FOR AGENDA

SM/85/116

CONTAINS CONFIDENTIAL INFORMATION

April 25, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Greece - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Greece. A draft decision appears on page 25.

It is proposed to bring this subject to the agenda for discussion on Friday, May 17, 1985.

Mr. Boorman (ext. 7858) or Ms. Christensen (ext. 8870) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

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INTERNATIONAL MONETARY FUND

GREECE

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Article IV Consultation with Greece

Approved by L.A. Whittome and J.T. Boorman

April 23, 1985

I. Introduction

Article IV consultation discussions were held in Athens from February 18 to March 1, 1985. The staff team consisted of J. T. Boorman (ETR), D. Brodsky, B. Vibe Christensen, P. Hedfors and P. Young (EP), with C. Strayer (all EUR) as secretary. Meetings were held with senior officials from the Bank of Greece, the Ministries of National Economy, Finance, Commerce, Energy and Natural Resources, and Foreign Affairs, and the Center for Planning and Economic Research. The mission head met with Mr. G. Arsenis, Minister of National Economy and of Finance, and the mission had several meetings with Mr. D. Chalikias, Governor of the Bank of Greece. Mr. S. Zecchini, Executive Director, and Mr. N. Coumbis, Alternate Executive Director, attended most meetings as observers. Greece continues to avail itself of the transitional arrangements of Article XIV. The last Board discussion took place on February 17, 1984 (EBM/84/26).

II. Economic Developments

1. Background

In recent years, the Greek economy has suffered from relatively high inflation, declining private investment and large external imbalances. While some of these problems are rooted in the structural weaknesses of the economy, they also reflect the insufficient policy responses to the two oil price shocks of the 1970s. After the first oil price shock, expansionary policies quickly restored growth following the sharp downturn in 1974. At the same time, however, the rate of inflation rose substantially above average price increases in Greece's partner countries (Chart 1). Wages expanded by nearly 8 percent per annum in real terms between 1974 and 1978, far exceeding the rise in productivity. The resulting decline in enterprise profits dampened investment, particularly in the manufacturing sector. Moreover,

industrial policy continued to subsidize and protect existing industries, thereby weakening the incentive for structural changes. As a result, little adjustment took place in the manufacturing sector during the 1970s.

The economy was therefore in a vulnerable situation when the second oil shock further increased inflation and raised the external deficit in 1979-80. The economic imbalances worsened in the election year 1981 when expansionary policies resulted in a doubling of the public sector deficit. In the same year, Greece joined the European Communities (EC) and reductions in import barriers exposed Greek industry to increased competition at a time when recession abroad dampened Greek exports. Moreover, increasing prices for agricultural imports associated with entry into the EC are estimated to have burdened the trade balance and helped fuel domestic inflation. These developments raised the current account deficit to 6.4 percent of GNP in 1981 and increased consumer price inflation to 25 percent.

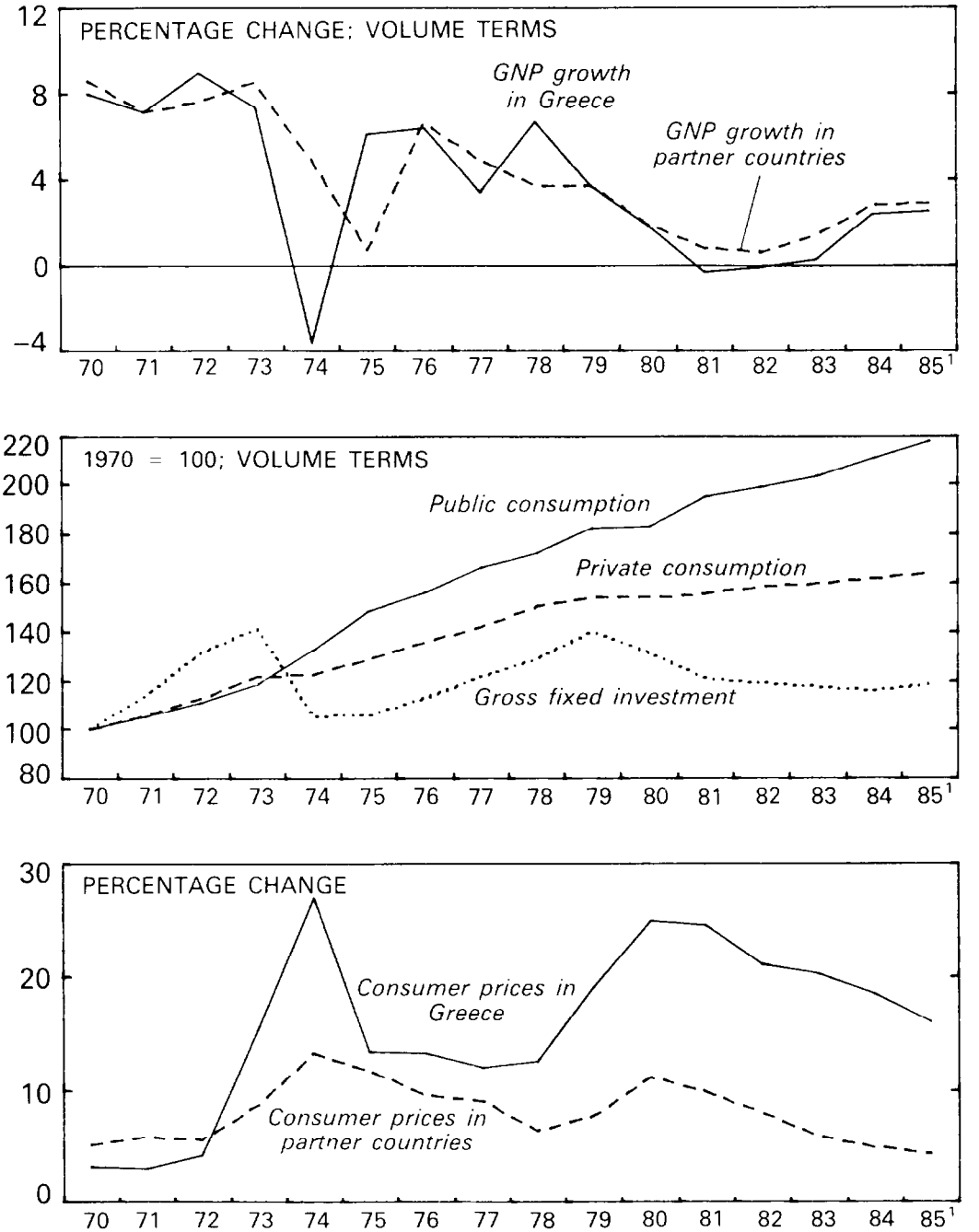
In 1982, the authorities took a number of steps to correct the imbalances which had emerged and to initiate the restructuring necessary to improve prospects for long-term growth. The authorities viewed a "gradualist approach" as desirable in order to minimize any adverse impact of these policies on economic activity and employment. This approach was also seen as necessary because of the depth of the structural problems which required major reforms in the economy. Some progress was achieved in 1982 and 1983. The public sector deficit was reduced from 14.5 percent of GNP in 1981 to 11.7 percent of GNP (on a cash basis) in 1983 despite stagnation in the economy. Similarly, monetary policy became less accommodating from mid-1982, as the Government's access to central bank financing was restricted and interest rates were raised toward positive real rates. The system of partial wage indexation which had been introduced in 1982 was modified in 1983 by delaying adjustments for inflation. This resulted in a decline in real wages and contributed to a modest decline in the rate of inflation to 20 percent. However, notwithstanding substantial increases in public consumption and investment over this period, growth remained flat and unemployment increased substantially. Furthermore, private investment which had declined precipitously since 1979, continued to fall, thereby delaying adjustment in the economy.

Despite the slackening in economic activity, the relative cyclical position of the Greek economy changed little after the second oil price shock (Chart 1) and the external current account deficit remained almost unchanged at 5-6 percent of GNP. This development contrasted to the rather sharp reduction in the current account deficits which took place

CHART 1

GREECE

LONG-TERM TRENDS IN OUTPUT AND PRICES



Sources: Data provided by the Greek authorities, IMF, *International Financial Statistics*, and staff estimates.
[1]Official estimates for Greece and staff estimates for other countries

in other Mediterranean countries. 1/ Exchange rate policy worked against a reduction of the external deficit, as the drachma was permitted to appreciate by 14 percent in real effective terms (relative consumer prices) from the fourth quarter of 1978 to the fourth quarter of 1982. This deterioration in competitiveness--indicated to be even more severe on a comparison of unit labor costs--resulted in a loss of market shares for Greek exports of merchandise and services. To reverse this development, the authorities depreciated the drachma by 15 1/2 percent in January 1983 and temporarily pegged it to the dollar. However, with the unexpected rise of the dollar and the continued inflation differential vis-à-vis partner countries, the drachma appreciated by 12 percent in real terms up to August 1983. At that point, the authorities abandoned the dollar peg and initiated a period of gradual real depreciation of the drachma.

The traditional surplus on services (e.g., tourism and shipping) dropped sharply from 1981, partly for cyclical reasons and partly due to the loss in competitiveness. Disguised capital flight may also have played a role. Remittances from Greek emigrants were depressed not only because of cyclical developments abroad but also due to a trend decline in the number of Greeks working overseas. However, transfers from the EC picked up significantly during this period (Table 1).

2. Developments in 1984

The Greek authorities emphasized that the basic stance of fiscal and monetary policies had remained unchanged in 1984. However, the fiscal deficit rebounded to 14.4 percent of GNP, equivalent to the previous peak level reached in 1981. Similarly, monetary aggregates accelerated as the public sector's increased borrowing requirement was accommodated (see Section III below). Real GDP growth picked up from 0.3 percent in 1983 to 2.4 percent in 1984. On the supply side, the increase was concentrated in agricultural production which typically expands more rapidly every second year. On the demand side, the resumption in growth was fostered primarily by a pickup in consumption and exports of goods and services; private investment continued to decline.

1/ (In billions of U.S. dollars)

	1981	1982	1983	1984	1985 **
Current account balance					
Greece	-2.4	-1.9	-1.9	-2.2	-1.7
Italy	-8.2	-5.5	0.8	-2.9	-6.8
Portugal	-2.9	-3.2	-1.7	-0.5	-1.0
Spain	-4.8	-4.3	-2.3	2.0	1.6

** Official forecast for Greece and staff estimates for other countries.

The protracted weakness of private investment constituted a major problem in view of the increasing urgency to restructure the economy and reduce domestic and external imbalances. In 1984, private investment declined by 5 percent, further reducing the share of private investment in GNP to 12 1/2 percent from a peak of 19 1/2 percent in 1979. Public investment rose from 5 1/2 percent to 7 percent of GNP over the same period (Chart 2). The authorities considered sluggish demand an important element in the continued weak behavior of private investment. An additional factor has been the almost continous redistribution of income from profits to wages over the past decade (Chart 2). The gradual increase in nominal and real interest rates also tended to compress profits and squeeze liquidity in enterprises. Greek industry was particularly affected because of the long history of subsidized interest rates and ample liquidity in the banking system which had resulted in very high debt/equity ratios. The removal of some remaining trade barriers following EC membership and some loss in price competitiveness in 1981 and 1982 exposed domestic industry to increased foreign competition and compressed profits further. By 1984, there was still no reversal in the profit situation.

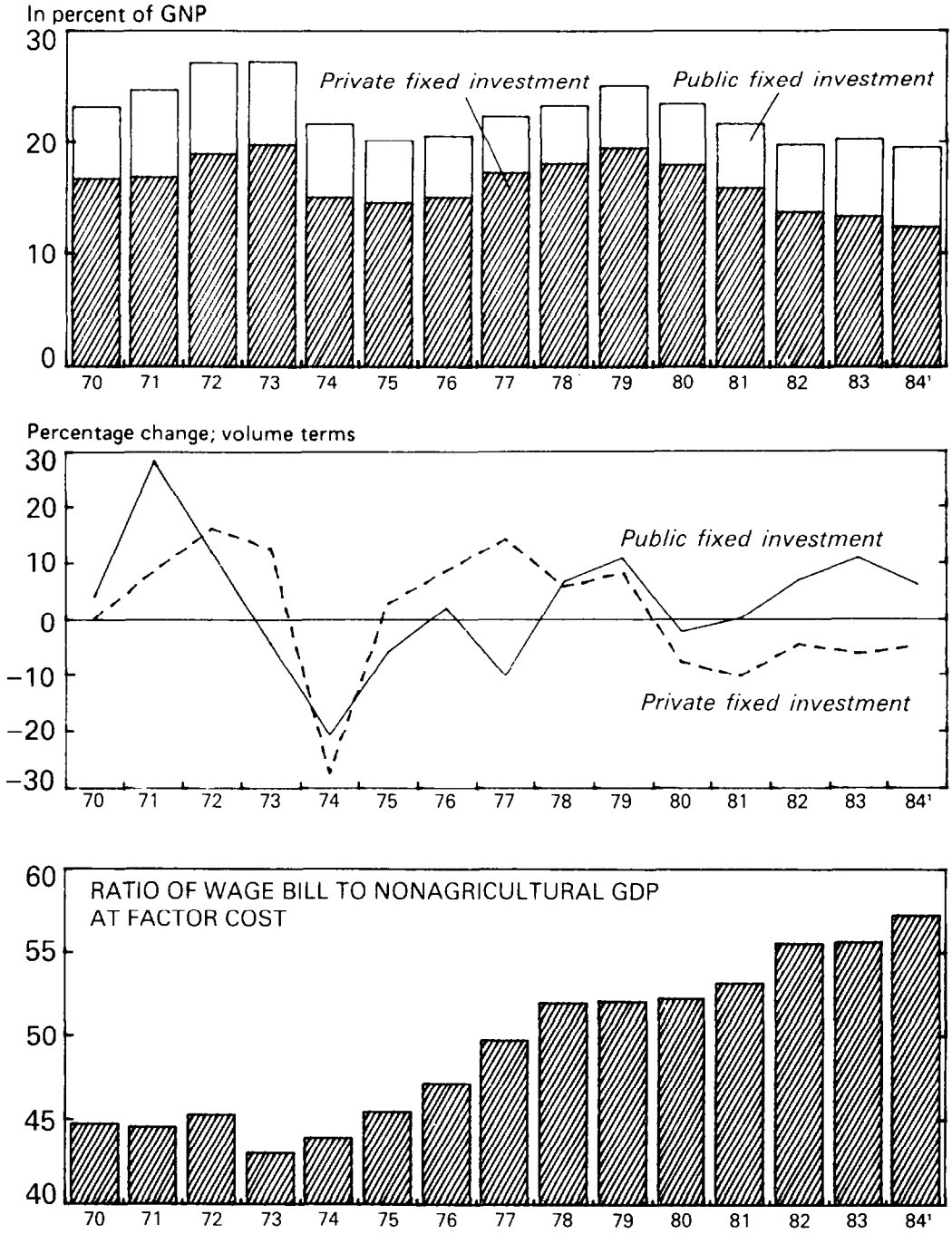
Consumer prices continued to decelerate slowly from 20 1/2 percent in 1983 to 18 1/2 percent in 1984 (Chart 3). However, the deceleration was largely attributed to lags in the adjustment of prices of public enterprises and other administered prices (Table 1). The GDP deflator decelerated by only 1/2 percentage point to 19 percent. Average incomes of wage earners decelerated sharply in 1983, but accelerated again in 1984. This was mainly explained by the delays in the indexation adjustments in 1983. Over the two-year period, real wages rose by a cumulative 1 percent, while real disposable incomes declined by 1 percent.

