INTERNATIONAL MONETARY FUND

Greece--1989 Article IV Consultation

Concluding Remarks

Following the disappointing economic performance of the Greek economy in the years after the 1979 oil shock, and after the general elections held in October 1985, the government embarked upon a two-year program of stabilization, supported by a large balance of payments loan from the European Communities. This program marked a new realism in economic policy-making: a consensus emerged on the need to reverse the macroeconomic imbalances and to establish an environment conducive to durable growth of output, employment and investment. The program brought considerable achievements:

-- the external current account deficit was reduced to a level that could be financed entirely by nondebt capital inflows, thus halting the accumulation of external debt earlier than planned;

-- consumer price inflation was reduced from 25 percent to 16 percent;

-- enterprise profitability was improved for the first time in many years as a result of a firm wage policy and price liberalization;

-- monetary policy succeeded in lowering the rate of growth of bank credit, gradually establishing positive real interest rates, and initiating a process of financial deregulation;

-- the PSBR was reduced from 18 percent of GDP in 1985 to about 13 percent in 1987; an achievement that fell short of initial objectives but was nevertheless significant.

Developments in 1988 reflected the benefits of the stabilization program, with real growth of 3 1/2 percent in GDP and 10 percent in fixed investment. The current account deficit was reduced further to 2 percent of GDP and foreign exchange reserves rose substantially. Despite these obvious achievements, there were also some disquieting tendencies. First, the relaxation of wage policies--though in part inevitable-- resulted in real wage increases that were well above the growth of productivity. Enterprise profitability declined and remained unsatisfactory when compared with earlier periods and with the recovery of profitability in other EC countries. Second, the PSBR not only failed to decline as budgeted, but instead rose by 2 1/2 percentage points to almost 16 percent of GDP, close to the level before the adoption of the stabilization program. Once again, actual revenues fell short of planned levels--despite stronger nominal GDP growth--and larger deficits were registered by public entities. Third, liquid assets in the hands of the public rose considerably. Fourth, the underlying rate of inflation may well have been higher than in 1987, allowing for the effects of the introduction of VAT and the lifting of price controls early in that year. Finally, while the current account balance improved in 1988, the nonoil trade deficit widened despite a favorable external environment.

The official projections for 1989 show a broadly satisfactory outlook: continued growth of output and investment, slightly lower inflation, and a comfortable external position. Apart from possible spillover effects from the fast growth of income and private sector liquidity in 1988, the foremost problem is the unsatisfactory financial position of the government. In a year of higher than average growth, the PSBR is officially projected to remain at 16 percent of GDP; it is likely to turn out higher. While revenue estimates appear to have been made more prudently than in recent years, conditions for improved tax collection are not favorable in 1989. Moreover, past experience shows that expenditure overruns are likely and that the deficits of public entities and enterprises tend to be considerably higher than initially envisaged. A PSBR higher than budgeted will put additional pressures on interest rates and monetary growth; this could imperil financial deregulation and pose an inflationary threat. Given the current underlying rate of inflation, there is a clear danger that--in the absence of temporary ad hoc measures--the inflation target will be exceeded unless both monetary and wage policies are more restrictive than currently envisaged. Against this background, the recently announced reduction in interest rates on treasury bills would appear a step in the wrong direction.

The size and nature of the current imbalances require that they be tackled over a number of years. What is needed is a medium-term strategy aimed at key financial and economic objectives embodying quantitative targets. Such a strategy should be designed to enable Greece to participate fully in the financial and economic integration of Europe and ultimately in the EMS. The appropriate medium-term framework should provide a nominal anchor and impose discipline on both public finances and private wage settlements.

The centerpiece of any macroeconomic strategy must be a clear objective for fiscal policy. Without discretionary fiscal action, the PSBR will trend rapidly upward. Interest on the public debt alone will ensure this, especially given the higher real interest rates required by Greece's progressive financial integration within the EC. The mission thus welcomes the intention of the government to begin corrective fiscal action in the course of this year. The stated aim of the Minister of National Economy is to stabilize the debt/GDP ratio by the end of 1992. The adjustment implied is, in our view, both necessary and feasible. Under the optimistic assumption that the PSBR in 1989 can be held below 16 percent of GDP and the primary deficit can be reduced by 2-3 percentage points a year from 1990 to 1992 (to achieve a primary surplus of around 2 1/2 percent of GDP by 1993), the debt/GDP ratio could be stabilized at its 1992 level.

