

BANK OF GREECE

ANNUAL REPORT 1998



ATHENS 1999

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ANNUAL REPORT

1998

PRESENTED TO THE 66th GENERAL MEETING
OF SHAREHOLDERS ON 29 APRIL 1999
BY GOVERNOR LUCAS PAPADEMOS



ATHENS 1999

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I. FINANCIAL RESULTS FOR 1998

The analysis of the Bank's financial results for 1998 shows that total gross revenue amounted to 169.8 billion drachmas and total operating expenses to 68.6 billion drachmas. Therefore, net profits reached 101.2 billion drachmas, compared with 100.4 billion drachmas in 1997.

Pursuant to a decision by the General Council in accordance with Article 71 of the Bank's Statute, it is proposed to the General Meeting of Shareholders that –out of net profits– 2.0 billion drachmas, corresponding to 12 per cent of the Bank's capital, be allocated for the payment of a first dividend. It is also proposed that 2.8 billion drachmas be allocated to raise ordinary reserves to the same amount as capital, following its latest increase. The Council of Ministers, by its Act No. 23 of 29 May 1998, approved an increase of 2.8 billion drachmas in the Bank's capital, which was effected by the issuance of 496,622 shares at par value of 5,600 drachmas each. Under Law 2065/92, this increase was approved by the General Council of the Bank, at its meeting No. 4 of 10 April 1998. An amount of 2.3 billion drachmas of this increase represents a revaluation of the Bank's land and buildings, while 0.5 billion stems from the provisions account. Shareholders are entitled to receive one new share for every five shares held in their portfolios on 3 June 1998. Following this development, the capital of the Bank of Greece reached 16.7 billion drachmas, corresponding to 2,979,733 shares, of 5,600 drachmas par value each. The General Council also proposes the payment of an additional dividend of 2.6 billion drachmas. It is therefore proposed that a total of 4.6 billion drachmas be distributed as dividend, compared with 3.6 billion drachmas in the previous financial year. According to the above proposals, the dividend will total 1,550 drachmas per share, compared with 1,450 drachmas per share for financial year 1997.

From the balance of net profits remaining after dividend distribution, 90.7 billion drachmas shall be paid to the government in accordance with Article 71 of the Statute, compared with 94.4 billion drachmas in 1997.

An amount of 18.1 billion drachmas was allocated to increase the “special reserve for foreign exchange valuation differences”, which concerns credit differences from foreign exchange valuation (unrealised profits) related to the valuation of gold and government loans and securities with a foreign currency clause. This reserve, which is destined to amortise any future debit difference from foreign exchange valuation, totalled 102.0 billion drachmas on 31 December 1998.

Total revenue from interest, commission fees and other receipts from domestic and foreign transactions –after the deduction of interest and commission payments– increased by 5.3 billion drachmas or 3.2 per cent compared with 1997 and amounted, as mentioned above, to 169.8 billion drachmas.

Net interest and commission fees from transactions in drachmas with the government reached 238.3 billion drachmas, compared with 207.1 billion drachmas in

1997, having increased by 31.2 billion drachmas or 15.1 per cent. This increase was primarily due to interest on loans with a foreign currency clause, which resulted from the conversion into a loan of the balance of foreign exchange valuation differences, as well as to interest on investment in government paper. Specifically, interest on government paper increased by 28.1 billion drachmas, owing to an increase in the average balance of these investments, while interest on claims with a foreign currency clause increased by 29.8 billion drachmas. By contrast, interest on long-term loans fell by 12.6 billion drachmas, a considerable amount of which was converted into negotiable securities. Commission fees for the keeping of government accounts and the management of government securities also fell by 8.3 billion drachmas (compared with a 4.6 billion drachma increase in 1997). Interest paid on government deposits with the Bank of Greece rose by 5.8 billion drachmas.

Commission fees from the management of public entities' funds, which accumulate at the Bank of Greece and are invested in government paper, rose to 2.3 billion drachmas from 2.0 billion in 1997, while revenue from the management of the system for monitoring book-entry securities reached 9.8 billion drachmas, as much as in 1997.

The Bank's revenue from interest on loans to credit institutions fell by 4.5 billion drachmas compared with 1997, mainly owing to the reduction in the average debit balances of credit institutions' current accounts with the Bank of Greece and in the penalty rate which applies to such cases. The amount of interest paid to banks was considerably larger, owing to the Bank's interventions in the interbank drachma market for the absorption of excess liquidity, in order to maintain interest rates at levels consistent with monetary policy goals. Specifically, the amount of intervention-related interest payments rose by 46.0 billion drachmas, reflecting the larger average amount, compared with 1997, absorbed on a daily basis through these interventions, as well as the higher average intervention rates throughout the year. It should be clarified that the size of interventions and their cost to the Bank are related to the inflow of capital from abroad and the growth of foreign exchange reserves, whose management led to increased revenue as well. Interest paid by the Bank on other types of credit institutions' deposits (not associated with interbank market interventions) grew by 20.7 billion drachmas, mainly owing to the widening of the reserve requirement calculation basis as from 1 August 1997.

The net result between revenue and expenditure related to the Bank's foreign exchange operations was, for the second consecutive year, a credit balance and reached 148.6 billion drachmas, compared with 106.2 billion drachmas in 1997, thus demonstrating a 42.4 billion drachma or 39.9 per cent increase. As mentioned above, this development was due to increased revenue from the management of foreign exchange reserves, whose average level was considerably higher than in 1997.

The Bank's gold and foreign exchange reserves rose by \$4.9 billion, compared with a \$5.8 billion drop in 1997, and stood at \$18.2 billion at the end of 1998. It should be noted that the Bank's reserves were calculated on the basis of the drachma/US dollar parity effective on 31 December 1998 (282.570 drachmas to one US dollar, compared with

282.610 drachmas to one US dollar on 31 December 1997). Gold was valued at 65 per cent of the average purchase price in US dollars in December 1998.

The Bank's total operating expenses, excluding amortisation payments and provisions, amounted to 58.5 billion drachmas in 1998, recording an increase of 3.4 billion drachmas or 6.2 per cent, compared with 1997. Specifically, outlays for personnel remuneration and pensions rose by 2.1 billion drachmas or 5.6 per cent, compared with 3.2 billion drachmas or 9.4 per cent in 1997. The increase in personnel remuneration in 1998 was related to the recruitment of new staff, the implementation of the accord at enterprise level and to the grade and pay advancement. Contributions to employees' insurance funds rose by 0.5 billion drachmas, compared with 0.8 billion in 1997. The bulk of the increase concerned the Pension Fund, to which the Bank makes a one-off contribution for each new recruit. Other operating expenses recorded a 0.7 billion drachma rise (1997: 0.1 billion drachmas). This rise is mainly attributable to rents, purchase of books and printed matter, repair and maintenance of buildings, personnel training etc.

In 1998, the Bank of Greece recruited 49 employees, 37 of whom specialise in information technology and 4 in economics and law. During the year, 41 employees retired, while another 7 left the Bank on 1 January 1999, as they had reached the age limit for retirement. Thus, the Bank's staff increased by 8, reaching 3,175 employees on 1 January 1999.

Year 1998 was of particular importance to the Bank of Greece in terms of institutional changes: on 11 May 1998 a decision taken by the Extraordinary General Meeting of Shareholders on 22 December 1997 concerning the addition, amendment or abolition of several articles of the Bank's Statute was ratified by law and the Monetary Policy Council was established. The Council is responsible for the formulation and conduct of monetary policy, as well as for issues related to the pursuit of exchange rate policy, the operation of payments systems and the issuance of banknotes.

Furthermore, organisational and technical adjustments aimed at modernising, making more effective and strengthening the Bank's security systems continued in 1998. Appropriate steps were also taken to prepare for the introduction of the euro and for the country's entry into EMU.

The Electronic Secondary Securities Market (HDAT) started operating in May 1998, after the completion of the required infrastructure. HDAT covers all over-the-counter large-volume and large-value transactions on government securities. It is linked to the Book-Entry Securities Clearing System and ensures automation not only of the secondary but also of the primary securities market, as well as the greatest possible transparency. HDAT has created conditions for a more reliable and objective assessment of the portfolios of credit institutions, mutual funds, insurance companies and all firms required by law to assess their portfolios.

In the context of establishing the necessary conditions for conducting the common monetary policy and following an authorisation by the General Council after a proposal

by the Monetary Policy Council, the Governor of the Bank of Greece signed on 1 December 1998 three agreements with the European Central Bank. The first one sets in force the Procedure Manual for the application of the Exchange Rate Mechanism, the second allows central banks of Member States that do not yet participate in the euro area to be linked with the TARGET payment system, while the third concerns the cross-border use of instruments that ensure payments through TARGET.

Both the System for Real-Time Settlement of Payment Orders in Euro (EURO-HERMES) and the Trans-European Automated Real-Time Gross settlement Express Transfer system (TARGET) have been operating since the beginning of the year. Other major applications, namely the System for the Real-Time Settlement of Payment Orders in drachmas, the new methodology for the compilation of the Balance of Payments and the new Accounting Plan of the Bank, are about to start operating. Additionally, the Help Desk and the Information Systems' Security Unit have been established and are already operational, while an Alternative Information Technology Centre is going to be created, according to requirements set by the European System of Central Banks. Furthermore, a consultants firm has been assigned the task of planning and supervising the computerisation of works carried out by the Foreign Exchange Department, while, with the support of an external collaborator, problems related to the millennium bug are being tackled and all applications will be fully covered by the end of the year.

In the context of the renewal of mechanical equipment at the Printing Works of the Bank with a view to printing euro banknotes, a new electroplating set has been installed, which has considerably improved the quality of the banknotes produced. With existing equipment, the Works can print the smaller denominations of euro banknotes, while the forthcoming installation of a silk-screen-printing set will enable the production of higher denominations. Steps are also being taken to purchase modern equipment for the production of top-quality euro coins.

To ensure effective supervision of credit institutions and companies offering investment services, the Bank of Greece and the Capital Market Committee signed a Cooperation Protocol on 15 December 1998. In this Protocol, the Bank and the Committee defined the principles and procedures by which they will exchange information and assist each other as necessary for the best possible performance of their duties.

In 1998, the Bank of Greece kept up its contacts with the central banks of Balkan and other neighbouring countries, with a view to strengthening their cooperation. In January 1999, the Governors of the central banks of Greece and Albania signed a Cooperation Accord, which concerns the supervision of credit institutions and the timely exchange of information between the two supervising authorities.

In order to promote procedures that will allow full, more objective and fair evaluation of personnel, the Bank has carried out a study and — after taking into account experience at home and abroad — has introduced a new Evaluation Report and a Regulation for writing it. Besides, to determine more accurately the Bank's needs in personnel and schedule new recruitments, placements and promotions in a rational way,

job descriptions have been completed according to international standards, particularly those set by the International Labour Office.

As regards security, a new Regulation has been drawn up establishing the “Committee for Studying Security Issues” and determining the specific responsibilities and tasks of security personnel and relevant administrative units.

In 1998, the Bank intensified the implementation of programmes concerning personnel training in information technology systems, the global understanding and assessment of Greek and international money and capital markets, and the operation and use of new financial tools for the management of risks connected with new types of transactions. As in previous years, the Bank offered intensive language courses and sent a considerable number of employees abroad for advanced training in techniques employed in the banking industry.

During the year under review, the Bank inaugurated a series of lectures by eminent staff members of the European Central Bank and other European central banks, with a view to informing the Bank’s executives – and the broader financial sector in Greece – on issues concerning the introduction of the euro, payment systems and the conduct of the single monetary policy. Furthermore, in connection with the active participation of the Bank of Greece and other EU central banks in community programmes for the training of personnel of non-EU central banks, special training seminars were conducted for the executives of Balkan and Eastern European central banks.

Work on the maintenance and re-arrangement of the interior of the Bank’s premises continued in 1998, in order to improve working conditions and achieve a higher degree of security for installations and transactions. At the Bank’s head office, the Balance of Payments Department has been relocated, and the multifunctional rooms on the second floor have been equipped with state-of-the-art audiovisual systems. The facades of the Bank’s head office were renovated, while those of the Piraeus branch premises are about to receive similar treatment. Studies were carried out for the construction of buildings to house certain of the Bank’s branches and a suitable site was bought in Thessaloniki for the building of the new Cash Sorting, Counting and Distribution Centre.

The Bank made intensive efforts in 1998 to enhance efficiency in all spheres of competence. More specifically, it made a substantial contribution towards the further deceleration of inflation and the promotion of preparatory works for the introduction of the euro and the participation of Greece in Economic and Monetary Union. Along with the upgrading of its functions, the Bank aims to modernise faster the credit system as a whole. Thanks to their conscientiousness, diligence and loyalty, the Bank’s personnel played a prominent role in the success of these efforts.

The General Meeting of Shareholders, held on 30 April 1998, elected nine members of the Bank’s General Council: Ms C. Sakellaridi, Mr I. Gozadinos, Mr V. Droukopoulos, Mr G. Kyriopoulos, Mr P. Konstantinidis, Mr C. Liakopoulos, Mr A. Mantzavinos, Mr N. Paleocrassas and Mr I. Stratos. The term of office of Mr V. Droukopoulos, Mr A. Mantzavinos and Mr N. Paleocrassas is determined by

the Presidential Decree for the appointment of the members of the Monetary Policy Council. The term of office of the rest of the General Council members was determined, according to the transitional provision of Article 21 of the Bank's Statute, by drawing of lots at the first meeting of the General Council that was held after the Ordinary General Meeting of Shareholders.

At today's 66th Ordinary General Meeting of Shareholders, in accordance with Article 21 of the Bank's Statute, the term of office of General Council members Mr P. Konstantinidis and Mr I. Stratos expires. The General Meeting of Shareholders will thus be called upon to elect two new General Council members for a term of three years, namely until the Ordinary General Meeting of Shareholders for year 2002.

The outgoing General Council members are eligible for re-election.

II. THE GREEK ECONOMY, MONETARY POLICY AND THE FINANCIAL SYSTEM

1. INTRODUCTION

1998 was a year of difficulties as well as achievements for the global and the Greek economy. The international economic environment was marked by repeated crises in many parts of the world and by turmoil in financial markets, not only in emerging but also in some advanced economies. As a consequence of the financial instability and the recession that prevailed in a number of countries, global economic growth slowed down appreciably, from 4.2 per cent in 1997 to 2.1 per cent in 1998. At the same time, however, 1998 was marked by an historic event: the successful completion of the long process that led to European monetary union and to the introduction of the single European currency, the euro.

Several economic crises broke out last year, with important and far-reaching repercussions. In early 1998, economic conditions in Asia took a turn for the worse and the Japanese economy entered a recession. The crisis in Russia —with the devaluation of the rouble and the debt moratorium— caused a new financial upheaval and a deterioration of economic conditions in many parts of the world. Financial instability worldwide adversely affected the investment climate in Latin America and aggravated fiscal imbalances, especially in Brazil, which devalued its currency in early 1999. The extensive and continuous worsening of economic and financial conditions led to a significant slowdown in the growth of international trade and global economic activity, as well as to sharp price fluctuations in the capital markets of developed economies. The slowdown in global economic growth was restrained by robust economic activity in the United States, which continued to expand at an annual rate of 3.9 per cent, the same as in 1997, owing to strong domestic demand which offset the effects of external pressures. Economic growth in the European Union (EU) was also satisfactory (2.9 per cent), slightly higher than in 1997.

In EU countries, the most important development was unquestionably the completion of the transition to monetary union. Since the beginning of this year, the euro has been the single currency of the eleven states which participate from the start in the last stage of Economic and Monetary Union (EMU). At the same time, the European System of Central Banks (ESCB) undertook responsibility for the formulation and implementation of the single monetary policy. The changeover to the euro was smooth, owing to the high degree of economic convergence which preceded it, as a consequence of the macro-economic policies pursued by EU member states over a number of years as well as of the preparatory technical work carried out by national central banks, the European Monetary Institute and the ECB. The transition to monetary union was not affected by world economic instability. The ESCB is conducting the single monetary policy at a time when inflation rates in the eleven states which have adopted the single currency are very low. The

level of interest rates in the euro area is also at a historically low level. These developments reflect the success of anti-inflationary monetary policy in previous years and create favourable conditions for the expansion of economic activity and employment in the European monetary union.

2. THE GREEK ECONOMY: DEVELOPMENTS AND PROSPECTS

Despite the deterioration of the international economic environment and financial market volatility and although Greece did not join the euro area with the first group of EU member states, the Greek economy continued to grow at a very satisfactory pace and made further considerable progress towards stability. In the course of the year certain episodes of international financial turmoil and other isolated events caused some pressures in foreign-exchange, money and bond markets. These pressures, however, were dealt with by monetary policy measures and, in most cases, market conditions soon returned to normal. With strengthening market confidence in Greece's prospects for participating in EMU, the impact of international financial disturbances on the Greek economy was minimal, as was the case after the unrest in Brazil in early 1999.

2.1 New policy framework

The entry of the drachma into the Exchange Rate Mechanism (ERM) of the European Monetary System on 16 March 1998 was an important event, which decisively affected economic developments and the policies pursued in 1998. The significance of the drachma's participation in the ERM for the economy's performance and prospects is manifold. First, another step was taken towards fulfilling the convergence criteria as, according to the Treaty, ERM participation and exchange rate stability are prerequisites for joining monetary union. Second, ERM entry and the simultaneous devaluation of the drachma led to the weakening of pressures which had built up in foreign-exchange and bond markets mainly since October 1997 and persisted in early 1998, though to a lesser degree. These pressures had initially been triggered and then maintained by several episodes of financial turmoil in emerging Asian economies, but they also reflected market estimates of the loss of competitiveness in recent years and speculation regarding the timing of the drachma's entry into the ERM. Although pressures were kept under control, interest rates had to be kept at a high level, with adverse effects on economic activity and public finances. Third, after the drachma joined the ERM, the economic policy mix was redefined. The conduct of an appropriate macroeconomic policy in the ERM context enhanced the credibility and thus the effectiveness of policy.

The successful entry of the drachma into the ERM and its subsequent smooth participation is due to various reasons. Understanding them is important both for assessing

the macroeconomic policy pursued and for implementing the appropriate policy in the future. Successful entry reflected the meticulous preparations and consultations that preceded it. A basic element of success, however, was the selection of the central exchange rate of the drachma against the other ERM currencies. This rate was agreed on the basis of two main criteria: first, to enable the Greek economy to regain the loss of international competitiveness in previous years primarily because of an inappropriate macroeconomic policy mix, and, second, to set a stable central rate for the period until participation in monetary union. Consequently, the central rate had to be credible and consistent with sustainable external balance and a high growth rate in the medium term.

