HELLENIC REPUBLIC
MINISTRY OF NATIONAL ECONOMY AND FINANCE

THE 1998 UPDATE OF THE HELLENIC CONVERGENCE PROGRAMME: 1998 - 2001

JUNE 1998

I. Introduction

The Convergence Programme (CP) of Greece, approved by the Council in 1994, covers the 1994-1999 period. The CP was updated in 1997 by taking into account economic developments in the 1994-1996 period.

The successful implementation of the Convergence Programme has allowed the participation of the drachma in the Exchange Rate Mechanism (ERM) in March 1998. The entry of the drachma in the ERM reflects, on the one hand, the substantial progress achieved in recent years regarding nominal and real convergence while, on the other hand, it reaffirms the government’s commitment to bring the Greek economy in the EURO-area in January 2001, that is before EURO-notes and coins circulate in physical form.

The devaluation of the drachma upon its entry in the ERM alters the fundamental assumptions upon which the initial CP was drawn and consequently warrants an updating of certain variables in the programme. The present update is also in conformity with the framework set by the Council declaration of the 1st of May 1998 for implementing the Regulation on "the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies".

Moreover, the commitment of the Greek government to a specific time path for adopting the EURO calls for the extension of the time horizon of the updated CP in order to include the entire adjustment path of the Greek economy towards EMU until 2001.

II. Overview of developments in the Greek economy during 1997

A. Economic Performance

The progress towards convergence during the first three years of the application of the CP, namely in the period 1994 - 1996, continued unabated in 1997. The targets set in the 1997 update of the CP for the main convergence and economic indicators have been comfortably achieved as a brief inspection of Tables 1 and 2 indicates.

Although the 1997 budget was admittedly an ambitious one, it was implemented successfully. The general government deficit to GDP ratio continued its downward trend falling to 4% from 7.6% in 1996, that is to a level lower than the 4.2% target set in the CP. Most importantly the primary surplus as a percent of GDP increased from 4.1% in 1996 to 5.5% in 1997, signifying the size of the fiscal adjustment achieved. Consequently, the public sector debt, which has remained stable since 1995 at 111.8, recorded a significant drop to 108.6% in 1997 overtaking the corresponding CP target by a slight margin.

The price stability oriented monetary and exchange rate policies combined with the strong fiscal consolidation effort and a reduction in unit labour cost growth from 10.4% in 1996 to 6.5% in 1997, led to further improvements on the inflation front. Indeed, average consumer price growth fell to 5.5% in 1997 from 7.5% in 1996.

At the same time real GDP growth, which has been gradually picking up during the first three years of the CP's implementation, remained buoyant in 1997, increasing to 3.5% from 2.6% in 1996. The main factors underpinning the acceleration in the GDP growth rate have been a higher degree of policy credibility, a considerable boost in business confidence and profitability, the increased public and private capital spending and the significant fall in nominal and real lending rates over the first ten months of the year.

Table 1: *Main Convergence Indicators - Targets and Outcomes for 1997*

	1997	
Convergence Indicators	**Programme**	**Outcome**
1. Consumer Prices (private consumption deflator, percentage change)	5.9	5.5
2. Public sector deficit (general government, % of GDP)	4.2	4.0
3. Debt (general government, % of GDP)	109.0	108.6
4. Interest rate (one year Treasury Bill, year average)	9.8	10.3

The unemployment rate amounted to 10.3% in 1997, hence overshooting the target set in the CP by a tiny margin. Nonetheless, it remained stable when compared to its 1996 level mainly due to the almost equal decreases in employment and the labour force by almost 0.5% respectively.

With reference to the current account deficit, the outcome for 1997 turned out to be better than the initially forecast level of 3.5% of GDP. The current account deficit on a national account basis was finally 2.4% of GDP. Not only the current account deficit evolved at levels lower than the CP target, but it also recorded a drop of 1 percentage point in relation to its 1996 level. The realised improvement in the current account is related to the recovery in tourism, the larger growth in exports of goods and the lower fuel prices.

