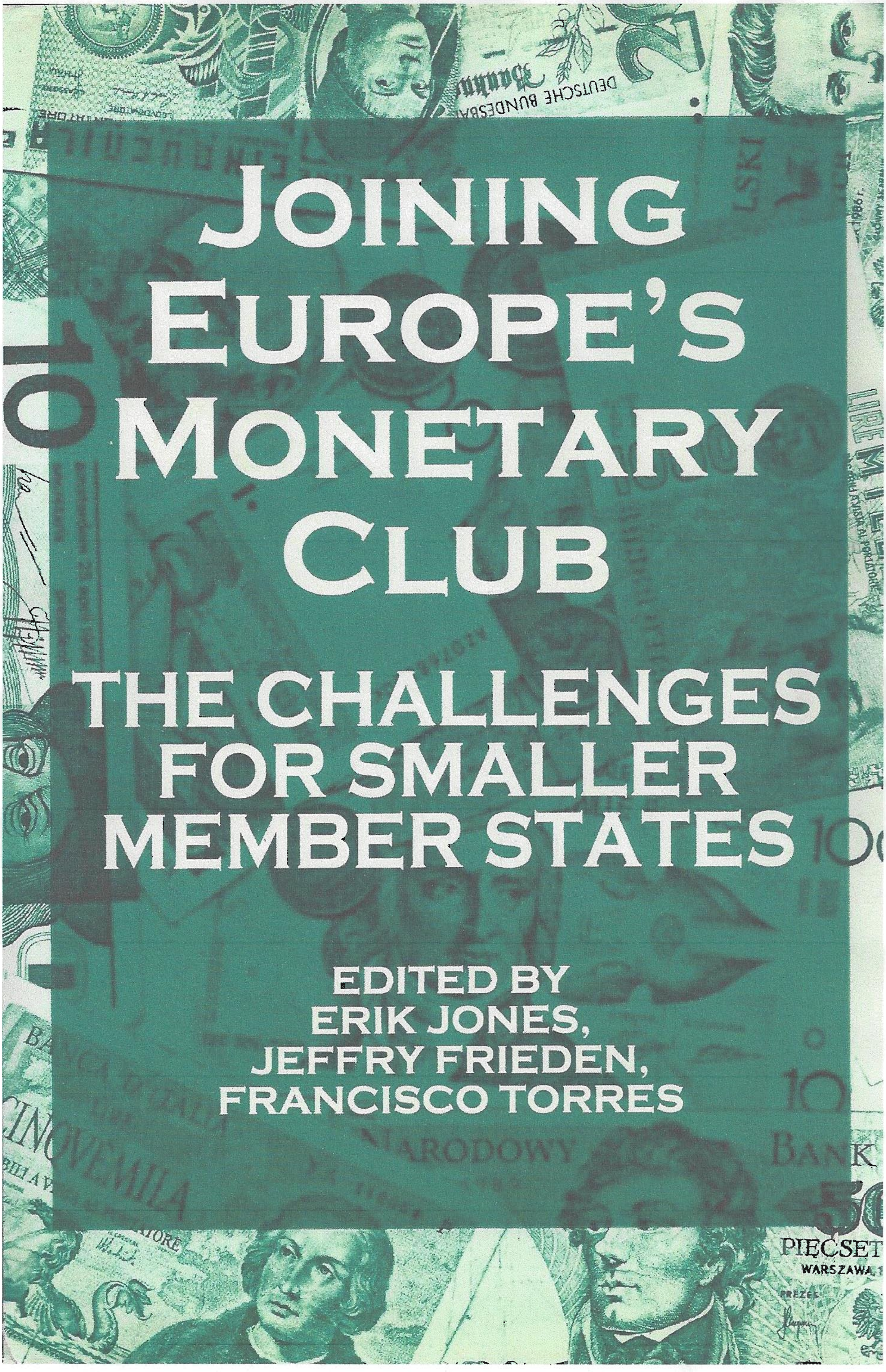


Joining Europe's Monetary Club

The Challenges for Smaller Member States

Edited by
Erik Jones,
Jeffry Frieden,
Francisco Torres

ISBN 0–312–17362–8

Library of Congress Cataloging-in-Publication Data

Joining Europe's monetary club : the challenges for smaller member states / edited by Erik Jones, Jeffry Frieden, Francisco Torres.
p. cm.
Includes bibliographical references and index.
ISBN 0-312-17362-8
1. Monetary unions—European Union countries. 2. Monetary policy—European Union countries. I. Jones, Erik. II. Frieden, Jeffry A. III. Torres, Francisco S.
HG925.J65 1998
332.4'566'094—dc21 97–32954
CIP

Internal design and typesetting by Letra Libre
First edition: April 1998
10 9 8 7 6 5 4 3 2 1

Contents

CHAPTER FIVE

Greece and EMU

Miranda Xafa[1]

This chapter addresses a number of issues in assessing Greece's prospects for convergence with the European Union and its integration in EMU:

