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November 7, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Greece - Change in Exchange Rate and Accompanying Measures

Attached for the information of the Executive Directors is a paper on a recent change in the exchange rate of the Greek drachma and accompanying measures.

Ms. Christensen (ext. 8527) is available to answer technical or factual questions relating to this paper.

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INTERNATIONAL MONETARY FUND

Greece - Change in Exchange Rate and Accompanying Measures

Prepared by the European Department and the Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by Brian Rose and J.T. Boorman

November 6, 1985

I. Introduction

On October 11, 1985 the Greek authorities announced a package of economic measures, which included a devaluation of the drachma by 15 percent, imposition of advance deposits on imports, modification of the wage indexation system, and fiscal and monetary measures. However, many decisions are yet to be taken, particularly in the fiscal field. The following description of the measures taken so far is based on information received from the Greek authorities. The last Article IV consultation discussions were held in Athens from February 18 to March 1, 1985; the Board discussion took place on May 17, 1985 (EBM/85/75). Greece continues to avail itself of the transitional arrangements of Article XIV.

II. Economic Background 1/

The economic problems facing the Greek economy stem partly from deep-rooted structural problems and partly from inappropriate economic policies. A long tradition of subsidization and protectionism and a steady decline in enterprise profits during the 1970s stifled the manufacturing sector, impeded adjustment to the second oil price shock of 1979-80, and increased the vulnerability of Greek industry to the greater competition associated with entry into the European Communities in 1981. These problems were compounded by highly expansionary policies in 1981, an election year, which contributed to a doubling of the public sector deficit (on a cash basis) to 14.3 percent of GNP, an external current account deficit of 6.4 percent of GNP, and a rate of inflation of nearly 25 percent (Table 1).

1/ The economic background is described in greater detail in Greece - Staff Report for the 1985 Article IV Consultation (SM/85/116, 4/25/85, and SM/85/116, Supplement 1, 5/13/85) and Greece - Recent Economic Developments (SM/85/122, 5/3/85).

In order to tackle these problems, the Government which came to power in 1981 opted for a "gradualist approach," which was formulated in terms of a medium-term plan for the period 1983-87. An important aim of this plan was to reduce the external current account deficit to 3-3.5 percent of GNP by 1987. This was to be achieved through a major reform of the monetary system and fiscal and industrial policies which were to promote a substantial shift from consumption to exports and investment. The initial efforts under this approach resulted in a modest reduction in the fiscal and external deficits in 1982 and 1983. However, the improvements were largely reversed in 1984, with the public sector deficit (on a cash basis) reaching 15.5 percent of GNP and the current account deficit 6.6 percent of GNP (US$2.2 billion). Moreover, private investment (including housing) continued to decline, with the fall cumulating to nearly 36 percent in volume terms since 1979. The rate of increase in consumer prices decelerated moderately since 1981 but inflation, at 18.5 percent (annual average) in 1984, remained high despite the maintenance of some price controls and slow adjustments of administered prices. External debt has increased rapidly, reaching US$12.8 billion or 38.4 percent of GNP in 1984, excluding foreign exchange deposits of US$5.4 billion or 16.3 percent of GNP. 1/ Total public sector debt amounted to 74 percent of GNP by end-1984.

Exchange rate policy has resulted in substantial swings in Greek competitiveness in recent years. 2/ From 1979 to 1982, exchange rate policy aimed at reducing the rate of inflation, leading to a real appreciation of the drachma of 8 percent between the first quarter of 1979 and the fourth quarter of 1982 on the basis of relative consumer prices, and of 36 percent on the basis of relative unit labor costs (Chart 1). 3/ The much sharper appreciation in terms of relative unit labor costs is partly the result of administrative price controls which dampened the increase in the consumer price index. The difference between movements in prices and costs indicates a severe compression of enterprise profits, which is also supported by other information on manufacturing profits. To improve competitiveness, the drachma was devalued by 15.5 percent on January 9, 1983. However, as cost and price inflation in Greece continued to be higher than in partner countries and adjust-

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1/ Foreign exchange deposits of commercial banks and specialized credit institutions are stated separately because an unknown share is held by Greek residents (including Greek seamen) and the remainder mainly by Greek workers abroad.

2/ Since 1975, a managed float of the drachma has been in operation, partially based on a basket of 15 currencies of Greece's main competitor countries. Although a member of the EC and, since July 1, 1985, also a participant in the EMS Agreement, Greece does not participate in the narrow margin arrangements within the EMS.

