, 1990; Stournaras, 1990)<sup>5/</sup> this expansion has been propelled by a political dynamic which incorporated

an electoral cycle, with deficitary peaks coinciding with election years.

Electoral cycles in the management of the economy are common in democratic countries. Somewhat artificially, they have been classified in the academic literature in two broad models. One is of cycles which are different according as the party in power is of the left or of the right, the other is of cycles which are the same regardless of party. We have conformed to the latter model in the eighties. This is the sort of thing you would expect from Democrats and Republicans in the United States but which some would deem surprising coming from PASOK and New Democracy.<sup>6/</sup> The trouble in our case is that the electoral cycle in the PSBR has also had an upward trend imbedded, so that each deficitary peak has been markedly higher than the preceding, resulting in the explosive path of the PSBR which I have described and with which you are all familiar.

However, let me now embark on a bit of revisionism. I will not revise the view that the public sector deficit in the 'eighties got out of hand and needs to be drastically reduced, nor will I need to revise what I have just said about the electoral cycle and trend in the PSBR. But the mind-numbing percentages of GDP which are obtained by conventional accounting are misleading and need to be revised. Inter alia, I hope that this will lead to a better perception of the contributions of absorption and (un)competitiveness in shaping the current account deficit.

The PSBR, unless offset by a private sector financial surplus, will be reflected in a current account deficit. It is this fundamental accounting identity which lies behind the notion that absorption matters and that in an open economy an exploding PSBR puts the current account in peril. But look at the figures. In Table I I have divided the data in three periods. Period I, 1978-80, is my base period. The years 1981-89 I have split in two parts: roughly before (Period II) and after (Period III) the stabilisation package which was introduced in November 1985.<sup>7/</sup> The big leap in the PSBR by seven percentage points of GDP between periods



TABLE I

PSBR, Current Account and Private Investment as % of GDP<sup>I/</sup>  
Annual averages for 1973-80, 1981-85 and 1986-89

	Period I 1973-80	Change between periods I & II	Period II 1981-85	Change between periods II & III	Period III 1986-89
1. PSBR (unadjusted)	5	7	12	3	15
2. Current Account	-4.5 <sup>2/</sup>	-2	-6.5 <sup>2/</sup>	3	-3.5 <sup>2/</sup>
3. PSBR, infla- tion adjusted <sup>3/</sup>	3	4	7	0.5	7.5
4. Gross private fixed investment I9		-6	13	-1	12
5. Residual (2+3+4)		-4		2.5	

Sources: National Accounts and Bank of Greece.

<sup>1/</sup> Percentages rounded to nearest half point.

<sup>2/</sup> Negative sign indicates deficit.

<sup>3/</sup> PSBR minus interest paid on drachma-denominated debt. Rationale explained in text.

periods I and II (row I of Table I) is accompanied by a much smaller deterioration of the current account, only two percentage points (row 2). The further rise in the PSBR between periods II and III by three percentage points is accompanied by an improvement in the current account by the same margin. The discrepancies are big and call for an explanation. Of course accounts are internally consistent by construction and show the required offsetting changes in the private sector. But that is a book-keeper's explanation, not an economist's. Stournaras (1990) has been stimulated into offering an economist's explanation. But I am inclined to think that part of the explanation lies in the misleading nature of the conventionally computed PSBR.

I am now entering territory which, I believe, has not been explored in Greece. So bear with me as I try to explain this important issue. I apologise to those in the audience who are familiar with the general principles.

I begin by pointing out that the PSBR we are talking about is net PSBR, i.e. it excludes repayment of maturing debt. This is as it should be because, other things equal, rolling-over maturing debt presents no problem. The lenders will relend in order to maintain their initial portfolio balance. The trouble is that, in the presence of inflation, the extent of debt repayment is not revealed by accounting rules which were devised for stable prices. At the risk of insulting your intelligence, let me give a simple example. Suppose that today I lend 100 drs, that inflation is 20% and that the nominal rate of interest is 20%. After one year I will get 20 drs which are deemed to be interest but are in fact redemption of capital, for after a year my loan, while still having a nominal value of 100, will only be worth 80 at today's prices. Conventional practice excludes redemption of maturing debt from the net PSBR but does not exclude the capital redemption component of what conventional accounting classifies as interest.

At the level of accountancy this is plainly inconsistent -- not a desirable property, I should have thought, for such an important matter. At the level of macroeconomic management, complete exclusion of the capital redemption component from the PSBR would be entirely right if lenders are free of nominalist illusion, by which I mean that they are able to distinguish between "return on capital and return of capital"<sup>8/</sup>. At the other end, if lenders are subject to total nominalist illusion, believing that all interest is current income, then the present practice of including all interest cost in arriving at the PSBR would be justified.

I have little doubt that, after some years of high inflation, nominalist illusion becomes small.<sup>9/</sup> I do not wish to claim nil illusion, but the case for calculating an inflation-adjusted PSBR, i.e. exclusive of the capital redemption component of the interest cost of the national debt, seems much stronger than for the conventional, unadjusted calculation. In Greece this leads to the deduction of the entire interest cost of the public sector's internal debt. This is because the average interest rate paid on the internal debt has been less than the rate of inflation (as measured by the GDP deflator) since the early 'seventies.<sup>10/</sup> The interest cost of the external debt is not excluded because, de facto, there is a large measure of indexation of the external debt and hence the capital redemption component in its case is small.<sup>11/</sup>

The inflation-adjusted PSBR gives, I believe, a truer, though still imperfect, perception of the problem of the public sector deficit, but the reductions of the PSBR to which it leads, particularly towards the end of the 'eighties, may appear startling to some of you. So let me say two things. First, inflation adjustment is not an eccentric novelty. Although not discussed in Greece, it was widely considered in other OECD countries in the late 'seventies and early 'eighties when inflation in those countries was more pronounced than it

has been since. The IMF fiercely resisted for a long time inflation-adjusting the PSBR. But in recent years it too has moderated its opposition. A turning point was reached when an article sympathetic to inflation adjustment by the director of its Fiscal Affairs Department appeared in IMF Staff Papers (Tanzi et al, 1987)<sup>12/</sup>. Second, even when inflation adjusted, the PSBR of the last few years was too big and unsustainable, if only because of the explosive growth of national debt to GDP which it implied, so deficit shrinking remains an essential target of fiscal policy. This is all the more so because government-related expenditures, presently financed from seigniorage outside the formal budget, will swell the PSBR when the revenue from seigniorage diminishes as inflation is, hopefully, reduced to its targeted levels.<sup>13/</sup>

You can see for yourselves in Table I, row 3, how much smaller the inflation-adjusted PSBR is compared to the crude figures (row 1). This gives us a better idea of the task that has to be faced. We do not need to be mesmerised by the demoralisingly high percentages indicated by the crude figures and hopefully we can make more room in our minds for other important policy concerns. In particular I hope we can pay more attention to competitiveness which is, as I have already emphasised, of special importance in the context of adjustment to membership of the European Community. With the help of the inflation-adjusted PSBR I hope to be able to reinforce this message by highlighting the importance of competitiveness in shaping the current account in the 'eighties.

