INTERNATIONAL
FIXED-INCOME
RESEARCH

20 MAY 1994

Greece

Salomon Brothers

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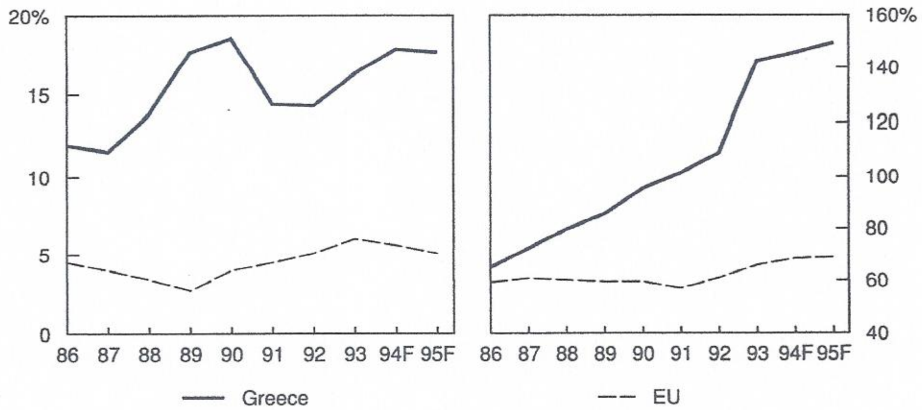
# Fiscal Tightening Needed to End Drachma Pressure

- The drachma will remain vulnerable to selling pressure until the root causes of currency weakness — high fiscal deficits, weak growth and inflation concerns — are addressed.
- The economic fundamentals are unfavorable: Greece has the weakest growth as well as the highest fiscal deficit and debt ratios in the European Union.
- A significant tightening of fiscal policy is needed. Such a shift would require tough political decisions ahead of the 12 June European Parliamentary elections.
- In the absence of fiscal action, markets will test the authorities' resolve to keep interest rates high despite the recession and rising debt service costs.

**Figure 1. Greece and EU — General Government Deficit (Left) and Debt[a] (Right), 1986-95F (as a Percentage of GDP)**

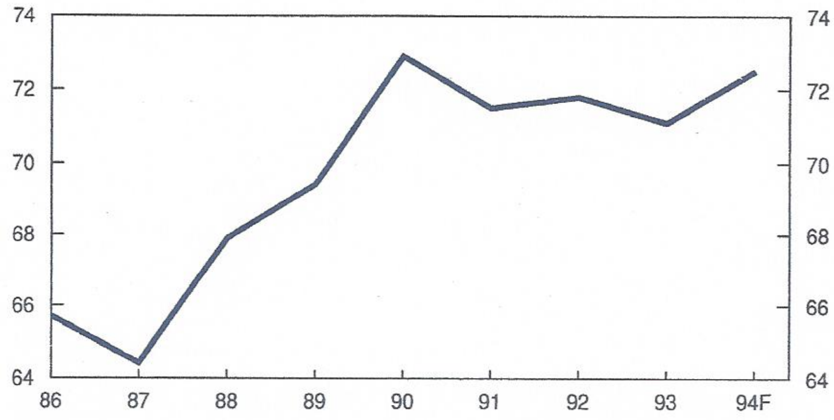



[a] The debt figures include the recent conversion of long-existing liabilities of the state to the Bank of Greece into long-term debt but exclude military debt, which amounts to some 10% of GDP.
Sources: EC Commission, Bank of Greece and Salomon Brothers Inc estimates.

The Greek drachma came under strong selling pressure last week, ahead of the end-June European Union deadline for full liberalization of capital flows. In response, the government reaffirmed its 'hard drachma' policy and interest rates were raised sharply to defend the currency.

Under the hard drachma policy, the Government aims to keep the depreciation of the drachma relative to trading partners below the inflation differential, leading to a small real appreciation of the currency (see Figure 2). Monetary policy and exchange rate management are thus targeted on the disinflation effort. Until mid-1993, this policy was accompanied by considerable progress in fiscal consolidation. Nearly a year ago, however, fiscal policy turned expansionary, so that monetary policy now bears the full burden of supporting the currency.

**Figure 2. Greece — Real Effective Exchange Rate[a], 1986-94F (Index, 1961-73=100)**

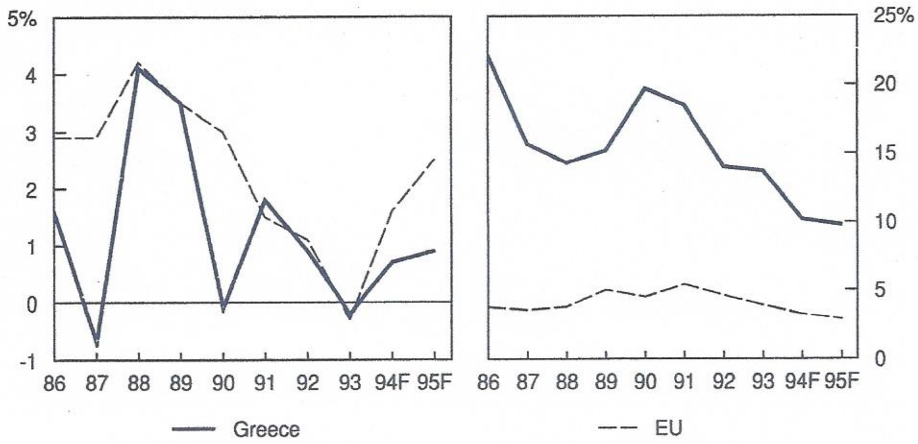



[a] Based on relative unit labor costs.
Source: EC Commission.