The current account deficit increased by more than 1 percentage point of GNP to 6.6 percent (US$2.2 billion) in 1984, slightly exceeding the recent peak recorded in 1981 (Table 1). The deterioration--in terms of GNP--was concentrated in the oil balance. Almost two thirds of the increase in the oil deficit was accounted for by the appreciation of the U.S. dollar against other currencies, with the remainder due to increases in stocks and oil consumption. The non-oil trade balance benefited from the gradual decline in the real effective exchange rate

CHART 2

GREECE

GROSS FIXED INVESTMENTS AND THE WAGE BILL



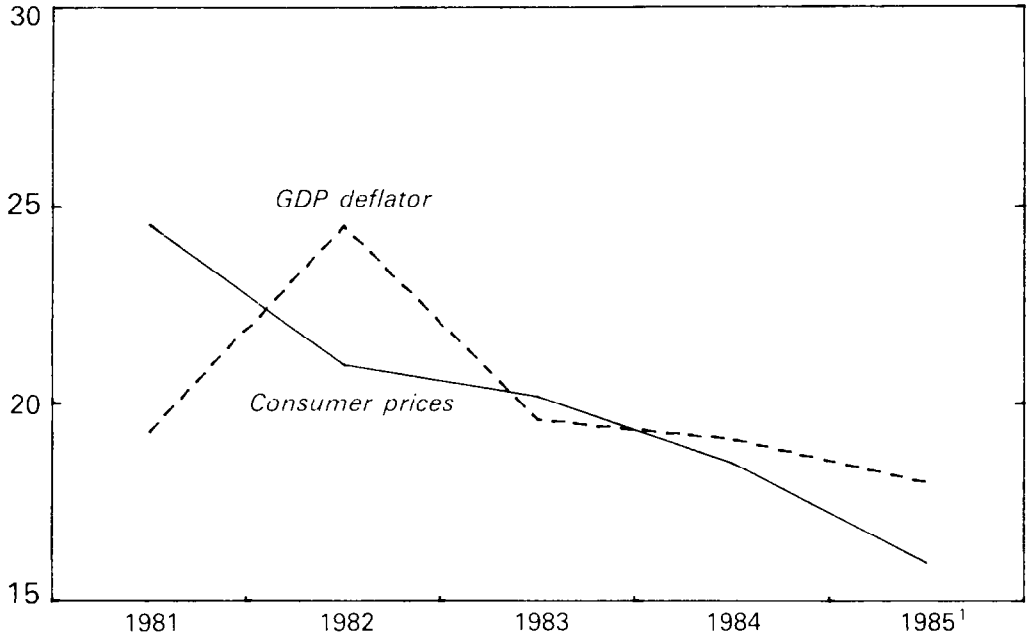
Sources: OECD, *National Accounts Statistics*; data provided by the Greek authorities and staff estimates.
¹Partly staff estimates.

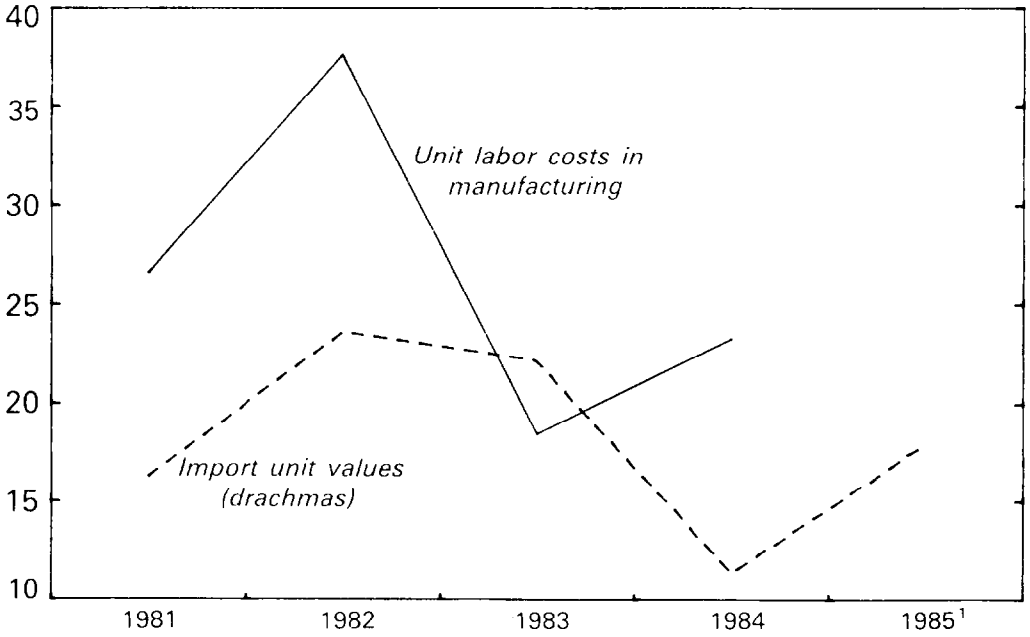
CHART 3

GREECE

COST AND PRICE DEVELOPMENTS

(Percentage changes)





Sources: Data supplied by the Greek authorities, and IMF, *International Financial Statistics*.
[1]Official forecast.

Table 1. Economic Indicators

	1981	1982	1983	1984	1985 1/
			(Percentage change)		
GDP	-0.3	-0.1	0.3	2.4	2.5
Private consumption	1.1	2.0	0.6	1.4	1.2
Public consumption	6.8	1.9	2.4	3.5	3.5
Private investment	-10.3	-4.5	-6.3	-5.0	0.1
Public investment	0.1	6.9	10.9	6.0	5.5
Net foreign balance 2/	-1.4	-2.7	1.0	1.3	0.2
Consumer prices	24.5	21.0	20.5	18.5	16.0
Administered prices	19.6	17.2	20.7	16.0	...
Market determined prices	26.3	22.3	20.1	19.4	...
Unit labor costs in manufacturing	26.6	37.6	18.4	23.3	...
Average real earnings (all sectors)	-0.4	4.2	-2.7	3.9	...
			(In percent)		
Unemployment rate (Urban area)	5.5	7.1	10.2	10.5	...
			(In percent of GNP)		
Net PSBR (cash basis)	14.5	12.8	11.7	14.4	12.7
			(Percentage change)		
Broad money (M3)	34.7	29.0	20.3	29.1	23.2
Broad money, including foreign exchange deposits 3/	35.4	29.3	24.5	30.5	...
			(In percent)		
Interest rates 4/					
Treasury bills (12 month)	14.25	15.25	15.25	18.0	...
Special time deposits 5/	16-20	16-20	16-20	17-20	...
			(In percent of GNP)		
Trade balance	-17.7	-15.2	-15.4	-16.3	-15.5
(excluding oil)	(-10.0)	(-9.8)	(-9.9)	(-9.7)	(-9.2)
Services balance	8.0	6.3	5.0	5.0	5.5
Transfer balance	3.3	4.1	5.1	4.9	4.9
Emigrants' remittances	2.8	2.7	2.7	2.7	2.6
EC transfers	0.4	1.4	2.4	2.2	2.3
Current account balance	-6.4	-4.9	-5.4	-6.6	-5.1
Errors and omissions	0.9	-0.1	-1.0	-0.8	-0.6
External debt 6/	22.0	25.6	31.5	38.4	...
Foreign exchange deposits 3/	12.2	12.7	14.9	16.3	...
External debt service (In percent of current receipts)	14.9	16.5	18.3	21.7	...

Sources: Data provided by the Greek authorities; and staff estimates.

1/ Official projections of February 1985.

2/ Change in the foreign balance in percent of GNP of the preceding year.

3/ Foreign exchange deposits are held by both residents and nonresidents.

4/ Interest rates are end-year values.

5/ Time deposits with maturity more than one year; interest rate depends on size of deposits.

6/ Staff estimate.

of the drachma and the pickup in foreign demand (Charts 4 and 5). Merchandise exports rose by some 20 percent in volume terms compared to 1983. 1/ The appreciation of the dollar also raised interest payments on dollar-denominated debt in terms of domestic GNP. Shipping receipts continued to weaken cumulating to 40 percent decline in dollar terms (US$1/2 billion) since 1981. Tourism receipts recovered from the depressed level of 1983, rising by 12 percent in U.S. dollar terms and recouping market shares in the OECD area which had been declining since 1981.

Private capital inflows which financed almost the total current account deficit (on average) in the second half of the 1970s, dropped precipitously during the beginning of the 1980s as a consequence of rising interest rate differentials and increasing uncertainties as to economic developments in Greece. Private inflows reached a low of US$650 million in 1982, covering only one third of the current account deficit. They recovered somewhat in 1983 but fell back to US$860 million, 40 percent of the current account deficit in 1984. The decline reflected primarily reduced long-term borrowing abroad by Greek banks and enterprises. Net official borrowing amounted to US$1.6 billion in 1984, of which the Bank of Greece accounted for almost half. The authorities reported that they had encountered no major constraint on external borrowing in 1984, which continued to take place on favorable conditions in several markets. Part of the official borrowing was diversified toward Japanese banks and yen-denominated loans.

According to staff estimates, the external debt of Greece increased from US$10.9 billion at end-1983 (31.5 percent of GNP) to US$12.8 billion at end-1984 (38.4 percent of GNP), a doubling of external debt since 1979 (Chart 6). External debt service rose from 18.3 percent to 21.7 percent of current receipts in 1984. The staff data for external debt include, in addition to the official debt figure (US$11.6 billion at end-1984), an estimate for (1) nonguaranteed liabilities of the private nonfinancial sector and (2) short-term debt of the financial sector. The staff estimate excludes military debt. Foreign exchange deposits, which amounted to about US$5 1/2 billion at end-1984, have not been included in these debt estimates as a large (unknown) share is held by Greek residents (including Greek seamen) and the remainder mainly by Greek workers abroad. Although these workers are nonresidents, the Greek authorities argue that the deposits should be excluded from external debt as they are held as savings for retirement of the workers in Greece, and because they have shown a steady increase in the past. The outstanding amount of external debt appears low compared with the