But first let me return to a bit of unfinished business. You will recall that in the 'eighties there were big discrepancies between changes in the unadjusted PSBR and changes in the current account. A comparison between rows 1 and 2 of Table I established this point. But they are not so large when you focus on the inflation-adjusted PSBR: the discrepancies revealed by comparing rows 3 and 2 (second and fourth columns) are decidedly smaller than those conveyed by comparing rows 1 and 2.



To proceed further, let me take private investment alongside the PSBR. This pairing is not arbitrary: there was probably a considerable exogenous element in the observed fall in private investment in 1981-85 compared to 1978-80, of which fall 60% was accounted for by housing investment.<sup>14/</sup> The figures for private investment are given in row 4 of Table I.

The exercise culminates in the "residual", which is the sum of rows 2, 3 and 4 and is set out in row 5. The residual is the difference between the observed change in the current account and the observed change in the combined absorption by the PSBR and private investment. Compared to the preceding period the combined absorption in 1981-85 fell (-2% of GDP) but the current account, instead of improving, deteriorated (-2%) -- a total (residual) difference of -4%. A negative residual, as in the second column of Table I, indicates that the current account did worse than implied by the combined absorption while a positive residual, as in the fourth column, that it did better.

These residuals need to be explained, all the more for having contrasting signs and for having the signs that they do despite the slower GDP growth in 1981-85 compared to 1978-80 and the faster GDP growth in 1986-89 compared to 1981-85. As many things happened in the periods concerned including, notably, a steady rise in EEC transfers and a collapse of oil prices at the beginning of 1986, it is both difficult and easy to construct explanations for the residuals: difficult because it involves selecting among the many stories that can be told; easy, but deceptively so, because a number of plausible points are available for arbitrary selection to suit one's prejudices. I may not be immune to the latter syndrome. But the contrasting signs of the two residuals sets a test: to offer a plausible unified explanation of this contrasting experience. I can pass this test by proposing competitiveness as the explanation.

Competitiveness (as measured by relative unit labour costs in manufacturing) deteriorated, on average, by 25.6% in 1981-85 relatively to the base period of 1978-80, plausibly explaining the negative sign of the residual. In 1986-89 competitiveness improved, on average, by 9.2% relatively to 1981-85, plausibly explaining the positive sign of the residual.<sup>15/</sup> The 1986-89 improvement in competitiveness is small but the period covers a big improvement in 1986 and 1987, effected through a combination of incomes and exchange rate policies during the stabilisation programme of these two years, followed by erosion in 1988-89.

Enhanced competitiveness leads to a potential improvement of the current account by making our tradeable goods cheaper or more profitable and to an actual improvement if there is a matching availability of resources to satisfy the absorption requirement. Enhanced competitiveness and the incomes/exchange rate policies that underlie it contribute directly to the required availability of resources and they do it through three channels: first, through expansion of output, triggered by the expenditure-switching effect of greater competitiveness (perhaps relevant in 1988 when real GDP grew by 4.1%); second, through reduction of the public sector deficit, via a lower wage bill (as in 1986, but already in row 3, or 1 of the Table); and third, through an increase of the (inflation-adjusted private savings ratio, via the income redistribution associated with lower relative unit labour costs. <sup>16/</sup> A deterioration of competitiveness, with which the period 1981-85 was heavily burdened, is symmetric in its effects.

Thus the ups and downs of competitiveness fit quite well as an explanation of the current account deviations -- for the better in 1986-89, for the worse in 1981-85 -- captured by the residuals of Table 1. I am saying an explanation, not a total explanation. On the evidence I have presented I am not entitled to claim the latter. But I think there is enough here

to highlight the importance of competitiveness and to underline the significance of our policy failures in this area.

We tend to associate failure with incompetence. But this is often simplistic. Not only is policy subject to severe political constraints but also the issues here are complex. Competitiveness is the joint outcome of costs in domestic currency and the exchange rate. In terms of policy instruments, it is the combination of incomes and exchange rate policy that bears on competitiveness. But the same two instruments bear also on inflation and this double effect leads to difficult and delicate problems of macroeconomic management. I believe, however, that in the 'eighties we violated two cardinal operational rules. First rule, you do not destroy the independence of instruments; second rule, you do not direct two instruments to one target. The violation of the first rule deprives you of an instrument, the violation of the second wastes an instrument. This is a serious matter when you are short of policy instruments, as we undoubtedly are. The first violation explains why the devaluation of 1983 failed to retrieve, except in the very short term, the previous loss of competitiveness. The second violation underlies the, by now, more than complete erosion of competitiveness obtained in 1986-87 in the course of the stabilisation programme of that period. I will expand on these violations and associated policy failures because there are lessons here for current and future macroeconomic management.

The first violation arose from the indexation of wages which came into operation at the beginning of 1982. De jure the indexation was not 100%. Above-average wages and salaries were underindexed. But de facto it was broadly equivalent to 100% because there was wage drift which, in the aggregate, compensated for underindexation. Against this background, the step devaluation of January 1983 was doomed to failure. With 100% indexation, the higher import prices resulting from devaluation

are compensated in full by higher wages. The higher wages are reflected in higher prices which are in turn reflected in higher wages ... and so on. This process ends when wage costs have risen in proportion to the initial devaluation, wiping out the competitive gain which devaluation was to bring about.<sup>17/</sup> To avoid this, the step devaluation of January '83 was combined with a temporary delay of indexation-triggered wage increases. But, by virtue of its temporary nature, the effect was transitional and by the middle of 1984 our competitiveness was back to the pre-devaluation unsustainable level.

Indexation had tied the exchange rate and nominal wages to a one-to-one relation and so exchange rate policy and incomes policy fused into one, violating the rule about the independence of instruments. There are respectable arguments to the effect that market mechanisms, if left to themselves will cause wages to compensate, more or less exactly, for a devaluation.<sup>18/</sup> That is why devaluation must be combined with incomes policy to make exchange rate policy effective. But if the two instruments are fused through 100% wage indexation, the ineffectiveness of the exchange rate instrument is institutionalised.

The second violation arose and continues to arise because since the end of 1987 the exchange rate as well as incomes policy has been directed at containing/reducing inflation. As this is current policy and it is also central to the issue of adjustment in an open economy, I will discuss it at some length. Please bear with me.