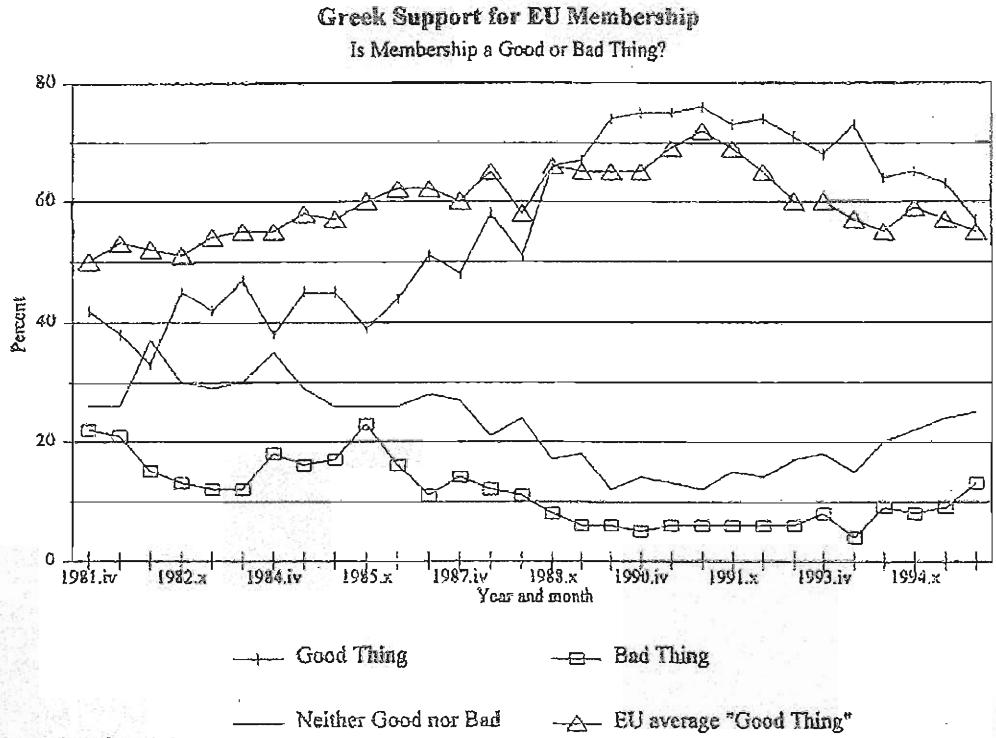
- Is Greece a good candidate for monetary union with the rest of the EU based on the criteria set out in the optimum currency area literature?
- What drives positive sentiment toward EMU and support for the "hard drachma" policy?
- How far is Greece from fulfilling the convergence criteria laid out in the Treaty as a prerequisite for joining EMU?
- What are the prospects for, and obstacles to, convergence?
- Does compliance with the fiscal convergence criteria ensure convergence?

Political Economy Considerations

Support for membership in the European Community (EC) in public opinion and across political parties has increased significantly since full membership in January 1981. (See Figure 5.1.) Public opinion turned mildly negative with the election of a Socialist government in October 1981, which denounced the European Community (and the North Atlantic Treaty Organization [NATO]) on grounds of conspiring to reduce Greece's sovereignty. Nonetheless, growing transfers to Greece from the EC structural funds and agricultural support funds subsequently helped increase public support for membership.

The deepening of European integration with the Single Market program and the Maastricht Treaty, the collapse of the Soviet Union, and the end of

Figure 5.1



Source: European Commission.

the postwar world order all had a profound impact on Greece's attitudes toward the EU. The Union was viewed as a pole of stability and prosperity in an otherwise turbulent region, particularly in view of Greece's geographical proximity to the armed conflict in Bosnia and the perceived threat of a change in Balkan borders. Greece's membership in the Western EU, agreed in principle in November 1992 and in effect since April 1995, was viewed as a guarantee of solidarity and as an improvement in Greece's ability to respond to perceived external threats to its security.

On the economic side, worldwide competition for export markets became more intense with the integration of the former planned economies and a growing number of developing countries in the world economy. The doubling of the EU structural funds in 1993 was considered as Greece's last chance to restructure its economy and acquire badly needed infrastructure so as to enable it to compete in a world that suddenly had become far more competitive. From a macroeconomic perspective, the EU structural funds were viewed as the only viable way of increasing public investment, catalyzing private direct investment, and pulling Greece out of stagflation without putting fiscal convergence at risk.

Time was running short. It was clear that the widening of the EU to include the former European Free Trade Associations (EFTA) countries and, eventually, the Central and Eastern European countries (CEECs) was a matter of time. Official statements by the government often warned that the CEECs were making faster progress in restructuring and privatizing their economies than Greece was. Unless Greece speeded up its convergence process, it was clear that it would become marginalized within an expanding EU, with core countries eventually moving to monetary union.

The Maastricht Treaty was ratified by parliament in 1992 with the overwhelming support of nearly all parties, including the Socialist Party, which had expressed concern over loss of sovereignty with EC membership while in government in the 1980s. The exception was the Communist Party, whose support for the former Soviet Union remained unabated despite its collapse, which voted against the treaty. In the 1996 national election, in which the Socialist Party won a fresh popular mandate, both major parties campaigned on a pro-European platform and pledged to continue ongoing efforts at convergence within the EU. Opinion polls taken at election time similarly confirm the widely held view that EU membership presupposes, and contributes to, stability and prosperity.

Costs and Benefits from EMU

The prospective EMU in Europe has revived recent interest in the optimum currency area literature pioneered by Mundell (1961) and rooted in the long-standing controversial discussion of the optimal exchange rate regime. In a region such as the EU, the function of money as a medium of exchange is enhanced, and the cost of currency conversion is reduced, the smaller the number of independently floating currencies. From the viewpoint of an individual economy, the benefits of lower transaction costs increase if: (1) the economy is open, (2) exchange risk is high, and (3) the external use of its currency is low. The more open the country's economy, the more it saves on transaction costs and the more it stands to gain by eliminating exchange risk through the adoption of a single currency. The savings on transaction costs is higher the lower the use of its currency in external transactions.