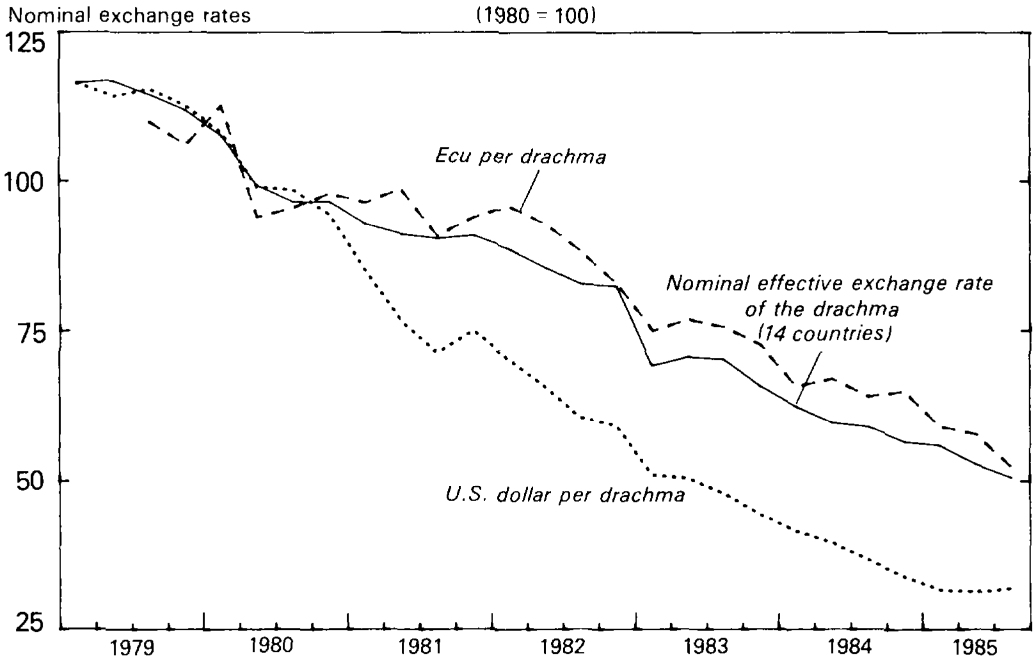
3/ Chart 1 shows real effective exchange rate developments calculated on the basis of 14 partner countries. Table 2 shows real effective exchange rate indices calculated also on the basis of 35 partner countries and EC countries.

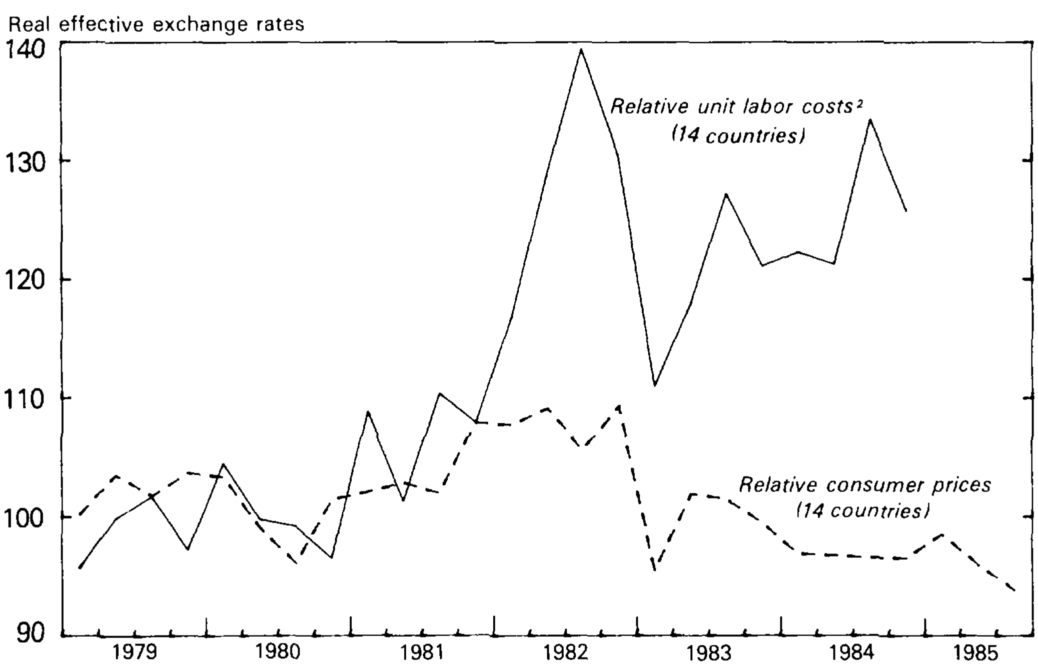
CHART 1

GREECE

EXCHANGE RATE DEVELOPMENTS[1]