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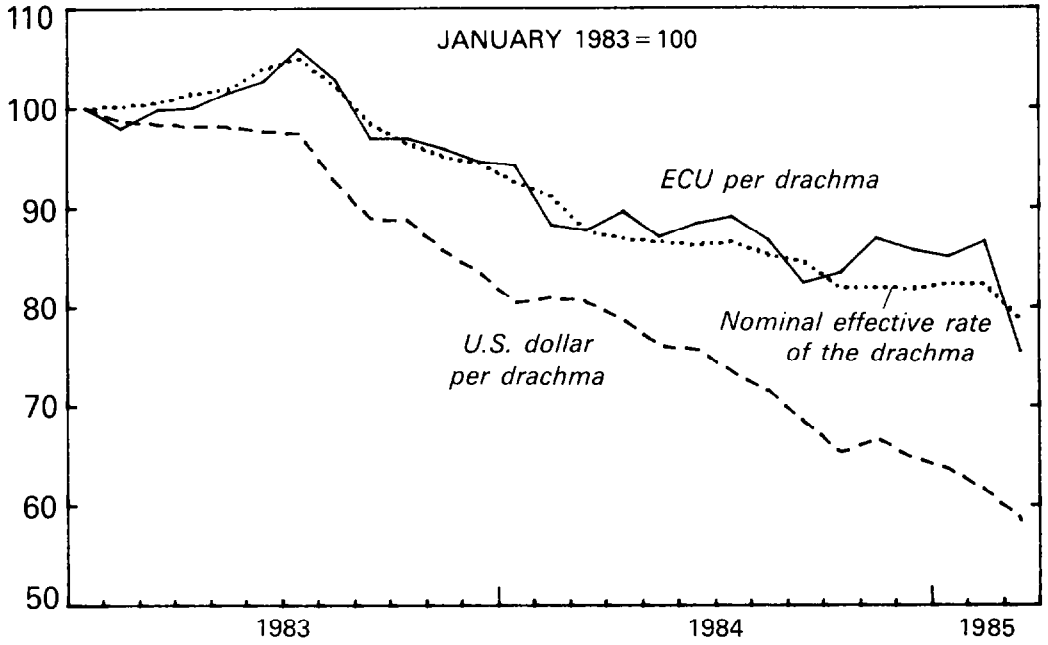
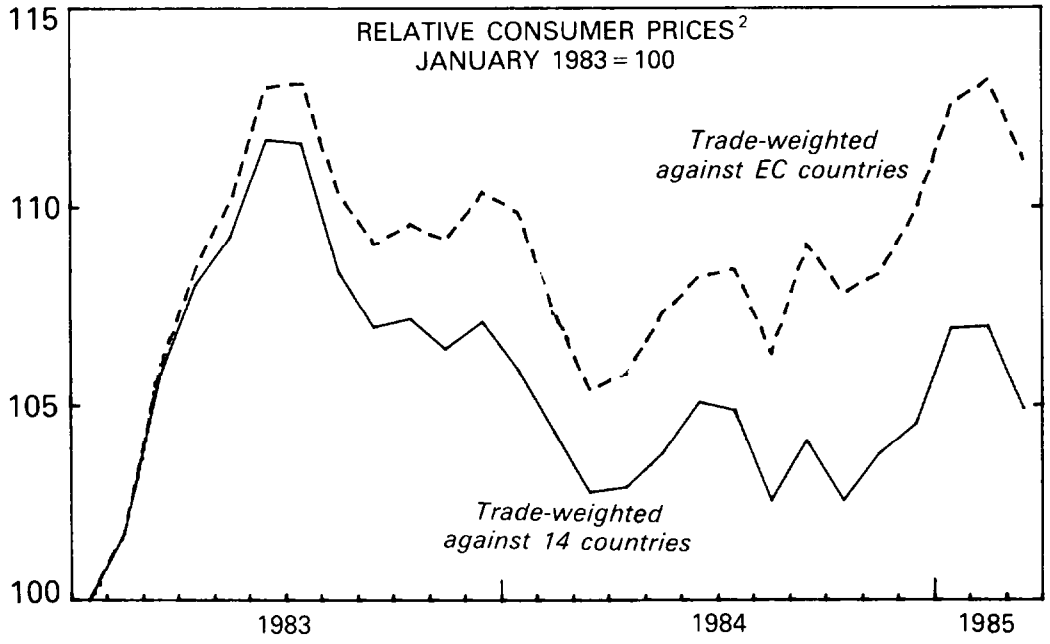
1/ Part of the increase in export volume was a result of a buoyant harvest and a sharp rise in exports of refined oil products. In addition, the fastest growing exports (e.g., iron and steel products) were goods of foreign origin which had been imported and processed in Greece but contained only a low domestic value-added.

CHART 4

GREECE

EXCHANGE RATE DEVELOPMENTS[1]





Sources: IMF, *International Financial Statistics;* and staff estimates.

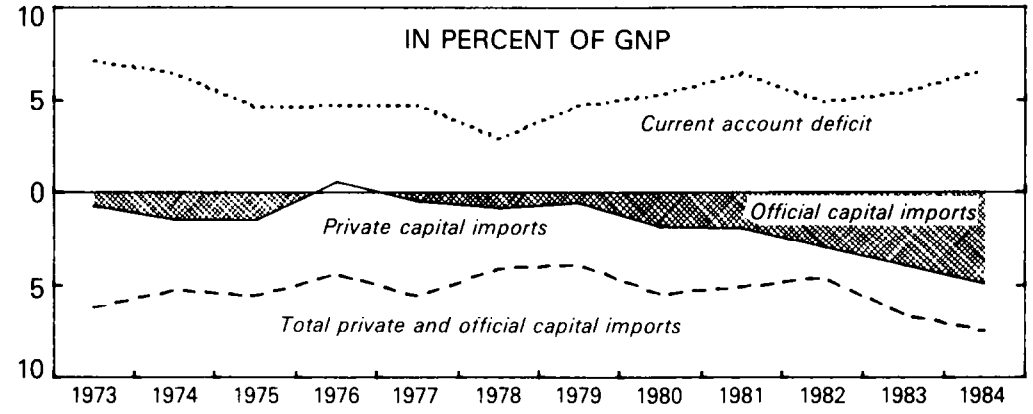
[1]An increase (decrease) in the indices indicates an appreciation (depreciation) of the drachma

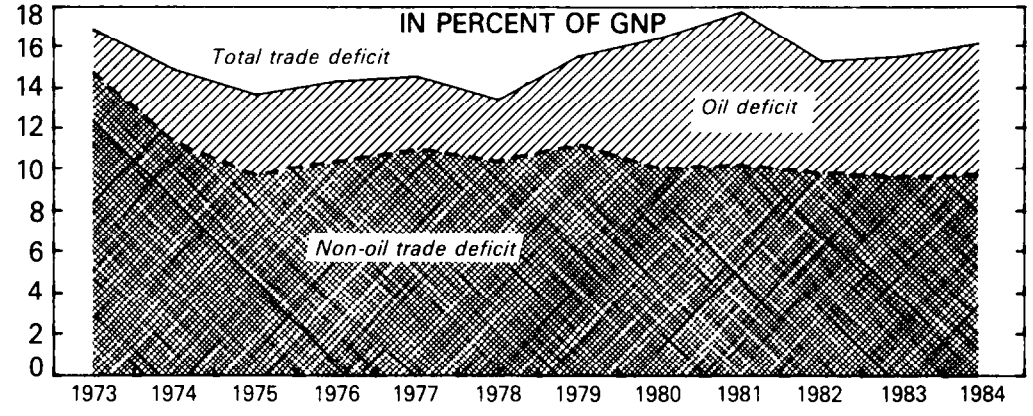
[2]Corrected for exchange rate changes.

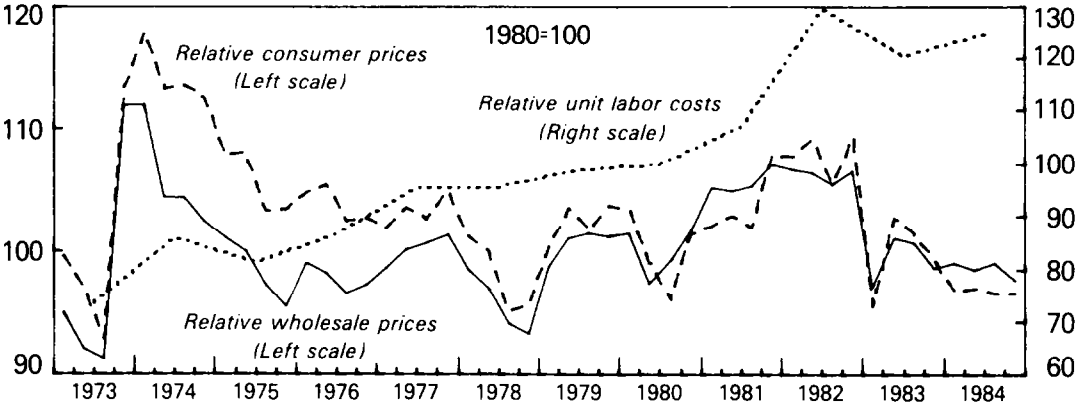
CHART 5

GREECE

BALANCE OF PAYMENTS INDICATORS





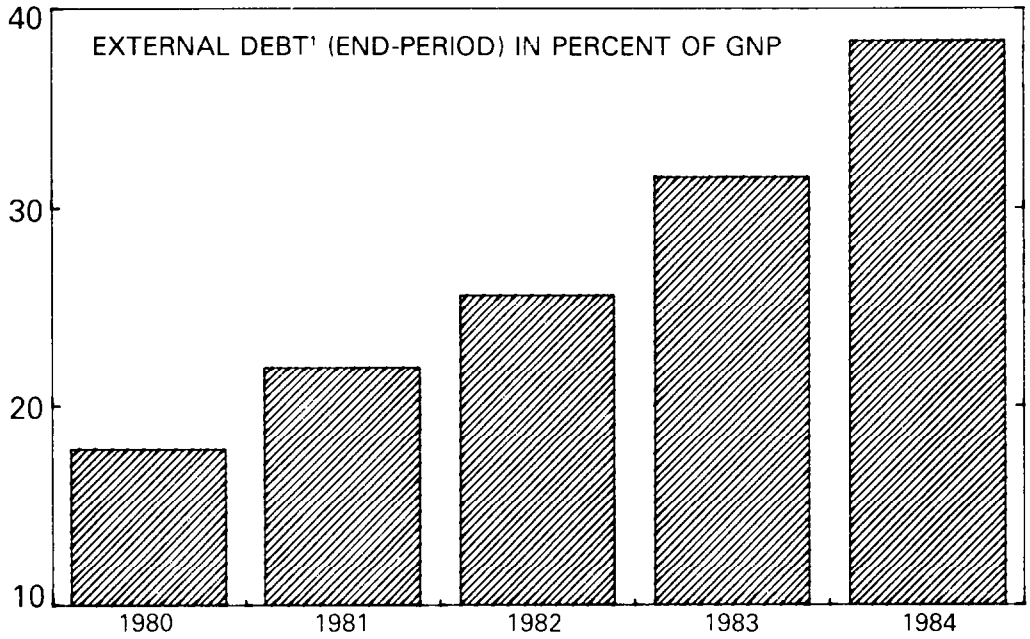


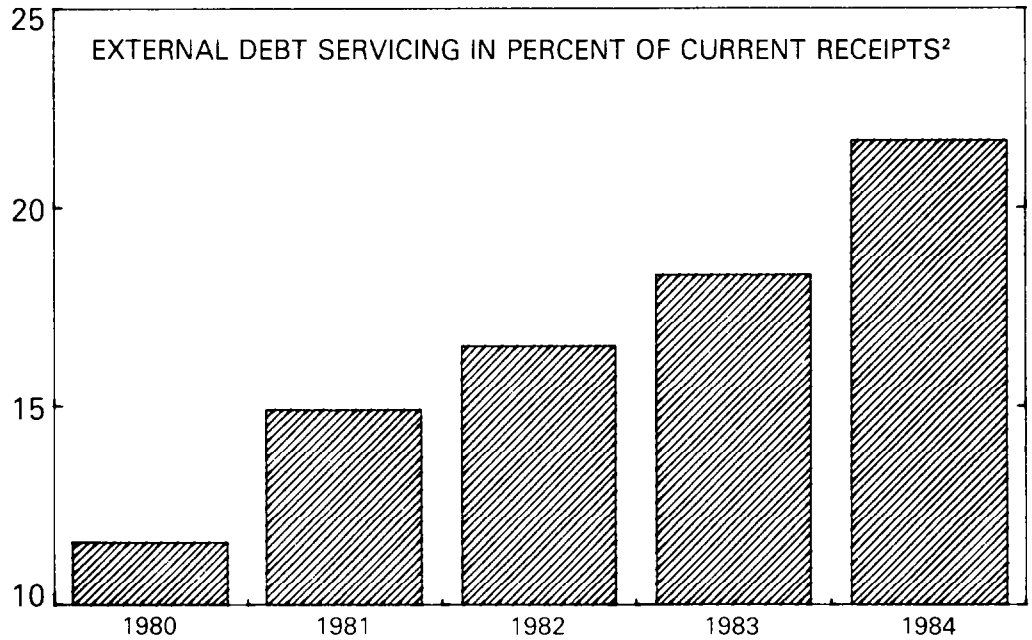
Source Data supplied by the Greek authorities, and staff calculations

CHART 6

GREECE

EXTERNAL DEBT AND DEBT SERVICING





Sources: Data provided by the Greek authorities; and staff estimates
[1]Staff estimates; excludes military debt.
[2]Official estimates; includes debt servicing on military debt

large current account deficits of the past. This is explained by the traditional high level of "nondebt"-creating capital flows; 1/ these flows financed 84 percent of the current account deficits during the 1970s.

3. Prospects for 1985

The official projections for 1985 were based on the assumptions of generally unchanged fiscal and monetary policies, a continuation of incomes policy implying automatic but partial compensation for inflation, and a small real effective depreciation of the drachma. Real GDP was forecast to grow by 2 1/2 percent, as in 1984, with total domestic demand contributing about 2 percentage points (1984: 1 percentage point) and the net foreign balance 1/4 percentage point to GDP growth (1984: almost 1 1/2 percentage points). The increase in domestic demand was a result of an expected rise in private investment by 1 percent, the first increase in six years. Some slight increase in residential investment reflected a strike-related shift in activity from 1984 to 1985, increased funding of a housing loan program for workers and the opening up of new areas for the controlled development of suburbs. Private nonresidential investment was expected to increase slightly (1 1/2 percent).

Private consumption was expected to grow by 1 percent. Despite partial indexation of wages and salaries, real disposable incomes were assumed to rise by 2 1/2 percent, partly because of increases in real incomes in the agricultural and public sectors, respectively. Public consumption was expected to rise at the same rate as in 1984 (3 1/2 percent).