However, the benefits of larger size in terms of reduced transaction costs must be set against the costs arising from giving up the exchange rate as an instrument of adjustment in a single currency area. The costs arising from difficulties in correcting payment imbalances increase if: (1) shocks are asymmetric across countries, (2) intraregional factor mobility is low, and (3) wages and prices are inflexible. The more asymmetric the demand/supply shocks across countries, the greater the difficulties of adjustment with a single currency if factor mobility and wage/price flexibility is low. Inadequate labor mobility in response to price/wage signals implies rising unemployment in countries adversely affected by external shocks. Similarly, price/wage stickiness with a fixed exchange rate implies that the real exchange rate will not move sufficiently to prevent unemployment in response to an external shock.

Greece stands to gain relatively little from EMU in terms of savings on transaction costs since the openness of its economy to intra-EU trade is low relative to the rest of the Union. However, this small gain must be set against the low exchange rate uncertainty since Greece adopted the hard drachma policy in 1990 and by the low use of the drachma in external transactions.

Turning to the costs, available evidence suggests that Greece is not a strong candidate for EMU. Greece's economic and trade structure deviates substantially from that of other EU countries and from the EU average. (See Gros and Thygesen, 1992; Gros and Vandille, 1995.) This deviation suggests that shocks tend to be asymmetric. Evidence from econometric estimates suggests, moreover, that nominal wages are not highly responsive to unemployment, indicating that external shocks would raise unemployment in the absence of exchange rate movements. At the same time, however, the pass-through from prices to wages is moderate to high, limiting the usefulness of exchange rate movements as a tool of adjustment (Alogoskoufis, 1992; Alogoskoufis and Philippopoulos, 1992; Layard, Nickell, and Jackman, 1991). Structural reforms aimed at increasing the downward flexibility of wages in the face of unemployment (such as the possibility of firms with losses to offer zero or negative wage increases) would improve Greece's potential to gain from EMU.

Background on Economic and Financial Policies

Greece has never joined the European exchange rate mechanism (ERM). During the 1980s, it pursued a crawling peg policy vis-à-vis a basket of currencies, including the dollar and the yen. Growing external and internal imbalances in the first half of the 1980s led to two successive devaluations, in 1983 and in 1985. Following the EC-supported 1986–87 stabilization program, during which the drachma depreciated significantly in real terms as a result of the temporary suspension of wage indexation and imposition of a strict economy-wide incomes policy, the real effective exchange rate appreciated somewhat.

The Socialist government elected in 1981 faced strong demands for redistribution, as it was the first left-wing government since the defeat of Communist insurgencies in 1946 to 1949. Minimum wages were raised significantly, entitlements were granted to various groups, and the size and scope of public sector activities were increased. These policies failed to elicit a sustained output response. Throughout the 1980s, economic performance was characterized by sluggish growth, double-digit inflation, and high external and fiscal deficits. (See Table 5.1.) The exchange rate depreciated by

Table 5.1: Greek Macroeconomic Performance, 1971-94

	1971-80	1981-90	1991	1992	1993	1994	1995
GDP growth (percent)	4.7	1.5	3.2	0.8	-0.5	1.1	1.6
Inflation (percent)	13.2	18.3	18.8	15.1	13.6	10.9	9.6
Fiscal balance (percent GDP)	-2.8[a]	-12.3	-11.6	-12.3	-13.2	-12.5	-11.3
Current account balance (percent GDP)	-1.9	-4.4	-6.1	-4.0	-3.2	-2.4	-2.3
Unemployment rate (percent)	2.2	6.4	7.0	7.9	8.6	8.9	8.8
Adjusted wage share (percent)	70.4	77.0	72.0	70.6	69.1	70.6	71.3
Gross fixed capital formation (percent GDP)	30.1	23.6	21.2	20.4	19.5	18.9	19.2

Note: a) 1979-80 average--figures not available on same basis for earlier years.
Source: European Commission.

more than necessary to offset differences in wage costs between Greece and its trading partners during that decade. Reliance on the exchange rate as an instrument of adjustment not only failed to improve export performance but also may have delayed needed modernization of production and products. There was thus growing awareness that competitiveness depends on the removal of structural rigidities and macroeconomic imbalances that impede investment, and on the containment of real wage increases below productivity growth, rather than on the level of the exchange rate. This experience gave the impetus for the hard drachma policy in the 1990s, pursued both because of European policy choices and on economic policy grounds independently of EMU.

Financial policies were tightened considerably in 1991–92 under a new EC-supported adjustment program undertaken by the Conservative government, which took office in May 1990. The program aimed to bring the deficit into a sustainable path so as to stabilize the public debt, reduce inflationary pressures, and release resources for investment. Expenditure reduction largely relied on a tight income policy in the public sector and on social security reform, while indirect tax increases and privatization provided additional revenue. In parallel with financial discipline, structural reforms were pursued to increase the responsiveness of the economy to market signals by curtailing state intervention in economic activity and lifting regulatory barriers to competition. These policies were expected to contribute to a leaner, more competitive economy and to a sustained rise in private investment and growth. The role of exchange rate policy in this strategy was to help contain inflationary pressures rather than to attempt to gain a temporary competitive advantage that soon would be eroded by inflation. The ultimate objective was to join the ERM after the inflation rate had dropped to single digits so as to enable Greece to meet the timetable for EMU set out in the Maastricht Treaty.

