Annex I

THE 1991 PROGRAMME OF FISCAL CONSOLIDATION

I. The Stabilization Programme

In April 1990 the newly elected government adopted a series of measures aimed at containing the rapidly deteriorating fiscal and macroeconomic trends. The package, which included a modification of the wage indexation system and a strict monetary policy, did not include exact quantitative targets except for the borrowing requirements of the public sector; absent also were structural reform measures. The inexact nature of the package eroded its credibility, and a more rigorous programme of fiscal adjustment and structural reform was adopted in light of the Community loan granted in March 1991(1).

The 1991 stabilization programme has two broad objective: containment and reversal of the fiscal imbalances and of the macroeconomic deterioration, and the restoration of the economy's ability to produce through the initiation of structural reform measures, and, consequently, the betterment of the real income prospects of Greece's citizens. The programme is defined in terms of a specific timetable. In order to achieve the final objectives intermmediate targets for key macroeconomic and structural variables are set. Thus, unlike the 1985/87 programme, the current one is very specific and represents an exogenous constraint to the conduct of economic policy. Another feature of the programme is the conditional disbursement of the loan tranches in order to secure that not only the programme objectives are achieved, but also to monitor the progress of the programme implementation.

The programme's targets are shown in Table I.1. Aknowledging the unsustainability of fiscal policy, the following steps are envisaged:

(1) the central government net borrowing requirements are to decline from 17% of GDP(2) in 1990 to no more than 10,4% in 1991, 5% in 1992, and 1,5% in 1993; similar restrictions apply to the borrowing requirements of public enterprises and entities;

(2) the tax base is to be broadened by introducing an alternative income tax system for professionals, and by raising a target tax revenue from agriculture, set at DRS 65 billion by 1993; a series of measures (such as computerization of tax offices and hiring of specialized

(1) The Council decision granting the loan is published in the Official Journal of the European Communities, no. L 66/22, March 13, 1991.

(2) The net borrowing requirements of the central governement have been revised to 17,6% in 1990.

personnel) aimed at increasing the effectiveness of the tax collection mechamism and at combatting tax evasion and fraud is also envisaged;

(3) employment in the public sector, measured on the basis of the stock of employees at the end of 1990, is to decline by 10% by the end of 1993; this is equivalent to a 52 500 reduction in employment; this

Table I.1
Macroeconomic and Fiscal Adjustment, 1990-1993
(percentage change and percent of GDP)

	1990	1991	1992	1993
Inflation (CPI end period)	22.8	16.6	12.4	7.0
Unit labour costs	22.1	14.5	10.4	6.8
Current account deficit	5.4	5.2	3.6	3.0
Real GDP growth	0.8	0.9	1.6	3.5
Total credit expansion	16.9	12.2	8.4	6.6
Money supply (M3)	14.3	13.0	10.1	8.4
Current tax revenues	25.4	28.9	31.5	34.3
Non-tax revenues	1.8	4.6	5.0	3.8
Ordinary expenditure (*)	29.1	28.2	26.7	25.9
Primary deficit	5.4	-1.9	-6.4	-8.3
Net PSBR	19.5	13.0	6.7	3.1
Public debt	109.2	108.2	101.9	94.1

(*) net of interest payments
Source: Commission services and Ministry of National Economy

will be achieved with a recruitment policy in which only one for every two employees who leave the public sector will be replaced, and by the privatization measures;

(4) an incomes policy, granting a 4% increase in nominal wages on January 1, 1991, and another 4% on July 1, 1991, is to apply to the central government and to the wider public sector; a restrictive incomes policy is to continue in 1992 and 1993; restrictions are also envisaged for non-wage expenditures.

The structural reform measures, already discussed in the main text of the study, are:

(1) the oil market will be deregulated within 1991;

(2) the transparency of the public sector accounts, and especially of the public enterprises and entities will be enhanced through a new system of monitoring and control;

(3) deregulation of goods, labour, and service markets is to be implemented according to a timetable for legislative action so that Greece participates fully in the internal market programme;

(4) the government is to undertake tax and social security reforms, reduce the share of the wider public sector, and liberalize international capital transactions;

(5) the government has also undertaken to proceed with a privatization programme so as to reduce the weight of ailing public enterprises on the budget, and also in order to narrow the presence of the public sector in the economy;

(6) policies of financial repression are to be phased out and the preferential access of the government to the banking system and to the Bank of Greece is to be removed by July 1, 1993.

Restrictive financial policies are set to complement the fiscal adjustment programme and to strengthen the disinflation process. Thus:

(1) the rate of domestic credit expansion, and the rate of monetary growth, are constrained to follow a declining trend;

(2) exchange rate policy will assist in the disinflation process by allowing a rate of drachma depreciation less than the inflation differential against Community member states; the ultimate objective is to join the ERM by 1993.