Unit labor costs were expected to decelerate from 20 1/2 percent in 1984 to 16 1/2 percent in 1985 for the economy as a whole. With import prices assumed to increase by 18 percent, consumer prices were projected to decelerate from 18 1/2 percent in 1984 to 16 percent in 1985, which implied a deceleration in the year-on-year rate of inflation from 18 percent in December 1984 to 13 percent in December 1985.

The Greek authorities projected the current account deficit to decline to US$1.7 billion in 1985 (5.1 percent of GNP) compared to US$2.2 billion in 1984 (6.6 percent of GNP). The improvement was shared between the trade balance and the services balance. Merchandise exports were projected to grow at least in line with foreign market growth. Oil imports were expected to decline slightly or remain constant in volume terms, with domestic oil consumption rising marginally and some decline in oil stocks. Non-oil imports were forecast to rise by 4-5 percent in volume terms. The terms of trade were assumed to remain unchanged.

1/ This concept has come to be interpreted--in the case of Greece--to include direct investment by enterprises, real estate investment, and net inflows to foreign exchange deposits.

The projected rise in services receipts was concentrated in tourism, which assumed an increase in arrivals of 10-12 percent with prices unchanged in dollar terms and a modest increase in expenditure per tourist. Interest payments were projected to fall, reflecting an expected drop in LIBOR from 11 1/2 percent in 1984 to 9 percent in 1985. The current account projections were based on the exchange rate relations and interest rates prevailing in January 1985 and assumed some modest real depreciation of the drachma during 1985.

The staff views the official projections for consumer prices and the current account as optimistic. The projected increase in consumer prices does not appear to allow for increases in prices of public enterprises sufficient to cover rising costs which will inevitably occur as a result of increases in domestic and imported costs during the year. In January 1985, for example, electricity prices were already raised by 12 percent for private households and the authorities were prepared to make further adjustments during the year to cover increasing costs. Alternatively, if prices are not raised, this will have implications for the public sector deficit. With respect to the current account, the staff projects somewhat lower invisible receipts (e.g., tourism, emigrants' remittances, and EC transfers) and higher interest payments. Moreover, based on exchange rate developments of the first three months of 1985, and assuming constant exchange rates between all currencies other than the drachma during the remainder of the year, the staff projects a current account deficit of at least 6 percent of GNP.

III. Economic Policies

1. Overall economic strategy

The major elements of the authorities' medium-term strategy are defined in the Five-Year Plan for Economic and Social Development, covering the period 1983-87. The Plan had been submitted to Parliament in May 1984, and approved in November; a preliminary outline had been submitted to Parliament in May 1983. The Plan attempted to strike a balance between the major objectives of easing the external constraint and promoting a restructuring and modernization of the domestic economy. Specifically, the Plan sought to: (i) achieve a substantial shift in expenditure--perhaps 5 percent of GNP--from consumption toward investment and exports; (ii) institute major reforms in the financial sector; (iii) diversify the basis for foreign exchange receipts and promote import substitution, particularly in high-technology goods; and (iv) decentralize and rationalize the public sector.

The authorities emphasized that the specific targets embodied in the Plan would be adjusted on a rolling basis and could not, therefore, be taken as indications of the stance of fiscal and monetary policies over the remaining plan period. In particular, it was likely that the target of 3-3.5 percent annual average GDP growth--which had already been reduced from the 4 percent growth rate envisaged in the preliminary

version of the Plan submitted to Parliament in 1983--would have to be revised downward in light of the outturns for 1983-84 and the prospects for 1985. The realization of the targets for both private and public gross fixed investment also appeared increasingly unrealistic; to meet the targets, both categories of investment would have to realize annual growth rates of more than 10 percent in real terms over the 1986-87 period. The one target which the authorities indicated was fixed--and indeed represented the most important objective of medium-term policy--was the projected reduction in the current account deficit from its 1984 level of 6.6 percent of GNP to 3-3.5 percent of GNP by 1987. An adjustment of this order was viewed as necessary in light of the rapid increase in external amortization payments which will begin in 1987 (See Section 7).

2. Industrial policy

The Greek authorities attributed the major structural problems confronting the Greek economy primarily to the highly protected environment in which Greek industry had developed in the postwar period and to the limited adjustment to the oil shocks of the 1970s. The lack of competitiveness of large segments of Greek industry had been made more evident by Greece's entry into the EC. For these reasons, a major industrial restructuring was called for by the Five-Year Plan; by early 1985, adjustment programs had already been finalized for a number of sectors. The authorities had also placed considerable emphasis on fostering conditions which would promote a recovery in private sector investment. To stimulate such investment, especially by smaller firms, legislation was enacted in 1982-83 offering substantial incentives, including grants, interest rate subsidies, and tax benefits. While the authorities viewed the response to this legislation as encouraging--in terms of the number of investment applications which had thus far been approved--during the first two years of the plan period (1983-84), private sector investment declined by a further 11 percent in real terms.

The authorities agreed that one of the factors underlying the continuing decline in private sector investment had been the decline in profit rates over the past decade. Legislation had been enacted in 1983 to deal with the growing number of large firms which had become illiquid and/or insolvent. An enterprise falling within the scope of the legislation--subject to a preliminary favorable assessment of its long-run viability--would be taken over temporarily by the Government, which would then conduct a more detailed study of its viability. If the prospects for the enterprise were judged positive, its outstanding debt would be restructured, a portion being rescheduled and the remainder converted to equity. Part of this new equity would be held by the Government, although it was the intention to fully restore these enterprises to the private sector once they had become profitable.

By early 1985, 39 enterprises--with a total employment of about 27,000--had been accepted on the basis of the preliminary assessment as candidates for restructuring under this legislation. The applications of 27 other enterprises were under review, while 64 enterprises had had their applications rejected since they were judged to be financially nonviable in the long-run (and in a number of cases had been forced to close down). 1/ Debt owed by the 39 "problem enterprises" is estimated to represent more than 20 percent of commercial banks' claims on the industrial and mining sectors. Interest payments by problem enterprises to domestic creditors have been suspended. Partly to compensate for reduced interest income, commercial banks have been granted retroactive increases in interest rates earned on several of their accounts with the Bank of Greece, as well as a 2 percent subsidy, to be funded by the budget and made retroactive to January 1984, on certain categories of time deposits. The authorities emphasized that interest payments to foreign banks were being paid on schedule, although external amortization payments were subject to negotiation between the problem enterprise and the foreign bank concerned.

5. Fiscal policy

a. Fiscal policy in 1984

Based on provisional data for the 1984 outturn, the authorities viewed recent fiscal developments as satisfactory, since the deficit of the Central Government (excluding the Petroleum Account) had been virtually identical to the budget forecast (Chart 7). This outcome had been realized despite a number of factors not foreseen when the 1984 budget had been formulated, particularly the 2 3/4 percentage point increase in treasury bill rates implemented in February 1984, and the considerably larger than anticipated depreciation of the drachma in terms of the U.S. dollar which, along with an increase in external interest rates, had led to substantially larger than expected external debt service payments in drachma terms.

At the same time, however, the overall public sector net borrowing requirement (on an accrual basis) increased from 11 3/4 percent of GNP in 1983 to 13 1/2 percent of GNP in 1984, 1 percentage point higher than projected. On a cash basis, the deterioration was even more marked, as the net PSBR exceeded the target by 3 percentage points of GNP, rising to 14 1/2 percent of GNP in 1984 (Chart 8). A major reason for the overshooting was a substantial deficit--equal to nearly 2 percent of GNP--in the Government's off-budget Petroleum Account which arose

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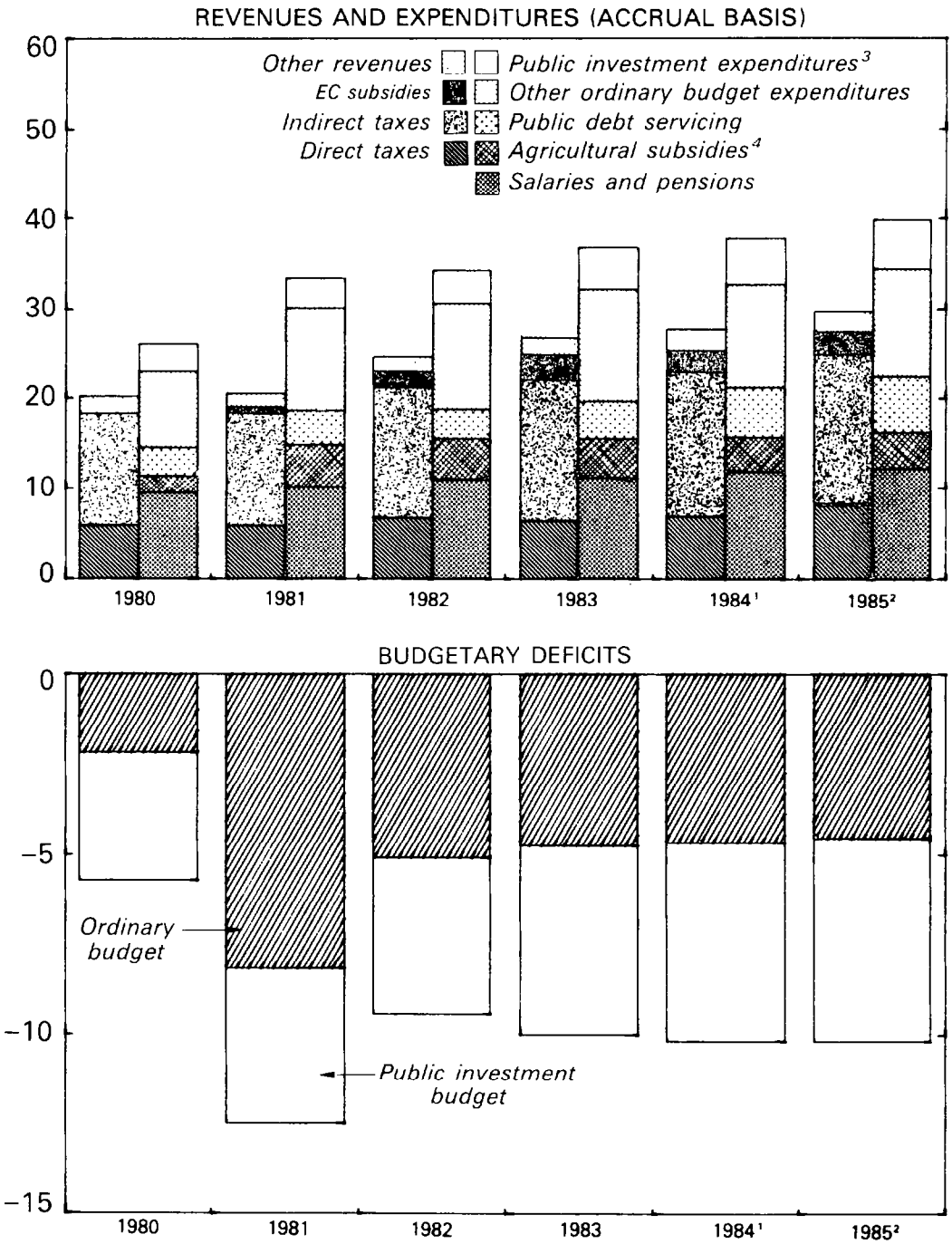
1/ For a more detailed description of the measures taken to deal with "problem enterprises", see forthcoming Recent Economic Developments, Chapter I.

CHART 7

GREECE

CENTRAL GOVERNMENT FINANCES

(In percent of GNP)