These efforts contributed to nominal and fiscal convergence. The general government deficit declined to 12 percent of gross domestic product (GDP) in 1991–92 from 15 percent in 1989, inflation fell, and the balance on external accounts improved. But disinflation and the end of financial repression served to highlight the size of the debt problem. The debt burden continued to rise as deficits remained high and the government took over previously unrecorded debts of the broader public sector. Moreover, progress toward fiscal consolidation was partly reversed in the 1993 electoral cycle, when the Socialist Party returned to power. With public debt already in excess of 100 percent of GDP, the new government recognized that the room for maneuver was very limited. Thus it favored substantial continuity in economic policies, except in the scope and pace of the privatization program.

The Hard Drachma Policy and EMU

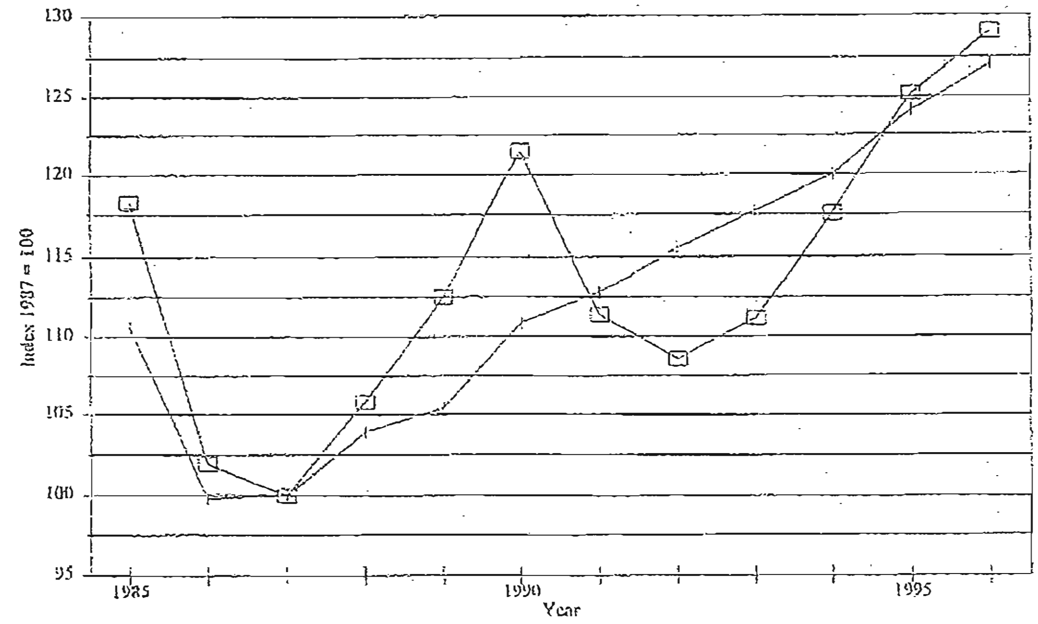
Since 1990, monetary policy and exchange rate management has been targeted at the disinflation effort. Under the hard drachma policy, authorities aim to keep the depreciation of the drachma relative to the ECU below the inflation differential, leading to a small real appreciation of the currency. ERM membership was targeted for mid-1996 under Greece's convergence program, with a view to facilitating participation in EMU by 1999, but was postponed as inflation remained well above the 5 percent target for end–1996.

The hard drachma policy was pursued against the background of important structural reforms in labor and financial markets and in the foreign exchange market, reforms that served to increase the credibility of the policy. The suspension of wage indexation and its replacement by free collective bargaining in 1991 was accompanied by government warnings that competitive devaluations were ruled out and that the exchange rate targets would be observed irrespective of the outcome of wage negotiations. The dampening effect on wages of the hard drachma policy in turn reinforced the sustainability of the policy. From 1991 to 1993, real wage restraint and productivity gains improved cost competitiveness despite a real appreciation based on relative prices. (See Figure 5.2.) However, excessive real wage increases from 1994 to 1996 eroded cost competitiveness, raising relative unit labor costs above their 1990 level. As financial liberalization accelerated, interest rates became the main policy instrument targeted at the exchange rate objective. In parallel, exchange controls were dismantled rapidly, in line with EC directives. Greece lifted remaining current account restrictions and accepted the obligations of Article VIII of the International Monetary Fund in

Figure 5.2

Real Effective Exchange Rates

Greece, 1985-1996



Source: European Commission.

July 1992; restrictions on long-term capital movements and most restrictions on short-term movements vis-à-vis EC countries were lifted in March 1993; the liberalization was extended to third countries in June 1993, and all remaining restrictions on short-term capital were lifted in May 1994.

Despite concerns about deflationary policies in a country with low growth and rising unemployment, the hard drachma policy has not been strongly challenged by interest groups or policy makers (although the markets have challenged it). The Federation of Greek Industries (SEV) occasionally has linked the hard drachma policy to Greece's loss of competitiveness but has not opposed it outright, recognizing that wage moderation since 1991 ruled out a significant additional real wage compression following devaluation. The only solution, therefore, was to pursue fiscal consolidation efforts so as to reduce borrowing costs and release resources for investment.

Increased recourse of the business community to foreign borrowing to avoid high domestic borrowing costs has created yet another constituency against devaluation. The General Confederation of Labor similarly has not opposed the hard drachma policy nor Greece's objective to participate in EMU as early as possible because the suspension of wage indexation probably has reinforced wage earners' preference for low inflation and also because participation in EMU is seen to favor labor demands through the implementation of the treaty's "social chapter." Moreover, investment and product upgrading are viewed as more important than short-term gains in price competitiveness achieved through exchange rate action.

