Greek Economy at a Turning Point: Recent Performance, Current Challenges and Future Prospects

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Introduction

This paper provides a survey and an analysis of Greece's economic performance in recent years. It examines recent economic trends in output, prices, employment, investment, interest rates and exchange rates, international trade, and the balance of payments. It examines the structural problems facing the country and the economic policies that are currently being pursued by the Greek government.

My presentation will begin with an analysis of the country's economic performance through the 1980s, with particular emphasis placed on the country's fiscal imbalances and their implications for the economy. Next, I will examine the challenges confronting the Mitsotakis government and will review the macroeconomic and structural reform policies being pursued by his government to restore the country's fiscal integrity and to set the foundations for economic convergence with its EC partners. The paper concludes with a discussion of Greece's economic prospects in the 1990s in the context of the new economic and geopolitical realities that have emerged in the Balkans since the collapse of the communist regimes in 1990.

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The most important challenge facing the Greek economy in recent years has been the structural macroeconomic imbalances that have resulted from years of lack of fiscal discipline and monetary control. The inability of the socialist government that ruled Greece in the 1980s to carry out the needed structural reforms to modernize the banking system, the capital markets, and the tax collection system has only served to aggravate these problems. The lack of a coherent industrial policy designed to improve the productivity of the Greek industrial and export sectors and to stimulate domestic competition has not helped the situation either.

The principal structural imbalance has been that of the public sector: Government spending, including interest on the public debt has grown from 30.7 percent of GDP in 1980 to 51.5 percent in 1990, while tax revenues have increased only modestly from 27.9 percent of GDP in 1980 to 32.5 percent in 1990 (see Figure 1). The outcome of this continuing fiscal imbalance has been the growth in the public sector deficit from 3.0 percent of GDP in 1980 to a staggering 19 percent in 1990, by far the highest figure in the OECD, and double that of the next worst performers in the OECD, Turkey and Portugal. The public debt of the Greek state has grown from Dr 674 billion in 1980 to Dr 11,666 billion in 1990, i.e., from a low level of 39.4 percent of GDP in 1980 to an onerous level of 111.6 percent of GDP in 1990 (see Figure 2).

The public sector's deficits have been financed through massive borrowing on Greek and foreign capital markets and through the creation of money by the Bank of Greece. The external debt has grown from $4.4 billion (11.9 percent of GDP) in 1980 to $22 billion in 1990 (33.2 percent of GDP). In 1989, for example, 86.9 percent of the public sector borrowing requirement (PSBR) was financed domestically (13.1 percent was financed through external borrowing), of which the banking sector supplied 58 percent of the total, debt markets (treasury-bills and bonds) supplied 18.9 percent, while the Bank of Greece supplied 10 percent of the total by monetizing debt—colloquially known as printing money (see Figure 3).

The implications of these enormous fiscal imbalances are obvious:

1) Public sector borrowing requirements (PSBR) have been absorbing an increasing share of private sector savings (see Figure 4), effectively crowding out households and businesses from credit markets and increasing the cost of borrowing. Borrowing rates for those few enterprises eligible to borrow from the banking sector have risen from 20.5 percent in the early 1980s to 29.5 percent in 1991. Firms in the service and high-tech sectors of the economy pay interest rates in the 30-50 percent range. These imbalances keep the cost of capital very high for domestic producers and they discourage productive capital investment and the expansion of domestic output.

2) The shortage of financing has supressed the economy's rate of gross fixed capital formation (GFCF) especially in the manufacturing and service sectors. Private and public non-residential investment has declined from 16.1 percent of GDP in 1980 to 14.4 percent in 1990 (see Figure 5) and is one of the lowest in the OECD. The slow rate of investment serves to reduce the economy's long-term growth potential, lowers the rate of productivity growth and impedes the competitiveness of domestic producers, both at home and on foreign markets—a high price indeed.

3) The way the Greek government has been financing its deficit requirements has undermined the soundness of the banking system, impeded the efficient functioning of credit, money and bond markets, and has contributed directly to inflation in the country. For many years, banks in Greece have been required by the state to finance the public sector's borrowing requirements. By law, banks were obligated to maintain 40 percent of their deposits in securities issued by the state, and a minimum of 10 percent of deposits had to be lent to state-owned corporations. These and other quantitative restrictions on the banks' lending and investment activity in effect expropriated private sector savings at negative real rates of interest (deposit rates lower than inflation rates; see Figure 6). These policies enabled the state to finance its needs while at the same time helped keep the real burden of the public debt low for the government. On the other hand, negative real rates of interest amounted to a

tax on savings, which reduced the supply of domestic savings, encouraged capital flight and undermined the quality of bank assets and weakened the capital structure of the banking sector. Negative real rates of interest on bank deposit and financial instruments coupled with the inflationary psychology encouraged Greek citizens to invest in assets which were viewed as hedges against inflation and which provided high real rates of return, such as residential buildings and automobiles, and diverted spending away from productive investment.