The present policy mix of high deficits and interest rates is unsustainable. A deficit-reduction package is needed in order to take pressure off interest rates and to convince markets that inflation will not rise further. In the absence of fiscal measures, pressure on the currency will continue despite high interest rates. However, high interest rates cannot be sustained without damaging the economy and adding to a debt burden that already exceeds 150% of GDP. Nonetheless, the Government appears reluctant to take fiscal measures ahead of the 12 June European Parliamentary elections.

Greece has the lowest growth as well as the highest fiscal deficit and debt ratios in the European Union, with little prospect for improvement next year (see Figures 1 and 3). The authorities therefore face the formidable task of convincing markets that interest rates will be kept at high levels notwithstanding rising debt service costs and the dampening effect on economic activity.

Figure 3. Greece and EU — GDP Growth (Left) and Inflation[a] (Right), 1986-95F (Year-on-Year Percentage Changes)




[a] Private consumption deflator.
Source: EC Commission.

## UNFAVORABLE ECONOMIC FUNDAMENTALS

Greece's macroeconomic situation is weak. Official EU economic forecasts released earlier this month project an increase in the deficit of the general government to 17.9% of GDP this year, with no prospect of an early improvement (see Figure 1). The economy has shown no sign of emerging from recession, while consumer price inflation edged up to 10.4% on a 12-month basis in April, reversing the disinflation trend of the past 20 months. Balance of payments data for the first two months of 1994 indicate a widening of the trade deficit to US$2.1 billion compared with US$1.7 billion in the same period of the previous year, offset by higher EC transfers.

Tax revenues have reportedly remained well below budgeted amounts so far this year, while the privatization program, projected to raise considerable revenues, has been scaled down and delayed. By April there were signs that the funding of the fiscal deficit through bond sales in the domestic market was reaching its limits at current interest rates. The benchmark 12-month T-bill rate has stood at 18.5% since the end of March, after being gradually cut by 1.75 percentage points since the end of January.

## CRISIS MANAGEMENT — PART ONE

Selling pressure on the drachma started last week as a new 15% tax on repurchase agreements took effect ahead of the lifting of all remaining exchange controls. On Friday 13 May, the Bank of Greece reportedly stepped up its interventions to DM1 billion. The following weekend, the Government announced that all remaining exchange controls would be lifted immediately rather than at the end of June and reaffirmed the hard drachma policy. To forestall pressure on the drachma, the Bank of Greece raised its Lombard and discount rates by 2.5 percentage points to 26.5% and 22.5% respectively, and its rate on commercial banks' overdrafts by 3 percentage points to 33%, with a daily surcharge of 0.4% which raised the effective annual rate to triple-digit levels. Interbank rates surged to 200% for overnight deposits early this week and to 500% today, with the three-month rate now up to 150%.

As a result of sizable intervention and high interest rates, the currency has weakened only slightly since the start of the crisis, from Dr147/DM to Dr150.7/DM at today's fixing. According to the latest figures published by the International Monetary Fund, foreign exchange reserves amounted to US$7.8 billion at the end of February.

## WHAT NEXT?

In the absence of fiscal action, markets will likely continue to challenge the Government's willingness to keep interest rates high. Current central bank and interbank rates cannot be sustained at these levels without being passed through to all domestic rates, thus depressing the already weak economy. As of this week, lending rates on new bank loans, including drawings from existing credit lines, have risen to triple digits, while time deposit and repo rates also rose sharply to levels approaching the interbank market. The impact of interest rates on economic activity will increase over time as existing loan agreements and deposits are renewed at higher rates.

Another challenge facing the authorities is how to fund the fiscal deficit without letting interest costs soar. Instead of its regular T-bill issuance, which normally takes place in the middle and at the end of each month, the Government issued ECU- and US dollar-indexed bonds this week, with a maturity of one-three years, reportedly raising the equivalent of almost US$1 billion. Funding needs will rise in early July, when a US dollar-linked bond issue equivalent to US$1 billion matures. At present, the spread on the US dollar-indexed bonds, at 120 basis points over LIBOR, remains small compared with other countries with fiscal imbalances of a similar size.

Greece's credit rating is BBB- by S&P and Baa1 by Moody's. In mid-February, Moody's placed Greece under review for possible downgrading, citing the increased fiscal imbalance and rising debt burden. If downgraded, Greece may face the prospect of widening spreads on its foreign currency debt and foreign currency-linked debt.

The authorities' reluctance to abandon the hard drachma policy and let the currency float likely reflects two factors:

- The desire to restrain the debt/GDP ratio. The ratio would rise substantially if the drachma falls because about one-third of the public debt was issued in, or linked to, foreign exchange.

- The risk that inflation would rise significantly if the drachma depreciates. Wage agreements in the private sector include an indexation clause in the event that inflation during the current year exceeds the official target of 10%. Also, despite slow growth, it is doubtful that considerable slack exists in the economy because low investment in recent years has reduced potential growth.

Despite these incentives to maintain the hard drachma policy, market participants likely will continue to expect a drachma depreciation in the light of the unsustainable policy mix. Moreover, the Government has yet to indicate that it intends to enact the kind of stiff measures needed to correct the policy imbalance. Near term, with European Parliamentary elections looming, measures that would yield immediate budget revenues, such as hikes in administered prices and in indirect taxes, will be difficult to implement.