The Bank of Greece, for its part, points to the inefficiency of monetary policy compared with structural policies as an instrument targeted at growth. (The "assignment problem" literature is sometimes evoked in this regard.) Policy makers also recognize that the structure of the public debt is such that it closes the escape route of devaluation and inflation sometimes used to reduce the real value of the debt. With 36 percent of the debt denominated in, or linked to, foreign currencies and with the domestic debt consisting of short-term government paper and floating-rate notes, the devaluation and inflation needed to achieve a given reduction in the debt burden becomes very high. There is thus broad consensus on the need to maintain the hard drachma policy.

Markets have challenged the exchange rate policy on two occasions. The currency came under pressure during the September 1992 ERM crisis and again in May 1994, a month ahead of the scheduled removal of all controls on short-term capital. In 1992, the drachma was defended by imposing controls on short-term capital and by accelerating the rate of crawl relative to the ECU. By contrast, in 1994 interest rates were raised to three-digit levels, exchange controls were lifted ahead of schedule, and the exchange rate target was fully observed. State-controlled banks played an important role in preventing the high interest rates from damaging the economy by continuing to lend at precrisis rates and getting compensated for their losses by the government and the Bank of Greece after the crisis was over.

The authorities' successful defense of the hard drachma in May 1994 demonstrated the primacy of monetary stability as a policy objective. Mild pressures on the drachma triggered by the impact of the depreciation of the dollar on the EMS in early 1995 receded quickly as local investors were convinced of the authorities' resolve to stick to the hard drachma policy almost at any cost. However, the policy mix of high interest rates and still-high fiscal deficits may prove difficult to sustain without damaging growth prospects and adding to an already high debt burden. Doubts about how this dilemma will be resolved add to the premium embedded in interest rates.

Financial Sector Reforms

Financial liberalization in Greece started in the mid-1980s and accelerated in the 1990s. EU membership played an important role in promoting financial sector reform, initially by expanding the role of market forces as trade was liberalized and later through the Single Market program and EMU requirements. Today the liberalization process is virtually complete. However, new reforms are needed to develop the domestic financial market, not all of which are mandated by the Maastricht Treaty. These reforms include central bank independence; the privatization of state-controlled banks; the development of a bond market, a yield curve, and a domestic institutional investor base by lifting restrictions on pension fund investments.

Reforms since the mid-1980s focused on lifting restrictions on bank lending and interest rates intended to channel credit to preferred sectors, facilitate the financing of budget deficits, and reduce borrowing costs. These reforms have been largely completed. Interest rate controls have been lifted and government paper bears market-related returns. Obligatory purchases of treasury bills by commercial banks were phased out and were completely eliminated for new deposits in mid-1993. Direct financing of budget deficits by the Bank of Greece also was phased out and eliminated in January 1994 under a 1992 law that implemented the EU Second Banking Directive. Now the budget deficit is financed mainly through sales of government paper to the non-bank public. To encourage the development of capital markets, drachma denominated bonds issued by international organizations were given tax-free status in 1993. A number of organizations issued three- to five-year bonds since early 1994, including the European Investment Bank, the World Bank, and the European Bank for Reconstruction and Development. These fixed-rate bonds issues were the first on the Greek market and thus marked the beginning of a long-term interest rate and a yield curve as a benchmark for financial and policy decisions. But the amounts issued were small and were followed, with a long lag, by government bond issues in November 1996.

Despite substantial reforms already implemented, additional reforms are needed to develop the domestic financial market, improve its ability to assess creditworthiness, and increase the effectiveness of monetary policy. First, as of July 1997, formal independence has not yet been granted to the central bank. Second, obligatory investment of pension fund assets in Treasury bills prevents the development of an institutional investor base that would increase market efficiency and liquidity. It is also unclear whether restrictions on pension fund investments are compatible with the spirit of the Maastricht Treaty's ban on privileged access (Karamouzis, 1995). Third, the presence of large state-controlled banks implies that, despite the phase-out of compulsory purchases of T-bills by banks, the ban on privileged access cannot be enforced effectively. Moreover, lending to uncreditworthy public or private entities by state-controlled banks adds to the creation of public debt. Fourth, the bond market will not be fully developed until the government—by far the largest borrower—taps that market with large and regular issues. Until that happens, no long-term interest rate will be needed as a benchmark to guide financial and policy decisions and eventually to assess compliance with the interest rate criterion of convergence.

Competition Policy

The stricter enforcement of EC provisions on competition policy under the Single Market program has also had a strong, if somewhat delayed, impact on Greek economic policies. In certain areas, the implementation of EU rules on state aids has increased competition and contributed to a leaner, more efficient economy. However, the impact came too late to avoid large subsidies, which significantly increased the public debt. The direct cost of these subsidies was not transparent because they were largely extrabudgetary, taking the form either of loan guarantees granted directly to state-controlled companies or capitalization of their debts due to state-controlled banks. Moreover, pressures from special interest groups often resulted in policy reversals.