A key aspect of the programme is the sharp decline in the primary deficit by 7.3 percentage point relative to GDP between 1990 and 1991, with the cumulative adjustment amounting to 13.7 GDP points between 1990 and 1993. Indeed, a primary surplus is expected for 1991. Similar large declines in the net borrowing requirements are also projected during the course of the adjustment. The tight monetary and fiscal policies are expected to foster external adjustment, and the current account deficit is projected to stabilize at 5.2% of GDP in 1991 and follow a downward trend to 3% by 1993. Inflation is expected to fall sharply between 1990 and 1993, reaching 7% at the end of the adjustment period. During the early part of the programme real GDP growth will remain below potential; in 1993, however, the economy is projected to recover, registering a growth rate of 3.5%. In the course of the adjustment public debt relative to GDP initially falls marginally, but from 1991 onwards it falls at a rapid rate and by 1993 it is projected to decline to 94.1%. This is achieved despite the measures undertaken to liberalize financial markets which will, no doubt, raise the real rate of interest paid on Greece's public debt. The debt adjustment is made possible by the sharp reduction in primary spending as well as by the recovery in output performance in response to the structural initiatives.

In order to secure substantial adjustment upon initiation of the programme, much of the fiscal and structural measures are to be implemented during 1991. This would clearly ensure that further initatives can be built upon the gains already made. There is an additional consideration supporting this strategy. Since the abandonment of the 1985 stabilization programme, Greece's credibility capital, domestically as well as internationaly, has declined markedly. Restoration of credibility and, more specifically, establishment of the credibility of the stabilization programme, requires not only the announcement of the intention to adjust, but also evidence that the government is implementing and will not reverse its adjustment policies. The gains from credibility could come in the form of lower interest rates, a stronger than otherwise capital account surplus, and a stronger international value of the drachma; in this respect the disinflation process would take place at a faster pace and the ultimate objective of joining the ERM would become easier to attain.

II. Fiscal Consolidation Measures

Fiscal consolidation is based on increasing current tax revenues from 25.4% of GDP in 1990 to 34.3 % in 1993, and non-tax revenue revenues from 1.8% of GDP in 1990 to 5% in 1992. The effectiveness of the tax collection mechanism is expected to improve, while the initiatives to broaden the tax base will distribute the burden of taxation more equitably. The Ministry of Finance has reviewed alternatives for the taxation of self-employed in an effort to combat tax evasion and fraud, and it is currently expected that the intended alternative tax system will not be implemented; instead, a system setting an exogenously determined tax liability according to various criteria related to the income-earning potential of the professional is planned to be introduced. The effectiveness of tax administration is expected to benefit from the requirement that all shops must have cash registers by 1993, from the recruitment of specialized tax inspectors, and from the programme of computerization. Already all customs offices are equiped with computers. In order to combat the problem of under-reporting of incomes for tax purposes, various wealth or consumption indicators (cars, yachts etc) are planned to be used in conjunction with the self-assessment to arrive at the "true" income of taxpayers. Furthermore, it is now required that purchases of real estate must be accompanied by a statement of thesource of funds, while a capital gain tax on property has also been introduced. Finally, the taxation of interest income from bank deposits, at a rate of 10%, was introduced effective in 1991, while interest from government bills and bonds remains free of tax. As a result of this, there has been a notable shift away from bank deposits towards Treasury bills and bonds during the first half of 1991; this shift is expected to be transitory reflecting a stock adjustment process or portfolio reallocation.

With respect to non-tax revenues two initiatives are envisaged: privatization of state enterprises, and the issue of land bonds. Privatization will be a novel experience in Greece. The IRO is planning to privatize all of its 170 enterprises, and seven have already been sold. It is also estimated that a profitable enterprise, the Heracles Cement Works, will be privatized in the fall of 1991, raising around DRS 50 billion, less than the DRS 135 billion initially estimated, in budgetary revenue. The government is also preparing the necessary regulatory framework to make possible the sale of shares in public utilities. While it is unlikely that such sales will actually take place in 1991, the medium-term revenue potential from the privatization of public utilities is very significant. Concerning land bonds, these are intended to provide the right to purchase public property at some point in the future. Land bonds are expected to yield DRS 125 billion in revenue in 1991; however, the preparatory work has been very slow and it is unlikely that this target will be achieved.

Public expenditure net of interest payments is projected to decline from 29.1% of GDP in 1990 to just below 26% in 1993; including debt service payments the ratio of central government spending in GDP, which was 48.6% in 1990, is expected to rise to 50.4% in 1991, and to decline subsequently to 47.8% in 1993. These trends are projected on the basis of the incomes and recruitment policy envisaged in the programme, while strict control of expenditure procedures are also expected to contribute to budgetary savings. Expenditure management will also be reformed so as to ensure that expenditure overruns are contained, while the tradition of spending all budgetary savings in a fiscal year through re-allocation from surplus to deficit spending units is to be abolished. The 1991 budget has already taken steps to reduce grants and subsidies and this trend will continue. In this respect, a new public investment policy has been proposed, relying more on tax incentives and less on grants and subsidies, and incorporating a stricter control of approval and monitoring processes. Concerning the burden of the social security system on the central government budget, this is expected to ease as the financial strength of the former is revived through a programme of structural initiatives. Finally, the public administration system is to be modernized by increasing the professionalism of the civil service, and taking steps to depolitisize public sector job allocation and reducing the influence of clientelism.

The implementation of the stabilization measures has not been advanced to the degree required to ensure achievement of the 1991 targets. There are serious difficulties in meeting the revenue targets stemming from the decline in nominal output growth, and from the failure to combat adequately tax evasion and to collect tax arrears, while the tax base continues to be inadequately narrow; non-tax revenues will not be collected according to plan either as the pace of privatization and of issuing land bonds has been very slow. Lacking also has been effective action on the tax administration front, and measures such as the introduction of an alternative tax system will not be brought forward as envisaged in the loan conditions.