There is no doubt that the exchange rate can exert influence on inflation and a strong one at that. It works both from the cost side and the demand side. But the problem is that if you target the exchange rate as well as incomes policy on inflation, you do not just lose an instrument with which to influence international competitiveness, you use the instrument perversely from the point of view of competitiveness. Thus it came about that in three brief years, from the end of 1987 to 1990, our relative



unit labour cost deteriorated by 28% (IMF mission report, 1991) and the deterioration has gone further in 1991. More has been lost than the entire gain in competitiveness attained during the two years of the stabilisation programme in 1986-87. A worrying matter.

Of course we are not the only country which has targeted the exchange rate instrument on inflation. Some have been successful in this operation, though usually at the cost of heavy unemployment. But bear in mind that for those countries which for whatever reasons, good or bad, do not have an incomes policy in their portfolio of instruments, the option of using the exchange rate as an instrument of competitiveness is an empty one. As I already noted, exchange rate policy must be combined with incomes policy if it is to be useful as an instrument of competitiveness. If it cannot be so combined, nothing is sacrificed in targetting the exchange rate on inflation. In Greece, however, incomes policy is available and recent governments have availed themselves of it. Much is sacrificed therefore in targetting the exchange rate on inflation. Is this essential difference adequately appreciated or are we aping other countries' practices, as we are prone to do, although our circumstances differ from some of them in a crucial respect.

I do not mean to imply that the practice which has been followed is entirely indefensible. Three possible defences spring to mind. The first is that the current account is so unimportant relatively to the inflation target that competitiveness can be neglected. I cannot imagine that many would be ready to adopt this defence in the light of Greek experience so far, which I summed up earlier in the sentence: macroeconomic weakness turns into crisis when the current account becomes sick.

The second defence is that the current account can be adequately addressed by controlling absorption and absorption can be controlled through fiscal policy and through incomes policy itself, the latter operating on the private savings ratio via income redistribution. There is no doubt that

absorption is very important. But as a defence of past practice this will not do, since the exchange rate was failing to help competitiveness at the same time as fiscal policy and incomes policy were failing to address absorption in the right direction. At the level of principle, a case can be made for this defence but it is, I think, a weak case. First, it is weak because you need a combination of competitiveness and (dis)absorption to minimise the cost incurred in effecting an improvement of the current account. Attending to (dis)absorption alone will lead to economic contraction (or growth well below trend), loss of output and increased unemployment (except in the make-believe world of perfect markets with wholly flexible prices). Second, it is weak because, other things equal, you increase absorption by overvaluing the exchange rate (because the latter raises real income, and hence consumption, for a given GDP) at a time when you need to reduce absorption in order to improve your current account. This by itself is not decisive. It is one of the unfortunate facts of life that in macroeconomic management an instrument which helps with the target to which it is assigned hinders at the same time the attainment of another target. This is why choosing the right mix of instruments -- when you have a choice -- and balancing their intensity is a difficult and delicate task. But in the case of exchange rate overvaluation for the sake of its anti-inflationary effects you damage not one but two desirable objectives: lower absorption and greater competitiveness.

The third possible defence of the practice of targeting the exchange rate on inflation is that incomes policy, as presently practised, is only partial -- it extends to the public sector only -- and an exchange rate policy also targeted on inflation is needed to extend the policy to the private sector. By overvaluing the exchange rate you put a low ceiling on the price of tradeable goods and (by extension) on the wages that can be paid to the labour force in the private sector, where the bulk of tradeables are produced. This is, I think, a tenable position -- up to a point. But remember that in Greece the public sector in the wide sense,

including banks and utilities, contains all the crucial wage-bargaining entities and where the public sector leads on the wages front it is likely that the private sector will follow closely, though admittedly not 100%. But, anyway, you can overvalue once, you can overvalue a bit more a second time, but you cannot keep extending overvaluation indefinitely. Nemesis, in the shape of a sick current account, will strike with fatal inevitability. That is why I said this defence is tenable, but only up to a point. I note, without further comment at this stage, that we have been extending overvaluation continuously for four years now. Finally, if the problem is perceived to be the uncertain application of incomes policy to the private sector, the optimal solution lies in making it more applicable to that sector. A compulsory extension of incomes policy to the private sector was instituted in November 1985 but that was perceived as an emergency. In more normal circumstances a consensus incomes policy, reinforced by tax and other penalties as a backstop, has to be sought. I will return to this.

I have reached the end of my review of policy in the 'eighties. I have not attempted to be exhaustive. I have concentrated on the points most relevant to my assignment -- macroeconomic policy in an open economy -- and to the theme of the conference -- adjustment. If some of you feel that I have not touched on supply-side matters, you could not be more wrong. Competitiveness is in large measure a supply side question though, I may add, it is not an antiKeynesian concern, in case anybody here thinks in terms of ideological polarities. Indeed, international competitiveness is the most important supply side question that is specifically related to the openness of the economy. By providing profit opportunities in the tradeable goods sector and giving scope for efficiency-enhancing expansion of scale -- the latter particularly important in Greece -- policy directed at improving international competitiveness targets the parts of the economy which face the outside world and especially our European partners.

The public sector deficit also has supply side implications. A swelling



of the deficit which is fuelled by public sector consumption or consumption-financing transfer payments, results in crowding out investment, to the extent that it is not offset by a rise in private saving or is not fully reflected in a worsening current account. Some supply side improvements are possible without investment but others require the intermediation of investment. So the crowding out of investment can be a serious matter. Gross private fixed investment was nearly one third lower, on average in 1981-85 compared with 1978-80, a huge fall (see Table 1, row 4). But 60% of that, as previously noted, was housing investment. Total investment in plant and equipment, which affects productivity growth most intimately, showed virtually no fall. It was a great piece of luck that the expansion of the public sector deficit was cushioned by such a large and (as previously suggested) largely exogenous fall in housing investment. Things would have been much worse without it.

I can sum up briefly my survey of the 'eighties. Viewed from an open economy angle, there were two major failures of policy: failure to restrain the public sector deficit and failure to prevent a deterioration of competitiveness. Two major failures, not just one. We have been obsessed by the public sector deficit, and up to a point rightly. But we have allowed this to crowd out competitiveness from the full space it deserves in our policy analysis -- that is unfortunate. Competitiveness has been important and remains important, especially in the context of adjustment to the European Community. I analysed our failure on this front in terms of two rules for the management of policy instruments which we have violated. These were not mindless violations. Reasons which have some foundations can be adduced to support them. But ultimately we pay the price. I suggested that the true dimension of the public sector deficit was exaggerated by the PSBR as conventionally calculated and that an inflation-adjusted version is more accurate and more helpful to our understanding. But even when inflation adjusted, the PSBR was still



unsustainable. We were lucky in having, largely by coincidence, a big fall in housing investment. Otherwise a public sector deficit of the magnitude that we have had would have inflicted an absorption disaster on a current account which was weak anyway for most of the 'eighties. But the explosive growth of the national debt resulting from a persistently high (as distinct from cyclically high) PSBR is an arithmetical inevitability and no lucky break in the world could counter it.