A fiscal program along these lines will need action on both expenditures and revenues. Some reversal of the rise in government non-interest expenditure--from 24 percent of GDP in 1980 to 36 percent in 1988--is important both to achieve the fiscal objective and more generally because a more restricted role of government in the economy should free resources for private investment. This will require control over hiring and salary increases, a reduction in transfers and subsidies to private as well as public entities, and a major reform of the social security system. In particular, pension benefits should be more closely linked to contributions and the provision of invalidity pensions strictly controlled.

No long-term adjustment in public finances is feasible without tax reform and a significant improvement in tax administration. Among the issues to be addressed are the expansion of the tax base to include income groups that at present enjoy tax privileges, the curtailment of income tax and VAT evasion, the enforcement of penalties for tax evasion, and harmonization of company taxation and taxes on capital income within the EC.

The medium-term objective of convergence of inflation to the EC average requires that monetary policy be coordinated with fiscal policy; the links between the PSBR and monetary expansion should be loosened, so that the task of curbing inflation is assigned primarily to monetary policy. This will necessitate greater sales of government debt to the nonbank public at rates of interest that are determined by market criteria. Eventually, with progress on the conduct of monetary policy, the mix of fiscal and monetary policy will be a principal determinant of the exchange rate of the drachma within a financial system free from controls.

Exchange rate policy will have to strike a balance between the conflicting objectives of achieving competitiveness and containing inflation. If anti-inflationary fiscal and monetary policies are adopted, a broadly stable real effective exchange rate policy, without immediate and automatic accommodation of wage increases, can provide such a balance. The opening of Greece's capital and financial markets will require a more active and flexible use of interest rates with enhanced monetary policy instruments. A credible and predictable nominal exchange rate path will help both to maintain confidence and to sustain the needed inflow of private capital.

We recognize that there is an obvious need to enhance employment opportunities and to converge toward the higher living standards enjoyed elsewhere in the EC. Indeed fiscal adjustment would be facilitated by a sustained growth of output. The experience of 1984-85 clearly shows that durable growth cannot rely on shortlived expansionary impulses from the public sector. Rather it requires a stable framework of incentives for private initiative. This means policies aimed at enhancing the supply responsiveness of the economy and fostering entrepreneurship. In the words of the Prime Minister's September 1988 speech in Thessaloniki--"we must cast aside restrictions and outmoded barriers of the past that still exist--and we must do it today." Integration with the EC and the increased financial transfers for structural policies provide both opportunities and resources for the necessary reforms. The key reforms we envisage are:

First, the tax-subsidy-regulatory system in itself constitutes a disincentive to economic activity. It is overly complex, opaque, and frequently produces allocative and distributive results that were never intended and are contrary to the objectives of sustained growth. A private sector preoccupied with benefitting from this system cannot focus on productive enterprise. A fundamental reform and simplification in this area should go along with the macroeconomic objectives of fiscal policy.

Second, the drive toward financial deregulation must be continued. Great progress has been made, yet the array of financial instruments is still narrow, secondary markets remain thin, bank lending is cross-subsidized, and the spread between rates obtained by savers and those paid by borrowers continues to be very wide. Measures to reduce this spread would increase the efficiency of financial intermediation.

Third, the regulations governing labor markets should seek to provide only a stable and equitable framework; frequent intervention in private activity should be shunned. Employers must be free to set wages so as to reflect productivity gains. If companies cannot reduce the work force in a downturn, they will be fearful of hiring in an upturn.

Fourth, there is a need for a policy reorientation toward leaner public enterprises and state-controlled financial institutions, with salary structures, geared to improving work incentives. Failing this and with the establishment of the single market, state-controlled banks and public enterprises will lose market shares, while domestic industry will be at a disadvantage because of its reliance on relatively expensive inputs.

Fifth, non-viable corporations should not be sustained indefinitely. In some cases, maintaining problem enterprises has required a costly transfer of resources from the budget, the banking system, the public utilities, and the social security system. Unless private purchasers can be found who are prepared to restore such companies to viability, the assets of these companies should be liquidated. In any event, public funds used to maintain such companies should be provided in a transparent form and subjected to proper cost-benefit analysis.

Clearly, we envisage a full agenda for Greece over the next few years. It will require leadership with courage and vision. But Europe is on the move and Greece cannot be left behind.

Athens, January 30, 1989