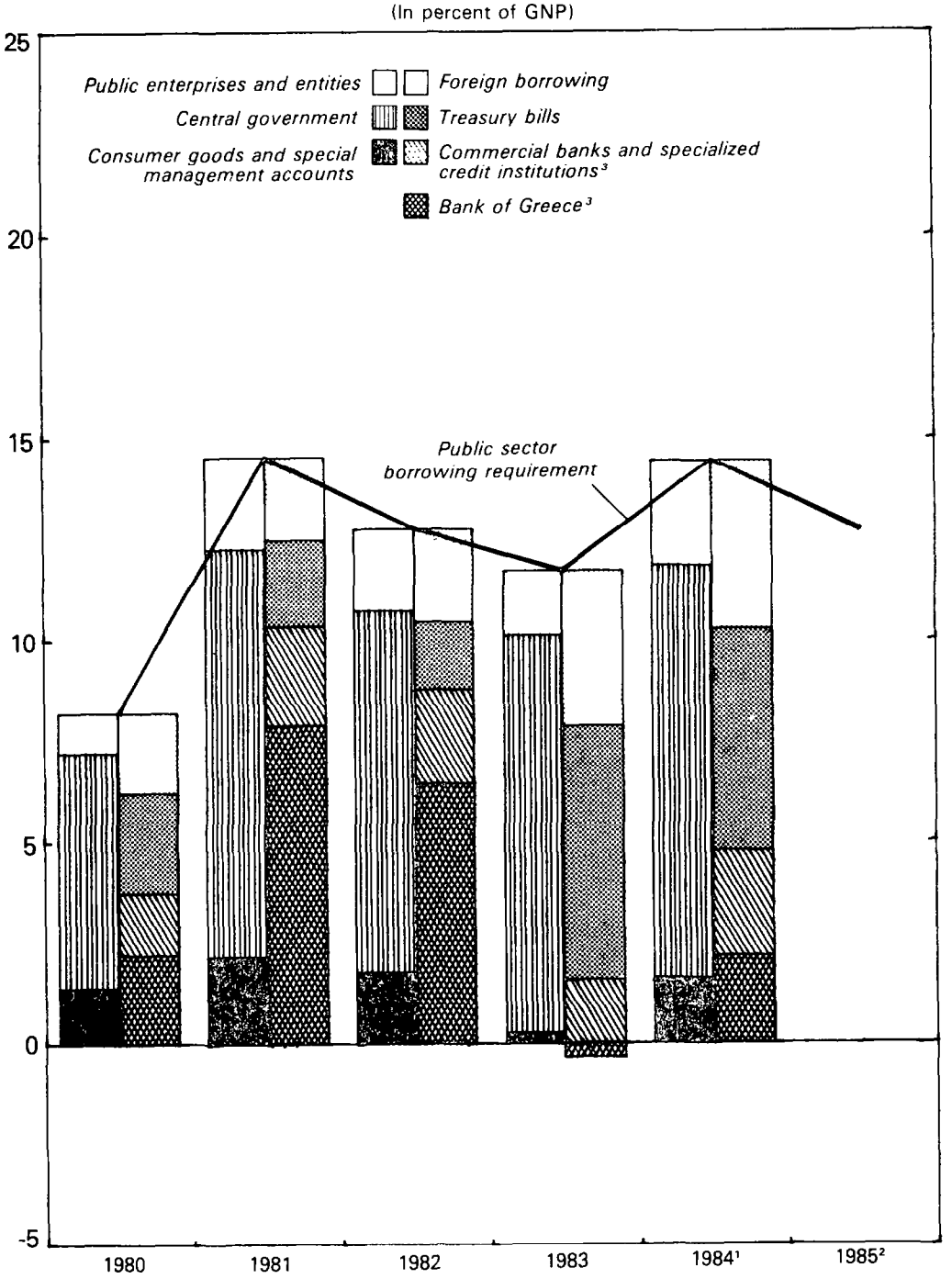
Source: Data supplied by Greek authorities.
[1]Provisional
[2]Official forecast as of February 1985.
[3]Excluding debt service payments.
[4]From both national and EC sources

CHART 8

GREECE

PUBLIC SECTOR NET BORROWING REQUIREMENT AND FINANCING (CASH BASIS)

(In percent of GNP)



Source: Data supplied by Greek authorities.
[1]Provisional.
[2]Official forecast as of February 1985.
[3]Excluding debt service payments.

primarily from a delay in increases in petroleum prices until January 1985. 1/ While the authorities acknowledged that petroleum prices had clearly been too low, in their view the issue was one of timing, i.e., a delay in price increases had been appropriate at a time when inflation was expected to recede and when there had been excess liquidity in the banking system. The staff pointed out, however, that the availability of liquidity in the banking system was no indication of the appropriateness of its use. Moreover, the distribution of deficits among the various public sector accounts appeared to reflect partly the Government's decision to raise the tax component of fuel prices in 1984--thus providing a significant boost to ordinary budget receipts--rather than the ex-factory price.

b. Medium-term fiscal strategy

The Five-Year Plan calls for a significant reduction in the PSBR, though no specific targets are provided. Fiscal targets identified in the Five-Year Plan include an increase in the ratio of direct to total tax receipts, and a further shift in the composition of public spending toward investment expenditure. In addition, a number of subsidies currently provided through the budget, including national agricultural subsidies not in compliance with EC regulations, are to be phased out gradually.

The authorities indicated that the planned reduction in the borrowing requirement of the Central Government is to be achieved primarily through a significant increase in revenues relative to GNP. This is in turn to be realized through both a more efficient collection of taxes--continuing the trend of recent years--and a significant expansion of the tax base. The latter will require major reductions in tax exemptions currently granted to certain sectors of the economy, although no measures have yet been taken in this respect. A major change in the tax system will occur with the implementation of a value-added tax (VAT), originally planned for 1984, which is now scheduled for January 1986. This is expected to be revenue neutral or only slightly revenue enhancing.

The authorities see little scope for reducing the level of government expenditure, which on a national accounts basis represented 41 percent of GNP in 1983. In view of the relatively undeveloped nature of the economy, public investment expenditures will have to continue to increase. The intention is that this be offset, at least in part, by a decline (relative to GNP) in public consumption expenditures.

Total public sector interest payments--domestic and external--are estimated to have reached nearly 7 percent of GNP in 1984, approximately double their level in 1980. Staff estimates suggest that continued

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1/ The authorities indicated that an unknown portion of this deficit may have arisen from operations in years prior to 1984.

large public sector deficits could lead to interest payments on public debt representing 10 percent or more of GNP before the end of the decade, especially if there is not a substantial decrease in inflation (which would permit a reduction in nominal interest rates on the domestic component of public debt). 1/ Thus, substantial reduction in the PSBR over the coming years could necessitate a proportionately larger reduction in the noninterest component of public sector expenditures.

A significant reduction in the borrowing requirement of the major public enterprises (projected at nearly 6 percent of GNP for 1985) was also seen as one of the principal objectives of fiscal policy over the medium-term horizon. To a large extent, these deficits, especially in the electricity and urban transportation sectors, have reflected political decisions on the part of the Government to limit price increases below increases in costs. Measures are currently being implemented for the "socialization" of the major public enterprises, under which each would become subject to control by a tripartite board of representatives from Government, workers, and other social entities. In addition to providing more efficient organization and management, the authorities view these boards as performing an educational role which will facilitate more appropriate pricing policies.

c. Fiscal policy in 1985

The net PSBR (on a cash basis) for 1985 is projected to decline to 12 3/4 percent of GNP, 1 3/4 percentage points below the 1984 outturn. The gross deficit of the Central Government (excluding the Petroleum Account) is projected to remain unchanged relative to GNP; the deficit on the Petroleum Account is to be eliminated. The authorities indicated that the latter will require further price increases over the remainder of the year. Contrary to the pattern of recent years--and to the strategy envisioned in the Five-Year Plan--ordinary budget expenditures were forecast to increase more rapidly in 1985 than expenditures under the public investment budget. Overall central government expenditures are projected to rise by 27 percent, or by about 9 percent in real terms. 2/ Expenditures on salaries and pensions are to rise by nearly 25 percent (7 1/2 percent in real terms), while public debt servicing payments--which in 1984 accounted for nearly 15 percent of total central government expenditures--are to increase by more than 40 percent, reflecting, in part, increased reliance on financing via treasury bills at competitive rates of interest. The authorities indicated that the relatively large increase in expenditures on salaries was due primarily

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1/ Total public sector debt at end-1984 was Dr 2,747 billion, or 74 percent of GNP, of which approximately 40 percent (US$8.2 billion) was owed to external creditors.

2/ Deflated by the projected increase in the consumer price index of 16 percent.

to the introduction of a uniform civil service salary scale, which would have a one-time effect of raising civil service pay scales.

Despite a major reduction in income tax rates affecting the majority of taxpayers in 1985, 1/ the authorities expect a significant increase in tax receipts (30 percent, or 12 percent in real terms) Direct tax receipts are projected to increase by 44 percent in 1985, due in large part to a more than doubling in collection of current and back taxes. When queried whether these revenue projections might be unduly optimistic, the authorities cited a number of measures which had been or were shortly to be implemented to improve the efficiency of tax collection, including the declaration of a period of tax amnesty for delinquent past tax returns.

The net borrowing requirements of the public enterprises are projected to increase to nearly 6 percent of GNP in 1985, reflecting a substantial increase in investment expenditures, while the deficits of the public entities are forecast to remain unchanged at 1 1/2 percent of GNP.

4. Monetary policy

The authorities placed considerable emphasis on their efforts to tighten monetary and credit policies since mid-1982, along with major institutional reforms in the financial system implemented over the same period. Government borrowing from the Bank of Greece had been placed under strict limits through the enactment of Law 1266 in 1982, 2/ while there had also been more effective control over commercial banks' credit creation resulting from a more consistent application of the penalty rates on their overdrafts with the Bank of Greece. In 1984, a major change had been introduced with regard to the financing of the two major specialized credit institutions, the Agricultural Bank of Greece and the National Mortgage Bank. Under the new arrangements, the Bank of Greece establishes only overall credit ceilings for the two institutions, rather than setting limits for individual categories of loans as had been done in the past. In addition, the two credit institutions are now required to finance the major portion of their credit programs from their own deposits, rather than from low-interest financing provided by the Bank of Greece.

1/ For an illustration of the decreased income tax rates, see Recent Economic Developments Table 30.

2/ Under the terms of the law, Bank of Greece credit outstanding to the Government is limited to 10 percent of budgeted expenditures under the ordinary and investment budgets for the current year. Also, Bank of Greece financing of the Consumer Goods and Special Management Accounts cannot exceed the value of the stocks held by these accounts.

The authorities also pointed to the changes in interest rates in 1984 as further signs of the increasing rationalization of the credit system. Interest rates on most categories of time and savings deposits were increased by 1-1.5 percentage points (and now range from 15 to 20 percent) while the rate of interest charged on government borrowing from the Bank of Greece in the form of treasury bills had been raised by 2 3/4 percentage points. The current rate charged on such borrowing (more than 18 percent, at an annual rate) was comparable to that charged on most other categories of loans extended by the banking system, and this was viewed as facilitating subsequent direct Government borrowing from the market.

With regard to the provisional 1984 outturn for the monetary and credit aggregates, the authorities acknowledged that the targets had been considerably exceeded. Domestic credit was estimated to have expanded by 25 percent in 1984 (Chart 9), compared to the target of 20 percent established in the annual monetary program, while broad money (M3) increased by more than 29 percent (compared to the target of 22 percent). The major overshooting occurred with regard to domestic credit expansion to the public sector, which was estimated to have increased in 1984 by 31 percent, compared to the target of 22 percent. More than four fifths of this overshooting was attributed to: (i) the deficit of Dr 73 billion (nearly 2 percent of GNP) in the Government's Petroleum Account; and (ii) the increase in debt service payments--estimated by the authorities at Dr 32 billion--resulting from the increase in treasury bill rates. The large overrun in the PSBR in 1984 necessitated government borrowing from the Bank of Greece which was both considerably larger than initially envisaged, and substantially in excess of the level which would ordinarily have been permitted under the terms of Law 1266/82. 1/

The overshooting of the monetary and credit targets in 1984 was seen by the authorities as a temporary phenomenon which should not be interpreted as a reversal in the trend to tighter monetary and credit policies established over the preceding two years. Similarly, the potential inflationary implications of the large increase in the PSBR in 1984--on a cash basis by nearly 3 percentage points of GNP--were viewed as limited. A significant increase in the public's willigness to hold monetary assets, attributed to both the relatively large increase in

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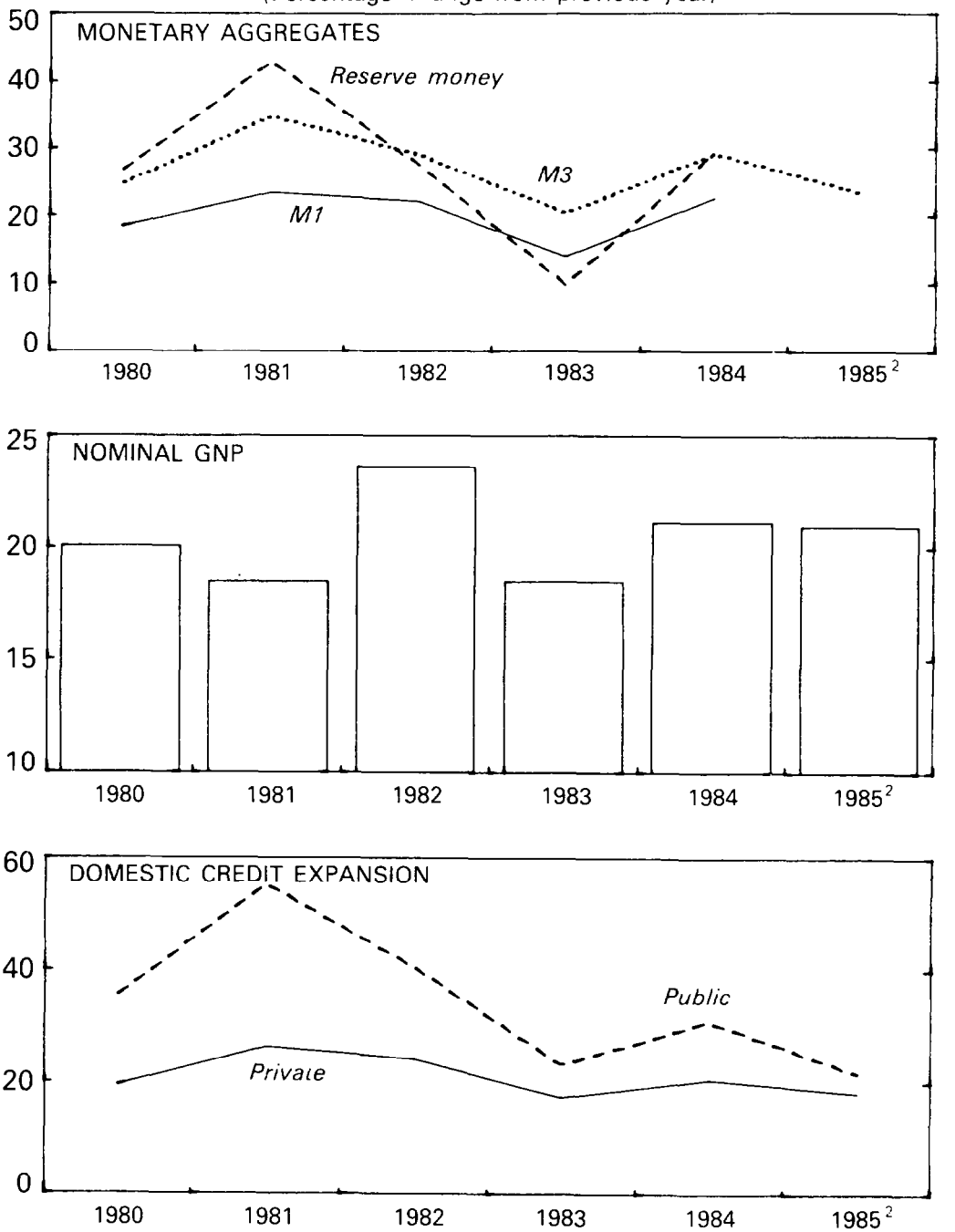
1/ This increased borrowing was made possible by using part of the proceeds (approximately Dr 40 billion) of a special Dr 150 billion long-term loan from the Bank of Greece to the Government, intended to restructure short-term credit previously granted to various agricultural supplies' accounts, to finance ordinary budget expenditures. The authorities emphasized the exceptional nature of this arrangement and indicated that, in future years, the limits on government borrowing from the Bank of Greece would be adhered to strictly.