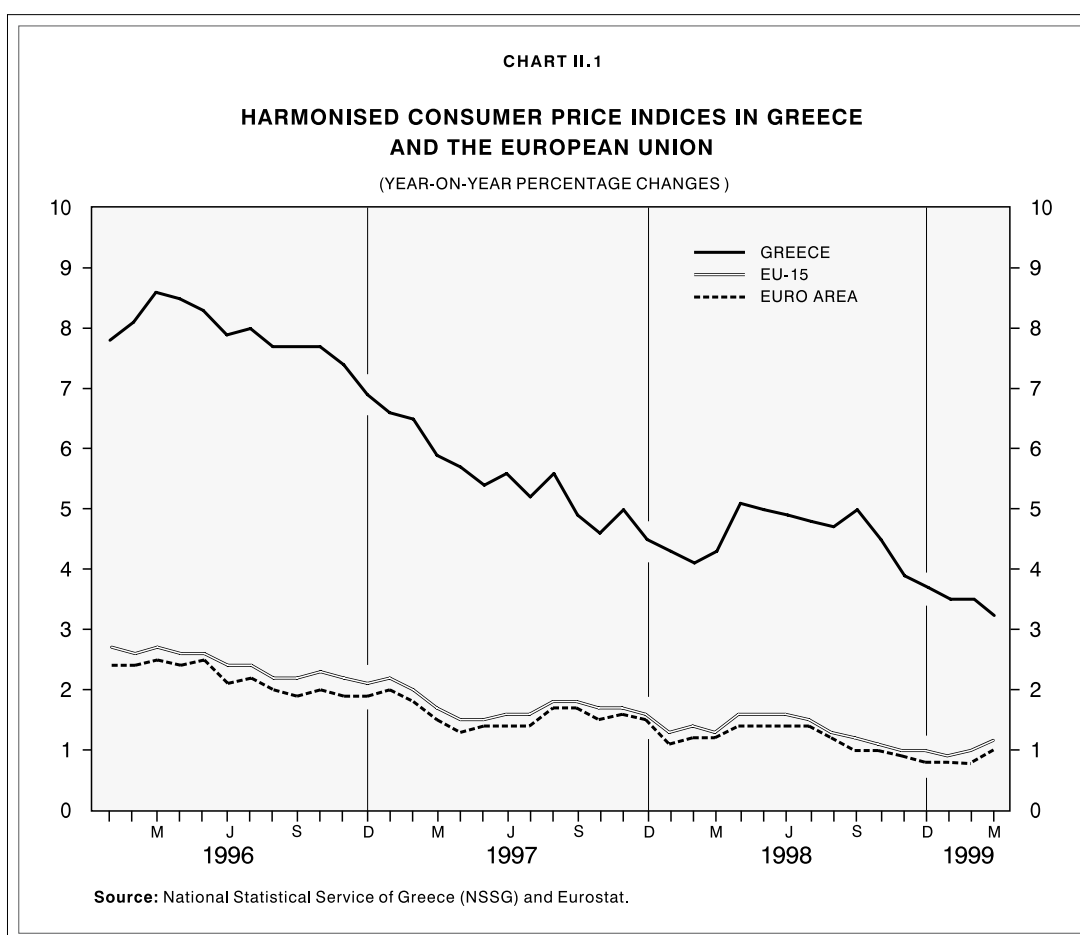
However, the most important factor for the smooth participation of the drachma in the ERM was that the economic and monetary policies pursued since joining the mechanism were stability-oriented and compatible with ERM requirements, while labour market developments were consistent with the containment of inflationary pressures and the maintenance of the competitiveness regained following the devaluation of the drachma. More specifically, immediately after the drachma's entry into the ERM, the government announced a package of measures for a faster and broader fiscal consolidation and structural adjustment, so as to speed up progress towards stability and enhance market confidence in the prospect of joining the euro area. Moreover, monetary policy retained its anti-inflationary stance and, although pressures on the drachma abated, it permitted only a gradual and limited drop in interest rates, in order to reduce and absorb the soonest possible the inflationary effects of the devaluation. Only in this way would it be possible to ensure, in the medium term, the stability of the drachma and the preservation of the regained international competitiveness of the economy.

2.2 Inflation

Inflation, as measured by the Consumer Price Index (CPI), accelerated immediately after the devaluation of the drachma in March, but resumed a downward course from June onwards and ended the year at 3.9 per cent, 0.8 percentage point lower than in December 1997. A similar slowdown was recorded in the average annual rate of CPI inflation, from 5.5 per cent in 1997 to 4.8 per cent in 1998. Core inflation, i.e. the rate of change in the CPI excluding fuels, fruit and vegetables, followed a similar course, but declined marginally during the year (December 1998: 4.9 per cent, December 1997: 5.1 per cent). As a result of these developments and of a corresponding deceleration of inflation in the EU, the inflation differential between Greece and the euro area average stood at 2.9 percentage points in December 1998, roughly as much as in December 1997 (see Chart II.1).

The inflationary effect of the devaluation of the drachma is estimated at about 2 percentage points. This effect was not limited to import prices and, through them, to the prices of domestic goods and services, but was also reflected in a widening of firms' profit margins. The adverse impact of the devaluation on inflation was more than offset, how-

ever, by the favourable effects of the economic and monetary policies pursued and of other factors; thus, headline CPI inflation decelerated in the course of 1998. Inflationary pressures abated also as a result of the favourable impact of some exogenous factors, such as the reduction in world fuel and raw material prices, the special government measures taken in the last five months of the year (e.g. a cut in indirect taxes on fuels and private passenger cars) and the promotion of “gentlemen’s agreements” with firms to contain price increases.



Inflation resumed a downward path after the devaluation of the drachma. This was largely due to the lower growth rate of unit labour costs, owing not only to the limited increase in nominal earnings but also to the continuing fast rise in productivity. Throughout the economy, unit labour costs are estimated to have increased by 4.2 per cent in 1998, compared with 7.2 per cent in 1997. In manufacturing they rose by about 1.5 per cent only.

Monetary policy contributed to the abatement of inflationary pressures and the return of inflation to a downward course. Interest rates remained at high levels and liq-

uidity was effectively controlled, in a period of large capital inflows after the entry of the drachma into the ERM. Anti-inflationary monetary policy kept the drachma strong within the ERM, restrained total expenditure growth at a rate compatible with the economy's productive capacity and had a dampening effect on inflationary expectations. The stability-oriented stance of monetary policy and the successful participation of the drachma in the ERM have favourably affected inflationary expectations and, through them, collective labour agreements.

The reduction in the general government deficit (on a national accounts basis) to 2.4 per cent of GDP in 1998, from 3.9 per cent in 1997, also weakened inflationary pressures. Specifically, the slower increase in the government's wage bill and the faster growth of direct tax revenue have contributed to containing real consumption expenditure, as shown by various indicators of consumer demand.

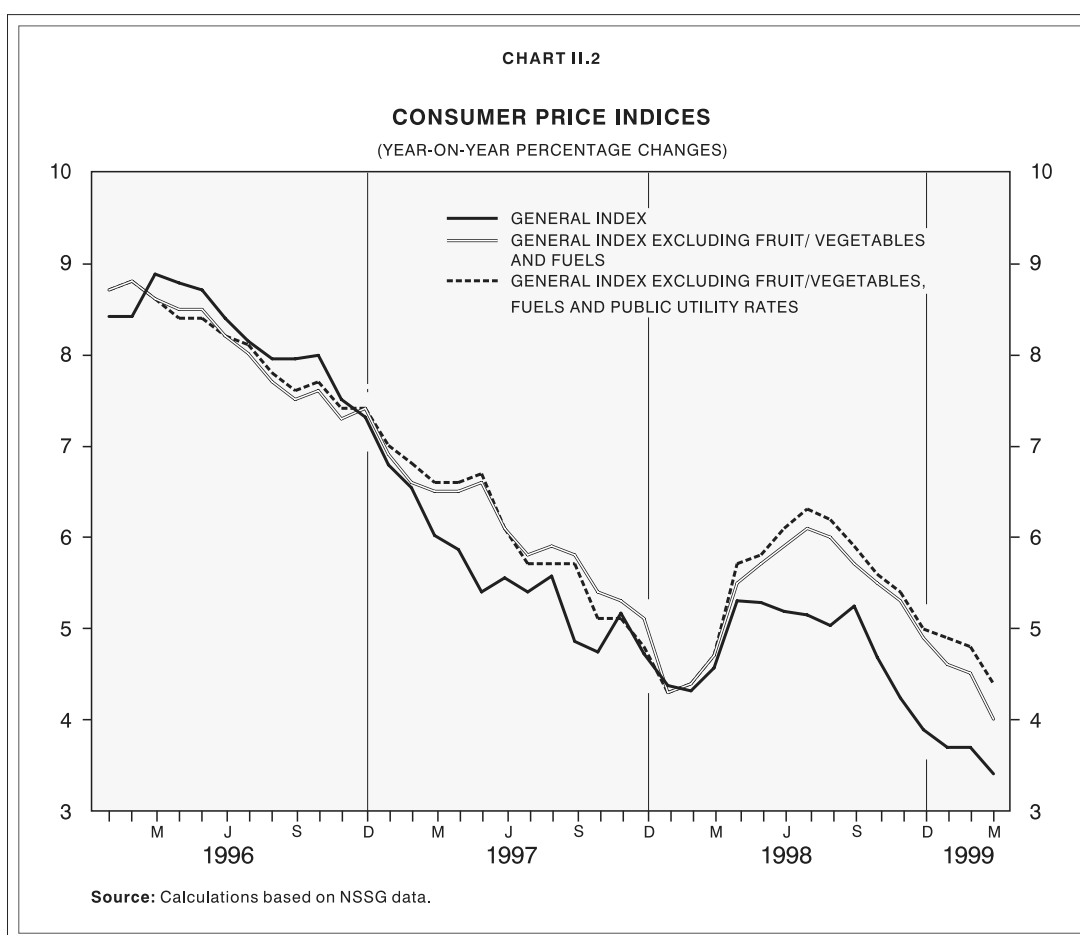
The favourable effects of the policies pursued and of labour market developments reduced the inflationary impact of the devaluation, and the twelve-month growth rate of the CPI began to decelerate gradually from June 1998 onwards. However, the deceleration of inflation in the following four months was very slow, considering the favourable effect on inflation of declining world prices of fuels and raw materials. This is corroborated by the course of core inflation (CPI excluding fuels, fruit and vegetables), which, after the devaluation, grew faster than headline CPI inflation and began to slow down from August 1998 onwards (see Chart II.2). These developments indicate that firms' profit margins widened, on average, in the April-December period of 1998.

The widening of profit margins in a period characterised by a restrained rise in consumer demand and a high unemployment rate, points to insufficiently competitive conditions in some markets, especially in the most sheltered ones. However, in the last months of 1998 and in early 1999, the profit margins of export firms declined, compared with February 1998. Nevertheless, the profit margins of industrial firms producing mainly for the domestic market remained higher than before the devaluation.

The slow abatement of inflationary pressures led the government to take special measures to accelerate the drop in inflation. In particular, cuts in the consumption tax on gasoline, heating oil and private passenger cars are estimated to have contributed 0.7 percentage point to the fall in inflation during 1998.¹ Moreover "gentlemen's agreements", providing for the containment or decrease in the prices of many goods and services, seem to have helped to curb inflation, though the price reductions recorded in the market were smaller than those specified in the agreements. It is, however, difficult to estimate the degree to which these agreements helped to lower inflation independently of the effect of economic conditions and other factors, as these agreements and the respective price adjustments occurred in a period of favourable developments in cost determinants, appreciation of the drachma, slowdown of consumer demand growth and increased profit margins.

1 Not counting the effect of the drop in the world price of oil.

Prospects that inflation will drop further and remain at a level fulfilling the respective convergence criterion in about a year from now are positive because the basic determinants of core inflation will continue to have a favourable effect. Monetary policy, as elaborated in the next section, will retain its anti-inflationary stance. Unit labour costs are forecast to grow at a lower rate (below 2 per cent) in 1999 for the whole economy and by about 1 per cent in manufacturing. The general government deficit, on a national accounts basis, is estimated to fall further to about 2 per cent of GDP. In addition, the freezing of



public utility rates and the reduction in VAT on electricity as from January will contribute to the faster deceleration of inflation; moreover, the “gentlemen’s agreements” announced last November can also help in the same direction, provided there are no significant breaches.

On the other hand, there are some factors impeding a further fall in inflation, as well as some elements of uncertainty. First, crude oil prices in the world market, which had fallen considerably in 1998, are rising this year faster than initially forecast. In mid-April, the price of crude oil exceeded \$15 per barrel, i.e. it was approximately 50 per cent high-

er than in December 1998. It can be expected, however, that, although rising oil prices may slow down the drop in inflation in Greece, they are not likely to hinder the fulfilment of the convergence criterion, as they have a similar effect on inflation in the rest of the EU. Second, the favourable effect of recent indirect tax cuts on the price level will be gradually exhausted, from September 1999 through January 2000, possibly resulting in an acceleration of inflation during that period.

The elements of uncertainty are mainly related to the prospects of domestic demand and the world economy. Regarding domestic demand, there is evidence that the “output gap” of the Greek economy is narrowing, owing to various factors (including the high expansion of consumer and housing credit), even though other factors have the opposite effect. With respect to international developments, the unchanging rate of world economic growth, sluggish economic activity or recession in some parts of the world, the possibility of international financial turmoil, as well as the Balkan crisis, are factors which may affect domestic developments in ways which could make it harder to achieve inflation convergence. However, the extent and, in some cases, the direction in which these factors affect domestic inflation and the fulfilment of the convergence criterion are difficult to assess. Moreover, fruit and vegetable prices are always an imponderable factor, as they depend largely on weather conditions. These uncertainties suggest that anti-inflationary policy must provide for adequate safety margins. Nevertheless, the Bank of Greece estimates that CPI inflation will approach 2 per cent this summer.

2.3 Economic activity and employment

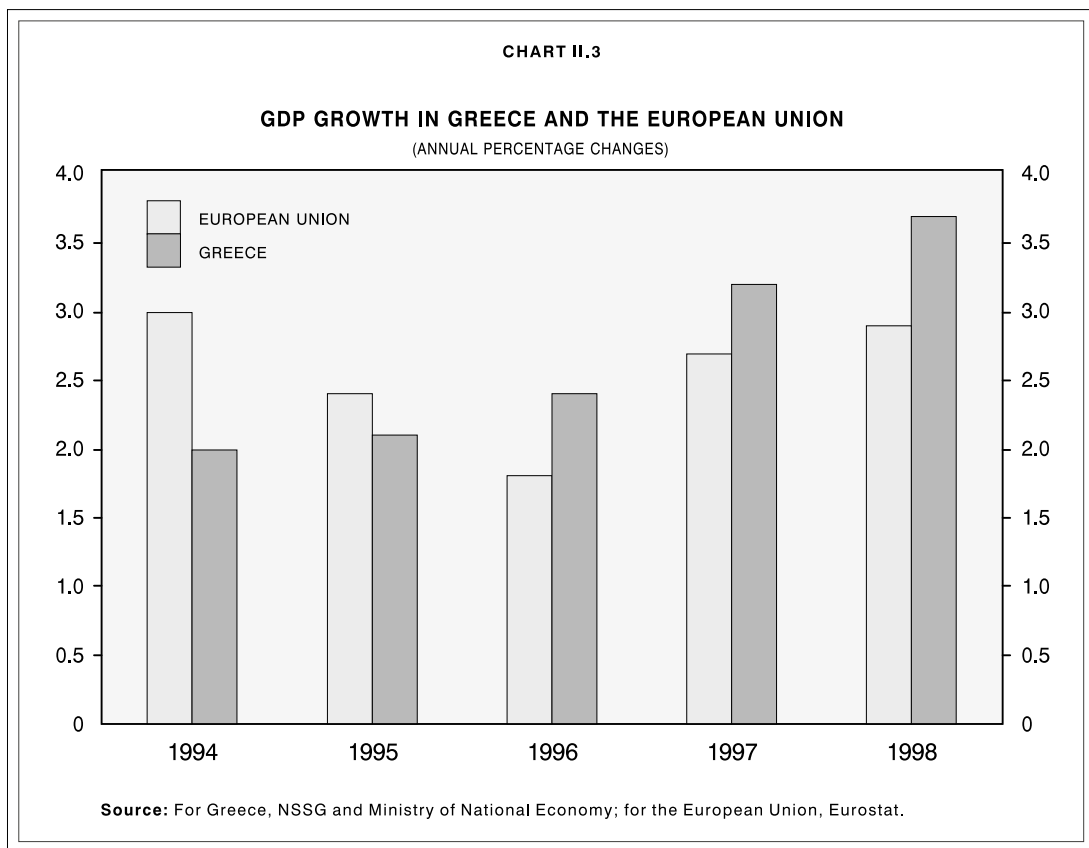
Economic activity

In spite of the conduct of a stability-oriented macroeconomic policy in Greece and the slowdown of world economic growth, domestic economic activity increased at a particularly high rate (1998: 3.7 per cent, 1997: 3.2 per cent). GDP growth accelerated, as the adverse effects of the slower increase in both domestic consumption and the world economy and international trade were more than offset by the influence of other factors, which strengthened aggregate demand and boosted domestic production. On the demand side, the significant increase in economic activity was chiefly due to the fast growth of both public and private investment. On the supply side, GDP growth was mainly due to the faster increase in industrial production and the maintenance of a high rate of growth in the construction industry. The rate of increase in GDP was, for the third consecutive year, higher than the EU average (2.9 per cent, see Chart II.3). Consequently, the Greek economy continued to move towards real economic convergence with the other EU countries.

A particularly favourable fact is that investment was the main lever of economic growth last year. Total gross fixed capital formation rose by 9.8 per cent in 1998 and accounted for 21.5 per cent of GDP. This was due not only to a large increase in public

investment, but also to increased private investment in capital equipment and housing. The cumulative rise in private investment and in public investment (including public enterprises and entities) by 40 and 43 per cent, respectively, over the four-year period 1995-1998, led to a substantial expansion of productive capacity and infrastructure, with a favourable impact on the country's development prospects, particularly that of sustainable growth combined with price stability.

The continuing fast rise in private investment and the acceleration of industrial production in 1998 were due to factors related to the economic policy pursued; they also



reflected favourable expectations with regard to the participation of Greece in the final stage of EMU. The entry of the drachma into the ERM in March 1998, its successful participation, and expectations of achieving stability and joining the euro area in 2001, have increased market confidence. Besides, these factors have underlined the need to increase and upgrade production capacity pending Greece's entry into the euro area. Another significant factor was the improvement in competitiveness in 1998, which is attributable not only to the adjustment of the exchange rate of the drachma but also to the slowdown in unit labour cost growth. International competitiveness, as calculated on the basis of unit labour costs in manufacturing, improved by about 4 per cent in 1998 and returned close to

the 1990 level. Consequently, the cumulative loss of competitiveness between 1990 and 1997 was fully recovered. A third factor, which favourably affected investment, was the further decrease in the cost of capital. This was due not only to the decline in drachma lending rates (by 1.5 percentage points) during 1998, but also to the increased recourse of firms to foreign-currency-denominated loans at a lower total cost (despite the devaluation of the drachma), as well as the raising of considerable amounts of low-cost funds through the Athens Stock Exchange. Furthermore, the continuing expansion of the activity of Greek firms in non-EU countries and the implementation of significant procurement agreements between industry and the public sector (for instance, in telecommunications) contributed to the increase in private investment and industrial production.