4) Between 1981 and 1990, prices have risen 357 percent, an annual rate of change of 18.6 percent during the 1980s (see Figure 7). By resorting to money creation, I estimate that the state has added between 5 and 7 percentage points annually to the rate of inflation during this period, while the lack of a firm restrictive stance by the Bank of Greece in recent years has resulted in negative real interest rates, depreciation of the currency, economic uncertainty, and speculation. As expected, these policies contributed to a major slow-down in the country's rate of economic growth. Whereas between 1950 and 1978 Greece enjoyed an average annual rate of growth of 6.2 percent—the highest in the OECD—growth in the 1981-1990 period, as can be seen from Figure 8, has averaged only 1.5 percent, one of the lowest rates of growth in the OECD area. During the 1980s Greece was capable of achieving growth of at least 4.5 percent per year. Real GDP could have been 35 percent higher by 1990, and per capita income could have been about 30 percent higher. Income per capita could have been higher by 360,000 drachmas per person in 1990!

Economic Policies and Adjustment Program

To address these problems, the newly elected New Democracy government embarked on a "Medium-term Adjustment Program for 1990-93." The goals of the program are to: 1) reverse years of fiscal laxness; 2) roll back the public sector; 3) eliminate pervasive market distortions and 4) fully integrate Greece into the European Community. Ambitious targets were set:

> Reduction in the budget deficit from 20.5 percent of GDP in 1990 to 9.9 percent by the end of 1993.

> Reduction of the public sector borrowing requirements (PSBR) from 17.8 percent of GDP in 1990 to 3 percent in 1993.

> Reduction in the rate of inflation from an average of 20.4 percent in 1990 to 9.5 percent in 1993.

> Reduction in the current account deficit from 5.4 percent of GDP in 1990 to 3.0 percent in 1993.

With two years of the program almost completed, the results are mixed, but on balance positive. The PSBR has fallen from 18.5 percent of GDP in 1990 to 15.7 percent in 1991 and is projected to fall to 11.0 percent in 1992. That is an improvement, yet short of the 6.7 percent target for 1992.

The inflation rate was cut from a high of 22.8 percent in December of 1990 to 17.8 percent in the corresponding period of 1991 and 14.2 percent in August, 1992. In 1992 inflation in Greece should average about 14.5 percent, a considerable improvement over 1991's 19.5 percent annual rate, but 2.1 percent points higher than the target (12.4 percent) for the year. Barring major surprises, consumer inflation will continue to fall in Greece in response to the tight fiscal, monetary, incomes and exchange rate policies being pursued, and should fall to 10 percent by the end of 1993 (3 percentage points higher than target).

On the plus side, the current account deficit was cut to 2.1 percent of GDP in 1991 from 5.4 percent in 1990, which is better than the 3 percent targeted for the end of 1993. The improvement in the current account is due to large invisibles inflows, especially from the EC. In 1991, total invisibles receipts (tourism, shipping and migrant remittances) amounted to $9.5 billion, while official transfers surpassed $4 billion (see Figure 9).

The government has continued with the liberalization of financial markets: The quantitative restrictions on bank investments were cut from 40 percent of deposits in 1990 to 25 percent as of February 1992 and are expected to be phased

out by the middle of 1993. Similarly, as of April 1, the requirement to allocate 10 percent of deposits to the financing of state corporations has been abolished. Major steps were taken to expand and deepen the Greek bond market with the conversion of the largest part of short-term public debt to banks into medium-term bonds and the development of an active repo market for treasury-bills. At the same time, the state's right to borrow directly from the central bank is being phased out, a significant step that will increase the central bank's independence and reduce the pressure to print money, a step that will go a long way toward permanently lowering the rate of inflation in Greece and stabilizing the drachma. In addition, foreign exchange controls were liberalized. As of May 1, 1991, restrictions on capital movements to EC countries were removed while restrictions on travel allowances and medium and long-term capital flows (including profit remittances, rents and pensions) to non-EC countries were lifted on February 1, 1992.

In 1991 and 1992 the government has continued with the privatization of state-owned corporations. Although a substantial number of public enterprises were privatized or liquidated, the pace has fallen far short of what was anticipated in 1990.

The government introduced in the middle of 1991 a comprehensive tax reform package, which broadened the tax base by reducing exemptions and loopholes and significantly reduced marginal income tax rates (top marginal rate was lowered to 40 percent from 50 percent). This year, the government is concentrating on measures to improve the tax collection and administration process in order to cut down on tax evasion and tax avoidance. Tax evasion remains a very big problem for Greek fiscal authorities. The tax administration has been computerized for the first time—cross computer checks are now possible; the tax audit program is being boosted—all firms have been forced to supply invoices on all purchases while penalties on those who have failed to pay their taxes are being stiffened.

Finally, the government is pursuing an incomes policy designed to keep the rate of increase in wages and salaries below the nominal rate of inflation. In early 1991 the automatic wage indexation system was abolished (ATA). Public and para-public sector wage increases, including pensions, have been

kept about 5 percentage points below the rate of inflation (4+4 in 1991, 3+3 in 1992 and 2+2 in 1993) while for the first time, many unions signed a national collective two-year wage agreement for private sector employees. The success of these measures and the resolve of the government to stick by its reform program will be severely tested in 1993, as an election is expected to be called by the end of 1993 or early 1994 by the Mitsotakis government. As in the past, Greek governments have been known to relax fiscal and monetary conditions just before national elections to increase their re-election chances.