Table 2: *Selected Economic Indicators - Targets and Outcomes for 1997*

	1997	
Economic Indicators	**programme**	**Outcome**
1. *GDP growth* (percentage change)	3.5	3.5
2. *Gross Fixed Capital Formation* (percentage change)	11.5	10.9
3. Unit Labour Cost (percentage change)	7.6	6.5
4. Primary Expenditure of the Ordinary Budget (as percent of GDP)	20.7	21.1
5. Interest Payments (as percent of GDP)	10.4	9.5
6. Primary surplus (as percent of GDP)	6.2	5.5
7. *Current account deficit* (as percent of GDP)	3.5	2.4

8. Unemployment rate (as percent of labour force)	10.1	10.3

This benign macroeconomic performance has generated a climate conducive to the smooth operation of capital and money markets. In particular, the Athens Stock Exchange General Index almost doubled between January to late October. However, the outbreak of the financial crisis in Asia in late October 1997 disrupted the smooth functioning of Greek money and capital markets. As a reaction to the pressure from those markets, the downward trend in interest rates was abruptly reversed in November. Hence, the average interest rate on 12-month treasury bills for 1997 was 10.3% , exceeding the target of 9.8%.

B. Monetary and Exchange Rate Developments

The primary objective of monetary policy in 1997 was to reduce inflation to 4.5 percent at the end of 1997 and to below 3 percent by the end of 1998. In order to help attain this objective, the Bank of Greece announced that both an exchange rate target and a monetary target would be used. The exchange rate target aimed at maintaining the drachma broadly stable against the currencies constituting the ecu basket. The specific monetary target was for the M3 aggregate to grow within a range of 6-9 percent (Table 3). Additionally, the Bank set monitoring ranges for the growth rate of M4 (M3 plus private holdings of government securities of up to one year maturity) of 8 to 11 percent and total credit expansion of 4 to 6 percent.

During the course of 1997, the drachma depreciated by 1.7 percent against the ecu. This outcome reflected sterling's strength in the foreign exchange markets, as the drachma was either stable or appreciated against all ERM currencies; against the German mark the drachma appreciated by 0.7 percent. M3 grew by 9.5 percent (in the twelve months ending) in 1997. The year-on-year rate of growth of M3 accelerated during most of the year, reaching 17.9 percent in October. This acceleration reflected a narrowing of interest rate differentials on instruments included in M3 relative to Treasury bills and bonds, as well as the government's policy of increasing the average maturity of its debt.(**1**) Subsequently, however, M3 growth decelerated sharply, reflecting a widening of interest rate differentials in favour of longer-term maturities. The shift into longer-term maturities also affected M4 growth which turned negative (1.6 percent) during the course of 1997. Total credit expansion accelerated to 9.6 percent (from 5.9 percent in 1996), reflecting the acceleration of credit to the public sector while credit to the private sector decelerated slightly. The acceleration of credit to the public sector occurred despite a 33 percent reduction of the PSBR in 1997. The rise in credit to the public sector is attributable to a marked reduction in the portion of the PSBR financed by the private non-bank sector.

In 1997 the private non-bank sector financed 25 percent of the borrowing requirement of the central government, compared with 80 percent in 1996. The decline in the share financed by the private non-bank sector was due to the lack of familiarity of the public with the new financial instruments issued by the Treasury and to the decline in interest rates during most of 1997.

Table 3: *Inflation, exchange rate and monetary aggregates* (percentage change December on December)

	1996		1997	
	Target/ Forecast	**Outcome**	Target/ Forecast	**Outcome**
Targets				
Consumer Price Index	5%	**7.3%**	4.5%	**4.7%**
Drachma/Ecu parity	broadly stable	**-1.0%**	broadly stable(1)	**-1.7%**
Money Supply (M3)	6-9%	**9.3%**	6-9%	**9.5%***
Forecasts				
Broader Liquidity Indicator	9-12%	**12.0%**	8-11%	**-1.6%***
Total Credit Expansion	5-7%	**5.9%**	4-6%	**9.6%***

1/ The target for 1997 concerned the stability of the exchange rate of the drachma against the currencies composing the ECU and not the ECU/Drachma parity.

