THE ROAD TO STABILITY AND GROWTH: LESSONS FROM THE GREEK EXPERIENCE

*George E. Oikonomou**

SUMMARY

In my speech, I will focus on the monetary and exchange rate policies pursued by the Bank of Greece in the 1990s that led to a successful stabilization of the economy and eventual adoption of the euro. Greece started the decade facing severe imbalances. The period of gradual disinflation posed significant challenges for the monetary authorities. A tight monetary policy, based on high real and nominal interest rates, led to significant speculative capital inflows and pressures for the currency to appreciate. Those speculative capital flows were subject to sudden reversals, which were more pronounced in the aftermath of the Asian and Russian crises, and led to devaluation ahead of Greece's entry into the ERM. The gradual acquisition of credibility by the Bank of Greece allowed us to weather these crises with relatively few problems. The disinflation had relatively few adverse effects on output in the short-run while contributing to higher long-run growth. The Central Bank's credibility helped restrain price and wage increases, while policy measures in other areas helped boost productivity growth. The monetary authorities had to walk a fine line between reducing inflationary pressures on the one hand and avoiding loss of competitiveness and hard-to-sterilize capital inflows on the other. During this period, the Bank of Greece had to develop a new framework of monetary control,

as policy-making moved from pervasive direct controls to indirect, market-based instruments.

Ladies and Gentlemen,

It is an honor and a pleasure to address the Annual Conference of the Bank of Albania, the fifth in a line of conferences on topical issues. Coming shortly after the enlargement of the European Union, the subject chosen for this year's Conference is particularly interesting as more and more countries in the region are starting to reflect on the details of pursuing economic policies consistent with their European perspective. In that sense, the Greek experience might provide some useful insights, and I will try to do this by noting both what we have done well, but also what we could have done better. While Greece did not face unique problems, the way we addressed them successfully may contain some interesting lessons of wider relevance. In the rest of my address, I will try to highlight some of those issues, with an unavoidable emphasis on what is important from a Central Banker's point of view.

In recent years we have witnessed long theoretical discussions on the choice of an appropriate exchange rate regime and monetary policy framework for emerging market economies. Certainly, the academic jury is still out, with no clear and convincing theoretical answer. In some regions, a dominant model has emerged, such as inflation targeting in most of Latin America and fixed or managed exchange rates in most of East Asia. On the other hand, the transition economies of Europe have opted for a variety of arrangements, covering the whole range from currency boards to monetary targeting. In this context, it is difficult to make suggestions applicable to all countries, and I certainly do not wish to suggest that the Greek experience is the only example to be followed. I only wish to present our experience, the challenges we faced and the solutions we opted for in the hope that they may be useful for others' thinking. What I think is the lesson from the Greek experience, and what I would like you to retain from my presentation is that orthodox economic policies geared toward medium-turn goals are the ones that can deliver growth with stability. Even when crises occur, and they unavoidably

occur, the solution is not to experiment with unorthodox measures, but to persevere with responsible macroeconomic policies.

When the Maastricht Treaty was agreed in 1992, Greece was eminently unprepared to adopt the single currency. The 1980s was a period of lax fiscal policies that resulted in the accumulation of a heavy debt burden, quite different from our policies and experience in the previous decades. At this point I cannot avoid expressing strong preference for some discipline device that can counterbalance political pressures for short-term expansionary policies. The Bretton Woods system of fixed exchange rates played this role in the three decades following the Second World War. In today's European Union, a credible Stability Pact could play the same role in limiting policy discretion. When Greece joined the EU in 1981, it was in a similar position as the new members are now. Greece was then a fast - growing economy, with a debt -to-GDP ratio below 40 percent, and significant needs to invest in infrastructure. Strong wage pressures, and an accommodative economic policy only helped fuel a relatively high inflation rate. One could have made the argument that Greece needed some fiscal leeway in order to invest in infrastructure. In fact, it took us less than a decade of profligate fiscal policies to burden ourselves with a debt ratio in excess of a hundred percent of GDP. If there is a lesson for new members is that it is better to stick with strict rules rather than experiment with lax policies, however tempting the theoretical arguments may sound.

The prospect of the introduction of the single currency helped forge a wide consensus, among political parties and the social partners that Greece should aim for eventual membership of the euro zone. This consensus helped in many ways, it led to a moderation of wage demands, and made the adoption of structural reforms easier, while the main opposition party refrained from attacking the difficult choices the then government had to make. I doubt whether the aim of achieving the criteria of admission into the euro area can be reached if this aim itself is contested.

Since the late 1980s the Bank of Greece had embarked on an effort to reduce inflation, reversing a pattern, established since the mid-1970s of accommodative monetary and exchange rate policies.

While explicit exchange rate targeting was introduced only in the second part of the 1990s, from the late 1980s Greece adopted a de facto policy of "managed float" trying to slow the rate of depreciation of the currency. Interest rates were also kept relatively high during this period, leading to occasionally excessive inflows of speculative capital, especially in the overnight market. The fact that the fiscal deficits remained quite high, occasionally exceeding 10 percent also added to the upward pressure on real and nominal interest rates. The first test of this policy came in 1994, when, in the aftermath of a government change, markets started to doubt our commitment to stabilization. While we faced significant capital outflows and pressures on the currency, the Greek authorities' response was not to impose capital controls, or other administrative measures, but to bring forward ahead of schedule the full liberalization of capital flows, as evidence of the country's commitment to orthodox policies, This reassured markets and the pressures quickly abated.

