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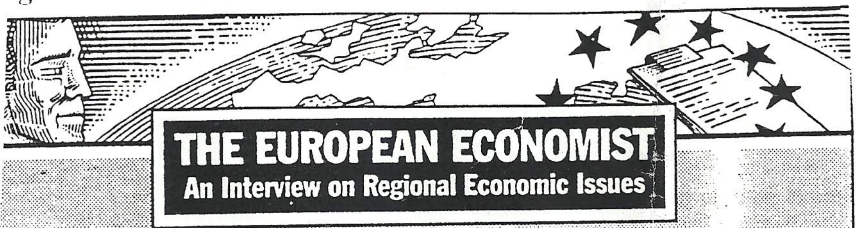

This Week with Miranda Xafa— Senior economist for eastern and southern Europe at Salomon Bros. International.

Greece Continues to Strive For More Fiscal Discipline

As the European Union's poorest member, Greece has no prospect of participating in European monetary union in 1999. With public debt of around 110% of gross domestic product and an inflation rate three times the EU average, Greece can only hope to meet the requirements for participation after 2000. The government recently announced a strict budget for 1997 calling for extra taxes and spending cuts. But it already has fallen behind schedule even according to its own targets. Miranda Xafa discussed Greece's economic problems with Jenny Paris, the Wall Street Journal Europe's special correspondent in Athens.

Greece is likely to be the only country that won't fulfill any of the criteria for participation in EMU by the end of next year. What does this mean for the Greek economy?

It doesn't necessarily mean Greece will be the only country left outside EMU. But it is the only country as of today that doesn't seem to have any prospect of joining the first stage. The cost of not participating is that Greece won't have a voice in shaping the institutions within which EMU will function. It will become (a) more peripheral country in the European Union.

But as long as Greece continues its efforts to be included in the second group of countries — the government has set as target the year 2001 — and as long as policies remain clearly focused on this objective, I don't think it's a big setback for Greece.

Is the goal for participation in 2001 realistic?

I think it is, in certain conditions. Greece has been trying to raise tax revenues and cut expenditure and this principle should continue to guide policy over the medium term. But wage growth remains excessive. Since 1996, the drachma has been pegged to the European currency unit. But inflation remains around 8%, way above the average of the other EU countries. For Greece to participate in EMU later on, it has to remain clearly focused on fiscal consolidation. It also has to accept that, as long as the drachma is pegged to the ECU, wage growth cannot exceed the average of the other EU countries.

The government has set ambitious targets in its 1997 budget. But under a two-year wage agreement in the private sector, wage growth in 1997 will not decelerate compared with 1996. That makes the government's target of slashing inflation to 4.5% by the end of 1997 unrealistic. My own forecast is for 6.5% inflation by the end of next year. A target of cutting the general government deficit to 4.2% of GDP from about 7.6% this year is also too ambitious. Greece has never cut its deficit by this much in a single year. Prime Minister Costas Simitis has vowed to fight tax evasion and remove tax breaks. He has introduced legislation to tax certain financial instruments, including treasury bills, which will raise a fair amount of revenue. But spending cuts are also needed.

Why does Greece lag so far behind the rest of its EU partners?

While most other EU countries have been in the European exchange rate mechanism for a number of years, Greece has never joined it. A few years ago, it still had an inflation rate of 20%. It was only in the 1990s that it started following an exchange rate-based inflation strategy under which the depreciation of the drachma was smaller than the inflation spread between Greece and its partners.

The public debts accumulated in the 1980s are also a major burden. With the removal of controls on interest rates, the government is now paying market rates on its borrowing, which wasn't the case in the 1980s. That creates annual debt servicing obligations amounting to around 12% of gross domestic product. The public sector is very large, and it includes a large number of money-losing companies. The government issues guarantees every year for the broader public sector, which are a form of contingent liability. When the guarantees are called, they are consolidated to new debt. As long as there is no restructuring of the public sector, the underlying cause of debt accumulation remains.

How was this enormous debt created in the first place?

The primary cause was the expansion of the public sector in the late 1970s and early 1980s. State-owned companies tend to rely on the government not just for direct budgetary subsidies but also for debt guarantees, which is what creates the problem of the debt. The government in the past has always paid out and that has created an enormous moral hazard. Olympic Airways is a case in point. Politicians interfered in the hiring, investment and pricing decisions. Management wasn't subject to the same requirements as private-sector companies, which have to explain to shareholders why they have negative results and what they are doing about them. There is enormous waste, inefficiency and overstuffing.


Miranda Xafa

Another source of debts has been the agricultural cooperatives that were created starting in 1981, when Mr. Simitis was minister of agriculture. Year after year, we've seen the debts of Greek farmers being written off, essentially being taken over by the taxpayers.

If Greece fails to meet the EMU requirements even at a later stage, what will be its future in the EU?

Eastern European countries will start joining in around 2002. If Greece is excluded from EMU, it could become totally marginalized. Some Eastern European countries are already closer than Greece to meeting the criteria. They have achieved this through very tough anti-inflation policies and by moving a lot faster to privatize both industrial companies and utilities.