### Current Policy

In 1990 both competitiveness and the PSBR were at their worst levels, not just in comparison with the preceding decade but for very much longer. Some serious steps have now been taken to reduce the PSBR in the shape of increased tax rates and measures to tackle the exploding cost of the national insurance system, which has been a major contributor to the swelling of the PSBR.<sup>19/</sup> The details are open to argument but the thrust is in the right direction from a macroeconomic viewpoint. On the other hand, two other steps, designed to make a large contribution -- their proceeds are budgeted to reach 5½ percentage points of GDP in 1991 -- are cosmetic and exaggerated respectively: the privatisation proceeds are cosmetic because they are not current revenue and the budgeted proceeds from curbing tax avoidance are not realisable to anything like the full amount.

I am not, however, interested in current policy from a short term viewpoint. Fortunately I can look into the longer term, as we have in operation a three-year stabilisation programme and some of its macroeconomic objectives for 1993 are embodied in commitments made to the European Community in connection with the loan that we have obtained. These are not soft commitments: they constitute the conditions that must be shown to be on the way to fulfilment before the second and third tranches of the loan are disbursed.

For the (unadjusted) PSBR the objective is to reduce it to 3% of GDP (1.5% central government plus 1.5% public enterprises and entities). I will assume that this is a serious target and that there is the necessary political will to attain it. As my working hypothesis I shall accept the attainability of all the other targets of the programme as well. This is not a forecast that they will be attained but a framework which will enable me to concentrate on the points on which I want to focus.

Since the (unadjusted) PSBR had reached 19% of GDP in 1990, a reduction of 16 percentage points of GDP is the target. A part of this reduction is (for lack of a better word) automatic, as inflation falls to its target of 7% in 1993. This is because the interest cost of the national debt shrinks as the nominal interest rate follows the rate of inflation downwards. When you take this out, the remaining reduction of the PSBR is the substantive one and I estimate it roughly at ten percentage points of GDP.<sup>20/</sup>

Ten percentage points of GDP in three years is still a big, big reduction, nobody should have any doubts about that. Three points will reinforce this assessment.

First, if you use correct inflation accounting, the target of 3% of GDP for the (unadjusted) PSBR implies negative borrowing. The inflation-adjusted PSBR will be -2% of GDP.<sup>21/</sup> This means that the ratio of debt to GDP will fall by two percentage points.<sup>22/</sup> Of course the nominal debt will still be (slowly) rising, but in real terms there will be debt repayment. The public sector, in just three years, will turn from huge borrower to net lender. Second, seigniorage revenue will be foregone as inflation falls and, to the extent that it finances extra-budgetary expenditure and is not therefore reflected in the projected reduction of of the PSBR<sup>23/</sup>, it will mean further budgetary retrenchment. Third, our PSBR includes borrowing by public enterprises. Even by the most austere

criteria, telecommunications, electricity and other such enterprises may legitimately resort to borrowing as part of the total financing mix for their large investments. A target which will turn the public sector into a net lender in three years is all the more striking when the public sector includes such enterprises.

Have we gone too far? In Greece we have been obsessed by our public sector deficit, as I noted before. But not just in Greece. The European Commission has also been obsessed by it. Given our record on this front, this is understandable. The public sector deficits of one or two other Community countries have also nagged the Commission but it is not a big exaggeration to say that the Greek case had a big part in inspiring the Commission (Delors report, 1989) to float ideas about entrenching in concrete austere binding rules on fiscal deficits and no bail-outs for errant governments. As our stabilisation programme is the joint product of the Greek Government and the Commission, has our shared obsession pushed us too far too quickly on the PSBR target?

I pose the question but I prefer not to answer it in this form. The reason is that my answer will be a mix of personal taste and general principles which will be wrong for an occasion such as this -- too much of the former and too little of the latter.

The question I will attempt to answer is about the balance of policies. The balance that concerns me most, as was evident from my analysis of the 'eighties, is that between absorption and competitiveness and between the instruments of policy designed to influence them. It is they that will effect the required adjustment on the most sensitive front, the external accounts of the nation.

The current account deficit in 1990 was 5.3% of GDP. A deficit of up to 3% of GDP is sustainable because there is a steady autonomous inflow of

private capital from abroad -- mostly Greek-owned -- of that order of magnitude. And indeed the programme provides for a reduction of the current account deficit to 3% of GDP by 1993, an improvement of 2.3 percentage points which I will round down to 2 points to take into account some non-recurring elements in the deficit of 1990. I note at this point, for future reference, that this implies that the repayment of debt implicit in the PSBR target will be repayment of internal debt only. There can be no repayment of external debt if the current account deficit is just offset by the autonomous capital inflow.

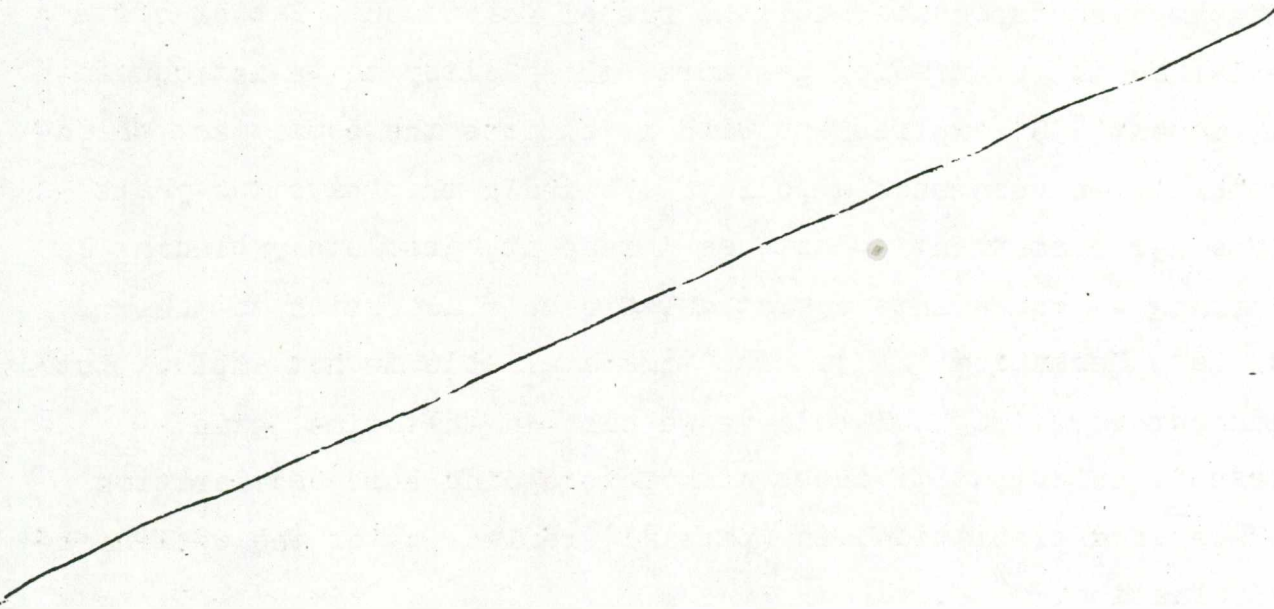
Clearly the disabsorption created by a substantive reduction of the PSBR of the order of ten percentage points of GDP covers the intended improvement in the current account of 2 percentage points much more than enough. Of course other claims on output, beside the improvement of the current account, are expected to materialise and claims emanating from private investment, in particular, will be encouraged to materialise. But allow generously for these and the comment is still valid, there is enough disabsorption and to spare to make room for the intended improvement in the current account.