Public investment increased by 13.7 per cent, a rate about twice as high as in 1997 (7 per cent), owing to the faster implementation of the Public Investment Programme (PDE) of general government and the sharp rise in public enterprises' investment (1997: 25.2 per cent, 1998: 28.5 per cent, at current prices). Disbursements under the PDE increased considerably (17.6 per cent) in 1998 and the rate of absorption of resources under the second Community Support Framework (CSF) rose impressively, exceeding the EU average for the first time. This rise was due to the faster execution of CSF projects and contributed to the improvement in the balance of payments and to the strengthening of economic infrastructure, with medium-term development benefits.

Lastly, private construction activity continued to increase at a high rate in 1998. This reflected substantial cuts in interest rates on housing loans and strong demand for dwellings, which can be deduced from the large (15.5-19 per cent in real terms) rise in the prices of real estate in 1997-1998.

Overall, prospects for economic activity in 1999 are positive. According to the latest (March 1999) forecasts of the Ministry of National Economy, prior to the outbreak of the crisis in Yugoslavia, GDP is expected to grow at a high rate (3.5 per cent, compared with 3.7 per cent in 1998),¹ since the main components of domestic demand will rise roughly as much as in 1998. More specifically, public and private investment should increase at a high rate (a little lower than in 1998 for public investment and somewhat higher for private investment), while private consumption will grow by about 2 per cent. Moreover, public consumption is expected to fall slightly, owing to ongoing fiscal adjustment.

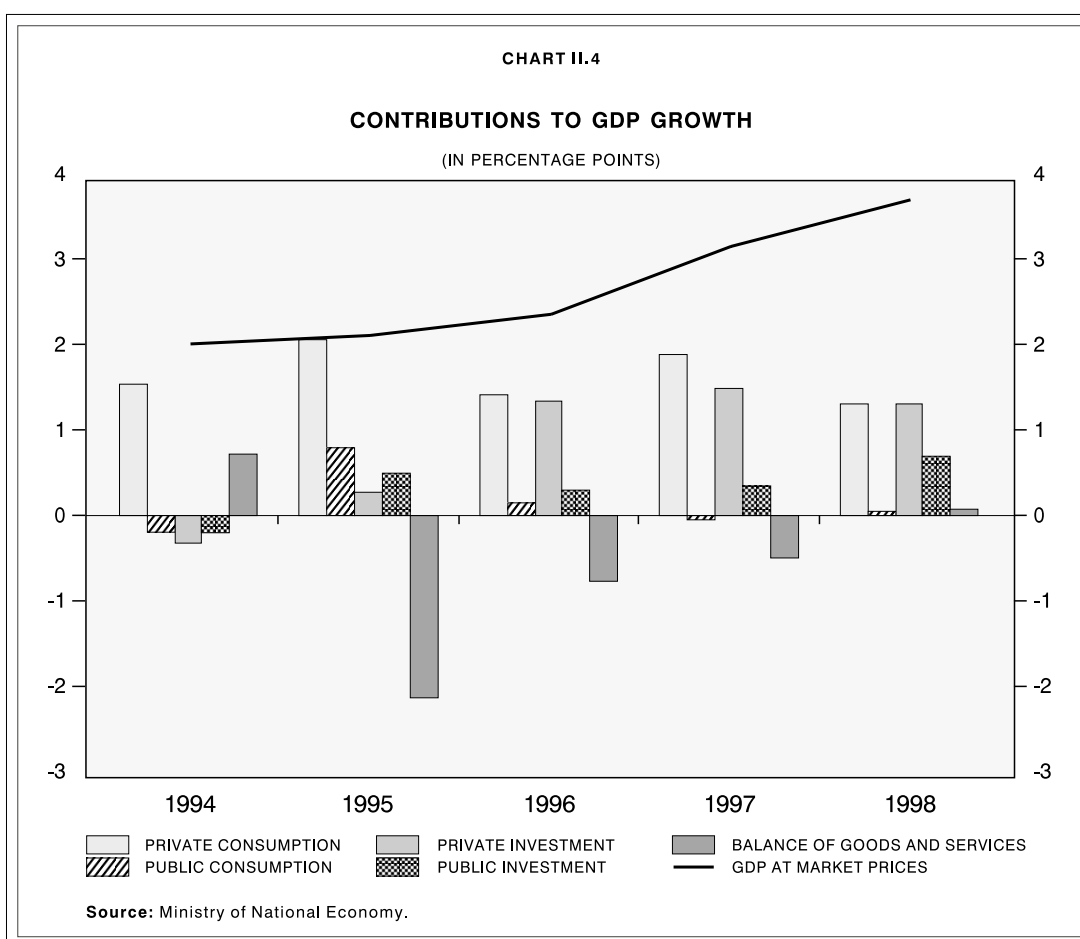
However, since the growth of the European economy (EU-15) is forecast to decelerate to 2.1 per cent this year from 2.9 per cent in 1998,² exports of goods and services (on a national accounts basis) are expected to grow at a satisfactory pace (6.5 per cent), though definitely less than last year (9.2 per cent). Therefore, considering that the growth rate of imports of goods and services is estimated to decelerate marginally, the contribution of

1 The latest forecasts by the European Commission (March 1999) and the International Monetary Fund (April 1999) on the growth of Greek GDP in 1999 are similar (3.4 per cent and 3.3 per cent, respectively).

2 European Commission forecasts (March 1999).

the foreign sector (net exports of goods and services) to GDP growth is forecast to be slightly negative, compared with a slightly positive contribution in 1998.

Moreover, it has already been pointed out that the inflow of funds from the second CSF (1994-1999) has played a crucial role in underpinning the robust growth of investment and the progress made by the Greek economy towards real economic convergence with the other EU countries since 1996. It is worth noting the following: first, almost three-fifths of GDP growth in the 4-year period 1995-1998 stemmed from the



increase in total fixed capital formation (see Chart II.4); second, the rate of absorption of funds from the second CSF (based on payments) reached 61.5 per cent at the end of 1998 (from 43.4 per cent at the end of 1997) and will exceed 80 per cent by the end of 1999.¹ Furthermore, the decisions of the Berlin European Council (24-25 March 1999) were particularly favourable to Greece, since they provide for the inflow of EU funds amounting to 25 billion euro (roughly 9 trillion drachmas) over the seven-year period

¹ The remaining funds are to be committed in the course of 1999 and absorbed in 2000.

2000-2006. This amount — on an annual basis — corresponds to about 2.5-3 per cent of GDP in the same period.¹

Although growth prospects in 1999 are on the whole positive, some elements of uncertainty still exist, as in the case of inflation. First, GDP growth in major trading partners of Greece may decelerate more than currently forecast. Second, should the crisis in Yugoslavia be protracted, it could have significant consequences for goods exports, tourism, transport and investment. If that happens, the increase in GDP will be slower than forecast,² while other economic aggregates may also be adversely influenced. In the present phase, it is not easy to assess accurately all consequences, but economic policy — using suitable means — could seek to minimise the adverse side-effects of any eventual aggravation of the crisis.

Employment

In 1998 the increase in total employment was limited and it is estimated that the rate of unemployment remained close to 10 per cent,³ though it fell slightly. Specifically, employment decreased in central government, in public enterprises and agriculture, but increased in the construction industry and in private-sector services. In manufacturing, where the growth rate of production accelerated significantly, employment decreased appreciably less than in 1997.

Developments in 1998 confirmed the basic trends observed during the last decade, i.e. the reduction in rural population, the fall in employment in the public sector (as a result of the implementation of stabilisation and consolidation programmes) and in industry (owing to restructuring), as well as the expansion of employment in private-sector services. It should be noted that between 1988 and 1998 the cumulative growth rate of GDP was 21 per cent and that of total employment 5.6 per cent. As a result, productivity improved by 14.6 per cent. At the same time, the unemployment rate rose by 2.5 percentage points.⁴ Lastly, the long-term unemployed amount to almost three fifths of the total number of jobless persons, while the rates of unemployment for young people and women are particularly high; in fact, they are higher than in the rest of the EU. However, the over-

1 If the national (public and private) funds to be allocated are also taken into account, the total amount should reach 4.5-5 per cent of GDP in the period 2000-2006.

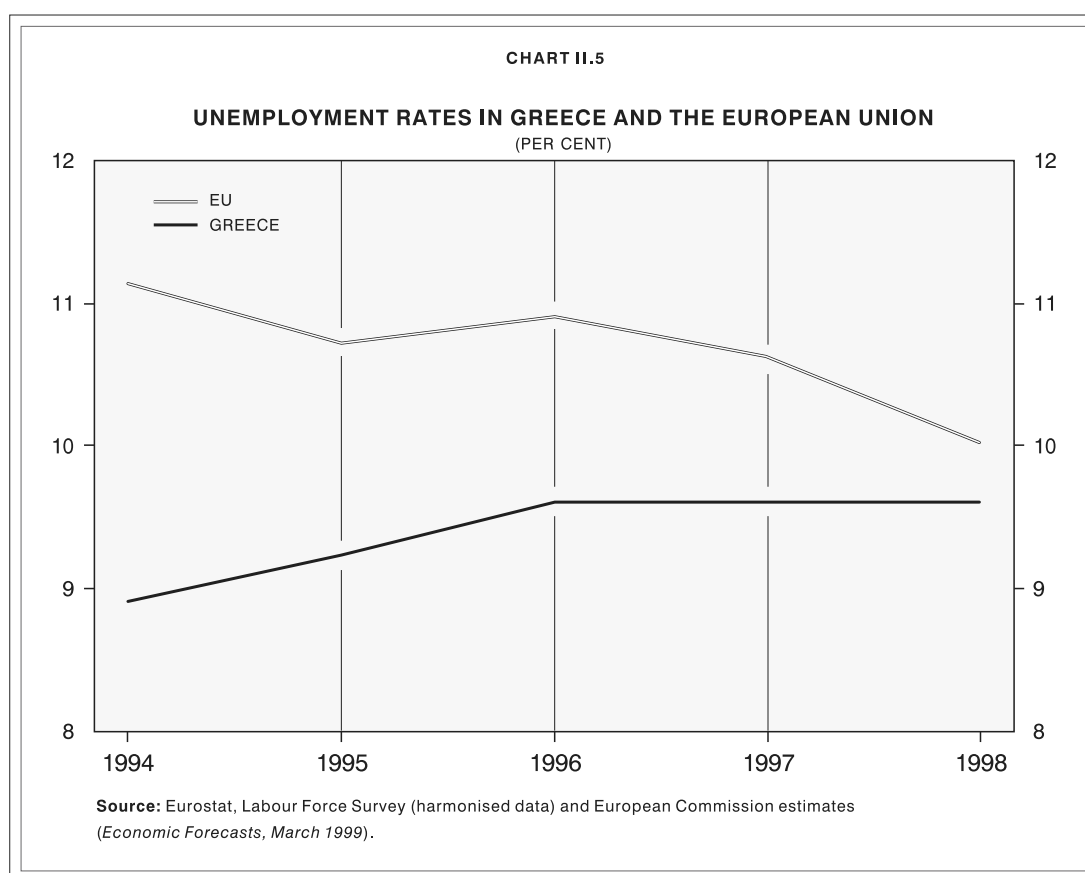
2 It should be noted that exports of goods and services (including tourism) represented 16.4 per cent of GDP in 1998. Should exports increase this year by only 3.5 per cent (instead of 6.5 per cent, according to current forecasts), the direct consequence would be that the growth rate of GDP would decelerate by half a percentage point (to 3.0 per cent, instead of 3.5 per cent).

3 Data from the NSSG labour force survey for 1998 are not yet available.

4 Data on the change in employment should be used with caution, because they do not fully reflect developments in the "unofficial" labour market, where the presence of foreign workers was particularly large in that period. As during the first stage of the legalisation process for non-EU foreign workers, which was completed in 1998, some 373,000 aliens were registered, it is clear that the increase in employment between 1988 and 1997-1998 was larger than shown in the NSSG surveys, given that the inflow of immigrant workers has increased since 1989.

all unemployment rate on the basis of harmonised data is slightly lower than the EU average (see Chart II.5).

The above suggest that the rise in unemployment in the last decade and the fact that it remains at high levels cannot be explained solely by economic activity trends or the macroeconomic policy pursued. As regards the latter, it is characteristic that, while the rate of increase in investment was almost equal to that of GDP in the ten years 1989-1998, in the four years 1995-1998 it was appreciably higher. Therefore, the evolution of unemployment during the last decade was also due to structural factors. These include the



shortcomings of the educational system, the inefficiencies of both the vocational training system and the public employment services, as well as certain labour market rigidities, related to working hours, labour mobility, wage determination procedures and non-wage labour costs, such as taxes and social security.

It is encouraging that in recent years, besides the aforementioned substantial rise in investment, considerable progress has been made in all these areas. Thus, according to forecasts by the Ministry of National Economy, the OECD and the European Commission, the rate of unemployment will start falling this year and will continue to do

so in the medium term. In particular, the introduction in 1990 of a new institutional framework for collective bargaining and the increasing credibility of macroeconomic policy have created a climate of growing consensus in labour relations, especially in the procedure for determining wage increases. As a result, the growth rate of labour costs has slowed down appreciably, with direct favourable effects on the deceleration of inflation, as well as an indirect positive impact on employment. At the same time, the efforts to reform the educational system continue, so that it can respond more effectively to the requirements of the economy. The modernisation of the Manpower Employment Agency (OAED) is also under way, while programmes for subsidising vocational training and employment have been expanded and improved.¹ In addition, important legislative measures were promoted in 1998, which increase working-time flexibility, as well as wage flexibility in high-unemployment areas, and are expected to lead to a fall in labour costs. Finally, the legalisation of immigrant workers from non-EU countries, which is to be completed this year, may raise labour costs in some sectors of the economy in the short term. In the medium term, however, it will create a level playing field in the labour market, help reduce or contain labour costs (at least for large firms in the “formal” sector of the economy) and increase the revenue of social security funds.

A comprehensive government policy aimed at stimulating job creation and reducing unemployment will be laid down in this year’s National Action Plan for Employment. This is being drawn up on the basis of the EU employment policy guidelines, which were adopted by the European Council at its meeting in Vienna in December 1998. At the same meeting, it was decided to promote a European Employment Pact and it is expected that the European Council, which will meet in Cologne in early June, will take concrete decisions regarding the pact. As specified in the proposals to be discussed, this pact should be based on a global approach, which will combine the growth and stability oriented macroeconomic policy with active employment policies and structural reforms that improve competitiveness and the functioning of markets for goods, services and capital. Key prerequisites, according to this approach, are the active participation of social partners in formulating and implementing employment strategy, as well as the underpinning by all EU policies of a high level of employment, together with the maintenance of price stability. These proposals for addressing the employment problem at the European level are also useful for Greece.

2.4 Public finance

Considerable progress was made in 1999 towards the restoration of fiscal balance. The general government deficit, on a national accounts basis,² fell by 1.5 percentage points to 2.4 per cent of GDP, i.e. below the reference value of 3 per cent of the relevant con-

¹ See also Chapter III.4.

² According to the definition in the Maastricht Treaty, regarding the assessment of a country’s fiscal position.

vergence criterion. The general government deficit/GDP ratio in EU countries is 1.5 per cent on average (see Chart II.6).

The drop in the general government deficit was due mainly to a significant increase in revenue, which exceeded government budget forecasts, but also to the containment of expenditure, which, despite a small overrun, decreased as a per cent of GDP, compared with last year. The satisfactory course of revenue was exclusively due to direct taxes and was the outcome of tax measures taken in February 1998 (e.g. changes in the method of tax withholding and increase in tax prepayment) and of certain economic developments (e.g. steep rise in motorcar sales and in transactions on the Athens Stock Exchange).

Furthermore, the consolidated debt of general government fell by 3.3 percentage points to 106.1 per cent of GDP, in spite of the devaluation of the drachma in March, which increased the drachma value of external debt. The cumulative decrease in the public debt/GDP ratio by 6.1 percentage points over the last two years suggests that "...it is sufficiently diminishing and approaching the reference value at a satisfactory pace", according to the provisions of the Maastricht Treaty.¹

The decrease in public debt as a per cent of GDP resulted from the continuous improvement in the basic determinants of debt dynamics, i.e. the gradual drop in government borrowing rates, the increase in the primary surplus and faster economic growth. Moreover, in 1998 there was a considerable weakening of the impact of other factors (e.g. taking over by the government of the public sector's debt other than that of general government, calling in of guarantees, interest capitalisation etc.), which had caused a direct increase in public debt in the past. Also, in 1998 public debt was reduced by 667 billion drachmas (1.9 per cent of GDP) through the use of privatisation proceeds. By contrast, the devaluation of the drachma increased external debt.

Developments in the main fiscal aggregates in recent years reflect the systematic effort made to approach the respective goals set in the convergence programme of the Greek economy. From 1994 to 1998, the deficit of general government,² as a per cent of GDP, was reduced by about 7.6 percentage points, the second largest reduction recorded in the EU. This development reflects a rise of 2.6 percentage points in the primary surplus of general government and a drop of 5 percentage points in interest payments. Over the same period, general government revenue, as a per cent of GDP, increased by 2.4 percentage points, while primary expenditure remained virtually unchanged as a per cent of GDP.

