The Greek Economy in the Post-Maastricht Era

Challenges and policy perspectives

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RÉSUMÉ

Dans cet article, l'auteur analyse les nouveaux défis auxquels fait face l'économie grecque après le traité de Maastricht et le pacte de stabilité signé à Amsterdam, les 16-17 Juin 1997. Afin de comprendre les conditions dans lesquelles se meut l'économie grecque, l'auteur a utilisé une approche méthodologique qui consiste à analyser trois périodes régulatoires distinctes: 1962-1981; 1981-1992 et 1992 à maintenant.

ABSTRACT

The author of this article analyses the new challenges facing the greek economy in view of the Treaty of Maastricht and the Stability Pact endorsed in Amsterdam on June 16-17 1997. The methodological approach used to understand the new policy environment is to go back and analyse what appear to be three distinct regulatory policy periods that span the years 1962-1981, 1981-1992 and 1992 to the present date.

Introduction

The expected adjustment of any economy to a shock depends largely on initial conditions. Accordingly the first section of this article highlights the principal characteristics of the Greek economy which have emerged from the developmental process in the post-war era.

It is difficult to comprehend the Greek development paradigm without reference to the significance of the geo-political position of Greece at the crossroads of three continents. Greece is the only European Union country that does not share a land border with any other EU member state. Furthermore, Greece occupies a strategic location on the international transportation, energy and communication networks that link the energy reserves of the Caspian Sea and Middle East to the major consumption centers of the West. From this perspective, the tensions arising from international competition over spheres of influence in the Balkans, Middle East or Black Sea region, as well as the inherent instability in the area, constitute fundamental factors in explaining the country's performance and development. The economic history of Greece is thus intertwined with prevailing conditions in the broader regional market of South Eastern Europe, since the latter influences directly various indicators such as the size of the effective Greek market, the entrepreneurial expectations of

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Greek and foreign investors, exchange receipts from trade and tourism, the Greek balance of payments, the level and rate of growth of defense expenditures.

Within this context, the prospects for Greek economic development can be evaluated with reference to the "régime switch" that is taking place in the 1990s as a consequence of the Treaty. The new policy environment becomes clearer through an analysis of what appear to be three distinct regulatory policy periods that span the years 1962-1981, 1981-1992 and 1992 to the present. In line with this methodological approach, the turning points of the Greek development process are the years 1981, when official entry of Greece into the EU took place, and 1992, when the Maastricht Treaty was signed.

Policy Régimes and Maastricht

The Pre-entry Policy Régime: State-Corporatism

The regulatory framework prevailing during the period 1962-1981 has been identified as a peculiar form of "state corporatism" (Katseli; 1990), characterized by the interplay of interests and actions among the state, a highly centralized banking system and a small number of businesses, which enjoyed preferential access to the financial and credit markets.

Within the context of "state corporatism", the Monetary Committee, which operated until 1982 and consisted of top government and banking officials, was responsible for all credit decisions including the actual amount of credit and the terms of loans extended to each and every company. The financial and credit system, led by a few major public banks subsidized, through negative interest rates, specific enterprises and excluded many others from access to credit. The absence of capital markets and the presence of exchange restrictions further restrained the free access of businesses to capital, thus forcing firms to remain very small and under-capitalized. On the contrary, those companies, especially the export-oriented ones, which enjoyed preferential access to the financial and credit system, soon became over-capitalized and their capital-labor ratio sky-rocketed (Katseli;1990). Distortions were amplified through the *ad hoc* application of various trade protective measures, including duties, import taxes and export subsidies on sectors or enterprises. Economically unviable enterprises were kept running through the prevalence of "soft budget constraints", a situation which implied the presence of selectively favorable regulations concerning such areas as debt-servicing, debt-cancellation and tax treatment. (Katseli, 1990).

These conditions gave rise to:

a) intense dualism of the Greek production system, featuring, on the one hand, the over-capitalization and over-enlargement of a few companies in each industrial sector and, on the other hand, the presence of many small and undercapitalized units.

b) prevalence of pre-capitalist organizational patterns, especially in the agricultural and service sectors, in conjunction with artificially enlarged and not necessarily viable enterprises in the industrial sector.

c) weakening of entrepreneurial incentives in the private sector of the economy and, consequently, the delay in the emergence of an entrepreneurial class, familiar with the operations of a competitive market.

d) extensive clientelism in the workings of the political system, and the perpetuation of a centralized, yet essentially weak, public administration system that has traditionally acted as the employer of last resort in an economy overburdened with hidden unemployment.