CHART 9

GREECE

DOMESTIC CREDIT AND MONETARY EXPANSION[1]

(Percentage change from previous year)



Source: Data supplied by Greek authorities and staff calculations.

[1]Growth rates for domestic credit and monetary aggregates are based on end of year observations

[2]Official projections as of February 1985

real interest rates in 1984 and the larger than expected increase in real incomes, was seen as having played an important role in minimizing the deterioration in the balance of payments.

The staff viewed the large overshooting of credit to the public sector in 1984 in a considerably less favorable light and as having offset the gains achieved in the 1982-83 period through the modest reduction in the fiscal deficit and in monetary expansion. In particular, the staff questioned the authorities' view that increased credit to the Government in 1984 had been appropriate because of "excess liquidity" among the commercial banks. To a large extent, rather than serving as a justification for increasing credit to the Government, this liquidity would appear to have arisen precisely because of the increase in Bank of Greece credit to the Government, as reserve money growth accelerated from 10 percent in 1983 to 29 percent in 1984 (Chart 9).

The authorities indicated that the stance of monetary policy in 1985 would be relatively tight, given the inflation target of 16 percent which had been taken as exogenous variable in formulating the annual monetary program. The authorities explained that the annual inflation target was based on projections for increases in unit labor costs, agricultural prices, import prices and indirect taxes. A more rapid deceleration in inflation was precluded by: (i) the carryover effect from the inflation rate of the preceding year, due to the system of wage indexation; and (ii) the general policy stance of the Government in favor of gradualism. The staff noted that several of the inputs into the inflation target were, to some extent, themselves functions of the inflation rate and hence a circular element appeared to be involved in the formulation of this target.

The annual monetary program for 1985 projects domestic credit expansion to decrease from the provisional outturn of 25 percent in 1984 to 20 percent in 1985, with the major decrease occurring with respect to the public sector. Domestic credit expansion to the private sector was targeted at 18 percent, or slightly below the expected rate of increase of nominal GNP.

A major innovation in 1985 will be direct sales of treasury bills to the nonbank private sector. This was viewed as an important step in the development of nonmonetary financial assets in Greece, and was seen as paving the way for the development of a private sector bond market. The authorities indicated that the Bank of Greece eventually would support the establishment of a secondary market for treasury bills; it was hoped that the existence of such a market would at some point allow the Bank of Greece to expand its instruments of monetary control to include conventional open market operations. Since treasury bills and quasi-money deposits are viewed as close substitutes--at least for the near future--their introduction was seen as facilitating a deceleration in the growth of broad money (M3), forecast to increase by 23 percent in

1985. The growth of M3 and its near-substitutes--treasury bills and bank bonds--was projected to remain above 24 percent in 1985, or more than 7 percent in real terms.

The staff cautioned that the realization of these projections was highly dependent on a continued reduction in inflation, and the expectations thereby engendered, and on maintenance of current levels of nominal interest rates, as the demand for monetary assets in Greece appears to be very sensitive to real deposit rates. Any reversal of the recent modest gains against inflation could become self-aggravating, by decreasing the willingness of the public to continue to absorb real financial balances at the projected rate, thus leading to a further deterioration in the balance of payments. In this context, the staff noted that the further development of the market for convertible drachma deposits, introduced in September 1984, could potentially play an important role in providing a signal on the appropriateness of domestic deposit rates. 1/

5. Incomes and price policies

The authorities view the system of partial wage indexation applied since 1982 as having played an important role in breaking inflationary expectations. Largely reflecting a delay in wage adjustments in 1983, average real wages were estimated to have fallen by about 3 percent in that year. The authorities indicated that the significant increase in real wages (nearly 4 percent) estimated to have taken place in 1984 should not be viewed as a change in policy, but only as a carry-over effect from the delayed wage adjustments in 1983. The general stance of incomes policy is to remain unchanged in 1985. Wage indexation will again be applied in the public sector and, while not legally binding on the private sector, agreement has already been reached between the major unions and organizations of employers that wage increases in the private sector will fall within the prescribed limits. Application of the wage indexation system, along with wage drift, was expected to lead to a 1 percent increase in average real wages in 1985 for non-civil service employees; for civil service employees, the increase was projected to be considerably higher (perhaps 5-6 percent), due to the introduction of the uniform civil service salary scale. To offset the real wage compression which would otherwise occur at higher income levels--as inflation adjustment is only partial for higher incomes--income tax rates had been reduced significantly.

1/ The introduction of these deposits was a condition for the inclusion of the Greek drachma in the ECU. Interest rates on these accounts are in principle market determined, although to date the Bank of Greece has intervened substantially due to the continued thinness of the market.

Despite its perceived effectiveness in restraining inflation, the authorities acknowledged that the present system of wage indexation, with its automatic carry-over to wages of past price increases, limited the scope for a more rapid reduction in the rate of inflation. At current levels of inflation, wage drift (including seniority increases), appears to more than compensate for the fact that only partial wage adjustments are made at higher salary levels. The inclusion of administered prices in the consumer price index used to adjust wages was also recognized as discouraging increases in public enterprises' tariffs which would be necessary to reduce the deficits of these organizations. Over a medium-term horizon, a reduction in real wages was viewed as a possibility. The authorities indicated that this might require some change in the present system of wage indexation, although no specific measures in this regard had yet been formulated.

With regard to the issue of price controls, the authorities emphasized the long tradition of such policies in Greece. In their view a substantial liberalization in price controls had already begun in mid-1984. The number of manufactured goods for which prices were set by the Government had been reduced to five, while a number of goods had been shifted from the previous regime of price determination by the authorities to one in which approval for price increases was granted automatically, subject to adequate documentation of costs. Certain broad categories of goods, e.g., clothing and shoes, were no longer subject to any form of price control. The authorities acknowledged that the move toward price liberalization had not been perceived as such by many in the private sector; in their view, this was a misunderstanding which could be attributed to the fact that, in order to improve accounting standards and tax collection, measures had recently been introduced to ensure more accurate reporting of profits by enterprises, and these measures had aroused considerable opposition.

6. External sector policies

The authorities considered the external deficit one of the most pressing problems for the Greek economy. They recognized the need for stepping up adjustment efforts so as to reduce the current account deficit and revive private capital inflows. In light of the stage of development of the Greek economy, it was not appropriate to aim for a complete elimination of the current account deficit. The Five-Year Plan embodied a target to halve the deficit to 3-3 1/2 percent of GNP by 1987.

The authorities indicated their intention to pursue a realistic exchange rate policy in order to promote adjustment. In particular, there was a need to improve cost competitiveness vis-à-vis EC countries, which had been eroded during the last several years (Chart 4). In this connection, the authorities noted that since EC membership the public had become less sensitive to changes in the drachma/dollar rate; this provided greater flexibility in managing the exchange rate. Since August 1983, the drachma had generally depreciated in real effective

terms (relative consumer prices). 1/ The authorities foresaw no departure from this policy. In this connection, they noted the importance of ensuring that the effect of the depreciation was not negated by increases in domestic wages and prices.

An effective industrial policy was considered an additional element in improving international competitiveness. In the past, industrial policies had tended to focus on large firms, while there was a large potential for structural change in dynamic small and medium-sized enterprises. One area for assistance was export promotion and coordination of export activities of these firms. As there existed no private trading company, the Government had encouraged the establishment of mixed private/public trading companies, one dealing with exports in all commodities, and others specializing in agricultural products. With respect to services exports, the authorities emphasized the need for promoting an upgrading of tourism services in the coming years.

Membership of the European Communities had resulted in an "entrance shock" for agricultural trade, in the form of trade diversion of imports from lower-priced non-EC countries toward higher-priced EC countries. As EC prices were above world market prices for Greek imports but not for Greek exports of agricultural products, EC membership had led to a deterioration in the terms of trade for agricultural products. On the positive side, Greece had received transfers, mainly agricultural subsidies, from the EC budget, which since 1982 had exceeded the estimated deterioration in the trade balance for agricultural products. These transfers had also benefited the government budget by substituting EC subsidies for national subsidies. The Greek authorities indicated that agricultural incomes had probably increased by more than would have been the case in the absence of membership. EC membership had also been accompanied by increased borrowing by Greece from EC institutions, accounting for one fifth of net official borrowing abroad in 1984. The authorities indicated that there was scope for a substantial expansion of this borrowing, pending submission of proposals for viable investment projects. In March 1985, the European Council agreed to launch the Integrated Mediterranean Program for the benefit of France, Greece, and Italy. Over a seven-year period budgetary transfers to these countries were to amount to ECU 4 billion, of which Greece would receive ECU 2 billion. In addition, loans from the European Investment Bank and New Community Instrument would be boosted by ECU 2 1/2 billion for all countries under this program. 2/

1/ The depreciation occurred mainly in 1983 in terms of both relative consumer prices and relative unit labor costs. Depreciation continued during most of 1984 but was reversed in the last few months of the year as the strong appreciation of the dollar was not matched by a sufficient adjustment of the drachma/dollar exchange rate. With the weakening of the dollar in March 1985, much of this loss in competitiveness was reversed.

2/ For details, see Appendix I in the forthcoming Recent Economic Developments on Greece.

Greece has removed all quantitative import restrictions vis-à-vis EC countries except on five commodities accounting for 1 percent of imports. These remaining restrictions were expected to be eliminated by the end of 1985. When Greece joined the EC, there existed an array of indirect taxes, discriminating against imports. The Greek authorities agreed to consolidate these taxes into a single regulatory tax in order to increase transparency. This was implemented in July 1984. The regulatory tax varies substantially between products but currently averages about 5 percent for all imports. The tax will be reduced in six steps, with complete elimination by January 1, 1989.

Greece provides various direct and indirect export subsidies. All merchandise exports, including agricultural exports, are eligible for a 6 percent rebate on the value of exports channelled through the banking system. In addition, manufacturing exports receive an export subsidy amounting to 6-13 percent on the f.o.b value of exports, depending on domestic value-added. Other export subsidies include tax allowances and a refund of the stamp duty. No changes have taken place in export subsidies during 1984. Agricultural subsidies from the EC and the Greek budget totalled Dr 142 billion in 1984 (nearly 4 percent of total GDP or 24 percent of agricultural GDP). National subsidies accounted for about 40 percent of total subsidies; two thirds of national subsidies were not in harmony with EC requirements.

Greece maintains restrictions on payments for imports and invisibles (including dividends and interest), which are subject to Article XIV of the Fund Agreement; these restrictions do not require approval by the Executive Board.

7. Medium-term scenarios

The staff has prepared medium-term external debt scenarios for the period 1985-90 with three possible speeds of adjustment of the current account deficit (Tables 2 and 3). The first scenario (I) assumes--like the Five-Year Plan of the Government--that the current account deficit will be reduced to about 3 1/2 percent of GNP by 1987; the second scenario (II)--based on lower export volume growth--projects that this target will not be realized until 1990, and the third scenario (III), based on only a modest increase in transfers in real terms and no decline in foreign interest rates, projects maintenance of the current account deficit in the range of 5-6 percent of GNP throughout the period 1985-90. 1/ For each of the base scenarios, two variants have been calculated with respect to the development of "nondebt" financing and errors and omissions: (A) an optimistic scenario showing a real

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1/ In Scenario I, export volume growth for 1985 is based on official projections of 8-9 percent; for 1986-87, export volume is assumed to grow by 7 1/2 percent and for 1988-90 by 6 percent per annum. Scenarios II and III assume export volume growth of 6 percent in the years 1985-90.

increase by 3 percent per annum in nondebt financing, and zero errors and omissions after 1985, and (B) a less optimistic scenario displaying constant nondebt financing in real terms and a level of errors and omissions in the 1986-90 period equal to their projected level in 1985 (an outflow of US$200 million). For a comparison, nondebt financing rose by 1 percent in real terms per annum, on average, between 1980 and 1984. Errors and omissions were positive amounting to, on average, US$172 million in the years 1980-81, but turned negative to, on average, US$222 million in the years 1982-84.