** Provisional data*

Economic Prospects for 1998-2001

A. The Performance of the Greek Economy during 1998

As envisaged by the CP and its 1997 update, the general government deficit is expected to decline well below the relevant Treaty criterion, to 2.4 percent of GDP in 1998. In conformity with this target, the formulation of the 1998 budget has been based on the following fundamental assumptions:

- a restrictive wage policy (2.5 percent increase)
- a strict recruitment policy (one new recruitment for every five civil servants leaving service, with the exception of education, health and the defence sectors where the corresponding ratio is 1:1)

- the modification of the system of granting state guarantees to public corporations borrowing through the introduction of strict conditionality clauses
- the introduction of a reimbursement list in order to curb pharmaceutical and health care expenses
- the introduction of discrete tax measures with an expected outcome of 0.8 percent of GDP
- the full activation of the tax-police.

The devaluation of the drachma upon its entry in the ERM last March altered the fundamentals upon which the 1998 budget was based. Therefore, the government, which remains fully committed to achieving the 2.4% general government deficit to GDP ratio in 1998, has accompanied the participation of the drachma in the ERM with the announcement of a set of additional fiscal and structural reform measures. The former concentrate principally on the expenditure side of the budget and aim at strengthening the fiscal consolidation effort, producing savings equivalent to about 0.9 percent of GDP. These savings neutralise the effects of the drachma devaluation on the budget and create a cushion against possible unexpected slippages. The fiscal measures include:

- A reduction of Ordinary Budget expenditure, amounting to about 80 billion GRD (0.22% of GDP). In particular, these concern budget transfers and other current expenditure.
- A reduction of the deficit of the public investment budget amounting to about 180 billion GRD (0.5% of GDP), mainly through restructuring and spending cuts.
- Further savings of the order of 65 billion GRD (0.18% of GDP) for 1998 and 0.8-1% of GDP in 1999 and thereafter as a result mainly of the legitimisation of illegal foreign workers and the payment of their social security contributions as well as from measures concerning the first stage of social security reform (see below).

Taking into account the above measures, the main components of the 1998 general government deficit are presented in Table 4.

The general government debt will continue to decline as a ratio to GDP for the second consecutive year and is projected to stand at 107.8% at the end of 1998. In fact, the large primary surplus and privatisation revenue are expected to outweigh the effects of the drachma devaluation and the interest rate rise in the first three months of 1998 on public debt.

Table 4 : *General Government Deficit (% of GDP)*

	1997	**1998**
1. Indirect Taxes	13.8	14.2

2. Direct Taxes	7.6	8.0
3. Social Security Contributions	12.4	12.2
4. Other Current Receipts	4.4	4.3
5. **Total Current Resources** (1+2+3+4)	38.2	38.8
6. Current Transfers	16.3	16.0
7. Actual Interest Payments	9.5	9.1
8. Government Consumption	14.6	14.4
Compensation of Employees	10.9	10.6
Current purchases	3.8	3.7
9. **Total Current uses** (6+7+8)	40.5	39.5
10. Gross Saving	-2.3	-0.7
11. Net Capital Transfers	-1.6	-2.2
12. Gross Capital Formation	3.3	3.8
13. Net Lending (+) or Net Borrowing (-) of the General Government (10-11-12)	-4.0	-2.4

The combination of the restrictive fiscal stance with the ERM-induced monetary and exchange rate discipline is expected to contain the inflationary impact of the drachma's devaluation. The government guidelines for wage moderation to the social partners and the granting of limited wage increases in the public sector aim at strengthening further the disinflation process. In fact, the conclusion of the collective wage bargaining last May is in conformity with the inflation target and is expected to nullify the second round effects of devaluation on inflation. Taking also into consideration the rather small impact the devaluation had upon inflation in the first few months following the drachma's entry in the ERM, it is estimated that the average consumer price inflation will decline to about 4.5% in 1998 from 5.5% in 1997.

Real GDP growth is envisaged to remain stable at 3.5% in 1998. This implies a (small) downward revision of the previous GDP growth projection for 1998, as the devaluation of the drachma and the accompanied fiscal measures are expected to curtail domestic demand. Thus, private consumption is expected to record only a 1.8% increase while gross fixed capital formation will grow by 10.7%, instead of the 13% increase foreseen in the 1997 update of the CP. The devaluation of the drachma is expected to have a beneficial effect on the current account since the demand for imports is projected to increase no more than 4.2% in 1998 while exports are projected to grow by 8.4%. As a result the current account deficit is projected at 2.7% of GDP, that is one percentage point lower than envisaged in the CP 1997 update (see Table 7).