In the context of "state corporatism", the weaknesses of both the production and the political system were cushioned and sustained by the continuous flow of transfers from abroad, initially in the form of foreign aid, later of shipping and emigrant remittances, and finally, in the form of invisible receipts from the European Community. The flow of transfers from abroad has supported domestic incomes, has acted as an anti-cyclical policy tool and has covered between 34 and 44 per cent of imports during the period 1957-1981 (Maroulis, 1991, Table 15, p. 82). If one subtracts tourist receipts, transfers have covered 43 per cent of imports during the period 1960-66, 39.8 per cent during 1967-1973, 37.2 per cent during 1974-1978 and 34,2 per cent during 1979-1981 (Bank of Greece, Monthly Statistical Report; various issues).

The structure of the labor market, characterized by the relatively small share of wage income in total income and the weakness of the tax system have not allowed for the enlargement of the taxation base and, consequently, the collection of high tax receipts. Public receipts have fluctuated from 22 per cent of GDP, in the period 1958-66, to 26 per cent, during 1974-1981, where almost half of this percentage consists of indirect taxes (Katseli, 1990, Table 8.3, p. 250). Already in the 1980s, the growing claims on public expenditures coupled with the hysteresis of tax collection have given rise to budget deficits that needed to be financed either via monetisation or via the issuance of public debt.

The Post-entry Policy Régime: Liberalization and Deregulation

With Greece's entry into the European Community in 1981, the Greek economy became exposed to a completely different institutional framework. Markets became liberalized as trade barriers were lowered and selective protection was abolished. Major changes took place in 1982 and 1983, including the abolition of the Monetary Committee, the rationalization of the interest rate structure, and a significant rise of average nominal interest rates to the rate of inflation. During the period 1981-86, trade was liberalized through the reduction of tariffs and quotas for final products. This process was concluded with the abolition of the remaining tariffs, of export subsidies and of the regulatory import tax in 1989.

The liberalization of the capital market started in 1986 and was completed within a decade, including both short-term as well as long-term capital flows. At the same time, state procurement policy was liberalized and "soft budgets" were hardened.

Under the new regulatory framework, the adjustment of the Greek economy was quite abrupt and brought about significant income and wealth redistribution. The over-indebted enterprises of the earlier regime were now unable to function under positive interest rates, and were rendered problematic. Since these enterprises were mostly export-oriented, the rise in debt-servicing costs and the removal of subsidies hurt their international competitive position. The structural competitiveness of the Greek economy, as measured by the Balassa Index, was reduced in all sectors of the Greek economy, including those traditional sectors in which, under normal circumstances, the Greek economy was supposed to possess a comparative advantage (Katseli, 1996, Table 7). The deficit in the trade balance expanded as a percentage of the GDP from 8 per cent in the period 1980-1985 to 13.4 per cent in 1986-1992.

The restructuring of the country's traditional productive base was slow and coincided with a period of a sharp decline in wages as a percentage of GDP from 74.2 per cent in 1985 to 64.5 per cent in 1993 (European Economy, 1996, No. 62). Many large corporations were forced to close down and this contributed to a vicious circle of deindustrialisation in regions which exhibited a high concentration of manufacturing units.

At the same time, however, dynamic new businesses emerged while domestic investment activity and capital flows from abroad increased. During this period, the inflation rate was reduced and inflationary expectations became stabilized.

The adjustment process was cushioned once again by the financial flows extended through the First Community Support Framework (1988-1992). Community transfers rose to 6.5 per cent of GDP in 1993, amounting to 20 per cent of the country's total export receipts. They financed 29.2 per cent of the country's trade deficit (Bank of Greece, 1997).

Market liberalization was completed in the early 1990s. While the structural adjustment of the Greek economy accelerated, the Maastricht Treaty, was signed in 1992. Under the Treaty, member states proceeded to deepen the integration process and to set the rules for an Economic and Monetary Union (EMU) to be in place by the end of the century. The Greek economy entered a third phase where macro-economic policy became constrained and in line with the convergence criteria imposed and policy instruments allowed. The Supra-national institutionalization of the macro-economic policy régime was completed with the Stability Pact decided in Dublin in 1996 and approved in Amsterdam a year later.