(1980 = 100)





Sources: IMF, *International Financial Statistics*, and staff calculations; data for September 1985 are staff estimates.
[1]An increase (decrease) in the indices indicates an appreciation (depreciation) of the drachma.
[2]Data on unit labor costs for 1985 for Greece is not available.

ments in the nominal exchange rate lagged, the drachma appreciated again in real effective terms from January to July 1983, largely nullifying the effect of the January devaluation. Consequently, in August 1983 the authorities began a period of more active exchange rate policy aimed at strengthening competitiveness. However, only in September 1985 did the real effective exchange rate of the drachma reach the post-devaluation level of January 1983 in terms of relative consumer prices. In terms of relative unit labor costs, the value of the drachma in real effective terms in the fourth quarter of 1984 (latest data) was still 14 percent above its post-devaluation level.

III. Developments in 1985

During the Article IV consultation mission in February 1985, the authorities indicated that they expected the public sector deficit to be reduced to 12.7 percent of GNP in 1985. This was to be achieved through adjustments in the prices charged by public enterprises so as to reduce subsidies and transfers and through a significant increase in tax revenue, the latter resulting mainly from improved efficiency in the collection of current and back taxes. The reduction in the public sector deficit and the introduction of sales of treasury bills to the nonbank private sector was also expected to permit some tightening in monetary conditions. Following the adoption of stricter monetary and fiscal policies and an exchange rate policy designed to improve competitiveness, the external current account deficit was expected to be reduced to US$1.7 billion (5.1 percent of GNP) in 1985 and the increase in consumer prices to decline to 16 percent.

In the staff report issued in May 1985, the staff indicated that it considered the official forecasts for the fiscal and external deficits and the rate of inflation too optimistic in light of the policies then in place and urged the authorities to adopt measures, in particular in the areas of fiscal policy and the wage indexation system, to improve the economic situation. These suggestions were generally endorsed by the Executive Board during the 1985 consultation.

Economic developments so far in 1985 have been substantially worse than expected. The current account balance showed a deficit of US$2.1 billion in the first eight months of 1985 compared with a deficit of US$1.4 billion during the same period of the preceding year. The bulk of the deterioration occurred in the trade balance, with non-oil exports declining by 7.3 percent and non-oil imports rising by 7.9 percent in U.S. dollar terms. 1/ Receipts from shipping and workers' remittances, which have shown a declining trend since the early 1980s, have continued to fall. Tourist receipts, however, have been rising.

To some extent, the sharp deterioration in the external accounts may have been due to the anticipation of policy measures, such as a depreciation of the exchange rate and the introduction of import restrictions, to be taken after the June parliamentary elections. However, the deterioration seems also to be a result of more fundamental factors: a much larger than expected public sector deficit and the long-term impact of insufficient competitiveness. The staff now estimates that the external current account deficit will rise to US$2.8 billion (8 1/2 percent of GNP) in 1985. While private capital flows financed 40 percent of the current account deficit in 1984, they covered only 35 percent of the enlarged deficit in the first eight months of 1985, necessitating a sharp increase in external official borrowing, especially by the Bank of Greece which accounted for more than four fifths of total official borrowing of US$1.5 billion. This borrowing appears to have taken place without difficulty and without a tightening in terms. During the first eight months of 1985 (latest data), gross official external reserves rose by about US$220 million to US$1.3 billion, equivalent to about six weeks of current imports of goods and services.

Consumer prices increased by 18 percent in the first nine months of 1985 compared to the same period of 1984. Several large increases in administered prices, including electricity prices, which took place in August will boost the rate of inflation during the remainder of the year.

IV. Economic Measures

On October 11, 1985, the drachma was devalued by 15 percent. Simultaneously, an advance deposit scheme on imports was introduced with effect from October 14. 2/ The scheme requires importers to maintain a noninterest bearing deposit with the Bank of Greece for a period of six months amounting to either 40 percent or 80 percent of the value of certain categories of imports. The commodities subject to this deposit requirement correspond to about 40 percent of the total value of

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1/ The deterioration in the trade balance compared to the official projections is due in part to slower market growth than expected. In February 1985, non-oil market growth in Greece's main partner countries was expected to reach about 4 1/2 percent in 1985 compared to 5 percent in 1984. The staff now estimates that Greece's market growth abroad will be approximately 3 1/2 percent in 1985 (all figures in volume terms).