Pressures also remain on public expenditure which will make it difficult to contain spending. The shortfall in revenues will make it necessary to finance a larger than anticipated deficit through issues of Treasury bills. This implies that debt service payments will exceed the ex ante estimates perhaps by a substantial margin. The government's incomes policy appears to be holding. However, recruitment pressures are intense and the objective of recruiting one employee for every two leaving the public sector is not being respected. There is a large number of authorization to recruit which, if acted upon, could raise public sector employment and expenditure very substantially.

The implications of the failure to meet the budgetary targets in 1991 is that the 1992 targets are at risk, and substantially greater efforts would be required to even remain within the targets, let alone make progress, in the remaining months. It is also certain that real interest rate will stay high, with deleterious effects on private investment spending, while it is also likely that the credibility of the monetary and exchange rate policy pursued will increasingly come into question.

III. A Comparison with the 1985/87 Programme

Unlike the current programme, the 1985/87 programme had more limited objectives(3) aimed primarily at containing the external deficit, inflation, and the fiscal deficit; a passing reference was also made to the need that the stabilization measures must be placed in a medium-term perspective. The experience of the 1985/87 programme, seen from the perspective of ten years of macroeconomic imbalances and declining productive potential, became very instructive in the design of the current programme in that it underlined the need for a coordinated fiscal and structural reform in the absence of which the viability of stabilization would come into question. These steps have been articulated in the 1991 programme.

The Council decision defined the following objectives to be pursued by the Greek government :

(1) a decline in inflation from 15% at the end of 1986 to less than 10% by mid-1987, excluding the effects of the introduction of the VAT from January 1, 1987;

(2) a reduction in the growth of unit labour costs through an adjustment in wage indexation; this was to be based on an advance inflation norm excluding the effects of import price inflation;

(3) a reduction in the borrowing requirements of the public by four percentage points of GDP in 1986, and by a similar amount in 1987;

(4) a reduction in the rate of expansion of domestic credit to 17% in 1986 and to 11% in 1987, and a significant reduction in the monetary financing of the PSBR;

(5) a reduction in the current account deficit "so that as early as 1988 the external public debt can be stabilized in terms of absolute value"(4).

---

(3) The programme was stated as part of the loan conditions. See the Council Decision in the Official Journal of the European Communities, no. L 341/17, December 19, 1985.

(4) Council decision point 5.

The decision also required that priority should be given to modernizing Greece's productive structures and to promoting the establishment favourable to the recovery of productive investment.

The Council decision was based on a series of measures proposed by the Commission; these were[5] :

(1) a foreign exchange, interest-free, deposit equal to 40%, and 80%, respectively, of the cif value of specified goods; these deposit certificates would be issued automatically; the deposits were to be released after six months;

(2) some exceptions to the import goods subject to the above condition were specified, concerning re-export of goods and related matters;

(3) Greece was to ensure that there was no discrimination in the granting of credits to domestic and Community producers;

(4) Greece was permitted to continue various restrictions on international capital flows up to a period of three years, as well as to provide export subsidies;

(5) the Commission and the Greek government would jointly review the progress in the application of the measures.

The programme was implemented with a 15% devaluation of the drachma against the US dollar and a restrictive incomes policy. However, little was done to redress in a fundamental manner the public finances, and there was no effort directed towards limiting the role of the state in economic activity. The restrictive stabilization measures and the depreciation-induced inflation eroded sharply the real incomes of Greece's citizens; together with the lack of structural reform the prospects for recovery were dimmed. These factors were crucial in the failure of the stabilization programme. The current programme has taken this experience into account and has placed strong emphasis on a change in the policy regime and in the implementation of both structural and stabilization measures to reform Greece's economy.

---

(5) See the Commission decision authorizing Greece to take measures under Article 108 (3) of the EEC Treaty published in the <u>Official Journal of the European Communities</u>, no. L 373/9, December 31, 1985.

Annex II

FINANCIAL MARKETS

1. Overview

The financial system in Greece operating for a long time under extensive administrative arrangements and controls has started responding positively to the liberalization measures and reforms taken by the authorities during the recent years. The pressure for these changes emanates from the urgent need to improve the efficiency of the financial markets and keep in pace with the developments in the Community concerning the completion of the internal market and the drive towards the economic and monetary union.

Despite the progress already made, the Greek financial markets still operate subject to considerable restrictions, notably on the external financial flows. The further relaxation and removal of these restrictions and the resulting increased competition is expected to improve the functioning of the financial markets and the allocation of resources. An important step in this direction was the removal, last May, of all restrictions on the movement of long-term capital. The structural problems and the modest performance of the Greek economy can be partly attributed to the low allocative and technical efficiency of the financial system.

The normal difficulties of the passage from a situation of tight foreign exchange controls and extensive credit regulations domestically - basic features of the postwar Greek financial system - to a system of free capital mobility and market determined allocation of credit are compounded by the serious macroeconomic imbalances and the high inflation.

This poses also a problem of timing and sequencing with regard to financial liberalization and the entry of the drachma into the exchange rate mechanism of the EMS : full liberalization and a quick entry in order to gain from the EMS credibility or a more gradual approach implying a prior substantial reduction of inflation and macroeconomic imbalances. Economic and financial considerations seem to suggest a gradual, but determined approach.