The Maastricht Treaty and its Effects

The Maastricht Treaty created a new framework for the conduct of economic policy in Europe. All member states adopted the convergence criteria proposed by the Treaty with the aim of lowering inflation and interest rates, constraining budget deficits to less than 3 per cent of the GDP and lowering debt towards 60 per cent of the national income. Common restrictive policies were thus imposed upon all member states that wished to be included in the Economic and Monetary Union.

Similarly, the degrees of freedom that member states enjoyed in the selection of policy instruments were seriously curtailed.

The approval by the European Commission of the multi-year Greek Convergence Program (1993-99), submitted in 1993, legitimized the pursuit of domestic deflationary economic policies. The macro-economic policy mix adopted since 1992 consisted of restrictive fiscal policy practices in conjunction with a strict monetary policy stance. The primary budget deficit was trimmed through cuts in real government spending and increases in tax receipts, largely from the imposition of "objective taxes" on the self-employed. Furthermore, a hard currency policy was pursued so as to prepare the grounds for the obligatory maintenance of a stable currency parity, for at least two years prior to integration in the third stage of EMU.

To avoid balance-of-payments problems and to limit domestic liquidity, high real interest rates were maintained throughout the post 1992-period. The combination of high real interest rates, an appreciating drachma (in real terms) and decreasing real *per capita* wages succeeded in restraining demand and lowering the inflation rate from almost 16 per cent in 1992 to 8.5 per cent in 1996.

The macro-economic performance of the Greek economy in this 'post-Maastricht era' can be summarized in the basic policy indicators presented in Table 1, and in the macro-economic performance indicators presented in Table.2.

TABLE 1
GREECE : ECONOMIC POLICY INDICATORS
(Annual Percentage Change)

	1990	1991	1992	1993	1994	1995	1996
MoneySupply (M2)	15.3	12.3	14.4	15	8.9	10.3	9.8
Public Deficit (% GDP)	-16.1	-11.5	-12.3	-14.2	-12.1	-9.1	-7.9
Nominal Wage	23.1	14.3	10.7	8.1	12.2	12.5	11.5
Real Per Capita Wage	2.6	-4.5	-3.8	-5.0	1.2	2.9	2.4
Interest Rates of Bonds (12-month)	22.83	23.33	21.63	21.23	18.96	15.47	12.87
Real Interest Rates (nominal minus average inflation for the next 12 months following expiration of bonds)	1.67	5.88	6.47	9.05	8.61	6.76	
Real Interest Rates (nominal minus current inflation)	2.50	3.78	5.70	6.76	8.04	6.16	4.34
Real Weighted Parity Index 1990=100	100.0	101.2	104.5	104.1	104.4	108.2	

Source:
Eurostat & DGII (1997), EC Economic Data Pocket Book, No 4/97

It is worth noting that after 1992 real interest rates fluctuated between 6 and 8 per cent. During that same period, the drachma appreciated in real terms by approximately 8 per cent.

TABLE 2
GREECE: PERFORMANCE INDICATORS

	1990	1991	1992	1993	1994	1995	1996
GDP Growth Rate	-1.0	3.2	0.4	-1.0	1.5	2.0	2.4
Inflation (%)	20.3	19.6	15.9	15.5	10.9	9.3	8.5
Unemployment Rate (%)	6.4	7.0	7.9	8.6	8,9	9.1	9.0
Employment Rate (%)	1.3	-1.8	1.4	0.8	1.9	0.9	1.2
Trade Deficit (% GDP)	-14.5	-14.1	-13.9	-13.7	-13.7	-14.4	-14.4
Income Capital Share *	44.4	48.2	49.3	51.7	50.5	49.4	48.5
Adjusted Wages Share **	77.2	72.5	68.9	64.5	68.8	70	71.6

Sources :
Eurostat & DGII (1997), EC Economic Data Pocket Book, No 4/97
° OECD (1996), Economic Outlook, June
°° European Economy (1996), No. 62 . For theyear 1990: European Economy (1995), No. 59
°°° European Economy (1997), No. 63.

The combination of market liberalization - nearly completed by the early 1990s - and of convergence to meet the exigencies of the Maastricht Treaty depressed demand and caused a major structural adjustment in the Greek economy. Unemployment increased throughout the 1990s, while a major redistribution of income took place, mainly in favor of financial capital.