2/ A deposit scheme for imports was also in effect between December 1, 1979 and April 25, 1980, (SM/80/200, 8/18/80).

imports. Raw materials reportedly will be exempt from the deposit scheme. On the basis of the information available, it appears that the imposition of the noninterest bearing deposit requirement gives rise to a multiple currency practice subject to the approval of the Fund under Article VIII, Section 3.

Effective January 1, 1986, the wage indexation system will be changed. The present system of wage indexation, which was introduced in 1982, provides automatic wage indexation at four-monthly intervals (January, May, and September), based on the increase in the consumer price index during the preceding four months. This system provides full compensation for lower-income workers and is tapered to provide less than full adjustment for higher incomes. 1/ Under the new scheme, wages and salaries will be set every four months on the basis of an official target for the inflation rate for the following four-month period, adjusted to exclude imported inflation. The exact manner in which the target will be set and the adjustment for "imported inflation" will be made is not known; the staff's understanding is that the adjustment will be made for all imported inflation whatever the origin. The wage and salary adjustments thus determined will be the maximum legally permissible in both the public and private sectors in 1986 and 1987. Wage increases exceeding the limits will be treated as illegal and noncomplying firms will be subject to a fine and will not be entitled to deduct as costs from their profits for taxation purposes the wage increases in excess of the legal limits. In addition, the salaries of public and private sector employees which exceed Dr 150,000 (US$950) per month will not be adjusted for inflation until May 1, 1986; after that date, only the portion up to Dr 150,000 will be adjusted. The authorities expect that the new wage indexation system will result in a decline of real wages by at least 5 percent in 1986. Presumably this will be achieved through the exclusion of imported inflation, including inflation due to devaluations of the drachma, from the inflation target. Price increases for agricultural commodities will be set below the targeted rate of inflation in order to contain incomes in the agricultural sector. While the large increase in administered prices which took effect in August 1985 was reflected in the September adjustment of wages and salaries, the exchange rate depreciation of October is not expected to influence the January 1986 adjustment according to the new wage indexation scheme.

With respect to fiscal policy, the Government aims at reducing the public sector borrowing requirement by 4 percentage points of GDP in 1986. Real government consumption and investment expenditure will be reduced. A new mechanism will be established for more effective control of public expenditure. Tax revenue will be boosted as a result of (i) a

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1/ The implied reduction in real wages from this system has not materialized due to wage drift and recent changes in government salary scales. See also Greece - Recent Economic Developments, SM/85/122, 5/3/85, p. 19.

one-year surcharge ranging between 3 and 10 percent on profits and incomes of self-employed; (ii) new legislation to make tax evasion a criminal offense; (iii) gradual elimination of tax exemptions; and (iv) stricter enforcement of taxation on agricultural incomes. In addition, the deficits of public enterprises are to be reduced through further adjustment of the prices of the goods and services they provide so as to reflect operational costs, and by imposing strict credit ceilings. The following decisions were also taken in respect of a number of ailing industrial enterprises: (i) six of these firms will be liquidated; (ii) the labor force of a number of other firms will be reduced; and (iii) the nonperforming part of the debt of firms which will continue to operate will be converted into equity to be acquired in part by the National Bank of Greece and in part by a government-owned holding company. The authorities hope that these shares could be sold later to the public through the stock exchange when these firms become profitable.

A minimum lending rate was set on short-term bank loans. This rate is 1 percentage point higher than the rate on savings deposits. The new minimum lending rate, which is currently 16 percent, replaces a number of low preferential rates that ranged between 12 and 14 percent on loans to the agricultural sector and to small and medium-sized firms. In addition, the authorities have reported that a number of measures had been taken by the Bank of Greece to absorb liquidity of the banking system amounting to Dr 35 billion in 1985 (10 percent of the projected credit expansion to the private sector in 1985 according to the monetary program). The deposit requirement on imports would also lead to a decline in liquidity of at least Dr 50 billion. These measures have already contributed to a rise in the interbank money market rate.

