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Highlights in this issue:

- **Strong growth in recent years gave rise to emerging internal and external imbalances**
- **Adjustment channels to secure a soft landing are fiscal, income and structural policies**

How could Greece engineer a soft landing?

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Summary

In recent years, Greece has emerged as one of the strongest growing economies in the euro area. However, widening current account deficits, persistently high inflation, the prospect of temporary factors conducive to growth petering out and a progressively loosening fiscal stance have heightened concerns about macro-economic imbalances building up and hence about the long-term sustainability of Greece's macro-economic policies. While it is sometimes claimed that imbalances are no major cause for concern in a catching-up country to the extent that they ultimately serve to enhance the economy's growth potential, this interpretation may not be entirely warranted in the Greek case. The key question then becomes whether these imbalances will gradually and spontaneously unwind or whether a change in policies is needed to engineer the wished-for soft landing. This note argues that, on unchanged policies, there is a risk of widening imbalances, so that some policy reaction will be required. This could usefully consist of some combination of (i) fiscal consolidation to make room for the automatic stabilisers and put the public finances on a more sustainable footing and (ii) structural and income policies to contain inflationary pressures, rebuild competitiveness and raise the economy's flexibility and productive potential.

Setting the scene: impressive growth …

Greek real GDP growth started to outpace that in the EU from the mid-1990s. Moreover, in marked contrast to the EU as a whole, Greece continued to record very high growth since 2001 in spite of the worldwide downturn.

Table 1: The composition of growth, Greece versus euro area (1995-2003)

	1995	1997	1999	2001	2002	2003	1999-2003	1999-2003 euro area
Real GDP growth	2.1	3.6	3.4	4.0	3.8	4.1	3.9	1.8
Contributions:								
- domestic demand:	3.7	3.8	4.2	3.1	4.1	4.4	4.0	1.8
* consumption	3.0	2.4	2.1	1.9	2.6	2.4	2.3	1.6
* investment	0.8	1.3	2.4	1.6	1.4	2.2	1.9	0.6
- net exports	-1.6	-0.1	-0.8	0.9	-0.4	-0.3	-0.0	0.1

Note: 1999-2003 = average over the period
Source: AMECO

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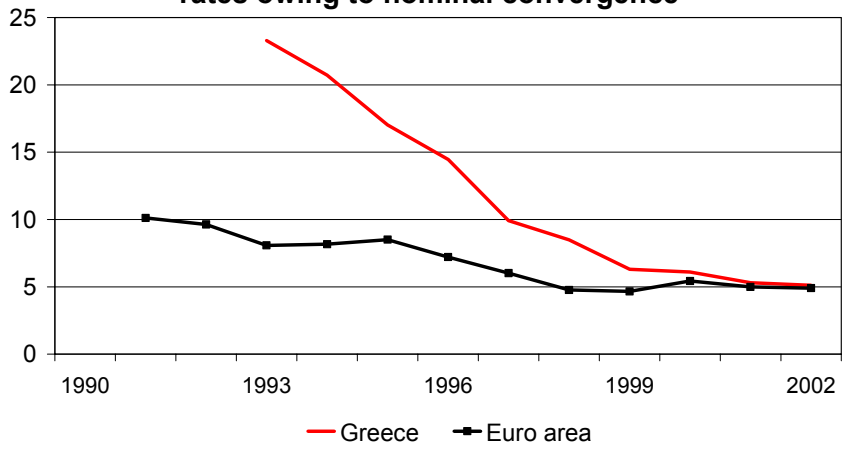
Growth benefited from a favourable constellation of factors

As shown in Table 1, Greece's impressive growth performance since the mid-1990s occurred mainly on the domestic side and reflects a combination of factors. First, a substantial drop in interest rates - owing to nominal convergence – has resulted in a level of nominal and real interest rates that is arguably too low from the perspective of the Greek cyclical situation (Chart 1). Together with an easing of credit restrictions, this has given a powerful boost to the economy. Second, after a phase of consolidation, fiscal policy has turned expansionary in spite of the buoyant state of the economy. Third, more recently domestic demand has benefited from large-scale investment activity ahead of the 2004 Olympic Games as well as from continuing large EU-transfers.

***Chart 1*: A dramatic drop in long-term interest rates owing to nominal convergence**



…coupled with internal and external imbalances …

High inflation and unemployment have a structural component

As shown in Table 2, the significant gain in real and nominal convergence has been accompanied by rising macro-economic imbalances, both on the domestic and the external side. On the domestic side, the persistent positive **inflation differential** with the rest of the euro area (though less than before) probably does not just reflect cyclical factors, but also structural ones that go well beyond the likely size of Balassa-Samuelson effects. Further, there is high structural **unemployment** and low labour mobility, which, coupled with losses in competitiveness and the relatively slow pace of deregulation in many sectors, point to substantial rigidities in labour and product markets.