The two sectors where the impact has been most controversial is shipbuilding and air transport. Two state-owned shipyards were privatized between 1992 and 1995, and the management of a third one (the largest) was transferred to the private sector as a result of EU directives on state aids to shipbuilding. However, one privatized shipyard was returned to state management in 1995 under the pressure of continued losses. The national airline, Olympic Airways, started implementing a restructuring program agreed with the European Commission in 1994 as a condition for debt write-offs. The program involved large reductions in personnel, suspension of unprofitable routes and other cost-cutting measures, and abolition of Olympic Airway's monopoly on ground handling. Again, program implementation was interrupted in 1995 under pressure from the unions. Similarly, the 1991 privatization of Olympic Catering, a subsidiary of Olympic Airways, was partially reversed in 1994.

In view of the large amount of subsidies granted to both sectors since the late 1970s, it could be argued that privatization and restructuring were inevitable at a time of fiscal consolidation. While pressures from the European Commission enabled the government to argue with the labor unions that its hands were tied by obligations undertaken in the context of EU membership, pressures from the public sector labor unions were equally effective in aborting the reforms.

Labor Market and Unemployment

Labor negotiations in Greece are highly centralized. Since 1991, the General Confederation of Labor—the umbrella organization representing both private and public sector unions—negotiates anual or biannual wage contracts with the Federation of Greek Industrie: Wage bargaining occurs at national, sectoral, and firm levels, with nation: wage settlements imposing minimum remuneration levels. About one-thir of the labor force is unionized, but this conceals large differences betwen the public sector—where union membership is compulsory—and the pivate sector. Restrictive practices impeding labor market flexibility include eniority built into collective wage agreements and the inability of firms wh low or negative profits to grant wage increases below the national level.

Unemployment has increased in the 1990s lit remains below the EU average. As mentioned, the wage indexation sys:m introduced in 1981 was abolished in 1991 and replaced by free collecve bargaining. The government is no longer directly involved in wage negtiations but influences their outcome through its announced exchange rate irget and through wage policy in the public sector. Under the hard drachia policy, wage increases incompatible with the exchange rate target lead › a loss of competitiveness.

Real wage growth remained well above prodctivity growth in the 1980s, thus raising the share of wages in value addecand contributing to unemployment. Although this trend was reversed i. the 1990s, unemployment continued to rise. These data do not support te thesis that unemployment in the 1990s is neoclassical—that is, that labo is unemployed because it is overpriced. Rather, the rise in unemploymencs linked to sluggish investment. With private investment crowded out b high real interest rates and public investment constrained by budgetary asterity, the share of investment in GDP declined from 20 percent in 190 to 17 percent in 1994. Compounding the sharp fall in the investmenratio during the 1980s, this further decline in turn constrained economic gowth and job creation.

Labor market rigidities are likely to have cotributed to unemployment. For example, wage rigidities may explain why:edundancies in connection with privatization permanently raise the uneiployment rate. The exceptionally high unemployment rate among the yung also suggests labor market rigidities. On the other hand, relatively lovunemployment benefits for a maximum duration of 12 months do not sugest that overgenerous benefits have contributed to unemployment. An iiportant rigidity remains in the broader public sector, where powerful unios have often pushed for, and received, higher wage increases than civil servnts and even private sector employees. Demekas and Kontolemis (1996) ind empirical evidence that public sector wage and employment decisions ave had an adverse effect on employment in Greece.

The unemployment problem is central to tl· domestic policy debate but has not been linked directly to Maastricht requrements, perhaps because all governments in power during the 1990s have ciphasized that Greece's fiscal imbalance required tight policies independent of EU commitments. Both the center-right and Socialist governments ruled out countercyclical policies as a cure for unemployment, so as to avoid compounding the debt problem. At the same time, however, no major labor market reforms have been undertaken, except for the suspension of wage indexation and the introduction of free collective bargaining in 1991. Regional disparities in unemployment exist, with the highest rates of unemployment recorded in the northeast region of Thrace, but the regional dimension is not evoked frequently in public debate.

Convergence Targets

Greece submitted a convergence program to the EU in March 1993. The main target of the program was rapid fiscal adjustment so as to enable Greece to participate fully in EMU from the outset in 1997. Fiscal convergence was to be facilitated by broad-based privatization, expected to increase the efficiency of resource use, remove structural impediments to growth, and generate fiscal revenue. However, the program's fiscal targets were exceeded by a wide margin as a result of the government's loss of majority in parliament, which triggered national elections in October 1993, and the new government's subsequent cancellation of major privatization efforts then under way. An increase in public spending and a relaxation of tax collection efforts ahead of the elections, typical in Greece's electoral cycle (see Figure 5.3), contributed to the overruns.