V. Staff Appraisal

During the May 1985 Article IV consultation, the Executive Board concluded that a policy of gradual adjustment was no longer a viable alternative. Rather, it was stressed that measures needed to be put in place urgently to secure a rapid and substantial reduction in both external and fiscal imbalances and that the deep-seated structural weaknesses in Greece's industry should be tackled in a determined and comprehensive manner. Economic developments so far in 1985 have been substantially worse than expected earlier this year. While the staff has no updated information on recent fiscal and monetary developments, the sharp deterioration in the external accounts appears to be related, at least in part, to a large budget overrun and substantial monetary expansion. These developments have occurred at a time when it was most pressing to secure a considerable reduction in both the fiscal and external deficits.

The announced package of measures seems to indicate a determined effort on the part of the authorities to tackle the severe economic problems facing the economy. Many decisions have yet to be taken and at this point the staff can only form some tentative judgment. However, it appears on the basis of current information that even if these measures are fully successful in achieving the goals for 1986, the external balance will be brought back only to the level originally projected for this year. Thus, these measures represent only a first, albeit significant, step in a difficult adjustment process.

The change in the wage indexation system so as to eliminate the impact on wages of devaluations and also to make indexation adjustment forward-looking on the basis of an official inflation target is welcome. In order to improve the profit situation of enterprises and to secure the reduction in domestic absorption required for realizing the targeted lowering of the external current account deficit, it is crucial that the large reduction in real wages estimated by the authorities for 1986 be achieved. In this regard, much will depend on the level at which the authorities will set the inflation target for indexation purposes.

The intention to tighten fiscal policy sharply in the budget for 1986 is of overriding importance. Without a determined effort to tackle the fiscal problems, including the public enterprises, wage and price inflation is not likely to be controlled. Several measures have yet to be specified and it is therefore not possible to evaluate the fiscal package, which needs to be seen against the outcome for 1985 and in the context of the entire fiscal budget for 1986. The staff notes, however, the continued heavy reliance placed on administrative improvements in tax collection in the recent measures.

Cost indicators point to a considerable loss in external competitiveness in recent years at a time when entry into the EC increased competition for Greek producers. The depreciation of the drachma is an appropriate response to these developments and should help strengthen the external accounts. However, the need remains for the authorities to continue to pursue a flexible exchange rate policy, keeping developments in the external sector under continuous review so that, as a minimum, the level of competitiveness that has now been achieved will be maintained. The authorities are to be commended for their new incomes policy which should allow the exchange rate to be used effectively once again.

While the change in the exchange rate should help to restore profits in the manufacturing sector, thereby stimulating private investment and domestic production, the staff notes that the newly introduced surcharge on profits works in the opposite direction. However, the details of the tax measure are not yet known to the staff.

The staff regrets that with the substantial depreciation of the drachma, the authorities have found it necessary to introduce an import deposit scheme for a large number of import products, thereby reversing a trend toward liberalization of the trade and payments system. The effects of the scheme will be to impose a tax on imports while tightening liquidity. The staff would have preferred the use of different instruments to tighten liquidity. While the specifics of the implementation of the scheme are not known, the staff notes the possibility of unwelcome liquidity effects when the scheme is ended and therefore the risk that it will be maintained longer than intended. The staff urges the authorities to adopt policies that would permit them to achieve their balance of payments objectives and to terminate as soon as possible the import deposit scheme, which appears to involve a multiple currency practice under Article VIII, Section 3 of the Fund's Articles of Agreement. The staff will obtain more information from the authorities to examine the matter fully. In the meantime, approval by the Executive Board is not being proposed.

A full review of the policy measures and an overall assessment of recent economic developments and prospects in Greece will be conducted on the occasion of the 1986 Article IV consultation discussion with Greece, tentatively planned for May 1986.