2. Structural characteristics of the financial system

The structure and functioning of the Greek financial system during the last decades was determined, to a large extent, by the economic situation of the country and the political economy of growth chosen by the authorities : the financial system was considered as a crucial means for mobilising scarce national savings and channelling them to targetted industries and other productive activities.

The administrative arrangements used for this purpose were typical of those followed by most developing countries : tight foreign exchange controls on the external side and administratively set interest rates - below their equilibrium levels - combined with credit rationing in the domestic credit markets. To the above stated aim of promoting development was subsequently added, not always explicitly, the need to satisfy the rising borrowing needs of the state.

A financial sector dominated by the banking system, itself largely state-owned or controlled and highly concentrated, best served the aimed mobilisation and guided channelling of savings and this had been, and to a large extent still is, the basic structural feature of the Greek financial system.

These foreign exchange and credit controls have been considerably relaxed during the recent years. The main reforms and other liberalization measures taken as well as their impact are examined in the section 3 below.

The banking and payments system

Most of the financial savings of the public is kept in the form of bank deposits a fact reflected in the rapid rise of the liquidity ratio (M3 to GDP) in the economy :

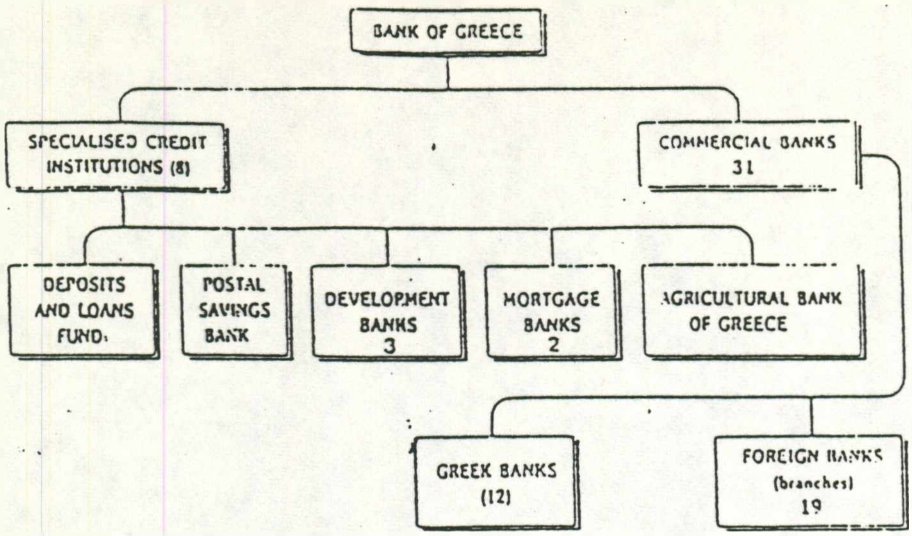
1. Liquid assets (*) of the private sector as % of GDP

1971	1981	1983	1985	1987	1989
0.43	0.55	0.60	0.67	0.73	0.80

(*) Deposits with banks and other credit institutions
Source : Bank of Greece

This rising ratio of financial savings to GDP indicates in principle a financial deepening of the economy, itself a positive factor. On the other hand it shows an inadequate range of attractive financial outlets available to investors apart from the potential problem of monetary control it may imply.

STRUCTURE OF THE GREEK BANKING SYSTEM



Source : Hellenic Banks' Association

Commercial banks accept all types of deposits and offer a wide range of financial services and short to medium-term loans. 95% of private deposits with commercial banks are in the form of savings (68%) and time (27%) deposits.

The largest commercial banks and all specialised credit institutions are state-owned or controlled. The first six largest state-controlled banks (including the specialised ones) represent 86% of total assets and 85% of total deposits (1988 data).

Six Greek banks were ranked among the top 1000 worldwide and three among the top 500 during 1989 (The Banker). The ranking of the largest, National bank of Greece, was 319.

The specialised Credit Institutions include 3 development banks extending long-term credit to the industrial sector. The larger, National Hellenic Development bank had been using funds from the central bank in financing its activities. Currently most of its resources come from bond issuing on the capital market.

Banks operating in Greece 30.11.1989 — Mrd DR

	Assets	Deposits
Commercial banks	7.266	5.124
Specialised credit institutions	3.763	2.307
	11.029	7.431

Source : Bank of Greece

Two other factors not easily quantifiable are cited as contributors to this rising volume of deposits. The sizeable underground economy as well as a certain "financial inertia" on the part of investors long accustomed to financial repression. The underground economy could explain the rising liquidity ratio only as long as it grows faster than "visible" economy.

The most noticeable characteristics of the payments system is the high proportion of banknotes in the total amount of means of payments. The ratio of banknotes and coin to narrow measure of money, M1, is twice as high compared to Community average :

2. Ratio of banknotes and coin to M1 %

	1980	1989
Greece	66.5	61.2
Community average	33.5	30.5

This extensive use of banknotes and the parallel limited use of checking accounts or other more advanced means of payments imply considerable transaction costs (in terms of time, risk, safety measures ect.) for the economy. For the banks the counting, storing and other related costs constitute a substantial burden (Report of the National bank, 1989).

National and international credit cards play an increasing though still limited role in the payments system. Salary accounts, automated fund transfers and cash dispensers are also in use but not as yet fully developed.