The stance of monetary and exchange rate policy during 1991 and 1992 has been restrictive. The rate of growth in the supply of money has been reduced, and real interest rates have turned positive for the first time in a long time, while the central bank has reduced to 5 percent the monetary financing of the public sector, down from 15 percent in 1990. The real effective exchange rate of the GDR has been moving up in recent years. To supplement the tight monetary policy, the Bank of Greece has been pursuing an exchange policy designed to keep the value of the drachma higher than its equilibrium value, thereby keeping the cost of imports low and reducing the foreign debt service burden. The Bank of Greece's policy is to allow the value of the GDR to fall by less than the differential in a trade-weighted index of inflation rates of Greece and its trade partners. In 1991, the GDR depreciated by an average 11.12 percent relative to a trade-weighted basket of currencies which constitute Greece's principal economic partners. This depreciation is one percentage point less than the difference in inflation between Greece and its trade partners, thus resulting in a one percentage point appreciation in real terms, as shown in Figure 10.

This policy of tight money and a "hard" drachma are helping restore investor confidence in the Greek economy and, together with a lower inflation and liberalized foreign exchange laws, will go a long way toward stimulating capital inflows both direct and portfolio into Greece. It is worth noting that in each of the years 1990 and 1991 foreign direct investment into Greece surpassed the $1 billion mark (see Figure 11), and reached $1,135 million in 1991. Other capital flows increased by $2.8 billion. In 1991, Greece's overall balance of payments had a record

surplus of $2.2 billion, which pushed the country's foreign exchange reserves (including gold) to a post-war record high of $6.5 billion by the end of 1991 (see Figure 12).

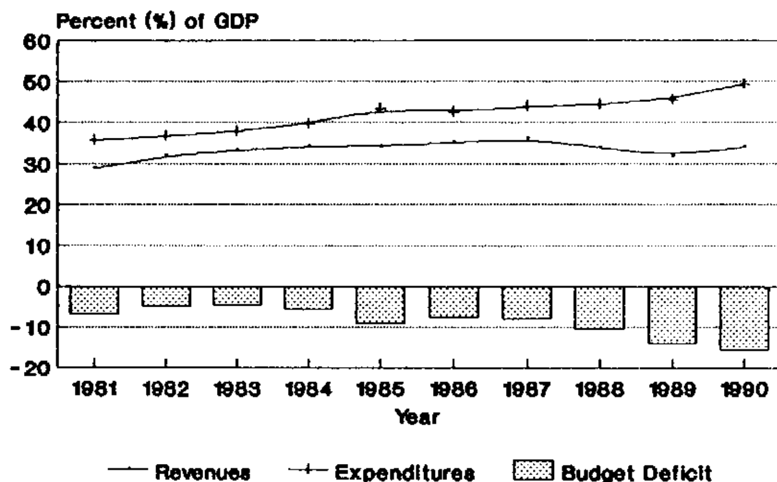
Prospects of the Greek Economy in the 1990s

Greece's economic prospects in the 1990s can be described as cautiously optimistic. If Greece is to remain a full partner in the European Community, it has no choice but to bring about convergence of its economy, laws, and practices to European standards—which implies an eventual balancing of public sector accounts, and a major reduction in the rate of inflation. Because of its unitary and parliamentary form of government, the Greek state sector can implement fiscal reforms such as cuts in program spending and transfer payments more easily than countries with federal structures (i.e., Canada and the U.S.). On one hand, the politicization of its citizens and the corporatist structure of many professions make it politically more difficult for governments to implement the necessary reforms. On the other hand, a strong government with a comfortable majority can easily push through the necessary reforms despite short-term opposition. Cutting the public sector deficits is not as formidable a task as it would first appear: 1) Income support programs and pensions are not as entrenched as they are in Northern and Western European governments and waste and inefficiency in the public sector is rampant, thus making it easier to cut spending. 2) Tax receipts as a percent of GDP are lower than those in the rest of Europe (32 percent vs. 38 percent for the G-7 and 44 percent for Canada), thus there is ample room to increase tax collections to balance the budget. This coupled with success in broadening the tax base and in arresting tax evasion in the country can easily do the job.

Greece's membership in the EC and decidedly Western orientation are a major source of stability and strength for the economy. Greece does not only gain monetarily from its affiliation with the EC ($4 billion in offical transfers in 1991, expected to reach $5 billion in 1992 or 7 percent of GDP). It also gains institutionally because of the wholesale transfer of EC