B. ***Medium Term Forecasts: 1999-2001***

The assumptions made about the international economic environment are based on the latest OECD and EU Commission forecasts and are presented in Table 5. According to these forecasts, GDP growth rate in the OECD area is expected at about 2.4% during the 1998-2000 period increasing to 3% by the year 2001. In the EU, GDP growth is estimated to be 2.8% in 1998 remaining at the 3% level thereafter. The growth rates in Central and Eastern European Countries (CCEE), is expected at 2.8% in 1998 and 3.7% in the period spanning from 1999 to 2001. Over the same period, imports of goods and services are projected to increase by about 7.5% in the OECD area and around 10% in CCEE (Greek exports towards these countries more than doubled in the period 1993-1997), while export prices in the OECD area are projected to increase by 1.8% in 1998, 1.5% in 1999 and 1% for 2000 and 2001. As to the oil price, a small increase is forecast, from 15.3 US$ per barrel in 1998 to 16.3$ in 1999 and 16.5$ in 2000 and 2001. Finally, regarding the evolution of long-term interest rates, the EU average is projected to record a slight decrease from 5.4% in 1998 to 5% in 2001.

Given these international environment assumptions and the government's economic policy mix, simulation scenarios for the period 1999 to 2001 show that the improvement in the main macroeconomic indicators will continue. In particular, it is expected that the Greek economy will be able to achieve the Treaty convergence criteria in 1999, that is the public deficit, inflation, long-term interest rate and exchange rate criteria, as it was envisaged in the 1997 update of the CP. The public debt will also display a clear declining trend. The main economic indicators generated by the macroeconomic scenario are presented in Tables 6 and 7.

Table 5: *External Environment Economic Indicators*

	1997	**1998**	**1999**	**2000**	**2001**
OECD GDP growth	3.1	2.4	2.4	2.5	3.0
EU GDP growth	2.7	2.8	3.0	3.0	3.0
CCEE GDP growth	1.6	2.9	3.7	3.7	3.7
OECD Imports growth	9.6	8.2	7.5	7.5	7.5

EU Imports growth	7.7	8.1	7.0	7.0	7.0
CCEE Imports growth	11.5	11.4	10.0	10.0	10.0
Export market growth of Greece	8.8	7.5	6.7	7.0	7.0
OECD Export prices	1.0	1.8	1.5	1.0	1.0
EU Export prices	1.0	1.5	1.5	1.0	1.0
OECD Inflation	4.1	3.5	3.2	3.0	2.8
EU Inflation	2.1	1.9	2.0	1.8	1.5
EU long-term interest rates	6.1	5.4	5.5	5.0	5.0
EU short-term interest rates	4.7	4.4	4.1	4.0	4.0
Oil price ($ per barrel)	19.1	15.3	16.3	16.5	16.5

Source: *OECD and EU Commission.*

The deceleration of inflation is expected to gain further momentum as unit labour costs are expected to record moderate increases in the years ahead (the rate of increase is projected at 1.5% in 1999, 1.2% in 2000 and 1.1% in 2001). Thus, the average growth rate of consumer prices is forecast to decline to 2.5%, 1.9% and 1.7% in 1999, 2000 and 2001 respectively.

In line with the decline in inflation and the easing of inflationary expectations as a result of further macroeconomic adjustment, nominal interest rates are projected to come down gradually over the period 1998-2001. The interest rate on 12-month Treasury bills, as incorporated in the general government accounts, is projected to fall from 10.3 percent (annual average) in 1997, to 9.5 percent in 1998, 7.5 percent in 1999, 6.5 percent in 2000 and 5.5% in 2001.

In the years 1998 to 2001 the substantial correction of fiscal imbalances and the large fall in lending interest rates coupled with the steady rise in investment spending will assist in the establishment of favourable and stable conditions for a gradual acceleration of GDP growth. Over this period, the annual average rate of growth is projected to increase from 3.5% in 1999 to 4.5% in 2001. Such growth rates are estimated to be in conformity with the potential growth rate of the Greek economy taking into account the rise in productivity due to high investment growth for a number of years and the beneficial effects of structural reform, as well as the positive growth rate of labour supply due to a higher participation ratio and a constant inflow of immigrant workers (see Tables 3 and 3A of the Annex).