What about competitiveness. I will quote an ominous passage from the EEC Council's decision. "With respect to exchange rate policy the Greek Government will follow, in 1991, a policy of not completely accommodating inflation differentials against other Member States". For beyond 1991 the wording becomes ambiguous. But any ordinary interpretation of our commitment for 1991 implies a worsening of our competitiveness or, at best, a non-improvement. As this comes on top of a 28% deterioration in relative unit costs between 1987 and 1990 (IMF mission, 1991 report), it worries me.

Clearly we are relying on disabsorption alone to generate the improvement in the current account to which we are committed. Disabsorption, when there is enough of it, is perfectly capable of doing it, but it will



do it while inflicting a recession or, at best, stagnation on the economy at the same time.<sup>24/</sup> To sustain the improvement, the loss of output cannot be just transitional. So the current account target can be achieved but we could not be said to have properly adjusted.



To improve the current account at a given level of GDP (or, in a growth context, with GDP at its trend path), disabsorption must be combined with incentives to buyers both here and abroad to switch to Greek goods and services and for Greek producers to expand the production of tradeables. This requires an improvement in competitiveness. In other words we need a balanced package, balanced between absorption and competitiveness, not all the emphasis on absorption. It seems to me that we are continuing to suffer from obsession with the public sector deficit and neglect of competitiveness.

As before, the neglect of competitiveness can be defended on the ground that the exchange rate is targeted on inflation. I have indicated my criticism of this position and will not repeat myself. Suffice to say that it is not possible to go on and on neglecting competitiveness. Unless remedial steps are taken on this front, the adjustment of the Greek economy will, at best, be incomplete. If productivity can be coaxed into a rapidly growing path, it will greatly help. But in the short and medium run some contribution from the exchange rate (in conjunction with incomes policy) needs to be made.

As these are delicate matters, involving a highly sensitive area of the economy, let me say at once that I do not think a step devaluation is needed. If all the other relevant commitments are in the process of attainment, it will suffice to engage in a rate of depreciation such that it overcompensates for the faster rise in unit labour costs in Greece than in our trading partners, this policy to be introduced the very moment 1991 expires and with it expires the commitment which we made that precludes such a policy. We shall then have two years before another commitment -- not, as I read it, absolutely binding as to its timing -- comes into operation, Greece's accession to the Exchange Rate Mechanism (ERM). The time available is not ample. But if we play our cards right I believe we can, in that time, gain significantly in competitiveness without foregoing some deceleration in the pace of depreciation, in (partial) reflection of the declining rate of inflation.<sup>25/</sup>

By attaining the targeted improvement in the current account -- two percentage points of GDP -- we will have a sustainable position in our external accounts. But this is not the only criterion which bears on the target we should be aiming at. I want to bring to your attention two other considerations. The first relates to absorption. When there is an enhancement of competitiveness the consequent current account improvement (which is now achievable at a given GDP or even with GDP close to its trend growth) will take up some of the disabsorption emanating from the PSBR reduction and there will be less disabsorption to spare than had there been no improvement in competitiveness. But with the aspiration to a current account improvement limited to 2% of GDP and a commitment to a PSBR reduction equal to 10% of GDP, my guess is that there will still be excess disabsorption, after allowing for extra claims on resources from other plausible sources. If so, we are still liable to have stagnation/recession inflicted on the economy, though to a lesser extent than in the absence of improved competitiveness.<sup>26/</sup>

The second consideration relates to the repayment of debt. You will recall that the PSBR target for 1993 implies a repayment of national debt equal to 2% of GDP. You will also recall that the current account target implies that all repayment will be of internal debt, none of external debt. Is this the right balance? At the beginning of the paper I described our external debt position as not dangerous but uncomfortable. When the present loan from the European Community matures, we either repay it from balance of payments surpluses or we finance its repayment by borrowing from foreign banks. The latter alternative will increase perceptibly our exposure to foreign banks and may only be feasible at a stiff price.

So far both considerations suggest as desirable a more ambitious target for the current account than we have. It will be anti-recessionary, by taking up some of the spare disabsorption and it will switch at least part of the debt repayment to external debt, which will be helpful. And it would not be utopian. Remember that following the stabilisation programme of 1986-87 we had a current account deficit of only 1.8% of GDP in 1988, despite a 4.1% growth of GDP in that year. There are, however, two points to be made on the other side. Point (a) is that we may not have enough time by the end of 1993 to effect, through a sliding parity, the improvement of competitiveness necessary to achieve a more ambitious target. Point (b) is that repaying external debt implies foregoing goods and services to the corresponding extent; repaying internal debt does not. Point (b) has to be balanced, however, against the recessionary loss of output that, as I have suggested, is liable to follow if we stick to the present current account target. It seems to me that a review in depth of the target for the current account would be helpful.

A last observation on current policies. It concerns our accession to the ERM, presently scheduled for 1993, and its relation to competitiveness, on which I have laid so much emphasis. It is vitally important that when we accede we do so at a central rate for our exchange parity which does



not handicap our competitiveness. For, once inside, the room for manoeuvre with respect to the exchange rate will obviously be limited.

I will sum up my assessment of current policy, as enunciated in the three-year stabilisation programme now in progress, in words that in various combinations I have used many times already. The policy is strong on absorption and weak on competitiveness. This is an undesirable imbalance. I am not suggesting that the policy as it stands is inconsistent with the attainment of the target for improvement in the current account but such an improvement is likely to be accompanied by recession. I believe a better balance is needed. Unless we make big progress on the competitiveness front, the challenge of adjustment to an open economy -- now much more open than in pre-EEC days and getting more open all the time -- will not be met.