Under the most optimistic scenario (I(A)), external debt will decline to 26 percent of GNP and debt servicing to 19 percent of exports of goods and services by 1990 (Table 2); the gross borrowing requirement will decline from a peak of US$2.2 billion in 1984 to US$1.5 billion by 1990. According to the most pessimistic scenario (III(B)), external debt will rise to 44 percent of GNP and debt servicing to 26 percent of exports of goods and services by 1990 with gross borrowing requirement reaching US$3.8 billion by 1990 (Table 3). In the staff's view, scenarios I(A) and possibly II(A) could be viable if domestic policies are changed sufficiently to accomplish the switch from domestic to external absorption. However, the other scenarios do not appear to provide realistic alternatives in light of a possible hesitation by foreign banks to increase substantially their exposure to Greece if significant improvement in the balance of payments is not visible.

IV. Staff Appraisal

At the time of the last Article IV consultation with Greece, Executive Directors questioned whether the targets announced by the authorities for 1984 were sufficiently ambitious to redress the major imbalances confronting the Greek economy, particularly with regard to the external and fiscal deficits. Considerable concern was also expressed that the policy measures envisaged by the authorities for 1984 might not have been sufficient to realize even the modest goals which had been set.

The picture that emerges from a review of developments in the Greek economy in 1984 is mixed, but in many respects the outcome is disappointing. On the one hand, there were signs, albeit uneven, of a recovery in output and a further modest decline in inflation. There was also some further progress toward reform of the financial system and improvement in price competitiveness. However, these positive developments were accompanied by a reversal of the modest progress made on fiscal and monetary accounts in 1982 and 1983, and a further increase in the external current account deficit. The net PSBR (on a cash basis) increased from 11 1/2 percent of GNP in 1983 to 14 1/2 percent in 1984 and had its counterpart in a substantial increase in the pace of monetary expansion. The current account deficit rebounded to 6 1/2 percent of GNP. In addition, the progress made in 1983 in reducing real

wages was seen to have been partly at the cost of an offsetting increase in 1984. There was no reversal in the profit situation of enterprises and private investment continued to decline.

The persistence and, indeed, enlargement of the fiscal and external deficits, and the associated domestic and external debt situation, can only heighten the concerns expressed by Executive Directors last year. Developments in 1984 cast doubt on the viability of the authorities' continued emphasis on a policy of gradual adjustment and even raise questions about whether adjustment can be said to have occurred. Annual current account deficits of 5-6 percent of GNP since 1979 have led to a doubling of external indebtedness over this period, and to a significant increase in the debt service ratio. As the grace periods on earlier borrowing begin to expire, amortization payments on debt already contracted will rise rapidly. This makes imperative a substantial and rapid reduction in the current account deficit.

The deterioration in the PSBR in 1984 has delayed and made more difficult achievement of the authorities' medium-term objective of substantially reducing that deficit. The authorities would de-emphasize the importance of this reversal--noting that the increase in the central government deficit derived, in large part, from a delay in adjusting petroleum product prices and restating their commitment to eliminate this component of the deficit in 1985. However, from a macroeconomic perspective, the effects of the enlarged deficit are independent of the particular government account in which that deficit arise. As important, the increase in the deficit occurred from an already high level, further raising future debt service payments. Moreover, the deficit reflects, in part, continued large subsidies to the major public enterprises.

The enlargement of the PSBR in 1984 and the associated overshooting of monetary and credit targets provide a further indication that monetary policy in Greece remains fundamentally constrained by the need to finance the large public sector deficits. Over the past five years, there has been a marked shift in the composition of credit expansion, with credit to the public sector now accounting for nearly two thirds of total credit expansion. The introduction in 1985 of treasury bill sales to the private sector represents a potentially valuable expansion in the range of financial assets available to domestic savers. However, this in no way reduces the urgency of bringing down the public sector deficit. Only through such action can the authorities bring about a reduction in the growth of money and liquidity in the economy, while at the same time making room for the hoped for recovery of private investment.

In the view of the staff, it is imperative that policies be directed toward a convincing reversal of the slippage which occurred in 1984 and to the establishment of a basis for a much more rapid movement to, or beyond, the authorities' medium-term targets for domestic and external deficits. The staff understands the appeal to the authorities

of a gradualist approach to adjusting the major imbalances confronting the Greek economy. However, as the Five-Year Plan period nears its midpoint, the major structural transformation of the Greek economy which it envisaged has yet to manifest itself. Indeed, in a number of areas the situation now appears markedly worse than it did at the beginning of the plan period. Hence, the staff believes that there is need for more rapid adjustment.

Staff projections indicate that the authorities' targeted reduction in the current account deficit to 3-3.5 percent of GNP in 1987 could--if accompanied by a recovery of "nondebt" capital flows--be consistent with maintaining external financial viability. However, the targets established for 1985 offer the prospect of only limited initial adjustment. In addition, the staff has reservations as to whether policies in 1985 will be adequate to achieve even the relatively modest objectives which have been set. The authorities' projection of a reduction in the current account deficit to 5 percent of GNP is based on a number of assumptions which appear optimistic. Staff estimates suggest a current account deficit of at least 6 percent of GNP--US$2 billion--for 1985. Similarly, some of the assumptions underlying the projected reduction (by about 1 3/4 percent of GNP) in the public sector borrowing requirement in 1985, imply substantial--and early--price adjustments and administrative reforms, the former of which could make the projected decline in inflation difficult to achieve.

More rapid adjustment will require a coordinated approach in policies. The staff agrees with the authorities that the high growth rates of output called for in the Five-Year Plan may have to be scaled downwards considerably. This implies, however, that the required adjustment in the composition of domestic demand--from consumption toward investment and exports--may not be possible within a framework of continually rising levels of real consumption. The staff also agrees that the high rate of inflation constitutes one of the most important factors underlying the current economic difficulties. For this reason, the staff would recommend early implementation of policies to achieve a considerably more ambitious target for a reduction in the inflation rate.

No significant deceleration in inflation is likely to occur without a major modification in the current wage indexation scheme and strong resistence to wage increases beyond those suggested by an appropriately modified scheme. While the present system of indexation may have served to limit inflation in previous years, its pass-through mechanism of previous price increases into current wage payments effectively precludes the possibility of a rapid decline in inflation. In addition, the presence of substantial wage drift and exceptions to indexation have continually resulted in wage increases above those implied by the partial indexation formula alone. The present system of wage indexation also severely restricts the scope for pursuing a more active exchange rate policy which is necessary to improve the external balance, as well as for adopting appropriate pricing policies for the major public

enterprises. Moreover, an unusually large proportion of workers in Greece are self-employed and not subject to this wage determination mechanism. For all these reasons, successful use of an appropriately modified scheme presumes, as a complement, tight financial policies to assure restraint in other income payments.

Tighter financial policies will require, as the most important element, a more rapid reduction in the public sector borrowing requirement. This involves a potential conflict among the authorities' aims insofar as their gradualist strategy necessitates a reliance on public investment spending as a leading sector of growth pending a recovery of private investment. The resolution of this conflict can lie only in an accelerated effort to decrease current expenditures, including subsidies, and increase government revenue in a manner which does not weaken private sector initiative. The staff agrees with the authorities that there exists substantial scope for generating increased tax revenues by extending the tax base to include certain sectors of the economy currently exempt from most forms of taxation and would advise early action to achieve this objective. There may also be scope for restraining the growth of central government expenditures, especially in the areas of salaries and pensions. A major contribution to reducing the PSBR will also have to derive from measures to reduce the large deficits of the public enterprises. This, in turn, will require both greater efficiency in management--including the shedding of surplus labor where necessary--and more appropriate pricing policies. It is hoped that, as the authorities believe, the policy of "socialization" of public enterprises will assist in this process.

The continuing decline in private sector investment is of major concern, raising further doubts as to whether a sufficient industrial base exists to foster a rapid growth in output. In the staff's view, the principal factor underlying the unsatisfactory investment performance has been the steady decline in enterprise profits over the past decade. This has been due partly to increases in wage costs substantially higher than warranted by productivity increases, but may also reflect the legacy of widespread price controls. The liberalization of such controls--which the authorities stated is currently taking place--would be a welcome development. The high nominal interest rates which have emerged as the necessary, and appropriate, consequence of continued high inflation have also been a significant factor in reducing profits in heavily indebted Greek enterprises. A significant reduction in the inflation rate which, after some time, should permit a decline in nominal interest rates, may be one of the most effective means of restoring profitability and, thereby, investment incentives. A more positive environment for private investment would also be fostered by a more transparent policy toward problem enterprises. The return of viable enterprises to the private sector intended by these policies should be effected as quickly as possible, not the least, to assure that they do not become an additional burden to the budget.

Structural reforms instituted by the authorities in recent years hold the promise for a more efficient operation of the economy in the future. This is especially true of the significant reforms in the financial system--including the adjustment of many interest rates to positive real levels--and the heightened attention being provided to small and medium-sized enterprises. Management of the exchange rate has also been put on a sounder footing, with a demonstrated ability to effect real depreciation as one means of improving competitiveness. The staff would encourage the authorities to continue the progress made in these areas and to complement it with immediate action to assure achievement of at least the official targets set for 1985 as a minimum first step toward restoring sustainable positions to the external and fiscal accounts over the medium-term.

The staff welcomes the introduction of the regulatory tax in order to increase transparency of taxes discriminating against imports and especially the intention to phase it out completely. The staff also notes the intention to remove some export subsidies when the value-added tax is introduced.

It is recommended that the next Article IV consultation with Greece be held on the standard cycle. The authorities have noted, however, that since consultation discussions can be most productive if held during May, it may be useful to extend that cycle toward 15 months.

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Greece, in the light of the 1985 Article IV consultation with Greece conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Greece continues, pursuant to Article XIV, to maintain restrictions on payments and transfers for current international transactions, as described in SM/85/--.

Table 2. Greece: External Debt Scenarios, 1985-90--Case A 1/

(In millions of U.S. dollars except otherwise indicated)

	1984	1985	1986	1987	1988	1989	1990
Scenario I (A)							
Current account deficit	2,182	1,703	1,537	1,188	1,119	1,017	880
In percent of GNP	(6.6)	(5.4)	(4.6)	(3.3)	(2.9)	(2.5)	(2.0)
Gross borrowing	2,191	1,712	1,385	1,389	1,746	1,592	1,508
Net borrowing	1,415	832	390	-46	-210	-412	-659
Debt service 2/	1,845	1,882	2,067	2,457	2,965	2,986	3,099
Amortization	776	880	995	1,435	1,955	2,004	2,166
Interest	1,069	1,002	1,072	1,022	1,010	981	933
Debt service ratio 3/	(19.1)	(19.1)	(18.9)	(20.1)	(22.0)	(20.1)	(18.9)
Debt outstanding (end of period)	11,615	12,447	12,838	12,792	12,582	12,170	11,512
As percent of GNP	(35.3)	(39.3)	(38.0)	(35.4)	(32.5)	(29.3)	(25.9)
Scenario II (A)							
Current account deficit	2,182	1,913	1,892	1,740	1,709	1,650	1,551
In percent of GNP	(6.6)	(6.0)	(5.6)	(4.8)	(4.4)	(4.0)	(3.5)
Gross borrowing	2,191	1,991	1,813	2,020	2,420	2,351	2,400
Net borrowing	1,415	1,111	818	585	465	312	111
Debt service 2/	1,845	1,895	2,115	2,550	3,118	3,238	3,507
Amortization	776	880	995	1,435	1,955	2,039	2,289
Interest	1,069	1,015	1,120	1,115	1,163	1,199	1,218
Debt service ratio 3/	(19.1)	(19.7)	(19.9)	(21.7)	(23.9)	(22.4)	(21.9)
Debt outstanding (end of period)	11,615	12,726	13,544	14,129	14,594	14,906	15,016
As percent of GNP	(35.3)	(40.2)	(40.1)	(39.1)	(37.7)	(35.9)	(33.8)
Scenario III (A)							
Current account deficit	2,182	2,028	2,067	2,068	2,137	2,191	2,222
In percent of GNP	(6.6)	(6.4)	(6.1)	(5.7)	(5.5)	(5.3)	(5.0)
Gross borrowing	2,191	2,106	1,988	2,348	2,848	2,906	3,122
Net borrowing	1,415	1,226	993	913	893	853	782
Debt service 2/	1,845	1,975	2,205	2,743	3,357	3,545	3,917
Amortization	776	880	995	1,435	1,955	2,053	2,340
Interest	1,069	1,095	1,210	1,308	1,402	1,492	1,577
Debt service ratio 3/	(19.1)	(20.6)	(20.9)	(23.6)	(26.1)	(24.9)	(24.9)
Debt outstanding (end of period)	11,615	12,841	13,884	14,747	15,640	16,492	17,247
As percent of GNP	(35.3)	(40.6)	(41.0)	(40.8)	(40.4)	(39.8)	(38.9)

1/ Case A assumes that errors and omissions will decline from an outflow of $268 million in 1984 to $200 million in 1985 and zero in 1986-90. Nondebt capital flows are assumed to grow by 3 percent in volume terms per annum (except for scenario I(A), in which 10 percent volume growth is assumed for 1985).

2/ Amortization assumes loans with 8 years' maturity and a 4 year grace period; excludes suppliers' credits.

3/ Debt service payments as percent of total current account receipts.