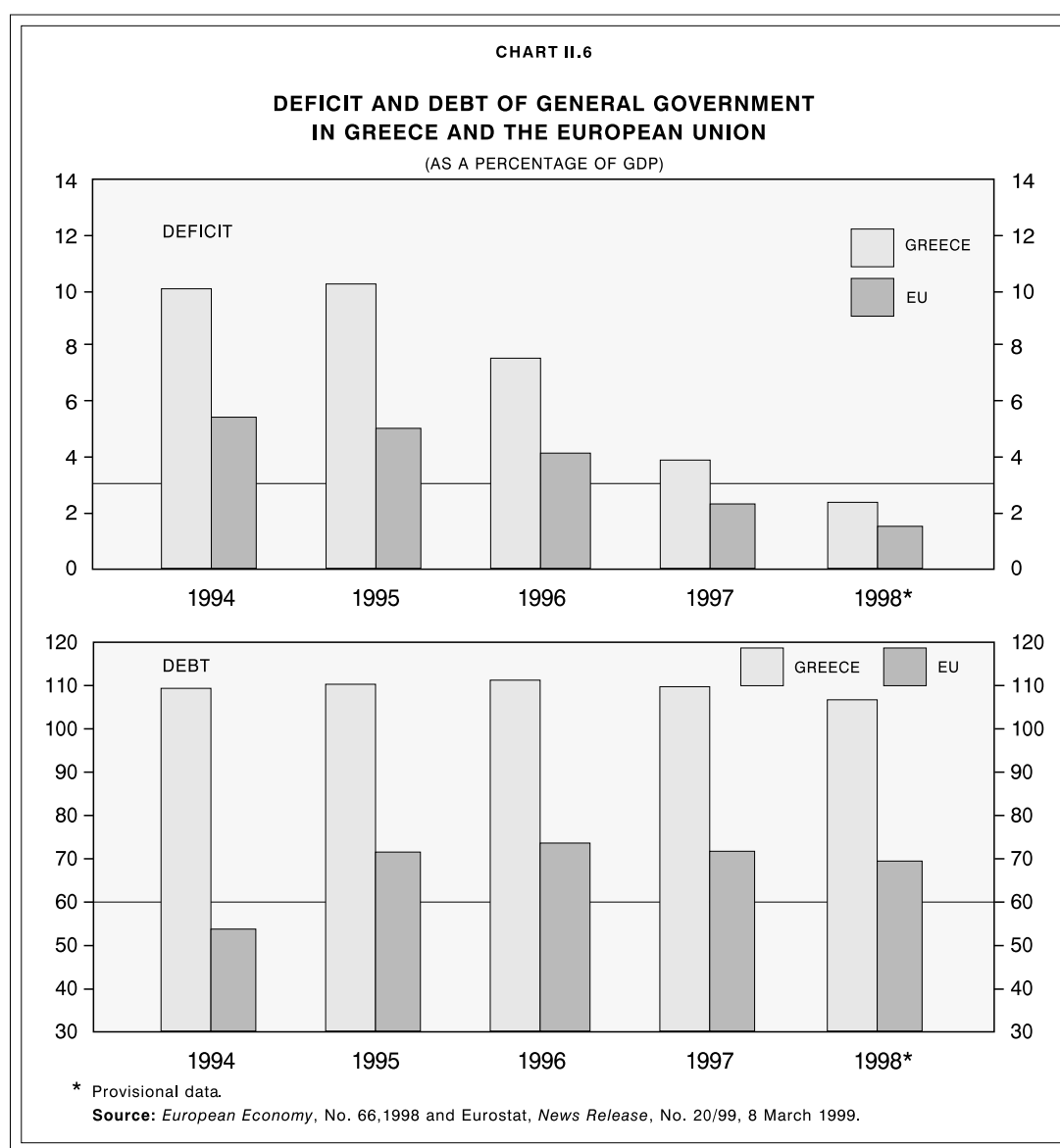
In spite of the improvement in basic fiscal aggregates, major structural problems of the public sector have not yet been dealt with adequately. An examination of the factors underlying the decrease in the central government³ deficit/GDP ratio indicates that, e.g., the containment of expenditure, from 1994 to 1998, was due almost entirely to the decrease in

1 Article 104c of the Maastricht Treaty.

2 On a national accounts basis.

3 The analysis of expenditure and revenue is based on accrual data, which offer more detailed information.

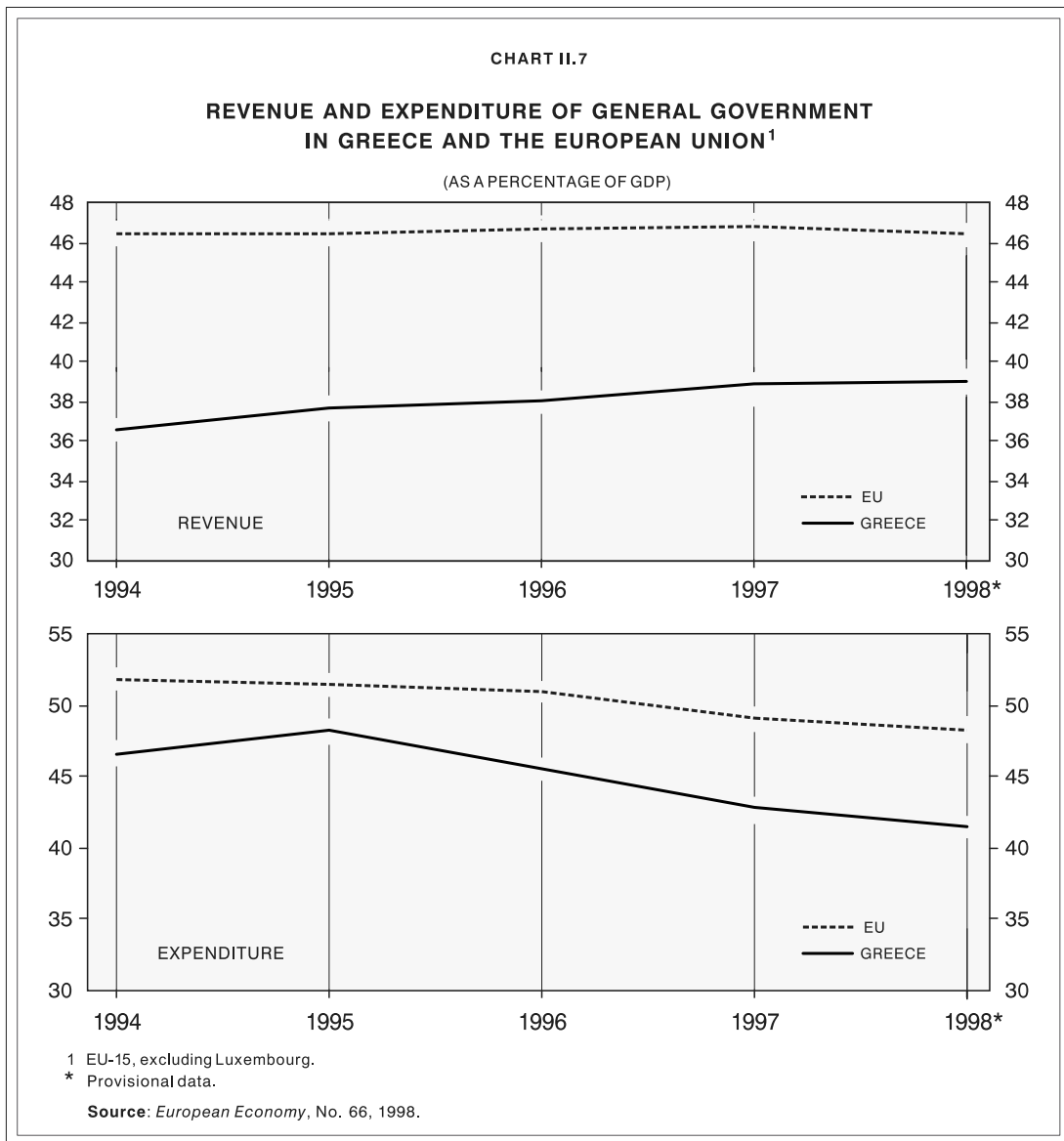
interest payments, while primary expenditure under the ordinary budget increased marginally (by 0.2 percentage point of GDP, on an accrual basis). More specifically, personnel outlays, a major expenditure component, grew from 9.5 per cent of GDP in 1994 to 10.8 per cent in 1998. These developments suggest that certain expenditure categories contributed less



than expected towards restraining total demand and decelerating inflation. Containment of public consumption over the coming years will be necessary, in order to attain a sustainable decrease in the public deficit, as evidenced also by international experience.

Considerable efforts were made to increase revenue, which yielded satisfactory results, as shown by the increase of 2.2 percentage points in the ratio of central government ordinary

budget revenue to GDP between 1994 and 1998. To increase revenue, various measures were taken in the last five years (as in previous years), whose favourable effect on revenue was limited to a rather small time horizon, as many of these measures were *ad hoc* provisions. These included the one-off tax imposed on tax-free reserves of sociétés anonymes, the change in



income tax withholding and the increase in the prepayment of income tax. Characteristically, while budget revenue from direct taxes increased by 26.6 per cent in 1998, a 0.8 per cent decrease is forecast for 1999, if there are no changes in tax laws. Indirect tax revenue fell considerably short of the amount budgeted for 1998, an outcome which was not due to the cuts made in tax rates in autumn; this suggests that long-term income elasticity has decreased.

A stable tax framework is essential for the medium-term planning and expansion of business activities, especially after Greece's entry into the euro area, where the choice of business location will depend more on the tax regime of each country. The increase in "tax competition" will limit the scope for *ad hoc* tax arrangements like those used during the current decade. Nevertheless, despite the significant rise in revenue in recent years, the general government revenue/GDP ratio is still about 7.5 percentage points lower than the EU average (see Chart II.7). Considering that certain tax rates may have to be reduced, owing to tax competition, it is encouraging that the government's programme for combatting tax evasion has started bearing fruit.

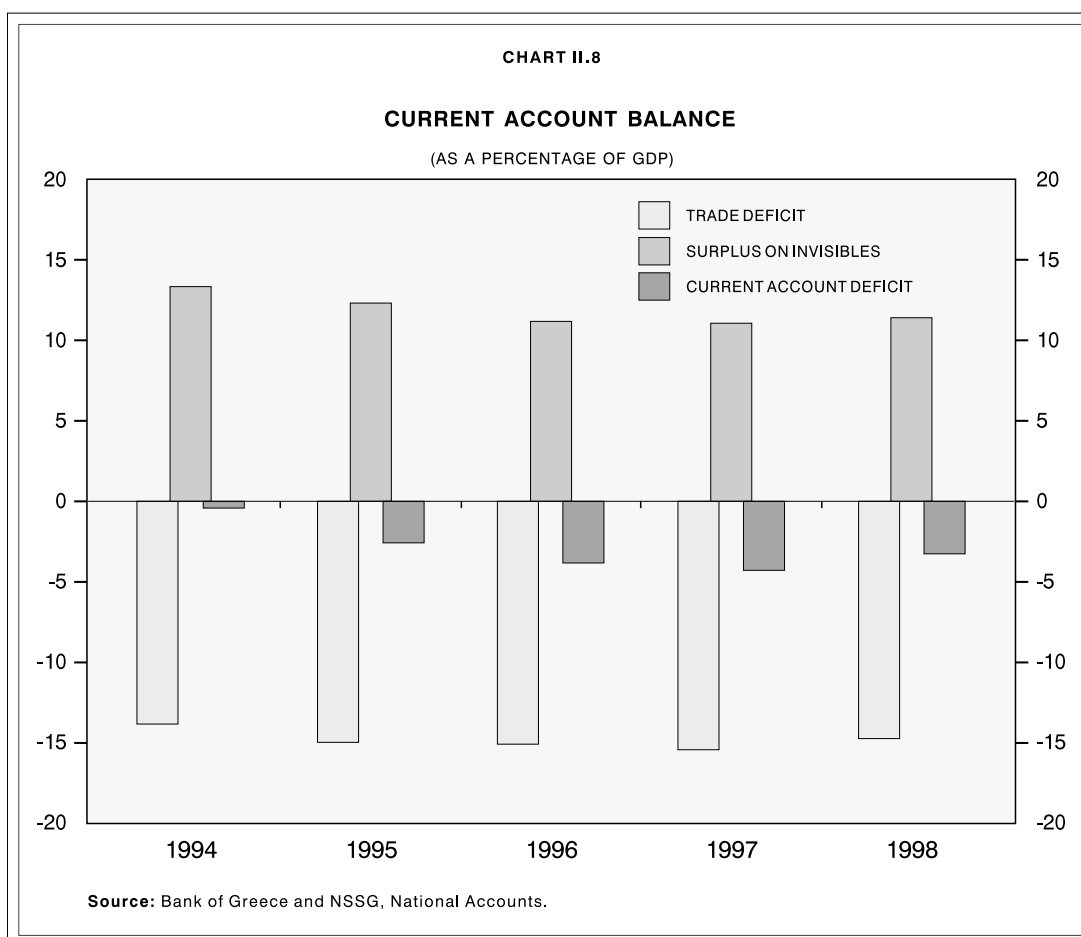
The public debt/GDP ratio, although falling over the last two years, is hindering progress towards a sustainable fiscal balance and remains much higher than the reference value of the relevant convergence criterion as well as the EU average (70.3 per cent) (see Chart II.6). Moreover, the high public debt and the way it is refinanced impede the conduct of monetary policy. In the March 1998-March 1999 twelve-month period, approximately 80 per cent of drachma-denominated securities issued was sold to non-residents; such sales were financed either with foreign exchange inflows or with drachmas acquired through currency swaps from the domestic banking system. It is clear that although non-residents' strong demand for drachma-denominated securities is a positive development helping to reduce government borrowing costs and meet the convergence criterion for long-term interest rates, it makes it more difficult to control the economy's liquidity.

Another feature of debt structure, which significantly influences fiscal aggregates, is the part of the debt accounted for by short-term government paper (Treasury bills) or government bonds with an annually adjusted interest rate. The proportion of government paper the interest rate on which is adjusted within a period of at most twelve months rose to roughly 66 per cent in December 1998. This public debt structure has two opposite effects. On the one hand, it entails a faster reduction in interest payments in a period of falling short-term interest rates. On the other hand, both the large proportion of debt with a floating interest rate and the substantial volume of government securities held by non-residents may burden debt servicing costs during periods of tension in financial markets. Nevertheless, the fact that the latest episodes of international financial turbulence had limited effects on Greek markets is a positive development.

2.5 External transactions

The balance of payments improved significantly in 1998. The current account deficit fell by \$1.2 billion to \$3.6 billion or 3 per cent of GDP, compared with 4 per cent in 1997. This reduction was due both to the drop in the trade deficit and to the increase in the surplus on invisibles. Moreover, following the entry of the drachma into the ERM, net capital inflows increased substantially, to \$8.5 billion in 1998, compared with only \$112 million in 1997.

For the first time last year's balance of payments was compiled from data aggregated for the most part using the new methodology, whereby all transactions between residents and non-residents are recorded, irrespective of currency. The new methodology promotes significantly the completeness and reliability of balance of payments aggregates, by item in particular. However, it should be noted that data provided by the new methodology differ in concept compared with those derived from the old one. This affects the intertemporal comparability of data, especially in certain individual items. The problem is



limited when aggregates consisting of different types of transactions are compared, such as the total of current transactions.

The current account balance was affected to a considerable extent by certain exogenous factors related to the international economic environment, as well as by endogenous factors connected with domestic economic developments and the policies pursued. Among the exogenous factors, the fall in international oil prices led to a reduction of approximately \$900 million in the oil balance deficit, accounting for 3/4 of the drop in the current account deficit. By contrast, the slowdown in global economic activity and

in world trade volume had a negative effect on the current account balance. Among the endogenous factors, the sharp rise in GDP, particularly investment in fixed assets, contributed to a significant increase in the volume of imported capital goods, which, however, help to improve productivity and the balance of payments in the long run. Nevertheless, the volume of manufactured consumer goods imports did not rise further, while the volume of food imports declined slightly. These developments also reflected a slowdown in domestic private consumption. Thus, the volume of total imports increased, but at a significantly lower rate relative to 1997.

The devaluation of the drachma at the time of its entry into the ERM — despite some appreciation of the Greek currency over the following months — and the slowdown in the growth rate of unit labour costs resulted in enhancing the international competitiveness of the Greek economy. This development had a favourable, though relatively small, impact on the balance of payments in 1998, as changes in relative prices have limited direct short-term effects on exports and imports of goods and services. The course of the effective exchange rate index of the drachma, weighted on the basis of relative unit labour costs in manufacturing, suggests an increase of 4 per cent in competitiveness in 1998. Other indicators of the effective exchange rate of the drachma, compiled using relative wholesale or consumer prices weights, point to a smaller improvement in competitiveness (2-3 per cent).

The large increase (40 per cent) in net receipts from tourist services as well as the increase (5.3 per cent) in net transfers from the EU are two other factors that positively affected current transactions and led to a rise in the surplus on invisibles. The institutional and administrative interventions effected in 1997 and in early 1998 for the improvement of the implementation arrangement of the second Community Support Framework led to an acceleration in the rate of absorption of resources from Structural Funds. As regards the contribution of net travel receipts, it should be pointed out that this was, for a significant part, due to the more accurate recording of relevant aggregates (receipts and payments) through the new methodology of balance of payments compilation. Other indicators (data on arrivals and mostly overnight stays) suggest that the increase in the inflow of tourists came to 8 per cent.

The entry of the drachma into the ERM, combined with its devaluation, determined the course of capital movements in 1998. The improvement in expectations about both the entry of Greece into EMU and the perceived yields on private investment and on Greek government paper resulted in high capital inflows over the year, especially in the period following entry into the ERM. These inflows were related to purchases of Greek corporate shares, investments in the interbank money market and mainly investments in long-term drachma-denominated Greek government securities, in anticipation of significant capital gains as a result of the expected convergence of their yields to those on comparable securities in the euro area. Increased capital inflows resulted in a rise in foreign exchange reserves to \$18.2 billion at the end of 1998 from \$13.3 billion a year earlier and to \$21.2 billion at the end of March 1999.

Developments in key balance of payments aggregates during 1998, as well as a more detailed examination of individual types of transactions, confirm earlier observations with regard to the components affecting the short-term performance and the medium-term prospects of the country's external transactions. First, the economy's dependence on imported fuels implies that any substantial change in international oil prices would have a considerable direct effect on the trade balance. Second, net transfers from the EU, corresponding to approximately 4 per cent of Greek GDP, are an important determinant of medium-term trends. Consequently, the expected increased inflows from the Structural Funds and the Cohesion Fund throughout the period 2000-2006, provided that they are used to improve competitiveness, will contribute directly and indirectly to faster economic growth and to external balance. Third, the increase in international competitiveness through the rise in productivity and the improvement of the quality of Greek products and services is still the main factor underlying the medium-term recovery of the balance of payments. In spite of the growing share of exports towards the Balkan and Eastern European countries, approximately 60 per cent of Greek exports is still directed towards OECD countries, where both quality and prices play an important role. Fourth, the increase in national savings, which will stem also from a further reduction in the fiscal deficit, should be a basic component of external balance. Finally, the lifting of restrictions on capital movements and the closer interlinking of money markets are creating a new framework of adjustment and assessment of external transactions. They contribute to a more efficient distribution of capital and to a drop in financing costs, while at the same time they necessitate the conduct of credible macroeconomic and structural policies with a view to ensuring external balance. With particular regard to Greece and in order to consolidate the gains from large capital inflows, the pursuit of appropriate economic and monetary policies must continue, thereby increasing market confidence in the performance and prospects of the economy.