#### Macroeconomic Management under a Tight ERM.

Having surveyed macroeconomic problems and policies of the past -- the 'eighties -- and of the present -- 1991-93 -- I will now peer into the future. The point in the future that I select is the stage before full EMU, i.e. before we come to a single currency and a single central bank. The critical feature of the selected point is that exchange rates among Community currencies are, in principle, irrevocably fixed and the system is completely free of exchange restrictions. I shall refer to this as tight ERM. Earlier stages in the transition to EMU are conceptually messier and therefore difficult to discuss in the abstract. I distinguish two phases in the tight ERM. In the first there are still some doubts about whether the parity will be truly irrevocable. In the second there are none. It will suit me to start with the second phase.

It is universally acknowledged that in the circumstances of the second phase an independent national monetary policy is utterly impossible.



Nominal interest rates will be the same throughout the Community. Any attempt by a national central bank to deviate from them will be swamped by arbitraging capital flows, since there is no perceived exchange risk to dissuade market operators from taking advantage of the slightest nominal interest differential.

But the need for national macroeconomic management does not disappear. An instrument of policy is lost but, since policy action would still be needed, the prospective loss of the monetary instrument is much lamented by some. One case, which illustrates the problems that may be posed, has received much prominence in Britain: nominal interest rates are the same everywhere in the Community but some countries are experiencing higher inflation than others; their monetary conditions must be made tougher but instead they are easier, their real interest rates being lower. The monetary authorities can do nothing about it. Not surprisingly, the hunt for alternative instruments is on. Fiscal policy, which at the peak of anti-Keynesian fashion -- the late 'seventies -- was viewed by many with derision, has become again a subject of active discussion.

Perhaps in Greece the loss of the monetary instrument will be felt less than in most other Community countries, provided we can restore some order in the public sector deficit. With respect to the PSBR the Bank of Greece has had a high profile in damage limitation. But generally the monetary programme is shaped not so as to determine macroeconomic performance but so as to be consistent with targets set and act as a backstop. One indication of this is that the monetary programme comes last chronologically in the big policy-making round in the run-up to each new year.

Can fiscal policy be effectively operated in Greece? Clearly not if our baseline is a large public sector deficit such as we have had in the last ten years. For then the pressure is only one way -- to get the deficit down -- and you cannot adapt your fiscal policy sensitively to the ups

and downs of the economy. But even if this is put right, it is said that a sensitive use of fiscal policy is impossible because of the large time-lags involved. In Greece this worries me less than the administrative inadequacy and the political culture. Between them they are not conducive to good choices under time pressure.

And so to incomes policy. I hazard the prediction that in the search for alternative instruments of policy, incomes policy will gain a higher profile in Community countries than it has had. Remember that incomes policy was "invented" in the period of firmly pegged exchange rates in the 25 years or so after World War II. For those who have forgotten it, it will be reinvented to fit the fixed exchange rates of ERM and later the single currency of the EMU.

Greece will be at an advantage because it is one of those countries which have not forgotten incomes policy. But we must improve it and, dare I say, perfect it. Incomes policy was used most successfully during 1986-87. It carried the bulk of the burden of the stabilisation programme of that period. Two unfortunate features were, however, associated with it. The first was that incomes policy became too closely linked in the public mind with a policy for incomes reduction. I do not mean to say that real incomes reduction was avoidable at that time or that there was a better way to do it than incomes policy. But in fact incomes policy can have two roles. One is indeed to influence real incomes if this is necessary, but the other is to serve strictly as an instrument to control cost inflation without interfering with real incomes. During 1986-87 and again in the current stabilisation programme the first role was the dominant one and it obscured the second. This is unfortunate.

At a high level of employment in the economy, average nominal wages are prone to rise faster than average productivity growth when wages are settled by uncoordinated bargains at industry or plant level, even if there is no excess demand in the system. By resorting to demand-

restricting measures you can, of course, squeeze out this cost pressure on prices but it is an inefficient and wasteful method, raising unemployment and pushing GDP below its trend growth path. Or, if you leave the economy alone, demand contraction via a deterioration of the current account (when other countries are not subject to inflationary pressure to the same extent) will ultimately have the same effect. The classical conception of the gold standard mechanism envisaged the system as operating in this way. And it was a wasteful method of operation.

By hitting demand when the source of the problem is on the supply side, you violate the first rule of optimal intervention which is to intervene directly at the source of the trouble, not indirectly via a related area. If you do the latter, your intervention will work if applied hard enough, but it will be a second or third best way of doing it. If you have no instrument with a direct effect, you have no choice. But incomes policy operates directly on the source of the problem. It can influence just the growth of nominal incomes while letting real incomes keep in step with average productivity growth (plus or minus changes in the terms of trade and indirect taxes).

The second unfortunate feature associated with incomes policy in 1986-87 was that it was compulsory. A feature which may be tolerated in an emergency, cannot serve when the instrument is meant to play a regular part in macroeconomic management, to be used in circumstances of reasonable normalcy. A consensual incomes policy, one that effectively extends to the private sector of the economy as well as the public sector, becomes much more feasible when it becomes understood that it is about nominal incomes, not real incomes. Consensus does not of course mean that the government cannot use a tax framework that will promote incomes policy and exert other influences that will coax and persuade. I do not pretend that it is going to be easy and I have no blueprint. There is a whole spectrum of options to choose from. But I believe that



the great challenge of macroeconomic management as we move to the EMU will be to formulate an effective and acceptable incomes policy. Past successes and failures in many countries have valuable lessons to teach. If we do succeed, even to a limited extent, in meeting this challenge, the problems of macroeconomic management close to the full EMU and inside the full EMU will not be as formidable as they are sometimes made out to be.

I have concluded my discussion of the second of the two phases into which I divided the tight EMU. I now turn to the first phase in which fixed parities have been declared irrevocable but market operators retain some doubts about whether they will hold. Chronologically this precedes the second phase but I have left it to the end because I think that for us it is the more difficult and dangerous phase of the two. In addition, the points made about this phase are of broader application. They will be largely relevant even under a loose ERM.

I have two basic observations to make. The first is that in this set up we will have to learn to pay more attention to the capital account than hitherto and also to relative nominal interest rates. I do not mean to imply that the capital account was or could have been neglected up to now. The difference between a weak and a dangerously critical balance of payments situation used to register emphatically in the capital account. But I would say that the onset of capital account sickness was generally driven by capital account sickness. This may not be so quite to the same extent in the changed circumstances.

Things will be different in a number of ways. First, the capital account will be more sensitive to sentiment about the drachma because capital flows will materialise which were previously deterred by controls and because some flows, previously disguised as current account flows in the face of restrictions on capital movements, will no longer need to be so disguised. Up to now, if you were, say, an importer and anticipated a devaluation, you would accelerate your purchase of the foreign currency



due for your imports; when capital flows are unrestricted and currency conversion very cheap you will purchase directly the foreign currency of your choice and time it to suit closely your speculative sentiment.