Investment in particular, partly financed by EU Structural Funds, will be the most dynamic component of domestic demand, since its annual average growth rate is forecast to rebound to 12.2 % in 1999 and reach 13.0% in 2001. Private consumption is expected to show only a modest increase in 1999 (1.9% annual average growth) accelerating slightly to 2.2% in 2001.

Exports of goods and services are projected to grow relatively strongly (7.4% in 1999, 7.8% in 2000 and 8.6% in 2001) due to the momentum gained through the devaluation of the drachma, the expansion of world trade and the expected recovery of tourist receipts. On the other hand, imports are forecast to recover from the 1998 setback in the years to come mainly due to the projected acceleration of domestic demand (especially investment). The projection for the annual growth rate of imports of goods and services for 1999, 2000 and 2001 is 5.9%, 6.2% and 6.6% respectively.

Table 6: *Updating of Convergence Indicators 1998-2001*

Convergence Indicators	**1998**		**1999**		**2000**	**2001**
	Progr.	**Update**	**Progr.**	**Update**	**Progr.**	**Progr.**
1. *Prices* (private consumption deflator, percentage change)	3.7	4.5	2.5	2.5	1.9	1.7
2. *Public sector deficits* (general government, % of GDP)	2.4	2.4	2.1	2.1	1.7	0.8
3. Debt (general government, % of GDP)	107.0	107.8	101.0	105.8	102.5	99.8
4. Interest rate (12 month Treasury Bills, year average)	7.7	9.5	6.5	7.5	6.5	5.5

The general government deficit is projected at 2.1% in 1999, while it is expected to decrease further to 1.7% in 2000 and 0.8% in 2001. The deficit forecast in the final year of the programme (2001) is fully consistent with the basic principle of the Stability and Growth Pact, as specified in the Commission document II/399/98-EN of 17 June 1998, entitled "Some Operational Aspects for Member States' Implementation of the Stability and Growth Pact" (see in particular Table A11, Annex II of the same document). Taking also into account that the expected deficit of the capital account in 2001 is more than 2% of GDP (see Annex, Table 6A), an expected general government deficit of 0.8% of GDP in 2001 implies a substantial surplus (about 2% of GDP) on current general government transactions. The ratio of public revenue to GDP is forecast at 38.9% in 1999, 38.8% in 2000 and 38.6% in 2001, while general government expenditure as a percent of GDP is expected to decrease gradually from 39.5% in 1998 to 36.6% in 2001. In particular, the targets set for the primary surplus to GDP ratio are among the highest, if not the highest, in the European Union; 6.9% in 1999, 6.9% in 2000 and 6.8% in 2001.

The attainment of the above fiscal targets relies in the strengthening of the fiscal consolidation effort as expressed in the planned medium to long-term budgetary and state-sector reform. This is focused on the expenditure side and includes:

- The reduction of government consumption in real terms. Specifically this variable is targeted to decline by 0.5, 0.2 and 0.3 percent in real terms in 1999, 2000 and 2001 respectively (see Annex, Table 1).
- The reduction of the wage bill as a percent of GDP through (a) the same recruitment policy as the one adopted in the 1998 budget and (b) a strict wage policy based on expected inflation.
- The merger and/or the elimination of hundreds of local authorities. The relevant law has already been adopted.
- The merger and/or the elimination of one hundred and seventy public organisations (such as hospitals, social security funds etc). The relevant law has also been adopted.
- The introduction of part-time work in the public sector and the gradual elimination of over-time work (the relevant legislation is to go through parliament this summer).
- The modification of the legal status of public organisations into public corporations or joint stock companies in order to be able to compete more flexibly in the market place. The relevant law has also been adopted.

Interest rate convergence both in the short and long end of the yield curve between Greek government bills and bonds and the EURO-area ones will also assist in reducing the deficit to GDP ratio. However, the current scenario is a prudent one, since it underestimates the full effect of interest rate convergence on interest payments. Although Treasury bill rates are forecast to fall to 5.5% in 2001 from 9.5% in 1998 resulting in a *ceteris paribus* reduction of interest payments to GDP ratio of at least 2.7 percentage points, the current fiscal scenario forecasts a reduction of interest payments to GDP ratio of only 1.3 percentage points.