Table 1. Greece: Selected Economic Indicators, 1981-85

	1981	1982	1983	1984	1985 1/
	(Percentage change)				
GDP	-0.3	-0.1	0.3	2.4	1.7
Private consumption	1.1	2.0	0.6	1.4	1.0
Public consumption	6.8	1.9	2.4	3.5	3.5
Private investment	-10.3	-4.5	-6.3	-12.1	-5.0
Public investment	0.1	6.9	10.9	10.9	5.0
Net foreign balance 2/	-1.4	-2.7	1.0	2.1	-0.4
Consumer prices	24.5	21.0	20.5	18.5	20.0
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	...
	(In percent)				
Unemployment rate (Urban area)	5.5	7.1	10.2	10.5	...
	(In percent of GNP)				
Net PSBR (cash basis)	14.3	12.6	11.3	15.5	...
	(Percentage change)				
Narrow money (M1)	23.3	22.1	13.7	22.5	28.3 3/
Broad money (M3)	34.7	29.0	20.3	29.4	32.7 3/
Broad money, including foreign exchange deposits 4/	35.4	29.3	24.5	30.8	33.1 3/
	(In percent)				
Interest rates (end-year)					
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	-18.3
(excluding oil)	(-10.0)	(-9.8)	(-9.9)	(-9.7)	(...)
Services balance	8.0	6.3	5.0	5.0	4.7
Transfer balance	3.3	4.1	5.1	4.9	4.5
Workers' remittances	2.8	2.7	2.7	2.7	2.0
EC transfers	0.4	1.4	2.4	2.2	2.5
Current account balance	-6.4	-4.9	-5.4	-6.6	-8.6
Errors and omissions	0.9	-0.1	-1.0	-0.8	...
External debt 6/	22.0	25.6	31.5	38.4	...
Foreign exchange deposits 4/	12.2	12.7	14.9	16.3	35.0 3/
External debt service (In percent of current receipts)	14.9	16.5	18.3	19.1	...

Sources: Data provided by the Greek authorities; and staff estimates.
1/ Staff projections as of October 1985.
2/ Change in the foreign balance in percent of GNP of the preceding year.
3/ May 1985 over May 1984.
4/ Foreign exchange deposits are held by both residents and nonresidents.
5/ Time deposits with maturity of more than one year; the interest rates depend on the size of deposits.
6/ Staff estimates.

Table 2 . Greece: Real Effective Exchange Rate Indices for the Drachma, 1975-85 1/

(Index: 1980 = 100)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1984				1985		
											I	II	III	IV	I	II	III
Relative wholesale prices																	
Trade weights																	
14 partner countries 2/	98.2	97.6	100.1	95.7	100.7	100.0	105.7	106.3	99.5	98.7	99.1	98.5	99.2	98.0	102.5	99.1	...
EC countries	98.5	99.4	101.6	97.3	100.3	100.0	110.5	110.9	105.1	105.9	105.8	105.8	106.6	106.0	111.6	106.5	...
Relative consumer prices																	
Trade weights																	
35 partner countries 3/	...	...	...	99.4	102.7	100.0	102.9	106.5	99.7	96.6	96.9	95.6	97.6	96.4	97.8	94.7	...
14 partner countries 2/	105.6	103.8	103.3	98.1	102.4	100.0	103.7	107.9	99.6	96.7	96.9	96.7	96.5	96.5	98.5	96.0	93.8
EC countries	106.1	106.9	106.6	101.8	103.4	100.0	109.1	113.7	106.6	106.0	105.5	105.4	106.0	107.0	109.9	105.9	102.6
Competitor weights 4/	101.7	102.2	104.2	102.4	102.5	100.0	104.0	108.2	103.2	99.4	101.2	100.2	98.6	97.6	98.3	97.3	...
Relative unit labor costs																	
Trade weights																	
14 partner countries 2/	81.2	86.7	95.4	95.6	98.9	100.0	107.1	128.8	119.3	125.7	122.3	121.3	133.5	125.8	...	...	...
EC countries	83.6	90.8	99.9	100.0	100.3	100.0	112.3	135.1	126.6	136.1	131.6	130.6	145.0	137.4	...	...	...
Memorandum items:																	
Nominal effective exchange rate																	
35 partner countries 3/	...	130.2	128.2	118.6	113.2	100.0	92.8	87.8	74.4	66.6	69.0	66.6	64.3	64.0	64.0	61.5	...
14 partner countries 2/	149.0	141.2	136.9	121.9	115.3	100.0	91.3	84.9	68.9	59.4	62.3	59.7	58.9	56.5	55.9	52.8	50.6

Sources: IMF, Information Notice System and International Financial Statistics; OECD, Trade by Commodities; and staff calculations.

1/ Relative price and cost indices adjusted for exchange rate changes; an increase (decrease) in the indices indicates appreciation (depreciation) of the drachma.

2/ Weights are based on Greece's bilateral trade with 14 partner countries in 1980 (Austria, Belgium, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom, and the United States).

3/ IMF, Information Notice System.

4/ These weights are derived by weighting the market shares of competitors for Greece's 32 main export commodity groups in total world exports of each commodity by the share of exports of these commodities in total Greek exports. The competitor countries included are France, Hong Kong, Israel, Italy, Korea, Portugal, Spain, Sweden, Switzerland, Turkey and Yugoslavia.