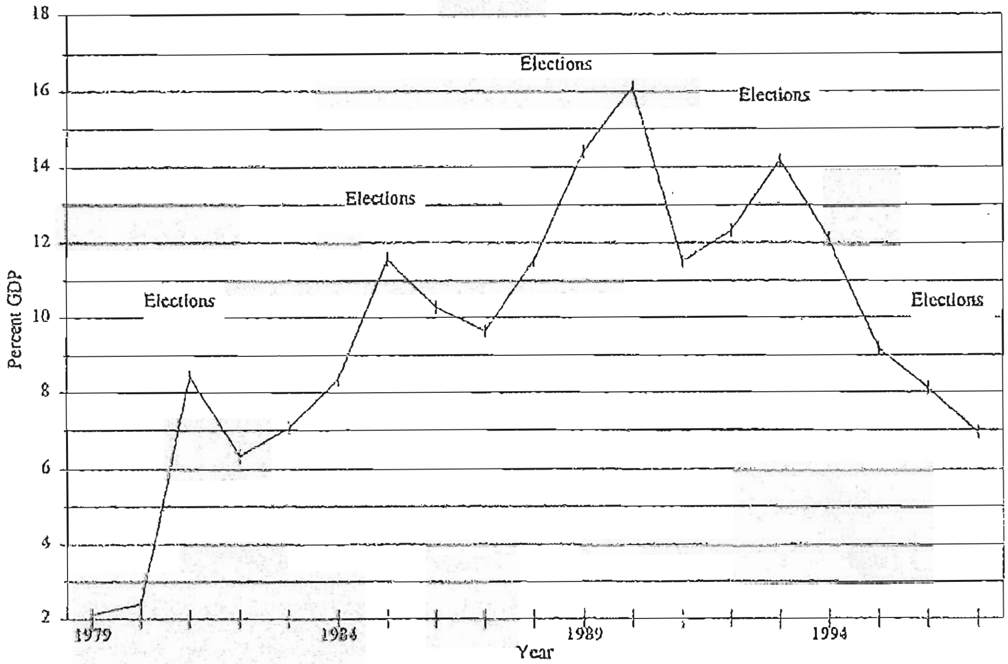
A revised convergence program was submitted to the EU in June 1994. The revised program envisaged a somewhat slower convergence, both as a result of the slippage that had occurred in 1993 and because growth was revised downward compared with the previous program. Thus it was no longer envisioned that Greece would meet the convergence criteria by 1997 but only in 1999. Under the program, there was an initial "adjustment" period from 1994 to 1996, during which time the debt would be stabilized, followed by a "growth" period from 1997 to 1999. Summaries of the main targets follow.

The fiscal target for 1994 was broadly met, but the gross public debt exceeded the targeted amount both because the privatization revenue envisioned in the program did not materialize and because the program did not sufficiently take into account the government's takeover of bad debts of the broader public sector. Despite the progress achieved, Greece is still far from meeting any of the convergence criteria. (See Table I.4.) Prospects for convergence depend on the government's sustained resolve to go against special interest groups that oppose spending cuts, additional taxation, and privatization.

Figure 5.3

Government Deficits in Greece

Percentage GDP



Source: European Commission.

Table 5.2: Greek Convergence Targets

	1994	1995	1996	1997	1998	1999
	Percent GDP					
Fiscal deficit	-13.2	-10.7	-7.6	-4.2	-2.4	-0.9
Primary surplus	1.3	3.5	4.9	5.1	5.4	6.1
Public debt	112.1	115.2	115.3	113.4	109.3	103.4
	Percent					
GDP growth	1.1	1.2	1.7	2.6	3.0	3.5
Inflation (private consumption)	10.8	7.9	6.1	3.9	3.5	3.3
Short-term interest rate	18.5	14.1	10.6	7.9	6.8	6.2

Note: First three rows are general government figures. These figures include privatization revenue of 0.6 percent of GDP per year between 1994 and 1996.
Source: Ministry of National Economy, Convergence Program, June 1994.

Obstacles to Convergence

Elections in Greece are dominated by interest group politics to a greater extent than in other EU member countries because the legacy of state intervention of the 1970s and 1980s fuels political patronage. Parties win elections largely because they are viewed by the organized recipients of state largesse as most likely to maintain or increase their entitlements (Kollyntzas, 1995). This fact may explain why political parties behave very differently in government than in opposition, with the party in power often not keeping pre-election promises and with the opposition party often engaging in populist rhetoric. Beyond the rhetoric, sometimes reforms initiated by one party are reversed by the other because they are not seen to favor their constituents. An institutional feature that promotes political patronage is the existence of state entitlement programs that are highly politicized and abused (for example, disability and veterans' pensions cover an implausibly large share of the population). More generally, the dominance of interest group politics, reinforced by their control over the media and by the lack of transparency in political parties' financing, adversely affects the country's ability to carry out macroeconomic adjustment and structural reforms.

The list of interest groups is long. Examples include: public sector labor unions opposing privatization on the grounds that the required restructuring would lead to job cuts and loss of benefits; suppliers selling goods and services to the state sector at perhaps twice the world market price; politicians offering public sector jobs and other entitlements to win votes; and farmers opposing a reduction in the subsidies and pensions they were handed in the 1980s and refusing to be taxed.

Privatization, the key element of the needed economic restructuring and budgetary consolidation, has been impeded by interest group politics. The first attempt to privatize telecommunications ended with the government's loss of parliamentary majority in 1993, the second was canceled in 1995 despite lifetime job tenure granted to existing employees, and the third was limited to an initial public offering of 8 percent of the shares in 1996. With the change of government in 1993, the privatization of the Athens Bus Company was reversed and a law abolishing the state monopoly in power generation was rescinded less than year after they took effect.

Additional impediments to the implementation of adjustment programs are poor public administration, soft budget constraints on public enterprises and entities, and limited consensus for privatization based on the belief—often cultivated by special interest groups—that a sell-off of state assets is not in the national interest. Prospects for convergence would improve with administrative reforms linking public sector pay more closely with performance, greater independence, and accountability of the management of state enterprises; more transparent accounting practices and audits based on international standards; improved public understanding of the trade-off between present and future consumption; and equitable burden sharing of the short-term costs of adjustment.

Issues in Assessing Fiscal Sustainability

Does compliance with the fiscal convergence targets ensure convergence? Two issues are of importance here: the stock-flow adjustment and the behavior of public enterprises that are outside the definition of general government.