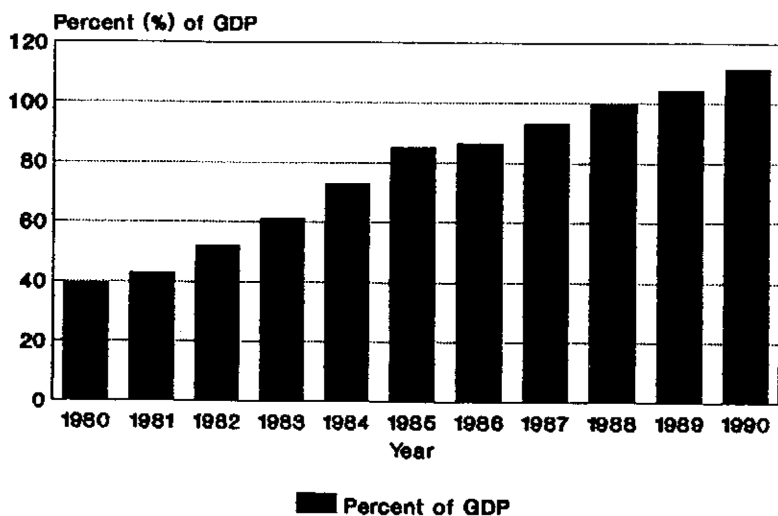
FIGURE 1

TOTAL GOVERNMENT TAX REVENUES, EXPENDITURES AND BUDGET DEFICIT, GREECE: 1981-1990



Source: OECD, Economic Survey, 1991/92

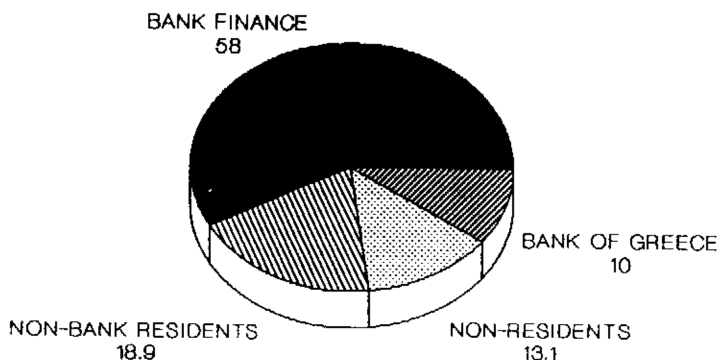
FIGURE 2



Source: OECD Economic Surveys

FIGURE 3

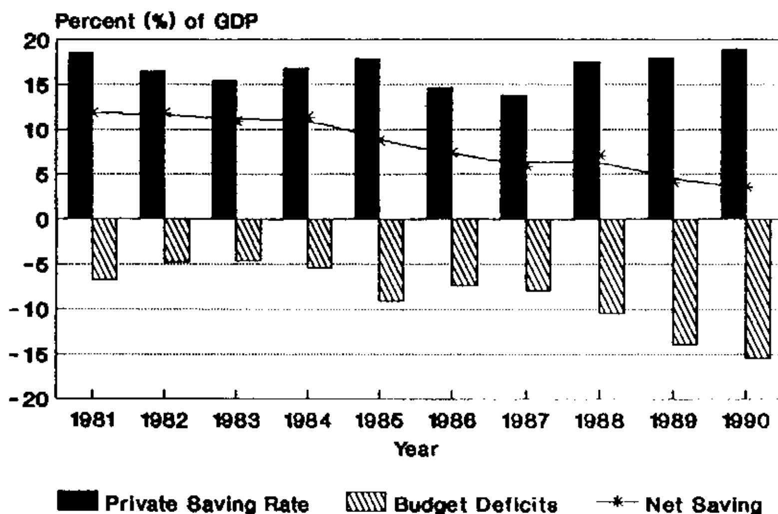
FINANCING OF PUBLIC SECTOR BORROWING REQUIREMENTS, GREECE, 1989



Source: OECD Economic Surveys and Bank of Greece

FIGURE 4

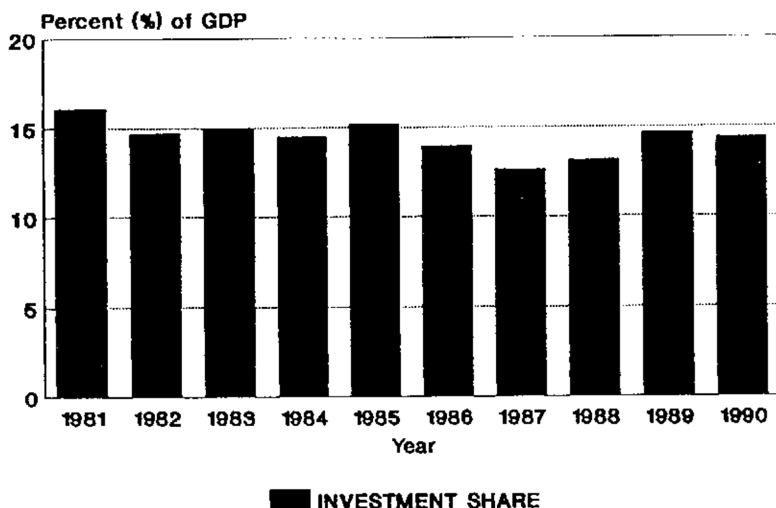
PRIVATE SAVING AND PUBLIC DISSAVING, GREECE: 1981-1990



Source: OECD, Economic Surveys, 1991/92

FIGURE 5