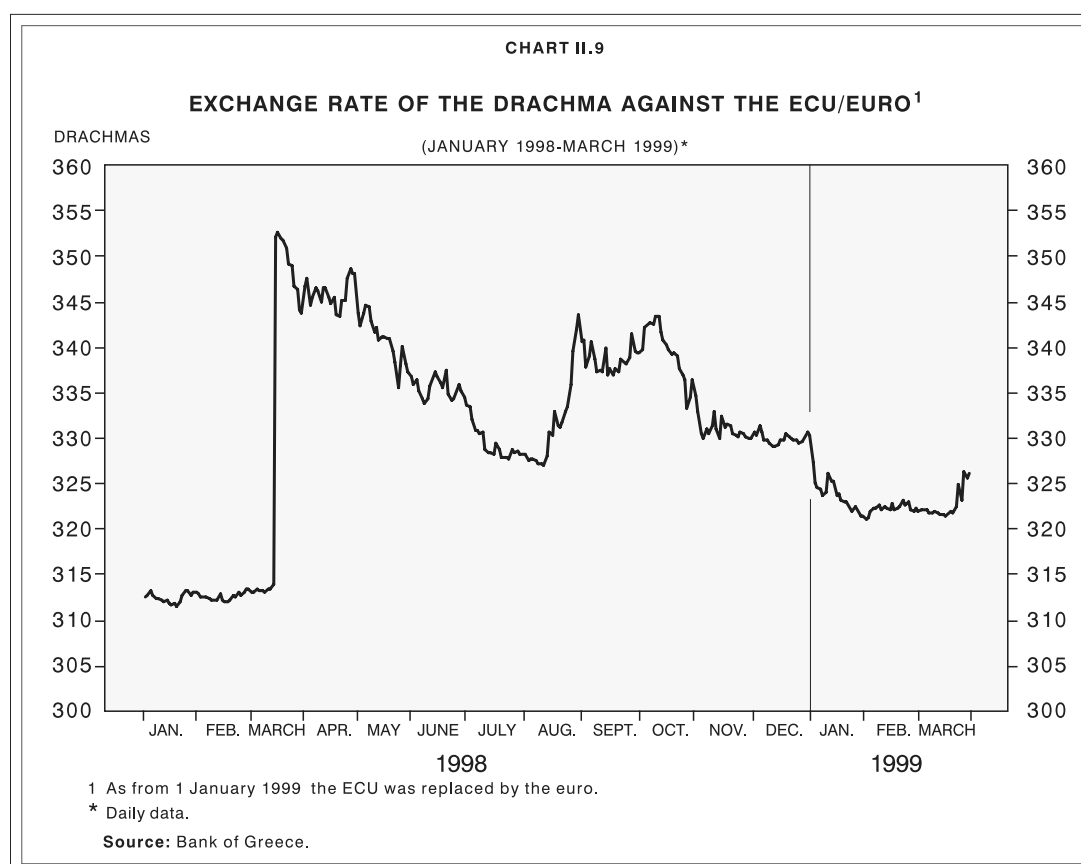
3. MONETARY POLICY

3.1 Monetary developments and policy in 1998

The primary objective of monetary policy is to achieve price stability by the end of 1999, which is compatible with an annual rate of inflation that does not exceed 2 per cent. Monetary policy in 1998 was aimed, in particular, at containing inflationary pressures and ensuring that inflation would resume a downward course as quickly as possible, after the temporary upswing caused by the devaluation of the drachma in March 1998.

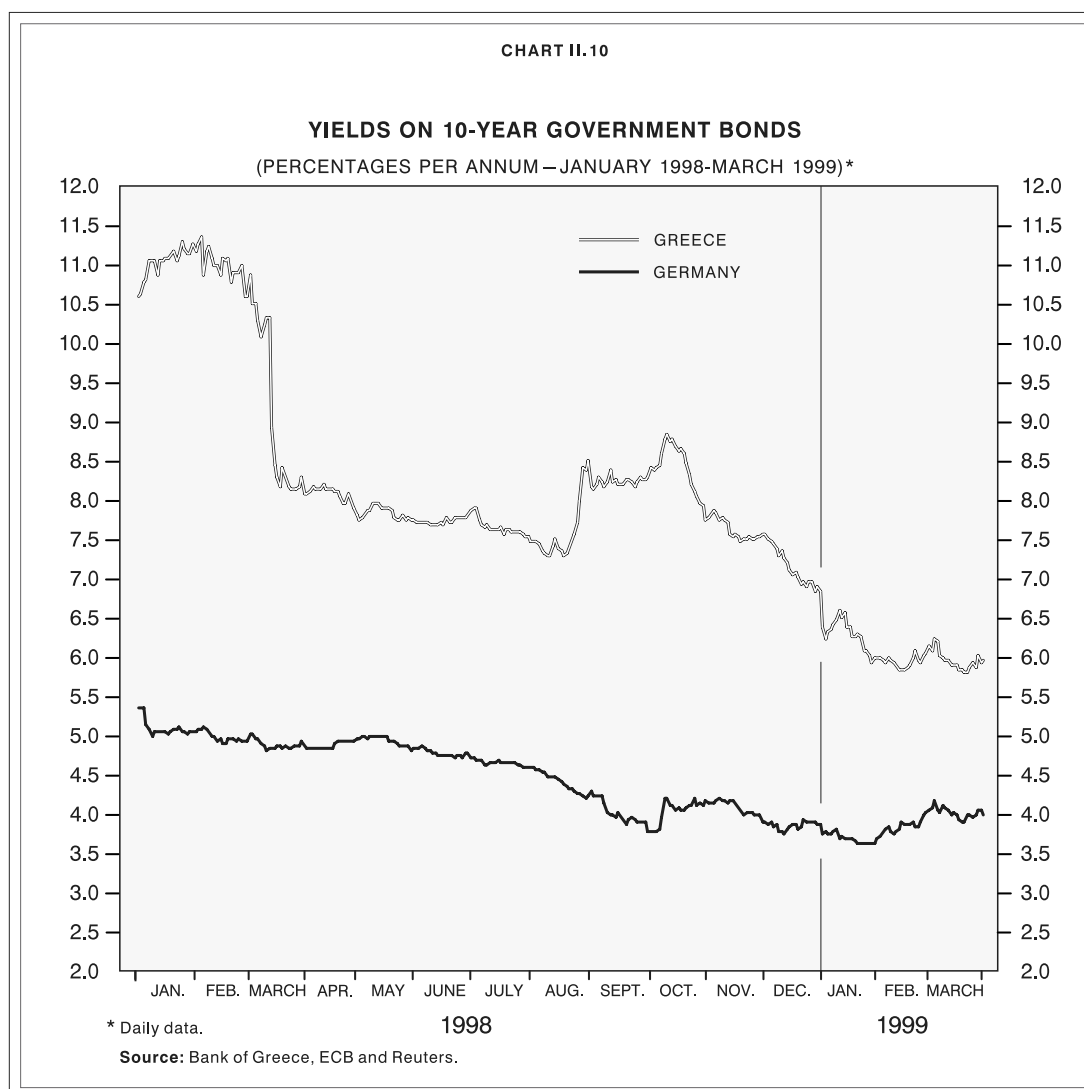
The intermediate target of the Bank of Greece was the relative stability of the drachma's exchange rate within the Exchange Rate Mechanism (ERM) of the European Monetary System, which the drachma joined on 16 March 1998. Owing to the prevailing

conditions in the goods and foreign exchange markets, the conduct of monetary policy focused on attaining the primary objective of price stability by maintaining interest rates relatively high. As a result, the drachma appreciated above its central rate against the ECU. Furthermore, the Bank forecast that M3 would rise by 6-9 per cent and total credit expansion would be 4-6 per cent, rates considered consistent in the medium term with the desired deceleration of inflation.



The drachma has remained strong since joining the ERM. Immediately after entry, significant capital inflows, combined with the tight monetary policy pursued by the Bank (involving relatively high interest rates and non-intervention in the foreign exchange market) led to a gradual appreciation of the drachma above its central rate against the ECU. This appreciation reached 8.1 per cent by mid-August, but fell to 4 per cent by end-August, as the domestic market was affected by the crisis in Russia. Capital inflows, however, resumed from early September onwards and intensified further in the last two months of 1998, causing the drachma to appreciate by 7-8.5 per cent. Substantial interventions by the Bank of Greece were therefore required in the last two months of 1998 and in early 1999 to restrain the upward trend of the drachma.

Broad money M3 increased by 8.9 per cent in 1998 (compared with 9.6 per cent in 1997), which was within the forecast range of 6-9 per cent. Until October 1998, the twelve-month growth rate of M3 was lower than the forecast range, owing to increased private non-bank holdings of liquid assets not included in M3, such as financial derivatives, government securities with a maturity of over one year and deposits in foreign currency. The

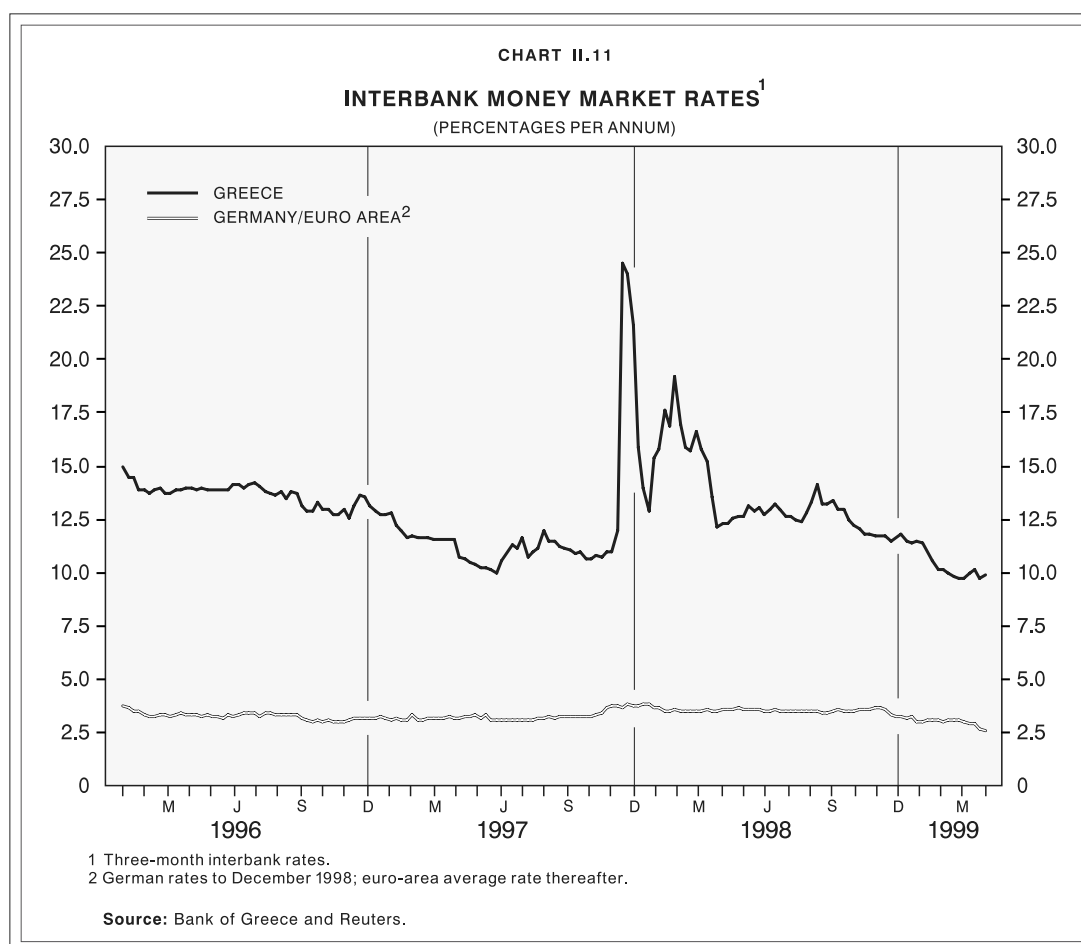


M3 growth rate, however, picked up in the last two months of 1998 mainly because of reverse shift of funds, i.e. from liquid assets not included in M3 to repos, following the abolition of taxes on yields from the latter. Broader monetary aggregates, such as M4, also point to the containment of the growth rate of liquidity.

As in 1997, total credit expansion reached 9.7 per cent in 1998 instead of the projected 4-6 per cent. Credit expansion to the private sector and, consequently, total credit

expansion were affected in 1998 by the devaluation of the drachma, which increased the value in drachmas of outstanding foreign exchange loans, without being associated with the granting of new loans.

More specifically, credit expansion to the public sector stood at the same level as in 1997 (7.1 per cent). However, the PSBR on a cash basis fell to 1,882 billion drachmas in 1998 from 2,142 billion in 1997. The unchanged credit expansion to the public sector, in spite of the reduction of the public deficit, was due to the increase in non-residents'



share in financing the deficit and a corresponding drop in the share of the private non-bank sector. This change in the way the deficit was financed contributed to liquidity creation in the economy.

Credit expansion to the private sector, adjusted for valuation differences, decelerated in 1998, falling to 13.2 per cent at year-end, from 15.3 per cent in December 1997. A breakdown of loans by sector of economic activity shows that credit expansion to industry, small-scale manufacturing and agriculture remained low, as in 1997. In contrast, commer-

cial and housing credit increased at high but decelerating rates, while consumer credit accelerated substantially (38 per cent in 1998 compared with 27.5 per cent in 1997). Outstanding consumer loans (1,010 billion drachmas at end-1998) now represent 7.9 per cent of bank loans to the private sector or 2.8 per cent of GDP.

After the devaluation of the drachma, the Bank of Greece followed a policy of gradual cuts in its key interest rates. However, interbank rates as well as lending and deposit rates fell even lower. More specifically, 3-month and 1-month interbank rates fell by 3 and 6 percentage points respectively. Also, the average short-term lending rate decreased by 1.5 percentage points (December 1998: 17.6 per cent, December 1997: 19.1 per cent) and the average savings deposit rate by about 1 percentage point (December 1998: 8.6 per cent, December 1997: 9.5 per cent). The reduction of inflation and the containment of inflationary expectations, coupled with growing confidence in the prospects of Greece joining the euro area, contributed to the drop in 10-year government bond yields from 10.7 per cent at end-1997 to 6.9 per cent at end-1998 and to their convergence with those of comparable EU securities.

The above suggest that, in spite of the difficulties caused by the devaluation of the drachma and the ensuing capital inflows, as well as by the prevailing uncertainty in world markets, monetary policy achieved the basic goals set for 1998, as inflation resumed its downward trend in June and the drachma remained strong after joining the ERM. Monetary policy thus contributed to the convergence of the Greek economy and the fulfilment of the Maastricht criteria concerning inflation, the exchange rate and long-term interest rates.

3.2 Monetary policy targets and strategy for 1999

The primary monetary policy objective, which is to achieve and secure price stability, must be attained by the end of 1999, so that the average annual rate of inflation satisfies the convergence criterion set by the Maastricht Treaty. Furthermore, inflation will have to remain at the same low level in the future, especially in the year 2000, if Greece is to maintain its international competitiveness after joining monetary union.

According to recent forecasts, average annual inflation across the euro area will fall and the reference value of the respective convergence criterion, based on the range of forecasts currently available, may reach 2.0-2.5 per cent, if it is calculated by the same method as that used to assess the eligibility of the first eleven entrants. Uncertainties concerning the inflation rate in the EU imply that anti-inflationary policy will have to provide for ample safety margins. The Bank of Greece estimates that CPI inflation will approach 2 per cent in the summer of 1999.

The monetary policy framework in the current year is determined by the participation of the drachma in the ERM II. Since the top priority of monetary policy is to attain the inflation target, the drachma may temporarily remain above its central rate against the euro. In the medium term, however, as inflation and interest rates decrease, the exchange

rate of the drachma against the euro will gradually converge to its central rate by the end of the year 2000, although the exact course of this convergence cannot be predicted.

In assessing the stance of monetary policy, the Bank of Greece relies on various indicators, which provide information on the factors affecting directly or indirectly inflation, especially core inflation (e.g. broad money M3, total liquidity of the economy and bank credit). The Bank of Greece recently defined a new liquidity measure, M4N, which is considered a more appropriate indicator of monetary conditions and monetary policy stance, because of its more stable relationship to GDP. This indicator comprises M4 (currency in circulation, residents' deposits in drachmas, repurchase agreements, bank bonds and Treasury bills), plus residents' deposits in foreign currency and money market mutual fund units.

This broader aggregate (M4N) is expected to increase by 7-9 per cent in 1999, while the same rate of increase is anticipated for total bank credit to the public and the private sector. The slowdown forecast for both these indicators (by 2 percentage points, compared with 1998 levels) is considered to be consistent in the medium term with the desired deceleration of inflation. It should be pointed out that both these estimates are not intermediate monetary policy targets, but simply indicative projections based on certain assumptions. This means that the Bank of Greece will not automatically adjust monetary policy instruments, whenever the growth rates of the above aggregates deviate from the projected levels, but will analyse the causes and nature of such deviations and assess their implications for inflation in the medium term. At the same time, it will examine other indicators providing information on labour market conditions, capacity utilisation and aggregate supply and demand.

The above-mentioned uncertainty about price developments does not cancel the generally positive prospects of reaching the inflation target. These prospects are based on the favourable impact of developments in the major determinants of inflation, in particular tight monetary policy and a lower rate of increase in unit labour costs. However, a possible slowdown in the rate at which inflationary pressures are receding calls for continuous vigilance as well as careful and consistent implementation of economic and monetary policies, so that price stability can be achieved by the end of 1999.

To this end, monetary policy will retain its anti-inflationary stance. Specifically, interest rate policy will continue to be conducted very cautiously, so that its effects on total demand, the exchange rate and inflationary expectations can contribute to faster and sustained disinflation. Among the factors to be taken into consideration when formulating interest rate policy is the progress that will be made in containing credit expansion. Only when price stability is secured will there be room for a gradual relaxation of monetary policy.

The conduct of monetary policy this year will be facing roughly the same difficulties and constraints as in the past. These constraints are partly related to the convergence process and Greece's anticipated entry into the euro area, as well as to the restructuring of and growing competition in the banking system. They are also related to the monetary policy framework determined by the drachma's participation in the ERM II.

The favourable prospects for Greece's economic convergence with euro area countries, in conjunction with the conduct of anti-inflationary monetary policy, lead to substantial capital inflows, primarily for the purchase of government bonds and for short-term interbank investments. These inflows and foreign investors' growing share in financing the public deficit and debt have resulted in the creation of drachma liquidity, which the Bank of Greece must continuously absorb in order to contain monetary and credit expansion at rates compatible with the desired deceleration of inflation.