Table 7: *Selected Economic Indicators 1998-2001*

	1998		1999		2000	2001
Economic Indictors	**Progr.**	**Update**	**Progr.**	**Update**	**Progr.**	**Progr.**
1. GDP growth (percentage change)	3.7	3.5	4.1	3.7	3.9	4.5
2. Gross Fixed Capital Formation (percentage change)	13.0	10.7	14.1	12.2	12.1	13.0
3. *Unit Labour Cost* (percentage change)	4.5	3.5	3.0	1.5	1.2	1.1
4. General Government Current Revenues (as percent of GDP)	40.1	38.8	40.3	38.9	38.8	38.6
5. General Government Current Expenditure (as percent of GDP)	42.5	39.5	42.4	38.9	38.1	36.6
6. Primary surplus (as percent of GDP)	6.9	6.7	6.6	6.9	6.8	6.9
7. Current account deficit (as percent of GDP)	3.7	2.7	3.9	2.7	2.6	2.5
8. Unemployment rate (as percent of the labour force)	9.7	9.8	9.3	9.3	8.6	7.5

The combination of high primary surpluses, faster GDP growth rates, proceeds from privatisation and lower real interest rates results in a sizeable reduction in the public debt to GDP ratio. The debt to GDP ratio is projected to fall to 105.8% in 1999, 102.5% in 2000 and 99.8% in 2001.

The expansion of economic activity in the 1998 - 2001 period along with the structural changes in the labour market and the implementation of the National Employment Action Plan from 1999 onwards, are expected to result in a reduction of the unemployment rate. Employment is expected to increase by 1.0% in 1998, 1.1% in 1999, 1.2% in 2000 and 1.7% in 2001, a rise which is sufficient to achieve a modest reduction in unemployment. In fact, the unemployment rate is forecast to decrease from 10.3% in 1997, to 9.8% in 1998, 9.3% in 1999, 8.6% in 2000 and 7.5% in 2001.

C. Monetary Policy during 1998-2001

The primary target of monetary policy during 1998 to 2001, as determined by the law granting independence to the Bank of Greece and as provided in the Bank's Report on Monetary Policy to Parliament, is price stability([2]). In this connection, the Bank stated that--in line with the generally accepted definition--an acceptable degree of price stability is achieved when inflation does not exceed two percent. In its Report to Parliament, the Bank affirmed that it aims to achieve its price-stability objective by the end of 1999. This time horizon for achieving price stability has been determined, firstly, by taking account of the lags through which monetary policy affects price developments and economic activity and, secondly, by taking account of the expected effects of the drachma's devaluation (in March 1998) on inflation in the short-run. According to the Bank's Report, during 1998 monetary policy will aim at containing inflationary pressures and re-establishing as soon as possible the downward trajectory of inflation.

As also stated in the Bank's Report to Parliament, the implementation of monetary policy during the period 1998-2001 will also have to take into account the new operational framework stemming from the participation of the drachma in the ERM. In this connection, the Report noted that the main intermediate target of monetary policy will be to maintain the drachma broadly stable against the other currencies participating in the ERM and, beginning in 1999, against the EURO. According to the Report, in 1998 the drachma parities against the other ERM currencies will be maintained close to their central rates and, in any case, parities are not expected to deviate from those rates by more than 2 1/2 percent on average during the year. It should be noted, however, that because inflation reduction is the over-riding objective of monetary policy, the Report stated that in 1998 the exchange rate may be allowed to appreciate by more than the 2 1/2 percent band. Such an appreciation above the central rate is considered to be consistent with the Commission's interpretation of the exchange rate criterion in May. Following the drachma's entry into the ERM, the drachma appreciated by more than 5 ½ percent above its central ecu rate due to increased market confidence and the positive interest rate differential on drachma denominated financial instruments. This appreciation is consistent with the policy of bringing inflation down to below 2 percent by the end of 1999 and underlies the maintenance of interest rates at relatively-high levels.