The unemployment rate exceeded 10 per cent in 1997 while the wage share declined by 5 percentage units between 1990 and 1996 (Table 2). The average GDP growth rate in the period 1992-1996 remained under 1.5 per cent (1.45%) while the trade deficit as a percentage of GDP - a good indicator of structural competitiveness - has exceeded 14 per cent in recent years.

There is substantial evidence that the adopted policy mix has stabilized inflationary expectations and has contributed to bringing about a significant deceleration of inflation from 15 per cent in 1992 to 4.5 per cent (year to year) in December 1997.

The adjustment costs associated with the low-growth environment of the 1990s have been mitigated by the influx of funds transferred by the European Union, under the Second Community Support Framework (1994-1999). These transfers, amounting to approximately 7 trillion drachmas, have supported incomes and the demand for goods and services. They have provided the necessary financial resources for the improvement of infrastructure, the upgrading of human resources, and for the assistance of structural adjustment of Greek businesses (Katseli, 1996). The developmental repercussions of the "Delors package", however, have not yet been evident due to considerable delays in the design and implementation phase, which have postponed the expected positive multiplier effects on income. These delays, have contributed to the ineffective use of resources and to their channeling towards consumption as opposed to investment purposes.

The Stability Pact

The Stability Pact[1], decided upon by the Dublin Summit Conference of December 13-14, 1996 and ratified by the Inter-governmental Conference of Amsterdam, has tied the hands of member states in the conduct of fiscal policy. The obligation to submit consecutive "convergence programmes", which would safeguard the nominal adjustment of each economy to the Maastricht targets, combined with the introduction of fines in the case of budget deficit "excesses", have restrained significantly each Government's flexibility in regulating economic activity. Beyond its deflationary impact on the European economy, the Pact has created incentives for the promotion of a pro-cyclical fiscal policy. Specifically, should an external disturbance reduce demand, GDP and, consequently, tax revenues, governments will be forced to adopt restrictive fiscal policies to secure the 3 per cent target. In so doing, demand will be further reduced and the downturn of economic activity will be prolonged.

The depletion or the permanent loss of policy instruments will become more severe in the face of the progressive integration of international capital markets. Small countries, such as Greece, already appear incapable to use tax policy instruments for budget purposes, as this option discourages investment activity by Greek or foreign business alike. Hence, the pursuit of a highly restrictive budget target has to rely increasingly on expenditure cuts. The margins for sizeable cuts, however, are limited, since public expenditure finances investment needs and covers social priorities.

Consequently, the "institutional regulation" of macro-economic policy at the European level, which originated in Maastricht in 1992 and was concluded in Amsterdam in 1997, entails the danger of a prolonged recession for the less-developed countries of the Union.

Through the Maastricht Treaty, the right of seignorage has been transferred to the European Central Bank and national public policy has been streamlined to the policy demands of European institutions. Through the Stability Pact, European governments have given away the remaining fiscal policy tools and have relegated their responsibility to regulate domestic economic activity and to meet policy challenges, such as unemployment.

Many European economists have already raised their voices against the increasing inadequacy of demand in Europe due to the systematic restrain of domestic expenditure and the deflationary bias in national policies. The low level of the Community's own budget and the absence of a unified tax and transfer system across European countries exacerbate the situation, since they preclude the pursuit of counter-cyclical fiscal policies at the European level. There is already evidence of social unrest against rising unemployment - especially among young people -, decreasing real incomes and the marginalisation of the weakest social groups. This social dynamic, should it be let out of control, would not only have negative repercussions for national governments but would eventually undermine the course of European integration.

Until today, demand in Greece has been sustained by the transfers provided through the Second Community Support Framework, which expires in 1999. The inflows of funds are expected to be reduced under the Third Community Support Framework due to increased demands by the incipient entrants to the Community, most notably by the Eastern European countries, as well as due to increased pressures by developed countries to meet rising social needs of underprivileged social groups.

Sustaining growth will thus be the primary challenge for the Greek economy in the years to come. Avoiding currency and financial instability is going to be the second most important policy challenge for Greek policy makers.

The financial vulnerability of the Greek economy has increased in recent years. In view of rising financial costs at home, many businesses have increased their foreign exchange exposure. At the same time, many households have increased their direct or indirect bank borrowing to sustain their consumption patterns.