Strong competition in the banking system to increase market shares, as well as expectations concerning Greece's entry into the euro area with substantial interest rate cuts by the end of 2000, affect conditions in the bank credit market and make it difficult for the Bank of Greece to control credit expansion. On the supply side, banks have recently lowered their lending rates by more than the decrease in key central bank rates, under the pressure of competition and in anticipation of future cuts in central bank rates. On the demand side, expectations that Greek interest rates will converge to euro area rates have stimulated demand for drachma credit, thus making credit expansion difficult to contain by keeping real interest rates high. At the same time, the drachma's participation in ERM II and its appreciation relative to its central rate, as a result of the capital inflows mentioned above, have also reduced the possibilities of using interest rates to control credit expansion.

For these reasons but also because the inflation target must be attained within a specific and short time period, recourse to alternative credit and monetary expansion control instruments, apart from interest rates, was judged necessary by the Bank of Greece in order to ensure the attainment of the price stability goal.

In mid-April, the Monetary Policy Council decided to take measures to contain bank credit expansion during 1999. More specifically, banks that increase their credit to the private sector and to public entities and enterprises at an annual rate of more than 12 per cent will be obliged to hold the excess amount in a non-remunerated deposit with the Bank of Greece for six months. This 12 per cent rate applies to consumer credit as well as other categories of loans. If the increase in lending to the private sector and public entities and enterprises is contained at the forecast level, overall credit expansion (including credit to central government) will be restrained to 7-9 per cent, which is considered consistent with the 3.5 per cent real GDP growth rate projected for this year and the targeted deceleration of inflation to below 2 per cent. Furthermore, to ensure the anti-inflationary stance of monetary policy and the effectiveness of these measures, banks have agreed that financial costs stemming from the implementation of the measures will not be passed onto depositors through cuts in deposit rates. These temporary measures were considered necessary not only to minimise inflationary risks from the fast rise in credit, especially consumer credit, but also because the convergence of the Greek economy and growing competition in the banking system have, as mentioned above, reduced the effectiveness of interest rates as a means of containing credit expansion.

Together with the implementation of a tight monetary policy, the anti-inflationary effort will have to be supported during this and the next year by appropriate fiscal and

structural policies, as well as by the adoption of rational price and wage policies. A precondition for the achievement of monetary stability is that economic agents will not relax their anti-inflationary effort.

4. CAPITAL MARKETS

The development of a well-organised market for fixed-income securities, especially government securities, not only contributes significantly to the reduction of the cost of government financing and the more efficient management of public debt, but it also has a positive influence on the operation of the whole financial sector and boosts the effectiveness of monetary policy. The procedures and methods for selling government securities have improved significantly in recent years. A series of measures were taken during the past 15 months, such as the systematic sale of securities through a competitive auction, the dematerialisation of securities and the introduction of Primary Dealers. However, what played a decisive role was the founding of the Electronic Secondary Securities Market (HDAT), thanks to which one of the most modern organised securities markets is now operating in Greece. With the introduction of Primary Dealers, the operation and effectiveness of the primary government securities market has also improved considerably. In February 1999, the number of Primary Dealers rose to 14, comprising 8 Greek and 6 foreign banks. HDAT, whose installation at the Bank of Greece was completed in May 1998, is a fully automated trading system, which covers the over-the-counter secondary market in government securities, ensures the safety and transparency of transactions and boosts market liquidity. These characteristics lead to representative and reliable prices for government securities. In addition, the government has established, by Law 2628/98, the Public Debt Organisation, which will start operating in 1999.

Sales of government securities in the primary market in 1998 were somewhat lower than in 1997. In 1998, government securities worth a total of 10,032 billion drachmas (nominal value) were issued, down from 10,419 billion in 1997. More specifically, the nominal value of Treasury bills issued in 1998 rose to 4,665 billion drachmas from 4,458 billion issued in 1997, while the nominal value of bonds with a maturity of over one year fell to 5,367 billion drachmas in 1998 from 5,961 billion in 1997. However, in 1998 increased sales of long-term securities maturing in over 7 years resulted in lengthening the average maturity of government securities compared with 1997.

Transactions in the secondary securities market grew significantly in 1998, owing mainly to HDAT's operation since May 1998. Specifically, in the period from May to December 1998 the average daily value of transactions on HDAT was 33 billion drachmas, while in the first quarter of 1999 it rose impressively to 143 billion drachmas. Transactions in long-term securities, i.e. in seven-, ten- and fifteen-year bonds, contributed much to this outcome, with their share in total transactions rising to 86 per cent.

A notable increase was observed in all stock market variables in 1998. Share prices rose by 85 per cent between the end of December 1997 and end-December 1998, and average daily turnover reached 56 billion drachmas in 1998, from 23 billion in 1997. Favourable stock market conditions in 1998 led many enterprises in various sectors of the economy to raise significant amounts of capital through the Stock Exchange in order to finance their investments. Specifically, the total amount of capital raised through the Stock Exchange rose to 827 billion drachmas in 1998 from 535 billion in 1997. The funds raised by banks in particular reached 210 billion drachmas in 1998, about the same as in 1997. Over the past two years, banks' recourse to the stock market, combined with their increased profits, led to a significant enhancement in the banks' capital. Developments in the market for shares in 1998 were favourably affected by the drachma's entry into the ERM in March 1998, the gradual decline in nominal interest rates and the higher profits of most listed companies.

The market capitalisation of shares increased to 22,839 billion drachmas or 64 per cent of GDP at the end of 1998, from 9,811 billion or 30 per cent of GDP at the end of 1997, thus slightly overshooting broad money (M3) held by the non-bank private sector (22,689 billion drachmas in December 1998).

The expansion of the stock market during recent years has been a positive development, because it contributes towards improving the allocation of financial resources and strengthening the competitiveness of firms. Greek firms, irrespective of type of business, now have more possibilities to raise low-cost non-borrowed funds, with obviously favourable effects on their investment activity and growth. At the same time, opportunities have greatly increased for savers to improve profitability by including in their portfolios assets with relatively high medium-term returns, such as shares. Despite the steep rise in share prices in 1998, the P/E ratio in the Greek stock market stood, at end-1998, at roughly the same levels as in euro area countries, particularly Italy, Spain and Portugal, where interest rate convergence was faster around the end of 1998. It should be noted, however, that, as stock markets are often characterised by sharp short-term fluctuations in share prices, decisions to buy shares should be part of a medium- and long-term investment strategy.

5. CREDIT SYSTEM AND BANKING SUPERVISION

The Greek credit system is now operating in a deregulated environment and is affected by international competition and developments in global financial markets. Further adjustment of the institutional operating framework has enabled Greek banks to cope successfully with the new conditions created by European integration, the globalisation of markets and impressive progress in the fields of information technology and communications. These developments have significantly modified the conditions under which financial markets operate and have strengthened competition to the point where

it is felt even in those operations that used to be considered strictly local. In the domestic market, the relationship between banks and their customers is gradually changing. Their best customers are now increasingly turning to the stock market to raise low-cost capital. At the same time, the widening range of financial products, with varying features and yields, supplied by the state and non-bank financial institutions (e.g. mutual funds), has expanded savers' options and led to a significant increase in their investments outside the banking system, thus reducing bank intermediation. Economic and Monetary Union is expected to reinforce already prevailing trends. Specifically, it is estimated that EMU will lead to increased competition, accelerate the disintermediation process, strengthen the internationalisation and geographical diversification of bank operations, squeeze banks' profitability, increase mergers and acquisitions and contribute to the creation of powerful financial groups. There will also be repercussions on the scope of banking, with the most immediate being a reduction in foreign exchange transactions, as well as an increase in other operations favoured by the introduction of the euro and macroeconomic stability.

Greek banks have, to a significant extent, taken advantage of the possibilities offered by deregulation and have achieved satisfactory results in recent years. Specifically, they have widened the range of services offered and have restructured their portfolios; as a result, they have increased their profitability and strengthened their capital base considerably. It is essential, however, that efforts to modernise and adapt to new conditions continue and intensify, since, as has already been mentioned, stronger competitive pressures are expected to squeeze profits, especially from traditional bank operations. Consequently, banks have to look for alternative revenue sources and expand their business, benefiting from increased demand for financial services in the single European market as well as from the opportunities offered by other countries' markets. A necessary precondition, however, is the further strengthening of their competitiveness.

Specifically, banks must further improve the quality of the products and services they offer by making more efficient use of human resources and investing in new infrastructure, mainly technological equipment. They must also reduce their operational costs, especially personnel expenses, which, in the case of Greek banks, are significantly higher than in the banks of other European countries. As regards investment in technological equipment, it should be noted that modern developments have rendered indispensable the upgrading of credit institutions' IT systems and the existence of an extensive and efficient distribution network for financial services. The high cost of these investments, however, presupposes a minimum business volume, so that they can contribute towards improving the competitiveness of credit institutions. Indeed, the cost of such investments is one of the most important factors underlying the international trend towards mergers and acquisitions. During the past year, several important mergers and acquisitions, as well as strategic alliances with foreign credit institutions, took place in the Greek financial market.

The deregulation and internationalisation of the Greek banking system and growing competition between banks have led them to assume higher risks, owing to their expan-

sion into new and sometimes more risky activities, in order to maintain or increase their profitability. The effective management of these risks by banks is a major objective of the Bank of Greece, which took additional measures last year to strengthen prudential supervision of the credit system. Specifically, the Bank set general criteria and principles which must govern banks' internal auditing systems, so as to ensure their effectiveness. It also instructed banks to take the necessary measures for this purpose, such as the establishment of an Auditing Committee and an independent Risk Management Unit, the obligation to submit annual reports evaluating the adequacy of lending procedures etc. Moreover, seeking to improve the quality and speed up the restructuring of banks' lending portfolios, the Bank defined an overall framework of minimum quantitative criteria for the assessment of the adequacy of banks' provisions against claims related to lending. The minimum provisions that banks must make for prudential purposes are defined as percentages on the outstanding balances of loans and range from 1 per cent to 50 per cent, depending on the maximum delay in loan repayment. The central bank is now informed more frequently and thoroughly about the relevant aggregates and is therefore in a better position to assess the capital adequacy of credit institutions. The capital adequacy of Greek banks is generally satisfactory, since the average solvency ratio is much higher than 8 per cent and rising.

It follows from the above that Greek credit institutions are now much stronger and can face growing competition and emerging conditions from a significantly more favourable position than that held only a few years ago. They must, however, continue their efforts to further improve their efficiency and competitiveness.

6. PREPARATIONS FOR THE CHANGEOVER TO THE EURO

The effective functioning of the Bank of Greece as a member of the European System of Central Banks (ESCB) presupposes organisational and functional preparedness, so that it can cope with the requirements of the single monetary policy. Article 12.1 of the ESCB Statute stipulates that the European Central Bank (ECB) is responsible for formulating monetary policy. However, based on the principle of subsidiarity, the execution of the relevant operations is the responsibility of national central banks. To ensure that the operations of the single monetary policy are carried out on the same terms and conditions in all Member States, national central banks were required to prepare and adjust their procedures to the monetary policy framework of the ESCB.

During the last two years, the Bank of Greece advanced to a very satisfactory degree the preparatory work required for the Bank's active participation in ESCB operations as soon as Greece joins Stage Three of EMU. This preparatory work was carried out in accordance with the decisions of the European Monetary Institute (EMI) and its successor, the ECB, and was part of the preparations made by EU member states ahead of the beginning of Stage Three and the creation of the ESCB. A large part of the preparations for the changeover to the euro were planned by the EMI working groups and com-

mittees, bringing together representatives of all EU national central banks, including the Bank of Greece.

This preparatory work, part of which has already been completed, covers a wide spectrum of activities related to functions in which credit institutions and other financial intermediaries participate as counterparties of the ESCB, as well as purely internal functions of the Bank of Greece. To assess the adjustments made and to check the degree of preparedness and the ability to meet the operational requirements of the ESCB, the Bank of Greece participated in a large part of the EU-wide general trial runs during the second half of 1998. The Bank's participation in these trial runs was very successful, judged by the criteria and standards that had been set.

The main adjustments made at the Bank of Greece to achieve harmonisation with the requirements of the ESCB concerned the operation and the institutional framework of the domestic foreign exchange market, monetary policy instruments, statistics and standards, as well as payment systems. At the same time, preliminary work was carried out for the production of euro banknotes and coins.

The Bank of Greece has already amended the institutional framework of the domestic foreign exchange market, adjusting its operating rules to the new conditions and requirements arising from the introduction of the single European currency. It has also issued timely and detailed instructions to facilitate banks' transactions in the new currency. Moreover, since the conduct of exchange rate policy and the ECB reserve management framework are governed by the principle of subsidiarity, the Bank of Greece is in the process of installing a specialised IT support system that will contribute to the full automation of foreign exchange operations and foreign currency reserve management, and will be compatible with the corresponding ECB applications.

In addition, the Bank of Greece has almost completed the adjustment of the monetary policy framework to ESCB standards. Relevant changes concern all three categories of instruments used by the ESCB, namely (i) open market operations, (ii) standing marginal lending and deposit facilities and (iii) a reserve requirement system. For the full adjustment of these instruments to ESCB standards, it will be necessary to modify some parameters of a technical nature and take measures to further improve technical infrastructure.

The conduct of the single monetary policy requires that the ECB receive timely and valid information based on harmonised statistical data from all euro area countries. Therefore, the reporting system for monetary and banking data provided by credit institutions and other financial intermediaries has been extensively revised. Moreover, the Bank of Greece has promoted the complete restructuring of the methodology for the compilation of data on external transactions. This methodology is based on the International Monetary Fund's conceptual framework and is harmonised with the special requirements of the ECB and Eurostat.

The effective conduct of monetary policy hinges upon the smooth operation of reliable and secure payment systems. Indeed, promoting the smooth operation of payment systems is one of the main tasks of the ESCB according to the Maastricht Treaty. The

EURO-HERMES payment system which is linked to TARGET was put in operation in Greece on 4 January 1999. Parallel to the development of the EURO-HERMES system, work progressed in 1998 on the completion of the payment system through which drachma payment orders will be settled in real time (HERMES payment system) and its operating regulations were approved. With the start-up of the HERMES payment system this year, credit institutions will conduct their drachma payments in real time, without any settlement risk, and the money market will operate more efficiently in view of the country's participation in Stage Three of EMU.

Beyond the efficient operation of payment systems, the conduct of the single monetary policy during Stage Three also demands a well-organised and properly functioning securities settlement system. To this end, the Bank of Greece has designed and developed the applications which ensure automation of the book-entry securities settlement system and has founded a securities depository.

The euro is expected to be introduced into Greece in physical form in 2002, at the same time as in the other Member States of EMU. In this context, the Bank of Greece Mint has participated, together with other mints across the EU, in a trial production of euro notes. It printed a number of 20-euro notes, which successfully passed the quality control conducted by the ECB. Regarding euro coins, the theme to be depicted on the "national" side was proposed by the Art Theme Selection Advisory Committee. Based on the Committee's work, the themes of the national side of all euro coin denominations have already been approved.

7. ECONOMIC POLICY STANCE

After persistent and arduous stabilisation efforts lasting several years, Greece has improved its economic performance substantially. Monetary stability is being achieved, since inflation is expected to approach 2 per cent within the next few months. Adoption of the euro as the national currency is now a realistic prospect. It is clear that the goal of Greece's entry into monetary union in 2001 has acted as a catalyst, accelerating fiscal consolidation and structural adjustment, especially in recent years, which have led to conditions of stability combined with faster growth.

However, economic and monetary policies still face major challenges: first, completion of the effort to achieve the desired nominal convergence in 1999; second, establishment of appropriate economic conditions in 2000 for a smooth transition to monetary union; third, the efficient operation of the economy within the euro area in order to attain a high and sustainable rate of economic growth and reduce unemployment.

It is feasible and highly probable that the criteria for the adoption of the euro in 2001 will be met in 1999, but it should not be taken for granted. In fact, although the targets are being approached through the policies pursued, some exogenous factors are hindering the convergence process, while there are also elements of uncertainty which could

influence the performance of the economy unfavourably. Moreover, the expectations of the public, the banks and the markets concerning the generally favourable prospects of entering the euro area and a possible relaxation of macroeconomic policy may influence capital and goods markets, making it difficult to achieve convergence. The uncertainties surrounding the course of inflation, the obstacles in the way of disinflation, as well as the possible effects of the international economic environment have already been described in detail. Today, however, the economy is facing further uncertainties due to the crisis in Yugoslavia.

So far, the impact of the Yugoslav crisis on the Greek economy and, more specifically, on the domestic bond, foreign exchange and money markets, has been in effect negligible. The prices of bonds and the drachma exchange rate have fluctuated within normal limits. Only share prices on the Athens Stock Exchange have shown wider fluctuations, reflecting in some cases corrections from the high levels reached previously. Any prolongation of the Yugoslav crisis would have repercussions on economic activity in Greece, but their exact size cannot be predicted, as it depends on the extent to which the crisis will affect tourism, transport and trade. The country's continuing progress towards stability, the macroeconomic policy being pursued and the acceleration of the structural reforms which enhance the prospects of joining monetary union are the crucial factors which shape economic developments, thereby minimising the effects of the crisis on Greek financial markets.

The elements of uncertainty and the other factors which hinder convergence, combined with the short time available to complete the process, make it necessary to strengthen anti-inflationary policy. The Bank of Greece has already taken a series of measures for a more effective control of credit and monetary expansion, so as to achieve the desired goal of price stability. It is essential, however, to support the anti-inflationary effort with fiscal and structural policy measures, not only because of the difficulties and uncertainties being encountered this year, but also in order to consolidate the conditions of stability during the transition to the euro area in the year 2000 and in the medium term. Ensuring monetary stability and fulfilling the other convergence criteria should not be treated merely as contractual obligations, but as essential prerequisites for the country's smooth entry into the euro area and the effective functioning and growth of the economy in the context of monetary union. Of course, when assessing whether Greece fulfils the economic prerequisites for adopting the euro, the degree to which unforeseen, exogenous and special factors have adversely affected economic performance is expected to be taken into account, as stated in the Treaty.

Ensuring price stability in 1999 and the following years depends also on the behaviour of the social partners. Developments in the labour market, as regards nominal wages and productivity, have contributed decisively to the weakening of inflationary pressures. Labour's contribution, in 1999 and 1998, to the effort to hold prices down is recognised and important. However, the evolution of prices, at least in some markets, is not so satisfactory. Business firms must adjust their behaviour and their pricing policies to the new,

more favourable conditions in the capital and labour markets, especially in view of the country's entry into the more competitive environment of the single currency. Firms are called upon to realise that, in most cases, raising prices by taking advantage of non-competitive conditions brings only temporary benefits. In contrast, at the present juncture, stability or even reduction of prices will not only contribute to the achievement of the national goal of adopting the euro, which implies new business opportunities and long-term advantages, but will also yield immediate and substantial financial gains. The national interest is closely linked to business interest. Businesses and professionals are rightly looking forward to interest rate cuts, because such cuts will immediately and significantly reduce financial costs and, in addition, will indirectly boost turnover and profits. However, they must understand that the more direct and substantial their contribution to the deceleration of inflation and its maintenance at a low level, the faster the desired interest rate cuts will proceed. This is because only when price stability is achieved and secured will the Bank of Greece allow a significant reduction in interest rates. Therefore, whether the expectation of cheaper financing will be realised depends largely on the behaviour of those who have such expectations. Compliance with the "gentlemen's agreements" already concluded, as well as the new efforts being made in the same direction by the government, commerce and industry, must be examined from exactly this angle.