The low degree of maturity of the financial system is the basic explanation of this phenomenon. Other more specific explanatory factors are the nature and organization of economic activity : the big number and small size of enterprises, the high share of self-employed in the active population, the importance of the agricultural sector etc.

Non-bank financial intermediaries

With regard to non-bank financial intermediaries the insurance companies and the pension funds are in many countries the most important. In Greece the pension funds are part of the government sector who finances their deficits.

With regard to the activity of the insurance companies the available information is incomplete as no agency keeps complete accounts for their activity. Data for the 0 largest insurance companies operating in Greece (covering 90% of the market) estimates their assets at 93 Mrd DR at the end of 1987. For the sake of comparison, banks assets were 5.031 Mrd. It should be noted that the biggest insurance companies were created and are controlled by the state owned commercial banks.

The low ratio of total gross premiums to GDP compared to Community average gives also a measure of the still unexploited potential of the insurance market in Greece.

3. Insurance services : gross premiums (% GDP, 1988)

Greece	EC average
1.42	5.5

The capital market

The degree of development of the capital market remains low although it started gaining in importance during recent years mainly for debt finance, following the increasing borrowing needs of the government. Despite a sharp rise of share prices since 1986 and a very active trading in the secondary market new equity issues are rare.

4. Athens stock exchange Mrd DR

	Market capitalization				Trading volume			
	1986	1987	1988	1989	1986	1987	1988	1989
Shares	156	565	633	997	4.5	59.6	44.3	89.1
Fixed interest securities	445	788	1786	2763				

Source : Athens Stock Exchange

The table below shows the share of the principal sources of funds in the financing of the non-financial sectors of the economy, during the last four years.

Sources of finance for the non-financial sectors
(shares in %)

	Capital market total	debt	equity	Banking sector	External borrowing*	Total
1986	2.6	2.2	0.4	74.1	23.3	100.0
1987	16.1	15.2	0.9	77.2	6.7	100.0
1988	23.8	22.3	1.3	73.6	2.6	100.0
1989	12.2	11.7	0.5	78.3	9.5	100.0

* Public sector only., No data are available for the external borrowing of the private sector
Source : Commission services estimates based on Bank of Greece data

As it is made evident from the above table the substantially increased share of the capital market concerns almost exclusively debt financing. New equity issues were few and the amounts involved remained limited although an upward trend is discerned. A break in the trend during 1989 is most probably due to the political instability during that year.

3. Flow of funds and financial policies

As was already noted the banking system during the last decades played a pivotal role in mobilizing the available funds of the net savers (Households and Rest of the world) and allocated them to the net borrower sectors (Enterprises and Public administration).

The explicit aim of the credit policy over this period was to give priority to the financing of industry in order to enlarge the productive potential of the economy and accelerate the economic development of the country. All measures concerning credit policy as well as detailed decisions for its implementation had been taken by the government Currency Committee.

The same policy in its general lines was followed during the first half the '80s. despite the abolition of the Currency Committee in 1982 and certain reforms, the complex framework of credit controls and regulations remained intact.

A central function of the financial markets is to ensure that the available funds are channelled into the most profitable investment opportunities. Although no straightforward application of this criterion of allocative efficiency is possible under a system of administratively allocated credit, a general assessment of the role of the financial markets in relation to the performance of the Greek economy can be made.

An examination of the composition of total bank credit during the two last decades shows that the bulk of it was indeed channelled to manufacturing sector. This privileged credit allocation is not, nevertheless, reflected in the composition of fixed capital investment.

6.	Total bank credit to the private sector composition (%)		Gross private investment in fixed capital composition (%)	
	1970-79	1980-88	1970-79	1980-88
Manufacturing	47.3	42.5	20.3	21.8
Agriculture	19.1	26.3	7.7	6.8
Dwellings	11.6	14.7	41.0	37.2
Other	22.0	16.5	31.0	34.2
Total	100.0	100.0	100.0	100.0

Source : Commission services estimates based on Bank of Greece and Greek National Statistical Service data.

It is noteworhty that investment in manufacturing throughout this period was almost half of that in dwellings whereas credit to manufacturing was three to four times higher.

A number of factors seem to have contributed to this phenomenon : (i) a diversion of part of the bank credits from their declared use, (ii) the preference of banks in granting short-term credits for working capital instead of long-term for productive investment and (iii) the use of part of low cost bank credits to industry for the financing by the latter of commerce or other activities having no or limited access to the banking system.

The above factors may be able to explain the disparity between credit and investment flows in manufacturing but do not suffice to explain the big difference between low credits and huge investment in housing. The inflow of funds from abroad seems to fill this gap. Balance of payments data show that these funds tock the form of either remittances by migrants and seamen (current account) or deposits in foreign exchange and capital for real estate investments (capital account). Irrespective of their form and origin an important part of these funds was absorbed by the housing sector.

An important feature, and chronic problem, concerning the financing structure of the manufacturing enterprises is their low ratio of own to external funds. The financial position and economic activity of these enterprises was adversely affected by this high reliance on external finance when interest rates rose sharply, firstly at the beginning of the '80s and further, later, under the pressure of the huge borrowing needs of the public sector.

7. Financial structure of manufacturing enterprises : ratio of own funds to total assets

1983	1984	1985	1986	1987
0.23	0.16	0.13	0.17	0.28*

Note :the average ratio of 8 Community countries, for 1988, was 0.53.