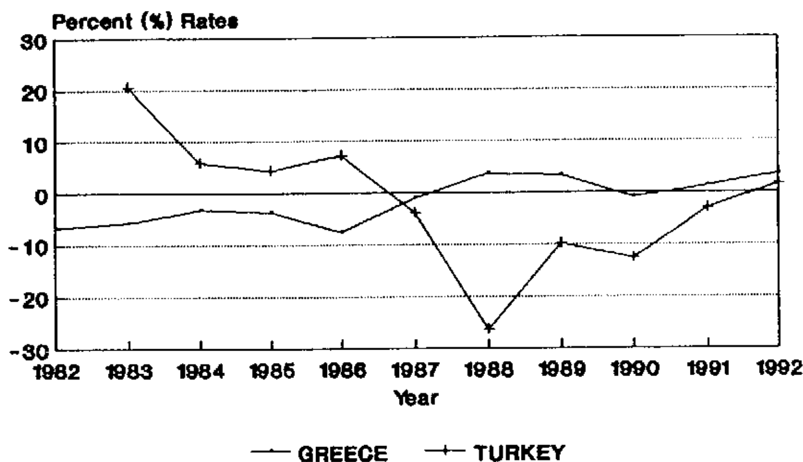
NON-RESIDENTIAL PRIVATE AND PUBLIC INVESTMENT IN GREECE: 1981-1990



Source: OECD, Economic Survey, 1991/92

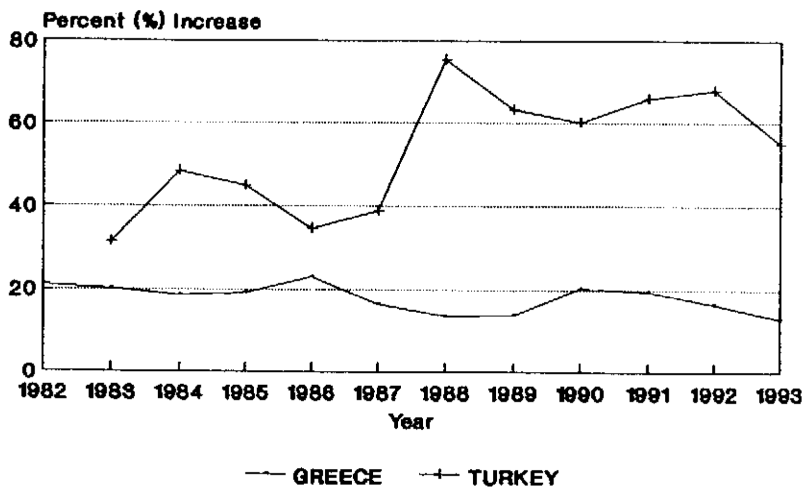
FIGURE 6

REAL INTEREST RATES: 1982-1992
GREECE AND TURKEY
Bank Deposit Rates less CPI Inflation



Source: IMF, International Financial Statistics, October, 1992

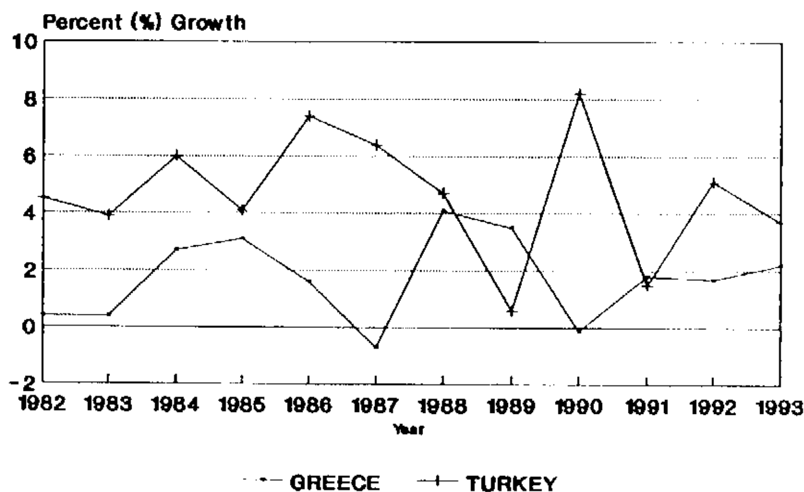
FIGURE 7



Source: OECD Economic Surveys, 1991/92

FIGURE 8

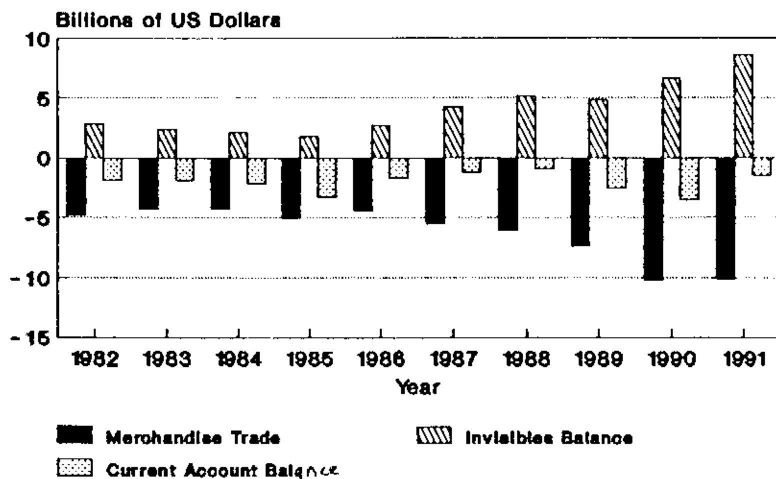
GROWTH IN REAL GDP: 1982-1991
GREECE AND TURKEY
1992 and 1993, OECD Forecast