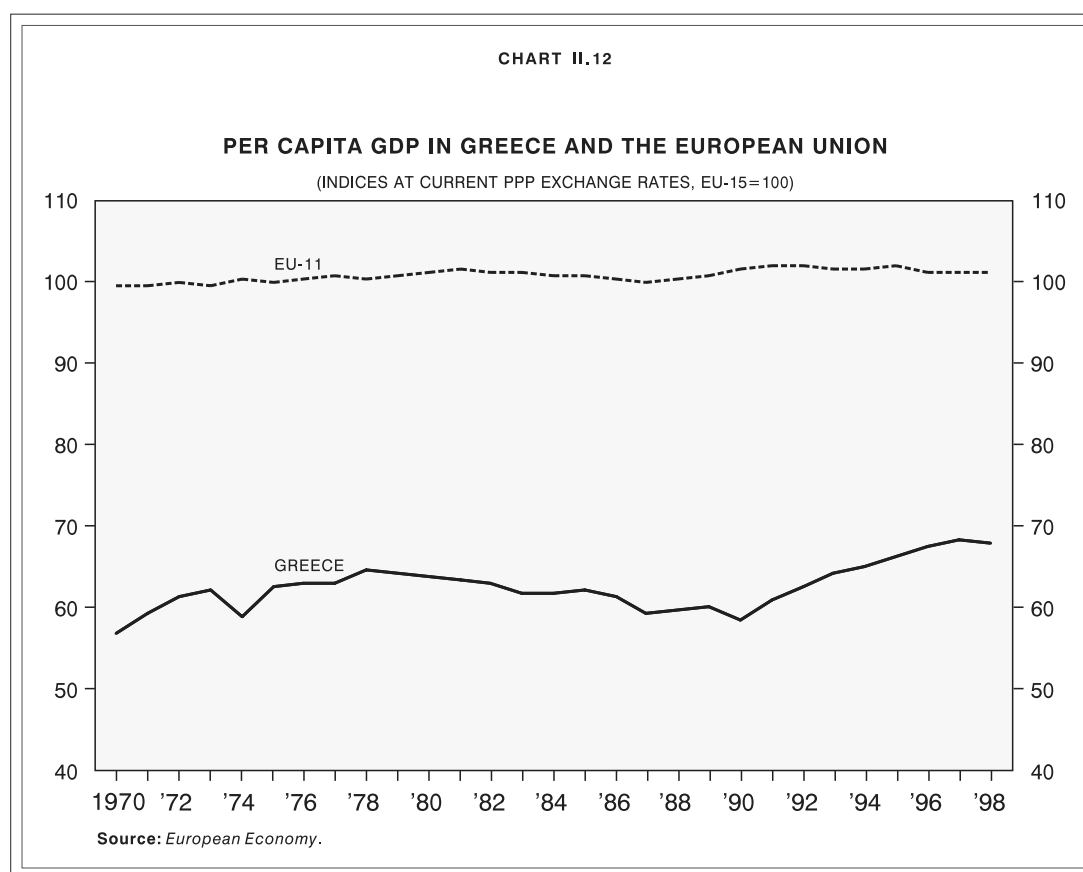
Undoubtedly, 1999 is the year of maximum effort, since the success of the country's attempt to join monetary union will be measured against this year's economic performance, which must be sustainable as well. During the final phase of transition to the euro area (i.e. in the year 2000), economic and monetary policy will have to be pursued in an environment which will have its own unique features, directly related to the adoption of the euro and the pursuit of the single European monetary policy in our country. It is essential that these new challenges for economic policy should be fully understood as early as possible, so that they can be dealt with successfully.

From mid-2000 onwards, when the date for Greece's entry into monetary union will be drawing nearer, a gradual relaxation of monetary conditions will take place, as Greek interest rates converge towards the corresponding euro area rates and the drachma's exchange rate against the euro tends towards the central rate. The change in monetary conditions is an inevitable consequence of the process of joining monetary union and the pursuit of the single monetary policy from January 2001. Therefore, during the last phase of the transition period, the ability to conduct an autonomous national monetary policy will gradually be limited.

It is estimated that the expected convergence of interest rates will have generally positive effects on spending, especially on investment, although one should not underestimate the fact that it will limit income from deposit accounts and other assets. Irrespective of the degree to which aggregate demand will be affected by the convergence of Greek interest rates, fiscal and structural policies must take into account the economic effects of the change in monetary conditions, so as to contain inflationary pressures and sustain the economy's competitiveness before and after entry into the euro area. The problem

becomes more difficult to the extent that monetary policy, this year and early next year, takes over a greater part of the anti-inflationary effort, seeking to ensure adequate safety margins on the road to price stability. This supports the view that this effort must be intensified, this year as well as in 2000, with fiscal and structural measures.

However, the biggest challenges for economic policy over the coming years will be to achieve real convergence of Greece's standard of living towards the EU average and to tackle the unemployment problem. Despite the progress made since the early



1990s, per capita income in Greece is still about 30 per cent below the EU average (see Chart II.12). After entry into the euro area, real convergence must be sought and attained in the context of the single monetary policy, which will be formulated and conducted on the basis of the monetary and economic conditions prevailing in the euro area as a whole rather than in individual member states. In addition, fiscal policy will be subject to the constraints of the Stability and Growth Pact, but more importantly to the real constraints due to the high public debt, the liabilities of the major social security funds, as well as the liabilities of public enterprises and other organisations outside the government sector.

The main components of the appropriate strategy for the economy's real convergence have been presented in the past and the general principles and basic means of carrying this strategy through have been accepted. The pivot of this strategy is the strengthening of international competitiveness, which can and must be achieved by completing fiscal consolidation and applying structural reforms aimed at improving productivity and at a more efficient operation of markets, including the labour market.

When Greece joins monetary union, fiscal policy and economic policy in general will have two very important advantages: first, financial benefits from savings on public debt servicing and, second, resources from the Structural Funds and the Cohesion Fund. These two advantages must be exploited in order to improve the economy's competitiveness. Increasing expenditure on education, vocational training and on boosting entrepreneurship is a basic means of raising competitiveness. Moreover, upgrading infrastructure and speeding up structural reforms aimed at the better operation of markets and public administration will contribute to the same goal. Effective implementation of this strategy will be instrumental in attaining a high and sustainable growth rate, which is essential for reducing unemployment.

Within its field of competence, the Bank of Greece will continue to pursue a monetary policy which aims primarily to achieve and maintain price stability. The Bank will use available policy instruments with determination, in order to attain monetary stability, which is a statutory obligation under the recently enacted law establishing the Bank's independence. At the same time, it will continue to promote the soundness and modernisation of the credit system, in the context of its supervisory powers. In addition, it will accelerate, in cooperation with banks and other financial institutions, the necessary preparatory work for a smooth changeover to the single currency. In this way, the Bank will contribute to the fast and sustainable growth of the Greek economy.

III. ECONOMIC ACTIVITY AND EMPLOYMENT

1. EXPENDITURE AND NATIONAL INCOME

1.1 General developments

In 1998 the growth rate of economic activity accelerated for the fourth consecutive year, reaching 3.7 per cent compared with 3.2 per cent in 1997. This was mainly due to the fact that investment continued to grow at a very high rate,¹ contributing 2 percentage points to the increase in GDP. At the same time, exports of goods and services grew much faster than imports;² as a result, the contribution of the balance of goods and services to the change in GDP was positive (+0.1 per cent), while the growth rate of private consumption declined by half a percentage point (see Table III.1).

It should be underlined that the rise in investment expenditure of the economy at the expense of consumer expenditure was combined with the continuation of the anti-inflationary effort. The achievement of a high, non-inflationary, GDP growth seems to be linked to the structural changes in the Greek economy over the last few years (i.e. creation of infrastructure, development of networks, interventions in the labour market, privatisations, etc.), as these are reflected in the improved performance of manufacturing, the rise in electricity production, the upturn of tourism, and the continuing expansion of total construction activity (see Table III.2).

1.2 Developments by category of expenditure

According to provisional national accounts estimates by the National Statistical Service of Greece (NSSG) and the Ministry of National Economy, in 1998 private consumption, at constant 1997 prices, increased at a slower pace than in 1997 (1998: 1.8 per cent, 1997: 2.5 per cent). This outcome, together with the fact that, according to the same national accounts estimates, real disposable income³ of the “private sector” rose by 2.8 per

1 Total gross investment of the economy grew by 9.8 per cent, compared with 9.6 per cent in 1997. It is worth noting that public investment growth accelerated sharply (1998: 13.7 per cent, 1997: 7.0 per cent), owing to a similar acceleration in the execution of major projects.

2 Exports of goods and services increased by 9.2 per cent, compared with 5.3 in 1997, while the corresponding imports grew by 5.7 per cent, compared with 5.4 per cent in 1997. However, if only goods are considered, the growth rate differential between exports and imports was negligible.

3 Owing to the lack of detailed data, national accounts estimates by NSGG and the Ministry of National Economy for recent years concern the gross disposable income of the entire “private sector”, which is defined to comprise households, private and public enterprises and the self-employed. Therefore, this aggregate covers the income of wage earners and the self-employed (both in urban and rural activities), pensions, households’ incomes from assets (rents, dividends, etc.) and business firms’ non-distributed profits.

TABLE III.1
GROSS EXPENDITURE OF THE ECONOMY AND GROSS DOMESTIC PRODUCT
(Constant market prices of previous year)

	Billion drachmas ¹	Annual percentage changes								
	1988	1990	1991	1992	1993	1994	1995	1996	1997	1998
1. Consumption	7,813.0	2.3	2.1	1.5	-0.3	1.5	3.2	1.8	2.1	1.6
Private	6,502.0	2.6	2.8	2.4	-0.8	2.0	2.7	1.9	2.5	1.8
Public	1,311.0	0.6	-1.5	-3.0	2.6	-1.1	5.6	1.0	-0.4	0.4
2. Gross fixed capital formation	1,966.7	5.0	4.8	-3.2	-3.5	-2.8	4.2	8.8	9.6	9.8
By type: construction	1,326.0	3.2	3.2	-8.3	-6.0	-4.3	1.7	7.1	9.8	10.2
equipment	640.7	8.4	7.9	6.7	0.6	-0.3	8.4	11.5	9.3	9.1
By investor: private	1,542.6	8.7	2.0	-6.3	-5.0	-2.1	2.0	9.9	10.5	8.4
public	424.0	-8.3	16.9	8.2	1.1	-4.7	10.9	5.9	7.0	13.7
3. Change in stocks and statistical discrepancy (percentage of GDP)	53.5	-0.2	0.9	-0.3	-0.3	0.1	0.7	0.1	0.0	0.3
4. Gross expenditure of the economy	9,833.2	2.9	3.7	-0.6	-0.9	1.2	3.9	2.9	3.4	3.3
5. Exports of goods and services	1,696.4	-4.1	3.7	10.5	-3.2	6.6	0.5	3.0	5.3	9.2
(Exports of goods)	(1,111.6)	(-7.2)	(5.8)	(11.6)	(-6.9)	(4.6)	(3.7)	(4.1)	(5.1)	(5.0)
6. Imports of goods and services	2,360.6	8.7	6.0	1.4	0.2	1.3	9.2	4.9	5.4	5.7
(Imports of goods)	(2,157.9)	(9.0)	(6.8)	(1.7)	(0.2)	(0.7)	(9.9)	(5.8)	(5.4)	(4.8)
7. Balance of goods and services	-664.2	...	...	...	...	...	...	...	...	...
8. GDP at market prices	9,169.0	0.0	3.1	0.7	-1.6	2.0	2.1	2.4	3.2	3.7

Contributions to GDP growth										
1. Consumption	2.0	1.8	1.3	-0.2	1.4	2.8	1.6	1.8	1.4	
Private	1.9	2.1	1.8	-0.6	1.5	2.1	1.4	1.9	1.3	
Public	0.1	-0.2	-0.4	0.4	-0.2	0.8	0.2	-0.1	0.1	
2. Gross fixed capital formation	1.1	1.1	-0.7	-0.7	-0.6	0.8	1.6	1.8	2.0	
By type: construction	0.5	0.5	-1.2	-0.8	-0.5	0.2	0.8	1.2	1.3	
equipment	0.7	0.6	0.5	0.0	0.0	0.6	0.8	0.7	0.7	
By investor: private	1.5	0.4	-1.1	-0.8	-0.3	0.3	1.3	1.5	1.3	
public	-0.4	0.7	0.4	0.1	-0.2	0.5	0.3	0.4	0.7	
3. Change in stocks and statistical discrepancy (percentage of GDP)	0.1	1.2	-1.3	0.0	0.5	0.6	-0.1	0.0	0.3	
4. Gross expenditure of the economy	3.2	4.2	-0.6	-1.0	1.3	4.2	3.1	3.7	3.6	
5. Exports of goods and services (Exports of goods)	-0.7 (-0.9)	0.6 (0.6)	1.7 (1.3)	-0.5 (-0.8)	1.0 (0.5)	0.1 (0.4)	0.5 (0.4)	0.8 (0.5)	1.5 (0.5)	
6. Imports of goods and services (Imports of goods)	-2.4 (-2.3)	-1.7 (-1.7)	-0.4 (-0.4)	-0.1 (0.0)	-0.3 (-0.2)	-2.2 (-2.2)	-1.2 (-1.3)	-1.3 (-1.2)	-1.4 (-1.1)	
7. Balance of goods and services	-3.1	-1.1	1.3	-0.6	0.7	-2.1	-0.8	-0.5	0.1	
8. GDP at market prices	0.0	3.1	0.7	-1.6	2.0	2.1	2.4	3.2	3.7	

1 1988 prices.

Source: 1988-95: National Statistical Service of Greece (NSSG)/National Accounts (September 1998). Final data on the basis of the European System of Integrated Economic Accounts (ESA).

1996-97: NSSG/National Accounts (September 1998). Provisional estimates.

1998: Ministry of National Economy/Directorate of Macroeconomic Analysis (March 1999). Provisional estimates.

cent in 1998, compared with a 0.5 per cent fall in 1997, resulted in an upswing to 12.4 per cent in the average propensity to save, after a continuous decline between 1989 (21.3 per cent) and 1997 (11.6 per cent). It should be noted though that the recovery of the “private sector’s” real disposable income was mainly due to the appreciably faster nominal growth of net non-wage income (profits, etc.). By contrast, the growth of wage-earners¹ real disposable income decelerated markedly, thus considerably restraining the growth of consumption. At the same time, however, the large expansion of consumer credit (the outstanding balance of consumer bank loans increased by 38.1 per cent in the course of 1998), which was partly linked to keener competition between commercial banks, made a positive contribution to consumption growth.

The slower increase in consumption is confirmed by available short-term indicators (see Chart III.1). As regards consumer demand for goods, retail sales volume increased by 2.4 per cent in 1998 (while the corresponding rate was almost twice as high in 1997). This chiefly reflects developments in furniture and household appliances (1998: –0.6 per cent, 1997: + 8.4 per cent), as well as in “other goods” (1998: +3.3 per cent, 1997: + 6.4 per cent). By contrast, demand for food rose by 2.7 per cent (i.e. exactly as much as in 1997) and was mainly directed to domestic production (which increased), while demand for clothing-footwear also recovered (1998: + 1.9 per cent, 1997: –0.1 per cent). The number of new private passenger car registrations continued to increase at a high rate (10.8 per cent), albeit lower than in 1997. Relevant indicators show that the increase in consumer demand for services (especially in the tourist and telecommunications industries) was also considerable.

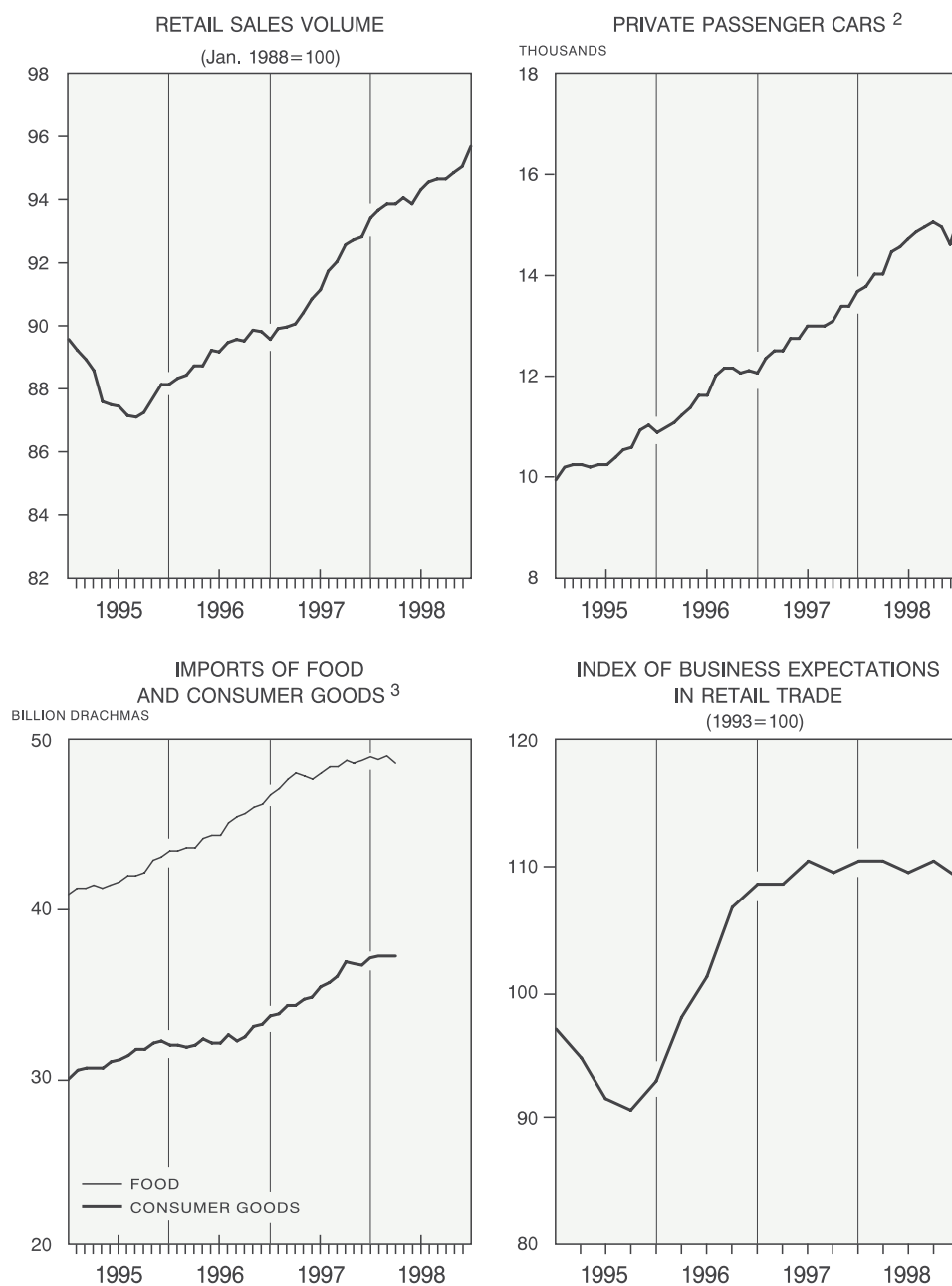
In 1998, total gross fixed capital formation, at 1997 prices, continued the upward course of the previous three years, increasing at roughly the same high rate as in 1997. Private investment (which increased by 8.4 per cent) contributed 6.3 percentage points to the growth of total investment (9.8 per cent), while public investment, whose growth rate more than doubled relative to 1996 and 1997 (1998: 13.7 per cent, 1997: 7 per cent, 1996: 5.9 per cent), contributed 3.5 percentage points. As a result, the share of public investment in total investment rose to 36.2 per cent in 1998, compared with 19.1 per cent in 1997. Besides, a breakdown of investment by type shows that investment in construction grew slightly faster (1998: 10.2 per cent, 1997: 9.8 per cent), accounting for about two thirds of the increase in total gross investment. Investment in machinery rose at roughly the same high rate as in 1997.