The importance assigned to the stability of the drachma in the ERM, along with complete capital market liberalisation and innovation in financial markets, have led to a de-emphasis on the usefulness assigned to targets for the monetary and credit aggregates. Consequently, the Bank's Report to Parliament did not set a monetary target for 1998. However, since changes in the quantity of money and in liquidity, as well as in bank credit, provide (under certain conditions) information on the factors that affect the development of inflation and inflation expectations, in its Report to Parliament the Bank stated that it will continue to carefully monitor developments in the basic monetary and credit aggregates. In this connection, the Bank has set monitoring ranges for M3 growth of 6 to 9 percent and total credit expansion of 4 to 6 percent. In the absence of financial innovation, these monitoring ranges are considered to be consistent with the disinflation process. Additionally, the Bank also noted that it will continue to monitor a series of other indicators which provide information on inflation developments, particularly core inflation. Specifically, the Bank will monitor indicators which provide information on conditions in the labour market and on aggregate supply and demand, such as the unemployment rate and capacity utilisation.

While the stance of monetary policy in 1998 is targeted to further reduce inflation, the Bank's Report to Parliament noted that the stance of monetary policy is also expected to be compatible with an increase of real GDP of 3.5 percent. In this connection, maintaining the drachma's exchange rate close to its central rate in the ERM, in combination with the further deceleration in inflation, means that the economy will benefit from the significant improvement in competitiveness, which will contribute to an increase in the domestic production of tradable goods. This outcome is expected to have positive effects on employment.

Real rates at the short end (i.e., under one year) are currently around 8 percent. During the years 1998 to 2001, interest rates are expected to follow a declining pattern. The following factors are expected to lead to significant reductions in interest rates across the maturity spectrum : (1) the deceleration of inflation; (2) the further improvement in the fiscal balances; and (3) the further reduction in the exchange rate risk premium, particularly with the approach of Greece's entry in the EURO area. With regard to specific interest rates, by the year 2001 the nominal rate on twelve-month Treasury bills is projected to fall to about 5.5 percent (or about 3.6 percent in real terms). The yield on 10-year government bonds is expected to decline to about 6.4 percent (or 4.5 percent in real terms). These interest rate trajectories are considered to be in line with developments in other Member States in the convergence process leading up to Stage Three of EMU. Therefore, by reducing inflation, monetary policy aims to provide for an environment conducive to sustainable economic growth.

IV. Structural Adjustment

In order to secure the participation of the drachma in the EURO- area on 1st January 2001 and to promote real convergence with the Member Sates in the European Union, a rapid progress in structural reform is required. In this context, structural adjustment will focus upon the following areas:

A. Wages and labour market flexibility

The government has decided to introduce a series of measures in order to increase the flexibility of the labour market. These include:

- Annualisation of working time, which allows more flexible use of working hours without extra costs.
- Introduction of part-time work in the public sector.
- Strengthening the local and company level of the wage bargaining process, especially in areas of high unemployment.
- Elimination of restrictive labour practices in public corporations to ensure higher flexibility and productivity (the Parliament has already voted the relevant legal framework).
- The legitimisation of private labour (job-seeking) offices.

Legislation enacting the above measures will be introduced in June 1998.

B. Privatisation

Twelve public corporations and five state-controlled banks have been scheduled for privatisation, including the transfer of management in certain cases, in 1998 and 1999. Since the beginning of the current year, the Macedonia and Thrace Bank and the General Bank have already been privatised, following the second tranche of the Hellenic Telecommunication Organisation last year.

The corporations that will follow and the indicative timetable are :

- The Public Petroleum Corporation (June 1998),
- The Duty Free Shops (June 1998),
- A third tranche of the Hellenic Telecommunication Organisation (September 1998),
- The International Exhibition Centre in Thessalonika (October 1998),
- Olympic Catering (November 1998),
- The Corinth Canal (November 1998),
- The Athens Stock Exchange (December 1998),
- The Athens Water Supply Company (March 1999),
- The Thessalonika Water Supply and Sewage Organisations (May 1999),
- The Horse-racing Organisation (June 1999),
- The Thessalonika Harbour Organisation (June 1999),
- The Pireaus Harbour Organisation (September 1999).

The remaining state-controlled banks due to be privatised following the privatisation of the Macedonia and Thrace Bank as well as that of the General Bank last April are:

- The Bank of Crete (June 1998),
- The Ionian Bank (Summer 1998),
- The Bank of Central Greece (July 1998).

The expected average proceeds from privatisation accrued to the state and used to redeem general government debt are of the order of 0.8 - 0.9 percent of GDP per year, although these proceeds will be skewed towards 1998.

The privatisation programme will continue after the year 1999 with more public corporations, which currently undergo restructuring.