Second, the capital account will register turbulence elsewhere in the Community. If there is a build up of expectations, say about a LM upvaluation, sufficient to give the idea some credibility despite the commitment to irrevocable parities, the Greek capital account will reflect this.

Third the capital account will be much more sensitive to interest differentials. The ease and cheapness of currency conversion will make it worth while to shift balances in response to even small differences in nominal interest rates (but see below).

Having said all this, I would nevertheless incline to the view that in the Greek circumstances the current account will remain the more important and prior concern, if to a less pronounced extent than before. In the nature of the economy, the financial sector will be small, even relatively speaking, and this will moderate the role of the capital account. Sentiment about the drachma will continue to be dominated by the performance and prospects of the current account. The capital account, however, will reflect this sentiment much more sensitively and acutely, which means that any problems in the current account will be magnified more than before.

This emphasises the importance of entering the ERM at a truly competitive exchange rate and for subsequently defending it against erosion. It also poses the question again whether we should be aiming at more than a just sustainable position in the current account, this time in order to have in reserve a margin of confidence that will prevent relatively small problems being uncomfortably enlarged through the new volatility in the capital account.

My second basic observation is that for a long time the drachma will be subject, more than most currencies in the Community, to the feeling that it is not fully secure against a downward realignment, even when on objective tests of the then current position it is no less sound than other currencies. We shall be carrying the burden of our history. This means that our nominal interest rates will have to carry a premium to compensate for the perceived additional risk. In turn, this means that if our inflation rate is the same as in the rest of the Community, our real interest rate will be higher than elsewhere. As this is perverse, given that Greece is one of the least developed countries of the Community and needs to encourage investment, it is one of the justifications for compensating transfers from the Community and for disproportionate access to Community funds under structural and regional programmes. But it is also yet another reason for emphasising competitiveness and a comfortable current account position. To the extent that we perform well in these respects, the climate of expectations will be friendlier and the risk premium on our interest rates will be lower than otherwise and its duration less prolonged.

#### Summing Up

I have travelled over a lot of ground. But there is one unifying theme which extends across all the periods of my survey -- the importance of competitiveness. With short-lived exceptions, we have failed to pay adequate attention to competitiveness, having allowed the problem of the public sector deficit to dominate our thinking even when, effectively, nothing or less than nothing was being done about it. The absorption problem, of which the public sector deficit is a crucial part, is very important but it has to be viewed in conjunction with competitiveness and a balanced package of policies has to be implemented to tackle both. In the long run competitiveness is bound up with productivity growth, quality enhancement, innovation etc, but in the shorter run macroeconomic

management must secure competitiveness and defend it against erosion. In an open economy competitiveness is of capital importance. On joining the European Community in 1981 the Greek economy became more open and with 1992 soon upon us, the single market will bring still more openness and yet more openness will follow later with the march towards European Monetary Union. While Greece needs to adjust on many fronts, adjustment on the competitiveness front is one of the most challenging and most pressing.

## NOTES

1. The transitional element has been roughly quantified from shares of employment and growth of value added per person employed by sector, as given in OECD, 1991a. It was assumed that marginal product equalled average product in each sector. On plausible assumptions -- increasing returns in industry, diminishing returns in agriculture or, more strikingly, disguised unemployment in the latter -- the transitional component of growth in previous periods would be larger.
2. When we enter the ERM and as the ERM rules tighten, the capital account will play a greater part than it does at present and in that context I will give it some attention. For now I place the emphasis deliberately on the current account.
3. A relative wholesale or producers' price index can fall because of a squeeze in home producers' profit margins resulting from uncompetitiveness. A relative retail price index can fall because the import content benefits from exchange rate overvaluation which is, however, detrimental to competitiveness. For a discussion of alternative measures of competitiveness see Durand and Giorno (1987).
4. The need for adjustment to the high oil prices of the early 'eighties was obviated by the price collapse in 1986.
5. Also Spraos (1991) in a book of conference papers presented in 1987.
6. The academic who formalised the first model was Norbhaus (1975). We have clearly conformed to one part of the model: the cycle in economic management. The business cycle expected to result from it has not materialised in the Greek case.
7. The stabilisation package began to unravel at the beginning of 1988 but some of its effects lingered through that year. 1989 does not fit well in period III but was included to complete the decade.
8. The phrase is taken from Tannzi et al (1987) -- see below.
9. That it is small for at least some people is indicated by the fact that ECU-indexed bonds can be floated at an interest rate lower than non-indexed government debt by an amount which bears some relation to the rate of depreciation of the drachma. Other bits of evidence include the sizeable negative coefficient of the inflation term in the consumption function (Garganas, 1991, chap. 2), which is replicated in many OECD countries (Dean et al, 1989).



10. The resulting PSBR differs from the so-called primary deficit in that, unlike the latter, it does not exclude the interest cost of the external debt. Beyond the present context, there is another difference between inflation-adjusted and primary deficit. Unlike the latter which excludes all interest payments, the inflation-adjusted deficit would not exclude payments attributable to a positive real interest rate while, if the interest rate was negative, the resulting pure inflationary erosion of the debt would, in principle, be allowed for. The latter is not done here in order to keep things simple.

11. The indexation is imperfect to the extent that (a) there is inflation abroad and (b) the effective exchange rate (weighted by the currency shares in the foreign debt) does not keep in step with domestic inflation. The ECU-indexed drachma debt is similar to the external debt but it is too small to matter.

12. The annual IMF mission to Greece has not yet included in its reports inflation-adjusted figures for the PSBR but the last report (1991) inflation-adjusts the private savings ratio which, in a closed economy, would have been the same thing with the sign reversed.

13. The authors of a European Commission study (1990) estimate seigniorage in Greece at 2.34% of GDP in 1985-87 and 2.75% in 1988. Their measure of seigniorage is, however, unusual and creates some problems. Measured as the increase in currency in circulation plus interest-free compulsory bank reserves, seigniorage comes out at 2.1% of GDP for the years 1988-90. As 56.25% of compulsory bank reserves were interest-bearing but at below market rate, some seigniorage accrued from that source also but it was insignificant. A part of seigniorage revenue finances directly the PSBR (Stournaras, 1990) and would be double-counted if PSBR and seigniorage were summed without appropriate adjustment. Alogoskoufis and Christodoulakis (1991) derive a figure of 2.6% of GDP as the maximum attainable seigniorage revenue: beyond a certain inflation rate (estimated at 18%) the economising of money balances, induced by the inflation-related nominal interest rate, dominates in their model and seigniorage cannot be raised any higher.

14. It was not interest rates that caused the huge and persistent decline in housing investment -- real interest rates rose only marginally between periods I and II -- nor the tightening of concessionary loans, nor incomes. A plausible cause could be sought in demography -- the decline in urbanisation -- though the rapidity of the decline needs more to explain it. From within the time frame relevant to macroeconomic management, demographic factors must be deemed exogenous.