*The rise of the ratio this year reflects mainly the capitalization of the debt of "problematic" companies.

Source : Ionian Bank of Greece, Quarterly bulletin.

The reasons for companies' excessive reliance on borrowed funds should be principally sought in the said easy access to bank finance, often at negative real interest rates, but also in their inability to generate enough profits, this last often as a result of government policies (inability to adjust the price of their products due to price controls, labour market restrictions etc.).

The overborrowing of the enterprises - originating from the availability of low cost credit - is often linked to a falling quality of investments. This seems a relevant question in the case of Greece if one takes into account the already mentioned diversion of bank credit, but also by looking at the type of realised investment as well as the competitiveness and export performance of Greek industry.

Evidence suggests that the competitiveness of Greek industry has deteriorated during the past decade. Its international specialisation is focused in products of low capital intensity, low value added and low technology. The share of rationalisation and new technology-embodying investments during 1986-89 was half to the Community average, a fact revealing a low degree of response to new competitive environment.

A noticeable development with regard to the flow of funds in the early '80s was the replacement of Enterprise sector by the Public administration as the most important net borrower sector.

8. Extract from the consolidated balance sheet of the monetary system

	1980	%	1989	%
ASSETS	1973.0	100.0	14699.1	100.0
Claims on government	494.3	25.1	5315.6	36.2
Claims on public enterprises and entities	131.7	6.7	1538.9	10.5
Claims on priv. sector	862.4	43.7	4017.8	27.3
other	484.6	24.5	3826.8	26.0

Source : Bank of Greece

The growing budget deficits during this period and their corresponding financing needs did not permit a quicker pace and higher degree of financial liberalization, at a time when such a development was most needed in order to improve the efficiency of the financial system, in view of the unified European market.

The effects of the huge budget deficits on the financial markets and the pace of liberalization work mainly through the adverse macroeconomic environment they create (persistence of inflationary pressures, high interest rates, growing balance of payments deficits) an element that increases the difficulties and risks of a rapid domestic and external financial liberalization. These very same elements complicate also the conduct and effectiveness of monetary policy and render difficult a strategy for an early entry of the drachma into the EMS.

4. Liberalization measures and reforms

Financial markets restrictions, along with administrative barriers, are regarded by Greek companies (Commission study on "cost on non-Europe", 1987) as the most important hindrance, among ten examined, to be removed by the creation of the single European market. This high ranking of capital market liberalization in enterpreneurs' priority list, the highest among Community countries, gives a measure of the problems these restrictions pose for Greek companies activity in the European market and of the urgency for financial liberalization and reforms.

During recent years significant measures in this direction have been taken by the Greek authorities :

- the highly complicated system of credit rules and controls, by which bank credit was allocated to favoured industries and activities has been almost completely abolished. Only Consumer credit is still subject to constraints;

- deposit and lending interest rates are now, to a large extent, freely formed. On the banks' liabilities side the only administratively set interest rate is a minimum rate on savings deposits. On the assets side about 90 percent of the credits to private sector and to public enterprises is market determined.

The real progress this situation represents, compared to the recent past, is nevertheless mitigated by the fact that commercial banks can freely dispose of less than half of their resources, as a result of the requirement to allocate 35% of their deposits(30% as from 1.7.91) to invest in treasury bills, 10% to finance other government selected activities (handicraft sector) plus banks' reserve requirements for monetary policy purposes. This compulsory bank financing of the Government budget and the handicraft sector, at lower than market rates, will be phased out at the margin by the end of June 1993.

- an important asymmetry marks the developments regarding exchange restrictions and capital movements. Inflow of capital by non-residents are almost totally free, while capital outflows are still subject to considerable restrictions although sgnificant liberalization measures have been taken also in this domain. An important development in this area is the liberalization last May of the purchase by Greek residents of real estate abroad and foreign long-term securities.

9. Capital movements : remaining restrictions

Inflow	Until
. Inflow of capital by Community residents	free
. Financial credits and loans granted to Greek residents (limited restriction)	31.12.1992
Outflow	
. Investment in securities (1)	free
. Investment in real estate (1)	free
. Short-term capital	31.12.1992*
opening of bank accounts abroad	
financial credits and loans	
physical transfer of funds	

(1) liberalized on 6 May 1991

* Possible extension for 3 years (maximum) under specified conditions, following a decision by the Council.

Source : Commission services

It is evident from the above that despite the progress already achieved, the Greek financial markets still operate subject to considerable restrictions, notably on the external financial flows. This renders difficult the development of key markets and the integration of the Greek financial system in the unified European financial area.

The foreign exchange restrictions still in place have not allowed the functioning of a forward exchange market enabling companies engaged in international activities to cover their foreign exchange exposure. The current arrangements in this regard cover contracts of a very short period (seven days) with the Bank of Greece bearing the foreign exchange risk.

Credit institutions are not allowed to have an open external position beyond specified limits while the central bank bears the foreign exchange risk for deposits in foreign currency with banks and specialised credit institutions. This last arrangement constitutes a source of subsidised funds for the financial institutions concerned. On the other hand the considerable amount of these deposits combined with the depreciation of the drachma lead to sizeable "valuation differences" which are a source of liquidity creation. The outstanding amount of these "foreign exchange differences" represented in 1989, 25.3 percent of total claims on private sector.

The table below gives an indication of the relative importance of the deposits in foreign currency with commercial banks and specialized credit institutions in Greece.