Source: OECD Economic Surveys, 1991/92

FIGURE 9

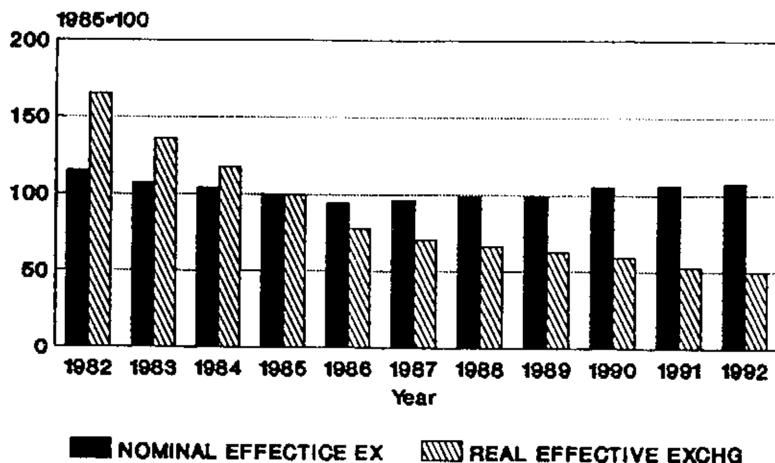
TRADE BALANCE AND INVISIBLE RECEIPTS, GREECE: 1982-1991



Source: IMF, International Financial Statistics, Oct. 1989, 1992

FIGURE 10

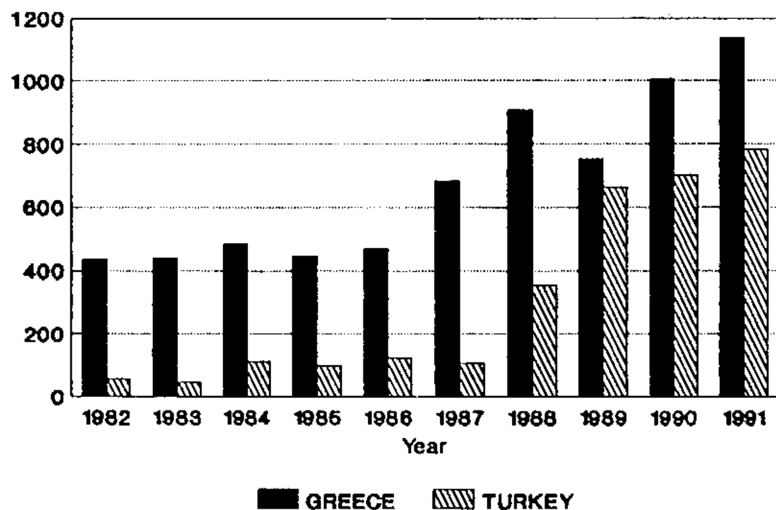
GREEK DRACHMA: 1982-1992
NOMINAL AND REAL EFFECTIVE EXCHANGE
RATES, 1985=100



IMF, International Financial
Statistics, October, 1989, 1992

FIGURE 11

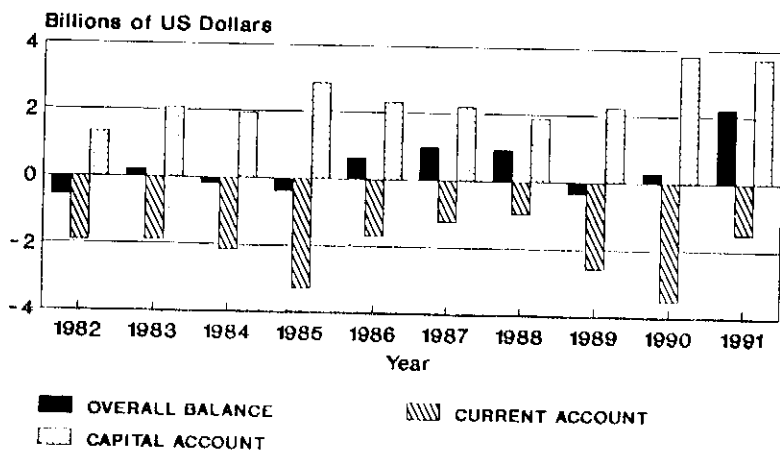
FOREIGN DIRECT INVESTMENT FLOWS: GREECE AND TURKEY, 1982-1991



Source: IMF, Intern. Fin. Stats

FIGURE 12

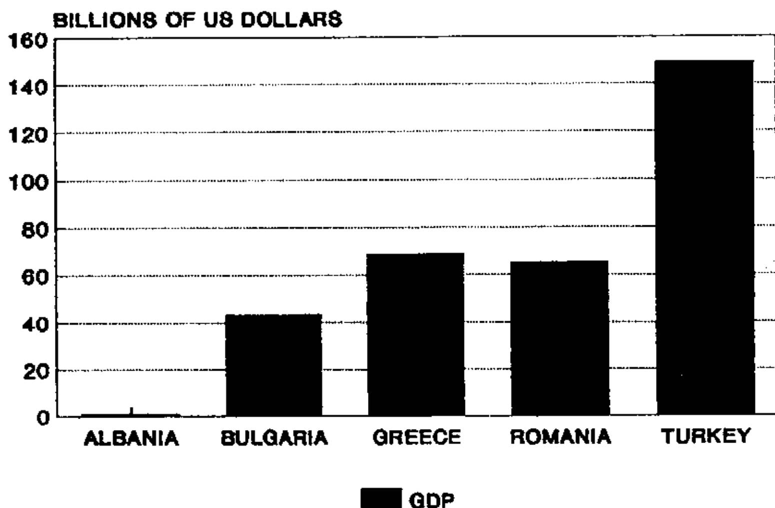
CURRENT ACCOUNT, CAPITAL ACCOUNT AND OVERALL BALANCE OF PAYMENTS, GREECE: 1982-1991