C. Social Security reform

The first phase of social security reform consists of the following measures:

- Penalties to contain the widespread evasion of social security contributions,
- the legitimisation of illegal foreign workers and the payment of their social security contributions,
- the merger of various complementary social security funds,
- measures to contain administrative, pharmaceutical and diagnostic costs,
- measures which impose limitations on the ability of pensioners to be employed, and
- the partial liberalisation of surplus fund management.

The second phase includes:

- the consolidation, among social security funds, of the retirement age-limits,
- the consolidation of the replacement ratios (that is the ratio of pensions to earnings) and other crucial parameters in order to secure the long-term viability and social justice of the system, and
- the introduction of complementary fully-funded occupational schemes along with the existing pay-as-you-go social security system and the existing private insurance schemes.

The first phase of social security reform will be implemented via legislation to be introduced in July 1998. The government will announce a timetable of measures at the end of 1998 concerning the second phase.

D. Restructuring of loss-making public corporations

The restructuring of loss-making public corporations (mainly in the transport, post-office and defence sectors), has already started in the context of law 2414/1996. It includes:

- the appointment of high quality international management,
- the appointment of high quality management consultants to design restructuring plans,
- the elimination of restrictive labour practises in order to increase productivity and competitiveness,
- the transfer of surplus personnel to other areas of the public sector with excess personnel demand (local authorities, public hospitals etc), and
- the formation of strategic alliances with domestic or foreign firms.

V. Conclusions

The market reception of the entry of the Greek drachma in the ERM has been beyond expectations. Up to mid-June the Athens Stock Exchange general index had risen by almost

70 percent, long term interest rates (10 year bonds) had fallen by almost three percentage points, foreign exchange reserves had increased by almost 8 billion dollars, while the drachma had appreciated by more than 5.5 percent above its ECU central rate. The reaction of markets signals the credibility of the Greek government's objective to adopt the EURO on 1st January 2001. The present update and extension of the CP describes the adjustment path of the Greek economy to the EURO area. The combination of stability oriented fiscal and monetary policies, a public investment programme financed to a large extent by the European Union's Structural Funds and a comprehensive programme of structural reform secures fiscal discipline, financial stability, sustainable growth and a sufficient level of competitiveness.

The scenario of fiscal adjustment described in the present update of the CP up to the year 2001 should be considered a prudent one and as giving a cushion for unexpected, adverse fiscal developments. Greek interest rates will ultimately converge to the EURO-area ones by 2001, implying a fall of four percentage points for Treasury Bill rates and of about two percentage points for long term interest rates, thus producing a (ceteris paribus) general government to GDP deficit reduction of about 2.7 percentage points between 1998 and 2001. However, the current scenario envisages a deficit reduction of only 1.6 percentage points, from 2.4% of GDP in 1998 to 0.8 percent of GDP in 2001, by limiting the effect of interest rate convergence on interest payments.

Competitiveness should be seen in a forward-looking way. In such a context, apart from the devaluation of the drachma last March, there are two particular factors offering considerable relative gains to the Greek economy in the following years. In fact, both of them are related to different aspects of the catching-up process.

The first is related to interest rate differential, and its eventual disappearance, between government bonds in Greece and its European Union partners. This will benefit mainly the general government budget but also the private sector through its effect on financial costs.

The second is related to the relative gains from the expected productivity increases due to a high investment ratio and structural reform. The latter has started only recently in Greece (privatisation, labour market flexibility etc.) while it is in a relatively advanced stage in the rest of the European Union.

These two factors, in combination with the government's commitment to stability oriented policies, imply further competitive gains through falling financial costs, increased productivity, stable wages, sound and sustainable growth.

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1. *This policy involved the following elements. First, the Ministry of Finance reduced the frequency of issuing Treasury bills. Second, the Ministry of Finance issued instruments of longer-maturity (such as fixed rate instruments of seven and ten years' maturity) instead of Treasury bills.*

2. *The law providing independence to the Bank of Greece was passed in the Greek Parliament in November 1997. The law, which was framed according to the provisions of the Treaty, provided for certain changes in the statutes of the Bank of Greece, including the orientation of monetary policy towards the goal of price stability. These changes in the statutes took effect following their approval by the Bank's General Shareholders at their meeting of December 20,*

1997.