The combination of still high fiscal deficits and the need to continue the disinflationary strategy kept both nominal and real interest rates at quite high levels during most of the 1990s. The resulting capital inflows created a persistent problem of excess liquidity in the banking system, which the Bank of Greece tried to address through increases in the minimum reserve ratio, or by open market operations and the deposit facility. These sterilization operations had a significant cost. The Bank of Greece had to deal and discourage speculative capital inflows most of the time, but occasionally, especially during the Asian and Russian crises, the problem reversed itself and we were confronted with capital flight. It took strong nerves and the use of all available instruments to keep clear of both risks.

The Asian crisis in 1997 had a destabilizing effect on Greece, as on many other countries. An outflow of capital was resisted at first by raising interest rates and running down our reserves, which stood at exceptionally high levels to start with. Obviously, this position would not be sustainable for a long period, and in March 1998 we devalued by about 12 percent, and at the same time joined the Exchange Rate Mechanism. At the same time, the government announced a program of fiscal measures and structural reforms. There is here one similarity with the 1994 incident, which I can not stress enough: Faced with

speculative pressures our response was to take measures to enhance the credibility of our policies and this approach worked very well indeed.

Another important lesson, which became all too clear to me at that time, was the importance of having a strong and well-functioning financial system. The cost of the devaluation was easily absorbed and did not impair the stability of our banks, or the financial system as a whole. While our banking history is not spotless, and possibly because of it, by the early 1990s it was widely accepted that the banking system should stay free from outside interference and the market should be allowed to allocate capital to the most efficient uses. The Bank of Greece's role evolved from enforcing numerous credit and banking regulation to ensuring the systemic stability of the banking system. As a result, and unlike many other countries in Asia and Latin America, we went through the 1998 devaluation with no adverse systemic repercussions.

The next three years, until we joined the euro zone, saw a relatively smooth operation of the exchange market. There was a slow upward drift of the real exchange rate, similar to what was observed in other countries attempting to disinflate. These years were characterized by the increasing confidence among market participants that Greece would join shortly the euro zone. This led to a resumption of capital inflows that were hard to sterilize. The drachma was revalued in early 1999 in order to absorb some of the inflationary pressures and the Bank of Greece kept interest rates relatively high. The Bank of Greece's ability to intervene was circumscribed by the target of joining the EMU. The drachma was already trading above its central parity and there were clear limitations on how much we could have tightened monetary conditions. Even after Ecofin formally endorsed in mid-2000 Greece's application to join the euro zone, the Bank of Greece delayed the convergence of its interest rate to the ECB's until the very last moment in order to limit the reemergence of inflationary pressures.

An important task for the Bank of Greece during the 1990s was also to create the institutional and operational framework that would allow us to conduct our policies and which would be harmonized

with the established practices in the rest of the EU. As a first step in that direction a marginal lending facility was created in 1993 allowing credit institutions to borrow from the Central Bank against collateral. An important feature was the imposition of ceilings on borrowing in order to avoid the build up of speculative pressures, especially when there was turmoil in the foreign exchange market.

Regular open market operations were introduced in 1995 with the dual purpose of absorbing excess liquidity form the system, but also in order to familiarize the Greek financial institutions with these tender procedures. While initially these operations had a monthly maturity they were soon changed into a 14-day maturity to bring them in line with the practices in the EU. These operations became quite important during the Asian crisis, when we had to fine-tune the flow of liquidity. At that time we also used varying short-term maturities.

Finally, a deposit facility was introduced in 1997 in order to help absorb the excess of liquidity at a predetermined interest rate. While trying to do this, we also wanted to avoid inviting capital inflows. For that reason, a two-trench approach was adopted, offering the basic interest rate up to a certain limit and a reduced one thereafter. Excessive liquidity beyond certain limits was thus penalized in some sense.

In order to enhance the liquidity of the government bond market so as to improve its ability to conduct open market operations, and also in order to have a well-functioning market from which to infer a full yield curve, the Bank of Greece took the initiative of setting up a secondary market for government bonds. The Electronic Secondary Securities Market (HDAT) system was introduced in May 1998, as a screen-based secondary market for the trading of Greek government securities. Until then the secondary market for Greek government securities was inadequately equipped to cope effectively with the needs of a rapidly developing financial system.

Looking back, I feel content for the efforts of the Bank of Greece to return my country to a low inflation path, as was the case during the two decades before the first oil shock. This marks a great change

for our economy and has certainly improved the lives of ordinary citizens and has contributed in establishing a climate of greater confidence. On the other hand, I feel that the Bank of Greece had the easy part in some sense; while we managed to stabilize the economy and bring inflation down impressively, we did not perform equally well in putting our fiscal situation in order. After joining the euro zone, the government followed a loose fiscal policy, entailing an increase of public deficit above 3% of GDP, the euro zone's budget deficit rule. The public debt ratio has remained stubbornly high and, with the retirement of baby-boomers approaching, the burden of the debt will restrict our policy options. While financial stability, which includes monetary stability, is a necessary condition for growth and prosperity, it is not a sufficient condition. Establishing financial stability is a necessary requirement, and may help achieve fiscal consolidation, but by itself is not enough to achieve high-quality growth.

The challenge facing us is to achieve a lasting improvement of our public finances so as to reduce our debt ratio very fast in the short window of opportunity that remains before our pension obligations mature. I believe that the wider consensus that emerged at the time for financial stabilization can re-emerge and support the measures that are still needed to achieve fiscal stabilization as well.

* Georgios Oikonomou: Member of Monetary Committee, Bank of Greece.