Source: IMF, International Financial Statistics

FIGURE 13

GROSS DOMESTIC PRODUCT OF BALKAN NATIONS, 1991



Source: OECD, US DEPT. OF COMMERCE

FIGURE 13

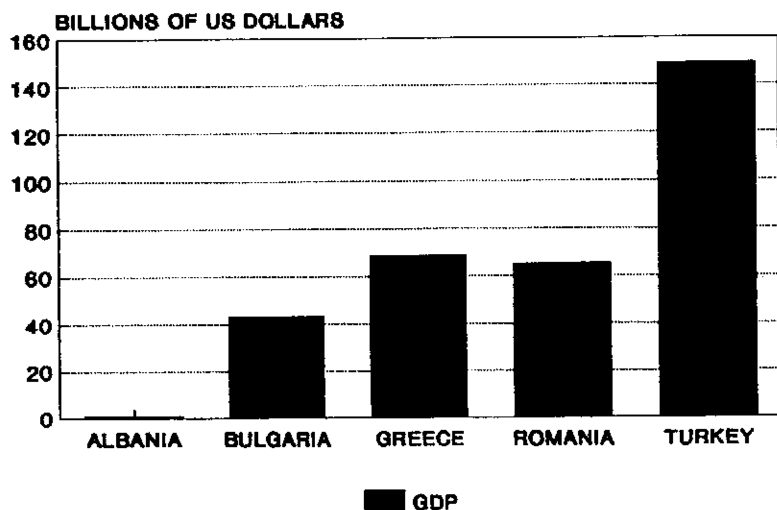
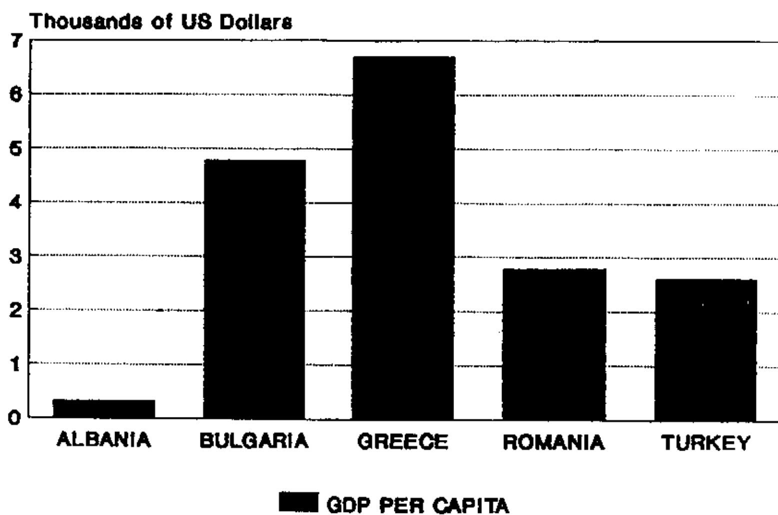


