

Monetary Policy in Greece on the Road to EMU

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The views expressed are those of the authors and should not be interpreted as those of the Bank of Greece.

Let me begin my story in 1994, because that is when Greece's adjustment effort began. Here are some facts.

1. In 1994, Greece's inflation rate was almost 11 per cent. The EU average was less than 3 per cent.
2. Greece's deficit-to-GDP ratio was about 10 per cent. The average EU ratio was about 5 ½ per cent.

The next six years saw an enormous convergence of the Greek economy toward the remainder of the EU. Inflation was reduced from around 11 in 1994 to around 3 per cent by the year 2000 while economic growth accelerated.

How was this done? In Greece, a significant tightening of monetary policy had taken place in 1994 which led down the foundation of disinflation of 1995 and beyond¹. Beginning in 1995, in an effort to focus market expectations, the Bank adopted a "hard drachma policy", under which the exchange rate was used as a nominal anchor. For the first time, the Bank announced a specific exchange rate target. The idea underlying this strategy is that if the exchange rate commitment is credible, so that it is really believed by economic agents, then the output costs of tight monetary policies will be reduced.

The hard drachma policy was an overwhelming success. During the years 1995-97, the Bank kept real interest rates in the range of 5 to 6 per cent. In those 3 years, inflation was more than halved, while real GDP growth accelerated, averaging about 3% compared with about 1% during 1991-94.

Why did real growth accelerate during a period when inflation fell from a high level to the single digits? Although the credibility gain is difficult to quantify, the hard-drachma policy provided an unambiguous target for monetary policy, exerting a measure of self-discipline and serving to tie down inflation expectations. Other factors that strengthened credibility included the following.

¹ The monetary policy was part of a re-orientation of economic and monetary policy specified in a revised convergence programme of Greece, 1994-99.

- Substantial fiscal adjustment occurred. The fiscal deficit fell from about 10 per cent of GDP in 1995 to around 4 per cent in 1997.
- Beginning in the mid-1980s, steps were taken to liberalise the financial system, and by 1995, it had been completely deregulated, while Community prudential rules in banking and capital markets were adopted. With the deregulation of the financial system, the Bank of Greece was increasingly able to use market-based instruments of monetary control.
- The Greek Parliament approved central bank independence and provided the Bank of Greece with a mandate to achieve price stability.

In economics, there is no such thing as a free lunch. Our world is that of the second best, one in which there are both benefits and costs associated with any particular policy. The hard drachma policy was immensely successful in reducing inflation and allowing growth to accelerate. Yet, it presented difficulties.

1. The relatively high Greek interest rates, coupled with the increasingly credible exchange rate peg, led to a capital inflows problem. If the inflows had not been sterilized, they would have increased the monetary base and pushed down nominal interest rates. This would have meant an easing of monetary conditions, contrary to the tight monetary policy stance needed to disinflate.
2. A response by the Bank of Greece to the inflows was to undertake sterilization operations. Sterilization, however, was costly, as the Bank had to pay a high interest rate to borrow the funds.
3. A fundamental problem confronting nominal-anchor exchange rate pegs is that the currency of the high-inflation country can become overvalued during the move to a low inflation regime. In the case of Greece, an appreciation of the real exchange rate contributed to a widening of the current account deficit to about 4 percent of GDP in 1997, from near balance in 1994.

The widening current account deficit fed market expectations of drachma overvaluation and provided a fertile ground for contagion from Asia, which

commenced with the devaluation of the Thai baht in July 1997. The sharp rise in interest rates required to support the drachma increasingly undermined growth and fiscal targets. As a result, by late 1997 and early 1998 Greece was confronted with a classic case of abrupt and sharp reversals of capital flows; a full-fledged speculative attack, was under way.

Consequently, by early 1998 the Government's objective of joining EMU in early 2001 was in jeopardy. In response, in March 1998 the drachma was devalued by about 12 per cent and the currency entered the ERM. There was no further speculative attack. There was no ensuing financial crisis. The drachma's exit from its central parity was one of the few orderly exchange-rate exits of the 1990s.

What made it so successful? A literature has recently been developed on how to attain orderly exchange rate exit strategies. Here is a checklist as applied to the drachma.

- The literature strongly advises that following the exit from a central rate, the country in question should establish low inflation as a key objective and grant operational independence to the central bank. A reduction of inflation had been the main goal of the Bank of Greece for several years, and, following the granting of independence, the Bank's mandate was to achieve price stability.
- The devaluation of the drachma was both backward looking and forward looking. The magnitude of the devaluation took account of both past inflation differentials between Greece and other EU countries and prospective differentials in the period leading up to Greece's expected entry in EMU.
- Third, the drachma exited a unilateral peg and entered the ERM systems' arrangement within which it benefited from the availability of the mutual support facilities and wide ± 15 per cent exchange rate bands.²
- The literature recommends implementation of prudential regulation of foreign exchange exposure prior to the exit. Prudential regulation had

² The operation of the ERM itself had been improved following its reform in 1993 and the widening of exchange rate bands and its credibility enhanced as the EMU project was well on track in early 1998.

been implemented in Greece, and banks had effectively no net foreign exchange exposure at the time of the devaluation.

- The exit strategy literature recommends that fiscal policy be tightened following the exit. Fiscal tightening had already been in process in Greece in the years leading up to the drachma's devaluation, and it continued following the devaluation.

Crucially, the Bank did not ease monetary conditions; it made clear that it would use its independence to ensure that the Maastricht inflation criterion was attained. The wide, ERM bands facilitated the disinflation strategy, allowing the Bank to maintain high interest rates and to let the exchange rate appreciate relative to its central rate.

The rest, as they say, is history. Convergence continued for the next several years and on January 1, 2001 Greece became the 12th member to adopt the euro. The main lessons are as follows: The success of the Greek disinflation effort underscores the critical role of the credibility of policies. It is essential that the government's commitment to deliver its policy goals is believed. Credibility, however, cannot be achieved overnight, particularly if there is a history of failed stabilisation attempts. In such a situation, credibility can be fostered by a change in policy regime; in the case of Greece, the hard drachma policy constituted such a regime change. While an exchange rate target can help establish credibility by providing a clear and transparent nominal anchor, it runs the risk that it may become unsustainable in the absence of supportive fiscal policy. Important factors reinforcing the credibility of the exchange rate nominal anchor were continued fiscal adjustment, the legislation providing independence to the Bank of Greece, and the entry of the drachma into the ERM. The wide ERM exchange rate bands permitted the Bank to continue its tight monetary policy in the period prior to entry into Monetary Union.

For Greece, entry into the EMU marked the end of one long road. It also represented the beginning of another road, bringing new challenges. For Greece not only wants to survive in the euro zone, it wants to thrive in the euro zone. Still another road? That is another story for another time.

Albania presentation