Public debt in Greece has increased substantially, more than one would expect from the officially reported deficits. Over the past 15 years, the increase in the debt has been almost twice as high as the integral of the deficits. Contingent liabilities of the central government fully account for this stock-flow discrepancy. Since 1990, the government has issued bonds and credits to assume bad debts of the broader public sector ("consolidation bonds"), explicitly recognize liabilities due to the Bank of Greece arising from exchange rate guarantees, and inject capital to state-owned banks. A portion of the interest due was capitalized or postponed, adding further to the debt burden. At end–1995 the explicit takeover of bad debts and other contingent liabilities accounted for 23.4 percent of GDP, or nearly one-fourth of central government debt (see Table 5.3), while outstanding guaranteed debt amounted to a further 9 percent of GDP.

The large amount of outstanding guaranteed debt and other contingent liabilities of the central government, and the continued issuance of such guarantees, cast doubt on the prospects for debt convergence even if the deficit targets are achieved, since part of the existing contingent liabilities are likely to be taken over by the government in future years, while new liabilities continue to be issued. Considerable moral hazard is involved in debt consolidation operations as borrowers and lenders expect that the government will bail them out in the future, as it has in the past.

Table 5.3: Contingent Liabilities in Greek Public Debt, 1995

	Percent GDP
Central government debt	120.8
of which	
Contingent liabilities	23.4
• Consolidation bonds	10.1
• Bank of Greece	11.7
• Capital increase of state-owned banks	1.6
Interest capitalization	4.8

Source: Greek budget, 1996.

In 1996, the government imposed a legal limit on the issuance of new guarantees, equal to 3 percent of budgeted public expenditures. Moreover, Eurostat methodology was adopted, under which debt consolidation is considered a capital transfer and is included in expenditure. Based on the new methodology, the 1993 deficit was revised upward by 2.1 percent of GDP to include the debt consolidated in that year. (See Table 5.4.) However, a part of the guarantees called in subsequent years had not been consolidated as of November 1996 and therefore were excluded from both debt and the deficit, thereby exaggerating their decline in 1994–95. Moreover, the authorities have started making use of Eurostat rules that permit budget transfers to public enterprises to be excluded from expenditures provided they are matched by increased equity participation by the state. In addition, the legal limit on the issuance of new guarantees does not appear binding since it was revised upward within a few months of its imposition through the exclusion from the limit of guaranteed credits extended by the European Investment Bank and the EU Social Fund.

What rules or practices at national or EU level would help assess fiscal sustainability in light of the stock-flow adjustment problem? At the national level, a share of contingent liabilities issued in any given year could be included in budgetary expenditure (as the Commission already does for capitalized interest). The current practice, under which contingent liabilities are included in expenditures only when consolidated, provides perverse incentives for governments to delay consolidations, and thus generates arrears to the state-controlled banks that adversely affect the liquidity of the banking system. Also, the exclusion of debt consolidations matched by increased equity participation by the state maintains the stock-flow adjustment problem intact. Greater transparency—and probably control—in the issuance of contingent liabilities would result if they were taken into account in assessing compliance with the fiscal convergence targets. It is nevertheless clear that accounting rules cannot be a substitute for structural reforms, including privatization or closure of unprofitable public enterprises and entities, needed to prevent the issuance of further contingent liabilities.

Public enterprise operations were excluded from the Maastricht Treaty's definition of the fiscal deficit on the basis of the argument that they are of a commercial nature even if publicly owned. This is not necessarily the case. In countries where the government appoints the management and has strict control over the pricing, employment, and investment policies of public enterprises, their deficits include quasi-fiscal operations. The temptation to "park the deficit in the next parking lot" is significant. In 1994, the deficit of public enterprises in Greece increased from 0.3 percent of GDP to 0.8 percent, reflecting tariff increases below cost increases and increased transfers to the central government in the form of dividends or

Table 5.4: Successive Revisions of the 1993 Greek Deficit

	Deficit	Revision	Justification
	Percent GDP		
Revised convergence program, June 1994	12.5		
September 1994 revision	13.3	+0.9	Inclusion of capitalized interest
March 1995 revision	13.2	-0.1	Correction on military debt service
September 1995 revision	12.1	-1.2	Inclusion of revenue collected by hospitals
March 1996 revision	14.2	+2.1	Inclusion of consolidated debt

Note: Under Eurostat methodology, debt consolidation is considered a capital transfer and is included in expenditure.
Source: Ministry of National Economy.

loan repayments, which are recorded as revenue of the general government. Although the amounts involved are comparatively small, they should in principle be taken into account, if only qualitatively, in assessing fiscal sustainability.

Conclusions

Greece meets the economic requirements for monetary union with the EU set out in the optimum currency area literature to a lesser extent than other EU members. Structural reforms aimed at greater price and wage flexibility would increase Greece's compatibility with EMU. Much progress toward convergence has been secured in the 1990s, but much remains to be achieved, given the initial conditions. Fiscal consolidation efforts have not yet secured a primary surplus sufficient to reverse the dynamics of rising debt. Greater deregulation and competition in goods, services, and factor markets would reduce costs and make price formation more sensitive to market conditions. The scope for privatization and deregulation to increase competition and efficiency in sectors dominated by the public sector (transport, telecommunications, energy, education, and health) remains large.

Note

1. The views presented in this chapter are strictly personal. The author wishes to thank George Alogoskoufis, Haralambos Christophides, Dimitri

Demekas, Michael Massourakis, and Paul Mylonas for helpful comments and suggestions. She has benefited from discussions with Jason Stratos and Nicos Analytis of the Federation of Greek Industries and Christos Protopappas of the General Confederation of Greek Labor.