The European Monetary Union is likely to become a reality by the end of the century. However, Greece will not join the EMU from its very beginning and will likely face increased currency pressures either because of speculative or more systemic reasons (Yotopoulos & Josling, 1996). These pressures are likely to be exacerbated since the drachma is overvalued in real terms and this overvaluation does not reflect a sustainable improvement in productivity.

The prospects of sudden capital flight due to either external shocks or speculative pressures on the overvalued currency would lead to a further increase of interest rates or to a devaluation of the currency. This situation will increase the debt burden of both businesses and households, threatening their financial sustainability, as witnessed amply in the recent Mexican peso experience.

Thus, the pursuit of the Maastricht convergence criteria have contributed to the reduction of deficits and inflation at the cost of prolonging the recession and increasing the financial fragility of the Greek economy.

As the degrees of freedom in the conduct of policy have been reduced, so have policy options. A more expansionary policy stance or a faster adjustment of the exchange rate, which would have looked optimal under a different policy regime, have become extremely difficult under Maastricht. Under present circumstances they might spur a vicious circle of capital flight, devaluation, inflation and/ or financial failures. The policy challenges that present themselves, need, therefore, to be evaluated under the present policy regime, namely that of the Maastricht Treaty and the Stability Pact.

It is important to realize that the restriction of policy options is an integral part of the Maastricht/Amsterdam deal. The decision to enter the EMU under the Maastricht and Amsterdam stipulations inexorably implies the loss of national sovereignty with regard to macroeconomic policy. Preservation of policy autonomy would have required a different policy stance at Maastricht and Amsterdam.

Policy Challenges and Policy Priorities

Within that policy régime, the first priority for Greece is to safeguard the smooth entry of the drachma into the European Exchange Rate Mechanism (ERM) and to do so with minimum destabilisation of its economy.

It is a public secret that the external balance of payments position of the country remains extremely vulnerable to short-run speculative movements, in view of the fact that the necessary productive restructuring and the improvement of structural competitiveness have not yet been achieved. Both the trade balance and the current account are instead worsening despite transfers from the European Union. Currency reserves may easily be depleted, should there be a sudden change of expectations with regard to the currency parity.

According to the Maastricht timetable, every member-state is required to tie its currency rate to the central rate at least two years prior to its official entry into the EMU.

The market is already becoming jittery. Market participants expect the parity value to be adjusted downwards, prior to entry, so as to safeguard competitiveness once the currency's value is tied to the central rate.

Naturally as the time for the integration of the drachma into the ERM is approaching, the speculative pressures on the drachma are intensifying. This situation makes it necessary to stabilize expectations and to avoid the speculative pressures arising from the entry process before it is too late.

A timely and orderly transition into the ERM through appropriate Central Bank action is therefore a necessary prerequisite to preserving exchange-rate and financial stability.

Early entry into the ERM, with a realistic parity will not be without its price. Firms which have borrowed abroad and the government, will have to bear significant adjustment costs, while, policymakers will lose forevermore the exchange rate as an adjustment instrument for meeting internal and external balance objectives.

The second policy objective is to obtain a firm commitment from the Community with regard to the flow of future structural funds. The assurance of continuous financing under a Third Community Support Framework, would help stabilize expectations with regard to the economy's future financial vulnerability.

Given the prospects of the European Union's enlargement, the market already anticipates these funds to be substantially curtailed. This possibility becomes more credible in view of the limited capacity of state agencies to manage efficiently the transfers associated with the present Community Program.

As the absorption rate continues to be relatively low, despite the fact that this program is in its fourth year, the negotiating position of the country *vis-à-vis* the Commission is eroding. It is thus essential that the government give top policy priority to the implementation of the present CSF. To do so, state agencies and social partners need to be mobilized effectively. It is only, then, that productive restructuring can be promoted; productivity, enhanced. Within that context, priority should be given to administrative reform, including the simplification of procedures and the containment of red tape, which are expected to reduce the costs of doing business and to accelerate the decision-making process.

The modernization of infrastructure, the adoption of new technological processes, the introduction of training and modern managerial techniques into both the public and private sectors, and the restructuring of small-scale industries constitute important policy priorities. If important steps are not taken towards implementation of the existing investment program, the outlook for growth and development will become bleak.

Meeting the dual challenge of financial stability and productive restructuring is thus the major task of policy on the eve of the 21st century.

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(1) - For a full analysis of the terms of the Pact and of its results, refer to Katseli, 1997.