10. Deposits
(outstanding in bn drachmes)

	1987	1988	1989
Total	6100	7543	9300
In foreign exchange	1205	1501	1870
In drachmes	4895	6042	7430

Source : Bank of Greece

With regard to the money markets, the operation of the interbank market constitutes an important first step towards the development of a fully-fledged drachma money market. Recent Bank of Greece decisions to proceed to sale and repurchase agreements, with banks, on treasury bills is a movement in this direction. The participation of non-banks and the trading of a wider range of financial instruments would contribute to the creation of a more mature money market. This would also improve the operational arm, of the monetary policy in the new framework of interest rates deregulation and financial liberalization.

The higher interest rates observed following their deregulation revived interest in the capital market especially on the part of the state in search of funds for the financing of its huge deficits. Although the interest of investors for equities is high, as is evidenced from the sharp rise of the share price index as well as the volume of transactions in the secondary market of the Athens stock exchange, the supply of newly issued shares remains limited. The extensive privatisation programme of the government is expected to increase substantially the supply of new equities and contribute to the further development of the capital market.

5. Outlook

Financial liberalization and EMS

Given the expressed firm commitment of the Greek government to the financial liberalization and to the economic and monetary union, which passes first from an entry of the drachma into the EMS, the question that has to be answered refers to the pace of liberalization process as well as the sequence of each policy engagement taking account, of course, of the Community timetables and decisions.

The basic options seem to be : full financial liberalization and a quick entry in order to gain from the EMS credibility or, alternatively, a more gradual approach implying a prior disinflation and substantial reduction of macroeconomic imbalances.

The main argument in favour of a removal of capital controls and quick entry into the EMS lies on the credibility gains such a policy would imply. In practical terms this would mean, among others, lower interest rates than it would be the case otherwise and thus lower interest burden on the public debt.

This argument is an important one and should be part of the elements to be examined. Nevertheless in an inflationary environment and in the presence of severe macroeconomic disequilibria the fixity of the exchange rate, even within the wide margins, combined with removal of capital controls entail the risk of financial instability.

The basic reason for such a risk - as shows the experience of financial liberalization in an inflationary environment - is that the "credibility channel" does not work when the economic and financial indicators do not exclude, in the perceptions of the financial markets, a future reversal of the policy options. This implies that interest rates would climb even higher than their present level with adverse effects for the financial stability of the highly leveraged corporate sector and in turn for the financial institutions. The existence of a high public debt would complicate the situation further.

In conclusion it seems that the best strategy, as far as financial stability is concerned, consists of a policy of rapid disinflation and reduction of the financial imbalances with parallel gradual removal of exchange controls. This is compatible with the timetable approved by Community capital movements directive which, indeed, provides for such a gradual process. A parallel, intensive, deregulation of the domestic financial and non-financial markets is an essential complement to the external financial liberalization because it would allow, when the decision for entry into the EMS is taken, the fixing of the basic economic and financial variables close to their equilibrium levels.

Public finance : actual and prospective effects of financial liberalization

The main consequence of the financial liberalization and interest rate deregulation for the public finances has been a higher cost of borrowing for the government as it had to bid for funds on the capital market at substantially higher interest rates than in the recent past.

11. Interest rates on Treasury bills
December

	1988	1989	1990
3-month	16.0	17.0	19.0
12-month	19.0	20.0	24.0

Source : Bank of Greece

This cost would have been even higher in the absence of the banks' obligation to invest 40% of their deposits in Treasury bills at rates fixed by the government. (This compulsory investment was reduced to 30% this year).

The imposition of a 10% withholding tax on the interest income as from 1.1.1991 created a new source of revenue and also rendered more attractive the government paper whose yields are not subject to such a tax. This affected adversely bank deposits during the first months of 1991.

The problem of debt servicing is expected to remain acute for some time in the future as the deregulation of the financial markets and the removal of the exchange restrictions would narrow the margin for a reduction in the interest rates. Moreover the phasing out of the present system of compulsory investment on government paper by banks is expected to increase further the pressure on government to offer competitive rates in order to attract investors' interest. Under these conditions a fall in public sector's borrowing costs passes first from a lasting progress in the disinflation process. This would allow certain margin for interest rates reduction, taking also into account the conditions in the international financial markets.

The disinflation of the economy and the free mobility of capital would imply much lower seigniorage revenue for the government : a low inflation target would necessitate a slower rate of currency creation while capital mobility, integrated financial markets and increased competition would tend to equalise, towards a low level, the reserve requirements imposed on banks (a tendency already observed within Community) reducing further the growth rate of the monetary base and the earnings from seignoriage.

The above elements underline the urgency for a rapid reduction of the public sector debt both because this is central to any economic adjustment programme but also for limiting the cost and risks of the financial liberalization.

Prospects for the financial sector in the unified market

The prospects for an active and profitable presence of the Greek financial sector in the unified market of 1993 are subject to the same conditions applying to any other sector : rationalisation of the cost structure, clear strategy, investment in key areas, European orientation etc.

Concerning factors specific to finance the following elements seem relevant to Greek banking :

(i) **Capital adequacy**. Data for 1988 indicate an average own capital/total assets ratio for Greek commercial banks of around 3% compared to 8% minimum ratio required (as from 1.1.1993) by Community regulations. This ratio has been probably improved since that date following capital raising by a number of banks but the problem remains for the sector as a whole.