Table 3. Greece: External Debt Scenarios, 1985-90--Case B 1/

(In millions of U.S. dollars except otherwise indicated)

	1984	1985	1986	1987	1988	1989	1990
Scenario I (B)							
Current account deficit	2,182	1,703	1,551	1,241	1,211	1,156	1,074
In percent of GNP	(6.6)	(5.4)	(4.6)	(3.4)	(3.1)	(2.8)	(2.4)
Gross borrowing	2,191	1,810	1,734	1,819	2,261	2,218	2,301
Net borrowing	1,415	930	739	384	306	201	67
Debt service 2/	1,845	1,887	2,093	2,517	3,069	3,153	3,383
Amortization	776	880	995	1,435	1,955	2,016	2,234
Interest	1,069	1,007	1,098	1,082	1,114	1,137	1,149
Debt service ratio 3/	(19.1)	(19.2)	(19.1)	(20.6)	(22.8)	(21.2)	(20.6)
Debt outstanding (end of period)	11,615	12,545	13,283	13,667	13,973	14,174	14,242
As percent of GNP	(35.3)	(39.6)	(39.4)	(37.8)	(36.1)	(34.2)	(32.1)
Scenario II (B)							
Current account deficit	2,182	1,913	1,896	1,778	1,777	1,756	1,702
In percent of GNP	(6.6)	(6.0)	(5.6)	(4.9)	(4.6)	(4.2)	(3.8)
Gross borrowing	2,191	2,020	2,079	2,355	2,827	2,844	3,025
Net borrowing	1,415	1,340	1,084	920	872	802	695
Debt service 2/	1,845	1,897	2,131	2,592	3,194	3,359	3,714
Amortization	776	880	995	1,435	1,955	2,043	2,330
Interest	1,069	1,017	1,136	1,157	1,239	1,316	1,385
Debt service ratio 3/	(19.1)	(19.7)	(20.1)	(22.0)	(24.5)	(23.2)	(23.2)
Debt outstanding (end of period)	11,615	12,755	13,839	14,759	15,632	16,433	17,129
As percent of GNP	(35.3)	(40.3)	(41.0)	(40.8)	(40.4)	(39.6)	(38.6)
Scenario III (B)							
Current account deficit	2,182	2,028	2,071	2,111	2,217	2,316	2,400
In percent of GNP	(6.6)	(6.4)	(6.1)	(5.8)	(5.7)	(5.6)	(5.4)
Gross borrowing	2,191	2,135	2,254	2,689	3,267	3,418	3,774
Net borrowing	1,415	1,255	1,259	1,254	1,312	1,361	1,393
Debt service 2/	1,845	1,976	2,221	2,792	3,444	3,684	4,151
Amortization	776	880	995	1,435	1,955	2,057	2,381
Interest	1,069	1,096	1,226	1,357	1,489	1,628	1,770
Debt service ratio 3/	(19.1)	(20.6)	(21.1)	(24.0)	(26.8)	(25.9)	(26.4)
Debt outstanding (end of period)	11,615	12,870	14,129	15,383	16,695	18,056	19,449
As percent of GNP	(35.3)	(40.6)	(41.9)	(42.6)	(43.1)	(43.5)	(43.8)

1/ Case B assumes that errors and omissions remain negative at $200 billion in 1985-90 and that nondebt financing does not grow in real terms during this period.

2/ Amortization assumes loans with 8 years' maturity and a 4 year grace period; excludes suppliers' credits.

3/ Debt service payments as percent of total current account receipts.

Basic Data

Total area	132,000 sq. kilometers
Population (mid-1981)	9.7 million
GNP per capita, 1983	US$3,560

	1981	1982	1983	1984	1985 1/
The domestic economy		(Percentage change)			
National account indicators (real terms)					
GDP	-0.3	-0.1	0.3	2.4	2.5
Private consumption	1.1	2.0	0.6	1.4	1.2
Public consumption	6.8	1.9	2.4	3.5	3.5
Gross fixed investment	-7.8	-1.5	-1.4	-1.4	2.3
Private investment	-10.3	-4.5	-6.3	-5.0	1.0
Public investment	0.1	6.9	10.9	6.0	5.5
Exports of goods and services	-4.1	-9.0	9.7	11.4	5.5
Imports of goods and services	3.4	5.0	2.6	3.0	3.5
Prices and wages					
GDP deflator	19.3	24.5	19.6	19.1	...
Consumer prices	24.5	21.0	20.5	18.5	16.0
Administered prices	19.6	17.2	20.7	16.0	...
Market determined prices	26.3	22.3	20.1	19.4	...
Average hourly wages in manufacturing	27.2	33.5	19.4	26.4	...
Unit labor costs in manufacturing	26.6	37.6	18.4	23.3	...
Unemployment rate (in percent)					
Total	4.0	5.8	7.8	8.1	8.3
Urban and semi-urban	5.5	7.1	10.2	10.5	...
Indicators of fiscal policy			(In percent of GNP)		
Central Government:					
Revenues	20.9	24.7	26.6	27.4	29.4
Expenditures	33.4	34.2	36.7	37.5	39.5
Gross borrowing requirement	12.5	9.4	10.0	10.2	10.2
Net borrowing requirement	11.5	8.6	9.2	9.0	9.1
Consumer goods and special management accounts (deficit) 2/	2.2	1.8	0.3	1.6	--
Public enterprises' net borrowing requirement	3.0	2.4	1.8	2.2	2.4
Public entities' net borrowing requirement	-0.2	0.6	0.4	0.6	0.6
Net PSBR (accrual basis)	16.5	13.4	11.7	13.5	12.2
Net PSBR (cash basis)	14.5	12.8	11.7	14.4	12.7
Monetary and credit aggregates 3/			(Percentage change)		
Reserve money	42.9	27.5	9.8	29.3	...
Narrow money (M1)	23.3	22.1	13.7	22.5	...
Broad money (M3)	34.7	29.0	20.3	29.1	23.2
Domestic credit (net)	36.4	30.7	19.8	25.2	19.8
Private sector	26.3	24.2	17.2	20.7	18.0
Public sector	55.1	40.4	23.2	30.8	21.7

1/ Official projection as of February 1985.

2/ In general, covers working capital only, principally for financing of inventories and time lags in money flows; for 1984, includes operational deficit of Petroleum Account.

3/ Annual growth rates based on end of year observations.

	1981	1982	1983	1984	1985 1/
	(In millions of U.S. dollars)				
Balance of Payments					
Exports, f.o.b.	4,771	4,141	4,105	4,400	4,500
Imports, c.i.f.	-11,468	-10,068	-9,491	-9,779	-9,650
Trade balance	-6,697	-5,927	-5,386	-5,379	-5,150
(Trade balance, excluding fuel)	(-3,796)	(-3,798)	(-3,464)	(-3,225)	(-3,050)
Travel (net)	1,520	1,153	814	978	...
Transportation (net)	1,455	1,396	1,079	928	...
Investment income (net)	-589	-647	-793	-944	...
Other services (net)	653	541	644	617	...
Services balance	3,039	2,443	1,744	1,579	1,824
Private tranfers (net)	1,076	1,039	931	903	876
Of which: emigrants'remittances	(1,057)	(1,016)	(912)	(883)	(857)
Official transfers (net)	161	560	835	715	750
Of which: EC transfers	(148)	(550)	(834)	(715)	(750)
Transfer balance	1,237	1,599	1,766	1,618	1,626
Current account balance	-2,421	-1,885	-1,876	-2,182	-1,700
(In percent of GNP)	(-6.4)	(-4.9)	(-5.4)	(6.6)	(5.1)
Private capital	1,200	649	933	862	...
Of which:					
Long-term	924	585	641	479	...
Short-term	276	64	292	383	...
Official capital	736	1,130	1,371	1,622	...
Of which:					
Long-term	681	709	1,471	1,289	...
Short-term	55	421	-100	333	...
Capital account balance	1,936	1,779	2,303	2,484	...
Errors and omissions	330	-40	-357	-268	-200
Overall balance	-156	-146	70	34	...
Use of IMF credit	-74	-12	-28	--	...
Change in clearing accounts	-99	-19	-12	27	...
Change in reserves (+ = decrease/- = increase)	328	177	-30	-61	...
			(End period)		
External debt 2/					
Total external debt	8,309	9,936	10,947	12,758	...
(In percent of GNP)	(22.0)	(25.6)	(31.5)	(38.4)	...
Foreign exchange deposits 3/	4,615	4,924	5,173	5,425 4/	
(In percent of GNP)	(12.2)	(12.7)	(14.9)	(16.3)	
External debt service 4/	1,674	1,686	1,758	2,095	...
(In percent of current account receipts)	(14.9)	(16.5)	(18.3)	(21.7)	...
	(Percentage change; annual average)				
Exchange rates					
U.S. dollar per drachma	-23.1	-17.1	-24.1	-21.9	...
ECU per drachma	-3.7	-5.7	-16.3	-11.6	...
Relative consumer prices 5/	3.7	4.0	-7.8	-2.9	...
Relative unit labor costs 5/	7.1	20.8	-7.0	3.4	...

1/ Based on official estimates of February 1985.
2/ Staff estimate.
3/ Deposits with commercial banks and specialized credit institutions.
4/ Including suppliers' credits.
5/ Corrected for exchange rate changes.

Greece - Fund Relations

As of end-March 1985

I. Membership status

Greece is an original member of the Fund (December 27, 1945). Greece continues to avail itself of the transitional arrangements of Article XIV Section 2.

A. Financial Relations

II. General Department

(a) Quota: SDR 399.9 million.

(b) Total Fund holdings of drachmas:
SDR 318.5 million (79.6 percent of quota).

(c) Fund credit:
None.

(d) Reserve tranche position:
SDR 81.4 million

(e) Current operational budget:
Purchases: Not applicable
Repurchases: SDR 2.8 million

(f) Lending to the Fund: Not applicable.

III. Current Stand-by or Extended Arrangement and Special Facilities

Greece had drawings of SDR 34.5 million from its ordinary credit tranche in 1975, cumulative total drawings of SDR 155.3 million under the Oil Facility in 1974-75, and drawings of SDR 58.0 million under the Compensatory Financing Facility in 1976. Repayments of Fund credit were completed in August 1982.

IV. SDR Department

(a) Net cumulative allocation SDR 103.5 million.

(b) Holdings: SDR 0.9 million, or 0.8 percent of net cumulative allocation.

(c) Current Designation Plan: Not applicable.

V. Administered Accounts

Not applicable.

VI. Overdue Obligations to the Fund

None.

B. Nonfinancial Relations

VIII. Exchange Rate Arrangements

A managed float of the drachma has been in operation since 1975 with the exception of the period January-August 1983, when the drachma was pegged to the U.S. dollar. Although a member of the EC, Greece is at present not a participant in the European Monetary System (EMS). The drachma/U.S. dollar rate is fixed daily and official quotations for other currencies are determined daily on the basis of the official rates between the U.S. dollar and the currencies concerned. The intervention currency is the U.S. dollar.

IX. Last Article IV Consultation was concluded at EBM/84/26 (2/17/84). Greece is on a 12-month consultation cycle.

Greece - Statistical Issues

1. Outstanding statistical issues

a. Monetary statistics

As a first step in extending the coverage of financial statistics in IFS, beginning with the April 1985 issue, the institutional coverage of the sector on nonmonetary financial institutions, which previously covered only "Development Banks," was expanded to cover all the "Specialized Credit Institutions" which are reported in the Bank of Greece's Monthly Statistical Bulletin (MBS).

The authorities are currently finalizing their responses to the recommendations contained in the report of a Bureau of Statistics technical assistance mission in 1983. On the basis of these recommendations, it is hoped that the classification of the accounts of the Bank of Greece and of the commercial banks can be adapted in order to introduce a Financial Survey in IFS.

b. General economy

There are large differences between trade data compiled on a customs basis by the National Statistical Service of Greece and on a payments basis by the Bank of Greece. Problems of reconciling data on the two bases occur because of differences in coverage, timing, and valuation. For instance, the National Statistical Service does not record the import or export values of crude oil financed without exchange control informalities. This has led to substantial under-recordings of oil trade on a customs basis in recent years. Similarly, under Legislative Decree no. 2687 customs statistics exclude certain imports (machinery and equipment for domestic shipyards and other plants owned by foreign firms) and military goods. However, customs statistics for imports include all new registrations of ships under the Greek flag, while payments data only include ships purchased by resident Greek companies. Import data on a payments basis are adjusted for barter transaction and import credits; export data are adjusted for barter transactions but not for commercial credits. In custom statistics, trade is valued at the official exchange rate on the date of customs clearance, while payments data make use of the monthly average dollar-drachma rate. No reconciliation of the two sets of trade data is possible at the moment. In addition, there are unresolved problems in terms of the volume/unit value breakdown of customs data.

c. International banking

In March 1982, Greece was invited to participate in the project on international banking statistics, together with 37 other international banking centers. The Bank of Greece has expressed its support for the

Fund in this matter, but no data have yet materialized. A staff member from the Bureau of Statistics is expected to visit Greece in the spring of 1985 to discuss the project in more detail.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Greece in the April 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics, which during the past year have been provided on a timely basis, except for those on monetary accounts for which reporting has been irregular.

Status of IFS Data

		Latest Data in April 1985 IFS
Real Sector	- National Accounts	1983
	- Prices	January 1985
	- Production	November 1984
	- Employment	January 1985
	- Earnings	August 1984
Government Finance	- Deficit/Surplus	October 1984
	- Financing	October 1984
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	November 1984
	- Deposit Money Banks	Q1 1984
	- Other Financial Institutions	Q1 1984
External Sector	- Merchandise Trade: Values	November 1984
	- Merchandise Trade: Prices	January 1985
	- Balance of Payments	Q1 1984 (partial)
	- International Reserves	February 1985
	- Exchange Rates	February 1985