FIGURE 14



Source: OECD, US DEPT. OF COMMERCE

FIGURE 15

STRUCTURE OF GREEK TRADE: DESTINATION OF GREEK EXPORTS, 1988

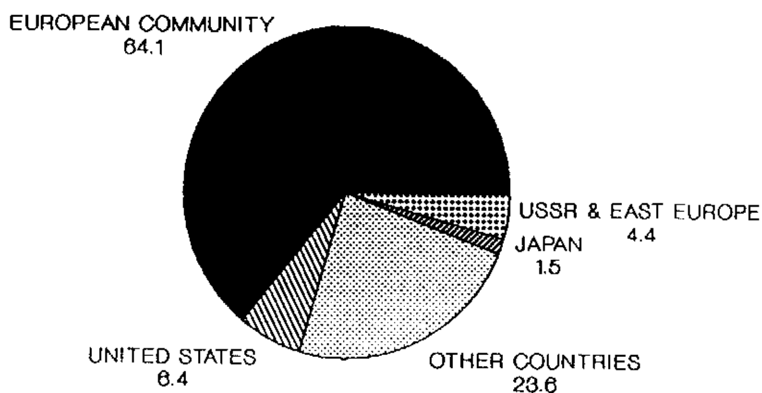
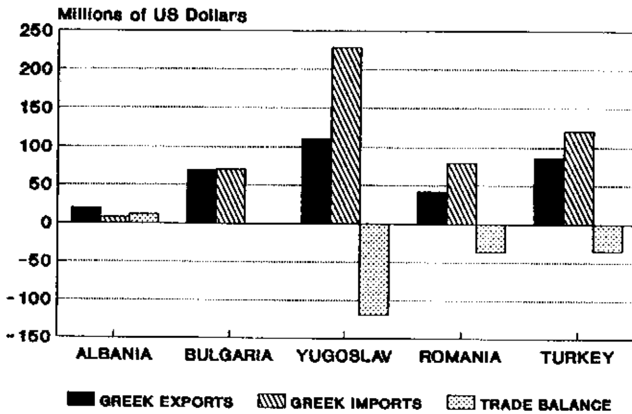
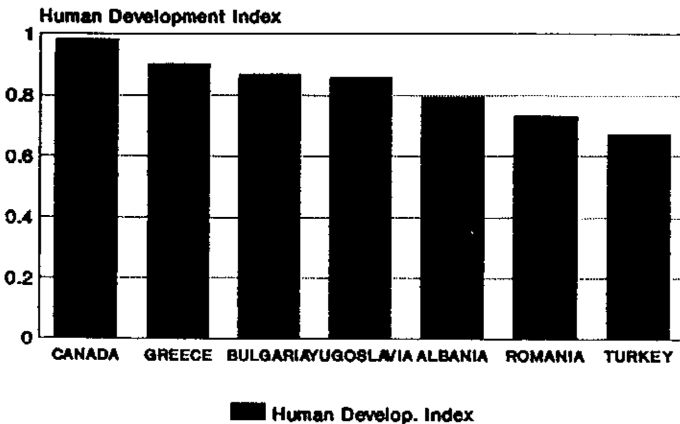


FIGURE 16



Source: ELIAMEP, Yearbook, 1992

FIGURE 17



legal and legislative frameworks and standards to Greece. For example, competition, labor protection, environment, communication and transportation laws, let alone trade and customs laws are being brought in line with those of its European partners. By setting a sound and stable institutional and legal framework to govern economic transactions, it will help stabilize and improve the performance of the economy in the long-term.

Given the collapse of the communist regimes in Eastern, Central and Southeastern Europe (Balkans) in recent years, Greece has emerged as a bastion of stability in the Balkan region with a free standing economy which, by now, is second largest only to that of Turkey (see Figure 13), and first in terms of standard of living (see Figure 14). Greece can take advantage of its newly enhanced status in the region to become the pre-eminent transportation, communication, and tourism sector in the Balkan region, as well as becoming a regional business, sales, and administrative center for European and American companies that want to expand trade and investment activities in the region (namely Albania, Bulgaria and Romania, as well as Serbia).

The collapse of the communist regimes of the Balkan peninsula has had a negative although small effect on the Greek economy. The principal negatives have been the disruption and increased cost of transporting Greek goods through the former republic of Yugoslavia (largely offset by alternate sea routes, Igoumenitsa, Patras, and Bulgarian land routes); the reduction in tourist flows, especially from Yugoslavia, and cross-border shopping of Bulgarians and Yugoslavs. The impact on Greek exports has been relatively small. As Figure 15 reveals, 64.1 percent of Greek exports are bound for markets in the EC, 6.4 percent to the U.S. and only 4.4 percent is bound to markets in Eastern Europe and the USSR. Greek exports to the former communist countries of the Balkans in 1989 amounted to $239.1 million, which is less than 4 percent of Greek exports in that year (see Figure 16). As Greece has never been too dependent on trade with its Balkan neighbors, the collapse of their non-market economies carries little down-side loss, but carries enormous opportunities for greater intra-Balkan trade, investment, joint ventures, and tourism. Trade with Greece's Balkan partners is bound to rise, inspite of the fact that their

economies have collapsed. The iron-curtain in Balkan trade that existed for over forty years has now been raised, and this will allow the whole region to begin economic integration and to expand economic relations along more natural economic rather than artificial ideological lines.

Although the new economic realities in the Balkans also favor the Turkish economy, Greece maintains a decided edge over Turkey, owing to 1) Greece's membership in the EC and its decidedly Western culture and orientation; 2) Greece's comparatively higher standard of living, economic and political stability, and more developed infrastructure and service sector and 3) Greece's longer land border and geographic position in the region. Bulgaria, Serbia, and Romania can reduce transportation time and cut costs by shipping many of their goods through Greek ports in Northern Greece (Thessaloniki, Kavalla, and Alexandroupolis), their only natural direct access to the Mediterranean Sea. In addition, Athens and Thessaloniki serve as natural regional air transport hubs for the Balkan region.

Although Greece has been undergoing major economic difficulties in recent years, Greece's outlook is not as bad as it is often portrayed in the Western media and Greek press. Greece is undergoing rapid structural change. Within one generation it is transforming itself from a poor developing nation to a mature post-industrial society. Dislocation and structural macroeconomic and other imbalances are often the price to be paid for this change. In its 1992 Human Development Report, the UN has ranked Greece 26th out of 160 nations, and only a hair below Spain and Italy. Bulgaria was ranked 35th, Yugoslavia 37th, Albania 49th, Romania 60th and Turkey 71st (Cyprus ranked 25th and Israel 18th, see Figure 17). Inspite of the fiscal legacy of the socialist experiment of the 1980s in Greece, the pre-conditions for sustained growth and continued development of Greece are firmly in place.

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