Community second banking directive sets also upper limits for the participation of credit institutions in non-financial enterprises. The control of numerous enterprises by the big state-controlled banks should be reviewed in view of this requirement but also taking into account the above mentioned need for banks to improve their capital base. The sale of these assets, which are peripheral to banks' core business, would serve both these requirements.

(ii) determination of the state's degree and form of participation in the financial intermediation business. This is linked to the already evoked need for increased capital requirements and the necessity to raise new funds in a period of strain in the public finance. Another important issue refers to the autonomy of bank management in view of the need for flexible strategies, investment decisions, co-operations and mergers;

(iii) an efficient supervisory and regulatory framework. Though this is a matter of public policy, it is considered central for the stability and development of a financial centre, especially in the passage from a system with tight credit and foreign exchange controls to a liberalised one. The high interest rates that accompany the financial liberalization lead often to phenomena of "adverse selection" - by which safer borrowers are replaced by riskier - and to a deterioration of banks' loan portfolio. This seems a relevant issue for part of the Greek banking system already burdened with debts of the "problematic" companies and the accumulated arrears fromm loans to public enterprises and entities (see below).

Considerable progress was made, in recent months, regarding the regulatory framework of banks. A number of key legislative acts have been prepared aiming at adapting national legislation to Community regulations. They are expected to become law before the end of 1991.

Επιτροπή Καραγά

(iv) the problems facing certain state-controlled credit institutions from accumulated bad debts. Two are the main sources of such debts : a) non-performing loans granted to "ailing companies" and b) accumulated arrears from loans granted to public enterprises and entities (PEs). Concerning debt of the second category the government, in a recent "consolidation operation", assumed 625 Bn drachmas of state-guaranteed debt which fell due up to end-1990. For the banks concerned the operation involved the exchange of claims of the above amount with newly issued government bonds. No interest will be paid on these bonds for three years. The accrued interest will be capitalised at the end of this grace period. Banks would be free to trade these securities in the secondary market only after a year from their issue.

Although the consolidation operation was an acceptable, given the circumstances, solution for the banks concerned it presents nevertheless certain inconveniences. Firstly, it restricts further banks' ability to manage freely their portfolios, an important constraint in view of the intensified competition of the Single market. Moreover, regardless of the accounting treatment of the accrued interest during the grace period, cash flow of banks would not improve. This would limit banks flexibility and range of strategic options when these elements are most needed.

Most disturbing is the prospect that such arrears would continue to accumulate. This prospect is based on the estimation that the amount of state-guaranteed bank loan was 3200 bn at the end of 1990. Moreover the continuing deficits of PEs (especially of social security funds) will accentuate this problem. It is considered of high priority for the stability and the strengthening of the competitive position of the banking system that drastic measures to remedy this situation be taken.

The superior local information can be a source of sustainable comparative advantage for small financial intermediaries and markets with a well established domestic network as is the case of Greek banks. The setting up of an information collection system on the credit rating of small to medium sized borrowers implies high fixed costs with uncertain return for the outsider. The nature of this comparative advantage, emanating from the credit rating of borrower, is not affected by any monetary arrangement - even in the case of a common currency.

The superior local information vis-à-vis the foreign banks should be considered only as an element creating a solid domestic base necessary for an active domestic and international presence and not as a substitute for such an activity.

Moreover economies of scale and scope are not necessarily relevant to banking and finance and therefore profitable activity could be compatible with both specialised 'niche' players as well as universal banks. This leaves open the possibility for the choice of an optimum size provided that a clear strategy regarding the nature of financial activity and the market segment has already been adopted.

ANNEX I

Consolidated balance sheet of the monetary system

bn DRA

	1980	% of total	1989	% of total
ASSETS	1973.0	100.0	14699.1	100.0
Claims in foreign exchange	126.0	6.4	1093.3	7.4
Claims on government	494.3	25.1	5315.6	36.2
Claims on public entities and public enterprises	131.7	6.7	1538.9	10.5
Claims on private sector	862.4	43.7	4017.8	27.3
Foreign exchange differences of the Bank of Greece	.....	....	1016.6	6.9
Other assets	358.6	18.1	1719.4	11.7
LIABILITIES	1973.0	100.0	14699.1	100.0
Money supply (M1)	313.1	15.9	1315.5	8.9
Private deposits	782.1	39.6	6438.9	43.8
Deposits in foreign exchange	190.4	9.7	1820.6	12.4
Liabilities in foreign exchange	59.3	3.0	1942.5	13.2
of which : L-T loans on behalf of the Greek state			1281.7	8.7
Other liabilities	628.1	31.8	3181.6	13.0

Source : Monthly Statistical Bulletin, Bank of Greece

ANNEX II

12. Balance of Payments : Capital movements
Mio $

	1987	1988	1989	1990
Total capital movements (net)	1802	2031	2776	3843
Private sector	1530	1826	1724	2762
Enterpreneurial	392	599	640	902
Real estate investment	675	896	739	993
Private Deposits in foreign exchange	377	193	610	566
Other	86	138	265	301
Public sector	272	205	1042	1081
Governm., Central bank				
Public enterprises	2290	2261	2713	3262
Commercial credits	- 21	3	- 12	- 10
Amortization	-1997	-2059	-1659	-2171

Source : Bank of Greece