15. Source: reports of IMF missions to Greece. 1985 was used for splicing two slightly differentiated series. The reports of IMF missions are not supposed to be available to the public. But Washington is not just the capital of the United States, it is the world capital for leaks.

The reports on Greece reach at least one Greek journalist at least as soon as they reach the Greek representative on the IMF. So I have no reservations about using their material. The Bank of Greece calculates its own index of relative unit labour cost, but I was told by the official most immediately concerned that it is confidential and I have respected that position. However, other officials, when publishing articles in their private capacity, print for all to see the Bank's index. Now that is leaking in style! But seriously, why do we not publish this and other indices of competitiveness? Many countries do and the OECD Economic Outlook devotes regularly a table to them, with Greece missing from it. The raw data for compiling indices of competitiveness for Greece are publicly available, so the resulting indices can hardly qualify as secret.

16. The share of wages and salaries in non-agricultural GDP averaged 54.5% in 1986-89 against 56.2% in 1981-85. The 1981-85 share, on the other hand, was higher than that of the preceding triennium by three percentage points. (Calculated from national accounts data.)

17. This assumes a constant gross profit margin. In 1983 profit margins had already been squeezed so low that no further lowering was sustainable.

18. The Bank of Greece model of the Greek economy deviates from this result partly because the coefficients were estimated over a period of trend decline in profit margins (Garganas, 1991, chap. 10).

19. Spending on pensions increased from 9% of GDP in 1980 to 17% in 1990 (Provopoulos and Tinios, 1991), which is a staggering increase. The OECD (1991b) also estimates the increase at eight percentage points (but starting from a base of 7% in 1980), making Greece a very strong contender for first place in the OECD pensions league (pensions as a percentage of GDP). A substantial proportion of this increase was non-discretionary, attributable to a demographic factor -- perhaps almost half. The earlier surpluses in the social security accounts, which contributed to giving at the time a healthy look to the public sector's financial position, were not reflecting a steady state position.

20. The interest saving has been calculated under the following assumptions: (a) the public sector will refinance maturing internal debt at a nominal interest rate of 7%; (b) there is no carry-over of internal debt at higher interest rates from previous years; (c) the drachma interest cost of the foreign debt will also be 7%; (d) the ratio of national debt to GDP at the beginning of 1993 will be the same as at the end of 1990; (e) there will be no growth of real GDP. Under these assumptions the interest saving works out at 7% of GDP. But most of these assumptions are optimistic. (a) implies zero real interest rate (given the 7% target for inflation in 1993), which is higher than the average incurred by the public sector for many years, but is nevertheless optimistically low, given the commitment to the EEC to abolish compulsory bank financing



by mid-1993. (b) is optimistic but in a small way because nearly all the non-indexed drachma-denominated debt has maturities of one year or less. (c) implies a virtual halting of drachma depreciation. (e) is optimistic in the present context in that growth of GDP will lower the interest cost reduction as a per cent of GDP. I therefore compensate in the bottom line by lowering the estimated interest saving to 6% of GDP. (d) is the most critical assumption, I therefore add that for each point by which the average interest rate exceeds 7%, the interest saving will be lower by one percentage point of GDP. This one-to-one relation arises because the debt/GDP ratio was 100% at the end of 1990 and by assumption (d) it will be the same at the beginning of 1993.

21. The internal debt at the end of 1990 equalled 71% of GDP. On the assumption that it remains the same at the beginning of 1993 and that the nominal interest rate is at least equal to the projected rate of inflation (7%), we have 71% of GDP x 7% = 5% of GDP, which is what must be deducted from the nominal target of 3% of GDP.

22. The question, what public sector deficit in Greece is compatible with a non-growing ratio of national debt to GDP over time, has been explored in a number of papers: Manessiotis (1990), Stournaras (1990), Alogoskoufis and Christodoulakis (1991). They all demonstrate the great importance of the rate of real GDP growth relatively to the real rate of interest, which is obscured when the target for the PSBR, as set, implies that the interest cost, regardless of its magnitude, will be absorbed inside the target. A feature of all these papers is that they take GDP growth as exogenous. A vast range of questions would open up if it were endogenised. Inter alia, the relative marginal products of capital in the private and public sectors would be material to the story if the one crowded out the other.

23. See note 13.

24. The topic of recession raises the question whether there was some informal understanding that the commitment was to a cyclically-adjusted PSBR. If not, a process of increasing fiscal retrenchment is ushered in as the (unadjusted) PSBR commitment is threatened by recession-induced contraction of tax revenues and expansion of social expenditures. The built-in fiscal stabilisers are neutralised.

25. Nominal interest rates will also be falling. The direction of real interest rates is more difficult to predict. A depreciating real exchange rate exerts an upward pressure when viewed from the angle of relative yields between home and abroad. But to the extent that the current account improves, the balance of payments needs less assistance from capital flows and the climate of expectations is improved, so that a more relaxed policy stance towards interest rates becomes possible. Probably the downward influence of a drastically lower PSBR will dominate.

26. OECD (1991b) projects a GDP 1.7% higher in 1992 than in 1990. As GDP and other critical projections in OECD surveys are usually compromises between the OECD and the government concerned, it must be presumed that the Greek Government believes (or believed earlier this year) that no less and probably more growth could be projected. But the GDP projection is based on a super-optimistic assumption of 1.3% growth in private consumption. How optimistic this is can be gauged from the fact that real wages are expected to fall by nearly 4% in 1991 (OECD, 1991b, p. 75) and employees' disposable income to fall by even more due to fiscal drag and to the increase by one percentage point in the rate of insurance contributions in schemes covering the private sector. In 1992 a further fall in real wages is projected, judging by the estimated reduction in employee real compensation by 1.2% (OECD, 1991b, Table 18, p.76). Regarding the self-employed, their disposable income will fall by the extent to which the revenue yield from curbing tax evasion budgeted for 1992 exceeds that attained in 1990. This is 4.1% of GDP (OECD, 1991b, Table 17, p.58). As a percentage of the income of the self-employed it is higher, even allowing generously for the black economy. Add to this that the pre-tax real incomes of the self-employed are unlikely to avoid some decline when employees' incomes fall sharply. A boom of debt-financed consumption is not impossible. It happened in many OECD countries in the 'eighties, following liberalisation of banking regulations. It is not an experience deserving imitation. It would be ironic if consumption financed by public sector debt were to end up by being replaced by consumption financed by private sector debt. Note, incidentally, that with respect to the improvement in the current account, on which the GDP projection is also based, it is apparently assumed that it can occur at an unchanged GDP (indeed in conjunction with a slightly growing GDP) without provision for enhancement of competitiveness.



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