Table 2: Internal and external balance, Greece versus euro area (1995-2003)

	1995	1997	1999	2001	2002	2003	1999-2003	1999-2003 euro area
Output gap (% pot. GDP)	-3.2	-2.1	-0.8	0.7	0.7	1.2	0.4	0.6
Employment growth	0.9	-2.2	0.1	-0.3	0.1	1.0	0.2	1.1
Unemployment rate (%)	9.2	9.8	11.8	10.4	10.0	9.5	10.5	8.6
HICP inflation (%)	8.9	5.4	2.1	3.7	3.9	3.6	3.2	2.0
Current account (% GDP)	-0.9	-2.1	-5.7	-5.7	-5.8	-5.2	-5.7	n.a.
GG balance (% GDP)	-10.2	-4.0	-1.8	-1.5	-1.2	-1.7	-1.6	-1.5
Primary bal. (% GDP)	2.6	5.6	6.5	5.7	4.9	4.3	5.4	2.3
GG debt (% GDP)	108.7	108.2	105.2	106.9	104.7	100.6	104.4	70.3

Note: 1999-2003 = average over the period
Source: AMECO

Two tales of the current account deficit

On the external side, the **current account deficit** is large. A widening current account deficit in a catching-up country need not be a cause for concern because of the concomitant rise in productive potential and thus in the future export earnings-generating capacity to pay off the external debt. However, the widening current account deficit may also reflect unrealistically optimistic expectations regarding future growth, warranting an attitude of caution rather than of benign neglect.

…raises issues of sustainability

The rigidities in labour and product markets hamper future growth potential because of barriers to competition and technology transfer. At the same time, relatively high inflation, very rapid credit expansion and a positive output gap point to overheating pressures. As regards fiscal policy, the current strategy of expansionary fiscal policy aimed at sustaining growth partly through the consumption channel cannot be sustained and risks becoming ineffective, especially if expectations turn negative due to a worsening macro-economic outlook and rising uncertainty about future incomes and taxes. Further, the contribution to growth from the construction boom and substantial inflows of EU funds can be expected to taper off. Finally, the substantial current account deficit and poor competitiveness will have to be addressed eventually even though within monetary union external imbalances can remain virtually unnoticed for a long time.

As some of the factors underlying the current Greek growth "miracle" are temporary and supply-side conditions are being strengthened only gradually, a slowing down of growth to more sustainable rates seems inevitable in the medium term.

Which adjustment channels are available?

The key policy question is whether the present imbalances can be expected to evaporate spontaneously or not, and, if not, how should policy respond to engineer a 'soft landing'?

Obviously, monetary and exchange rate policies are unavailable

On the menu of policy tools for a country in monetary union, neither monetary nor exchange rate policies are available to help a country deal with asymmetric shocks or to secure interregional adjustment. In the Greek case, the common monetary policy stance in the euro area is in fact unlikely to help secure a smooth adjustment in the near term. Barring a spectacular boom in the rest of the euro area and assuming a continuation of relatively high economic growth in Greece for the time being, the common interest rate is likely to remain at a lower level for some time than would be optimal for the Greek cyclical position. Nevertheless, euro appreciation may bring some offsetting tightening of the real effective exchange rate vis-à-vis third countries in view of the high share of Greek exports going outside the euro area.

Hence, the adjustment of the Greek economy needs to be brought about by other channels. The main potential adjustment channels are: (i) fiscal policy, (ii) policies to improve competitiveness, mainly incomes policy, and (iii) structural policies to improve the functioning of labour, product and capital markets and to enhance factor mobility.

There are compelling reasons to proceed with fiscal consolidation

Fiscal policy is perhaps the most obvious adjustment channel available to countries participating in a monetary union. In Greece, automatic stabilisers have been counteracted in recent years by pro-cyclical discretionary loosening up to the point where the room for manoeuvre in the event of a downturn has become very limited. In any case, given the structure of the Greek tax and benefit system, the effectiveness of automatic stabilisers is bound to be quite low. Moreover, the spell of favourable economic growth has not been used to appreciably reduce the substantial debt ratio.

Together with the need to avoid a deterioration of the fiscal balance, the high debt ratio and associated issues of sustainability, and the link between external and fiscal deficits argue for making further progress with fiscal consolidation. In the medium term, positive confidence effects and a falling interest burden owing to debt reduction could help improve the supply-side of the economy.

Review of wage-setting mechanism required

The Greek current account deficit could be reduced by **boosting competitiveness** through the real exchange rate channel, in particular through a narrowing of the price and wage inflation differential with the euro area. To this end, changes to the **wage-bargaining process** could be implemented to ensure that wages reflect productivity differentials and to contain inflationary pressures harmful to competitiveness.

High potential pay-off in the medium to long run

Structural reforms aimed at strengthening competitive forces should contribute to bringing down the inflation differential as well as improve the overall competitiveness of the Greek economy. Given that product and labour markets are relatively inflexible, however, it would be unrealistic to expect a large role for adjustment through this channel in the near term. Nonetheless, an improvement in the working and flexibility of product, labour and capital markets would increase potential economic growth and diminish the sensitivity to asymmetric shocks. In particular, productive potential would benefit from policies directed at removing mismatches in the labour market and encouraging participation and policies aimed at promoting innovation and strengthening the endowments of physical and human capital. In addition, policies to improve international factor mobility might also contribute to the adjustment.

Conclusion

The broad conclusion emanating from this note is that, on unchanged policies, there is a risk of widening imbalances. To help unwind them in an orderly fashion, some policy reaction will be required.

Among the measures that could usefully be considered by the authorities are (i) fiscal consolidation and (ii) structural and incomes policies. There are several reasons for proceeding with fiscal consolidation without delay, such as the need to reduce the very high debt ratio, to align expenditure with the revenue base and to avoid a budgetary deterioration once the current boom is over. Given the link between the public and external deficits ("twin deficits"), a reduction in the government deficit might have the additional advantage of narrowing the external deficit by freeing up resources for the tradeables sector. Further reforms in labour and product markets should be aimed at fostering more moderate wage and price increases, strengthening the overall competitive position and improving the flexibility of the economy. This would raise Greece's productive potential.

Background reading

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