On a national accounts basis, more than half of the pronounced rise in public investment stemmed from the 21.1 per cent increase (at constant prices) in investment by public enterprises, while the remainder of the rise was accounted for by the 9.7 per cent increase in general government investment. According to provisional data, disbursements under the Public Investment Budget (PIB)² increased by 17.6 per cent, at current prices,

1 See Chapter IV.2.

2 Bank of Greece data.

CHART III.1

INDICATORS OF PRIVATE CONSUMPTION ¹

¹ Twelve-month moving average centred on the last month of the period.

² Number of new registrations.

³ Foreign exchange statistics, at 1988 prices (deflated by the corresponding wholesale price index).

Source: NSSG, Foundation for Economic and Industrial Research (IOBE) and Bank of Greece.

in 1998, compared with 38.4 per cent in 1997 (see Charter III.2), while expenditure for jointly funded projects under the second Community Support Framework (CSF) rose by 27.4 per cent. The rise in government expenditure reflects the faster absorption, during

TABLE III.2
GROSS DOMESTIC PRODUCT AT FACTOR COST
(Constant prices of the previous year)

	Billion drachmas ¹	Annual percentage changes								
	1988	1990	1991	1992	1993	1994	1995	1996	1997	1998
1. Primary sector (agriculture)	1,034.5	-13.4	14.9	0.0	-0.3	5.9	4.2	-8.0	1.7	1.0
2. Secondary sector	2,264.5	-0.9	3.0	-2.6	-1.4	-0.9	0.3	4.0	3.4	5.8
Mining and quarrying	89.3	-4.9	-3.3	0.4	1.2	0.2	-1.1	5.3	3.1	-4.0
Manufacturing	1,308.7	-2.0	3.7	-3.5	-3.1	2.0	0.1	3.6	0.1	3.0
Electricity - town gas - water supply	214.1	2.5	3.3	8.1	-3.8	9.6	3.1	6.0	2.3	12.0
Construction	652.4	0.8	2.3	-4.4	2.7	-9.1	-0.2	4.0	10.3	10.0
3. Tertiary sector	5,243.5	1.6	0.4	2.4	-2.7	4.3	3.1	2.8	3.3	3.6
Transport - Communications	556.8	-2.7	0.6	11.4	3.2	-0.7	7.6	1.7	10.1	6.0
Trade	1,261.8	1.7	0.4	7.6	-0.4	3.0	2.8	5.3	3.2	1.5
Banking - Insurance	295.8	-0.9	14.8	9.6	-26.4	12.8	6.1	4.9	8.7	8.0
Ownership of dwellings	979.3	2.6	3.0	-4.4	-2.9	2.1	1.2	1.6	1.0	1.2
Public administration - defence	596.2	1.1	-6.7	-4.7	-0.7	0.6	8.6	7.4	-7.6	-2.0
Health - education	682.7	5.7	0.6	0.2	-2.9	11.6	-0.2	-5.9	2.2	1.5
Miscellaneous services	870.9	0.3	-1.9	3.6	0.3	4.8	2.1	5.2	7.7	10.0
4. Statistical discrepancy ²	-224.2	...	...	...	...	...	...	...	...	...
5 GDP at factor cost	8,318.3	-0.9	2.6	0.8	-1.7	2.8	2.2	1.9	3.0	3.7

1 1988 prices.

2 Net interest income (unallocated) of all branches.

Πηγή: 1988-95: NSSG/National Accounts (September 1998). Final data on the basis of the European System of Integrated Economic Accounts (ESA).

1996-97: NSSG/National Accounts (September 1998). Provisional estimates.

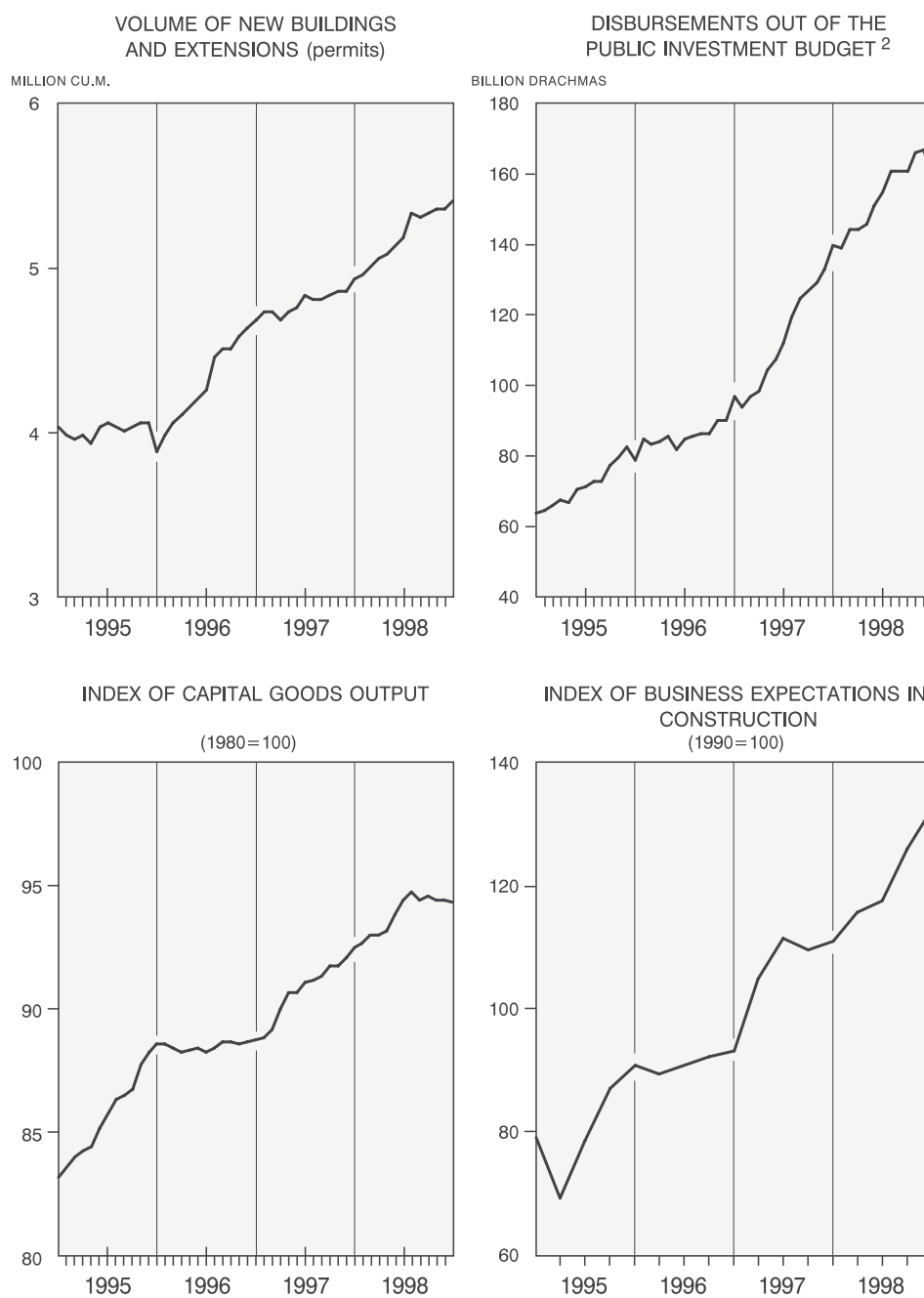
1998: Ministry of National Economy/Directorate of Macroeconomic Analysis (March 1999). Provisional estimates.

1998,¹ of resources from the 2nd CSF covering the 1994-1999 period, while a very substantial inflow of EU resources is expected over the coming years, following the agreement signed at the Berlin European Council.² According to the Introductory Report on the

1 According to EU data, the rate of absorption of Structural Fund resources under the second CSF reached, on the basis of payments, 61.5 per cent at the end of 1998, compared with 43.4 per cent at the end of 1997, while, on the basis of commitments, it rose to 82.2 per cent, compared with 59 per cent in 1997. This performance, which exceeds the EU average (79.8 per cent for commitments and 61 per cent for payments) places Greece in the fifth position among the EU Member States entitled to receive CSF funds, while the aim for 1999 is to achieve an over-80-per-cent absorption rate as regards payments and, of course, full absorption on the basis of commitments.

2 The Berlin Council (24/25 March 1999) reached an agreement, on the basis of which an amount of 24.88 billion euro will be allocated to Greece for the years 2000 through 2006, compared with 21.9 billion euro in 1993-1999.

CHART III.2

MAIN INDICATORS OF INVESTMENT ACTIVITY¹

¹ Twelve-month moving average centred on the last month.

² Disbursements to finance the public investment programme; on cash basis, at current prices.

Source: NSSG, IOBE and Bank of Greece.

Budget, public enterprises' investment rose by 28.5 per cent, at current prices, compared with 25.2 per cent in 1997, and is still focused on telecommunications, energy and transport, as in previous years.¹

The faster increase in construction activity was due not only to the large rise (14 per cent) in public construction activity (i.e. at a rate twice as high as in 1997), but also to the continuing increase in private residential investment (8.5 per cent). These developments are also in line with increased production in certain manufacturing branches, associated with the construction industry. More specifically, according to NSSG data, output of non-metallic minerals rose by 2.5 per cent in 1998, while the output of ready-made concrete rose conducted by 16.9 per cent and the production of cement (excluding clinker) increased by 2.5 per cent. The upward course of construction activity is also confirmed by the relevant business survey conducted by the Foundation for Economic and Industrial Research (IOBE), which shows that the index of business expectations of construction firms² continued to rise at a particularly high rate (19.3 per cent) in 1998. According to the survey, the business climate regarding the construction of "other buildings" (except dwellings) and the execution of public works³ improved. By contrast, business expectations of firms involved in the construction of dwellings were negative.

According to estimates by the Ministry of National Economy, in 1998 private residential investment continued to follow the upward course of the previous two years (1998: 8.5 per cent, 1997: 11.1 per cent and 1996: 20.7 per cent). This is inferred from the volume of new buildings (on the basis of permits issued), which rose at an accelerating rate (9.4 per cent, compared with 5.7 per cent in 1997 and 20.7 per cent in 1996). Increased activity in the construction of dwellings is mainly associated with the expansion of housing credit over the last years, owing to the decline in interest rates on housing loans (which stemmed from both the drop in inflation and keener competition between credit institutions, which leads to the supply of new banking products). Thus, according to provisional data, the outstanding balance of total bank credit to housing increased by 20.6 per cent in 1998, compared with 23.8 per cent in 1997 and 27.5 per

1 According to the Introductory Report on the Budget, investment in 1998 by the Public Power Corporation (DEH) totalled 309.3 billion drachmas (mainly for the construction of new plants) and that by the Public Gas Corporation (DEPA) 105.3 billion drachmas (completion of infrastructure and natural gas network). The Hellenic Telecommunications Organisation (OTE) invested 349.0 billion drachmas, the Hellenic Railways Organisation (OSE) 220 billion drachmas and the National Road Construction Fund (TEO) 295.3 billion drachmas (mainly for the modernisation and expansion of the telecommunications, railway and road networks, respectively). The investment programme for public enterprises is estimated to reach 2.1 trillion drachmas in 1999. Out of this sum 1.7 trillion drachmas will be used to finance projects under the CSF and 0.5 trillion drachmas will be allocated to projects financed exclusively by national resources.

2 However, data from the income statements of the 32 construction firms whose shares are listed on the Athens Stock Exchange show that their turnover rose by 18 per cent in 1998, compared with 7.1 per cent in 1997, while their net profits increased by a mere 7 per cent, owing — mostly — to cost conditions, but also to keen competition, which induces firms to operate with a narrow profit margin.

3 Intense activity is observed in construction industry with respect to mergers, as a new law is to be enacted, which will provide for incentives to merging companies or companies creating a common entity. Thus, Greek construction firms, by strengthening their capital base, will have more chances of being awarded major projects — self-financed or not — related to the 2004 Olympic Games, the third CSF, etc.

cent in 1996.¹ By contrast, the inflow of funds, in US dollars, for the purchase of real estate continued to decline (first 11 months of 1998: -7.4 per cent, same period of 1997: -4.9 per cent).

2. PRIMARY AND SECONDARY PRODUCTION

2.1 Overview

Activity in both the primary and the secondary sector of the economy increased in 1998. According to provisional data from NSSG and the Ministry of National Economy, GDP growth in the secondary sector reached 5.8 per cent, compared with 3.4 per cent in

TABLE III.3
INDUSTRIAL PRODUCTION (1980=100)

	Weights (1980)		Percentage average annual change					1998 level (1980=100)
			1994	1995	1996	1997	1998	
<u>TOTAL</u>		100.0	1.3	1.8	1.2	1.1	7.7	119.0
1. Mining and quarrying	5.8	100.0	-1.3	-3.2	3.3	3.6	-4.4	147.3
Lignite		26.9	4.6	0.1	3.5	-1.8	2.3	229.9
Bauxite		10.3	0.4	-6.0	9.0	-17.5	-4.3	58.3
Iron and nickel ores		2.5	56.0	8.3	4.4	4.2	-11.8	139.1
Chrome and manganese ores		1.0	-22.7	14.6	15.9	2.3	-29.4	6.3
Oil wells and extraction of natural gas		13.0	-9.4	-15.3	13.3	-8.7	-31.3	159.1
Marble/stone and other building materials		22.4	-0.5	7.8	3.2	18.8	2.3	190.7
Sulphur compounds, barytes		10.9	-22.0	-27.7	-45.3	125.3	14.2	69.9
Magnesite		13.0	4.2	5.2	-12.9	4.8	3.0	34.8
2. Manufacturing	87.8	100.0	1.0	2.1	0.6	1.0	3.4	105.4
<i>Category of product</i>								
Consumer non-durables ¹		60.5	2.5	0.5	0.7	-0.6	2.8	110.1
Consumer durables		5.5	-0.2	-1.5	2.4	6.7	24.2	118.3
Capital goods		34.0	-1.5	6.5	0.1	4.3	2.0	94.4
3. Electricity and town gas	6.4	100.0	5.1	3.5	3.8	0.4	48.0	280.5
Electricity		99.2	5.8	3.3	3.8	0.4	6.8	198.7
Town gas		0.8	-16.0	10.2	1.8	-0.5	1,587.1	10,961.2

1 Including consumer non-durables and intermediate products.

Source: NSSG.

1997, reflecting the increase in manufacturing output and the large output growth in the construction industry and in electricity, natural gas and water-supply. This development is

1 By an amendment (Law 2682/99 enacted in February 1999) to previously applicable legislation, the system of leasing was extended to cover the acquisition of real estate. Leasing is tantamount to a loan, which is paid off by instalments (monthly rent).

corroborated by NSSG data (see Table III.3), which show that total industrial production grew by 7.7 per cent in 1998, compared with 1.1 per cent in 1997, owing to the large increase in the production of electricity and natural gas,¹ and the faster rise in the manufacturing output index (1998: 3.4 per cent, 1997: 1.0 per cent). By contrast, mining and quarrying output followed a downward trend (1998: -4.4 per cent, 1997: 3.6 per cent).

2.2 Agricultural production

Estimates by the Ministry of National Economy point to a slight increase in agricultural production (1998: 1.0 per cent, 1997: 1.7 per cent). However, according to Ministry of Agriculture provisional data on agricultural output, plant production seems to

TABLE III.4
PRODUCTION OF BASIC AGRICULTURAL PRODUCTS
(Thousand tonnes)

Products	1989/90 ¹	1991	1992	1993	1994	1995	1996	1997	1998 ²	Average annual percentage change between two-year periods 1989/90 and 1997/98
Soft wheat	840	978	879	819	838	758	630	654	612	-3.5
Durum wheat	1,085	2,240	1,423	1,192	1,581	1,384	1,132	1,407	1,300	3.0
Maize	1,770	2,328	1,977	1,936	1,814	1,520	1,800	2,000	2,000	1.6
Alfalfa	1,491	1,495	1,479	1,489	1,428	1,396	1,266	1,237	1,232	-2.3
Tobacco	124	154	188	136	129	120	126	121	126	0.0
Cotton (natural)	712	880	818	986	1,180	1,250	962	1,100	1,170	6.0
Tomatoes										
for processing	1,184	1,177	966	850	1,100	1,130	1,162	1,167	1,226	0.1
Sugar beet	3,097	2,730	3,059	2,718	2,420	2,600	2,352	3,095	1,970	-2.5
Olive oil	244	330	304	268	330	330	337	400	386	6.2
Lemons	179	173	176	137	141	140	161	153	152	-2.0
Oranges	876	762	987	897	875	820	979	965	769	-0.1
Apples	309	186	385	331	321	323	335	292	332	0.2
Peaches	706	719	1,122	1,083	1,173	745	897	246	483	-7.9
Meat, total	521	528	545	528	522	510	525	522	493	-0.3
Milk, total	1,791	1,783	1,803	1,828	1,853	1,834	1,786	1,768	1,848	0.1

1 Two-year average.

2 Provisional data.

Source: Ministry of Agriculture.

have stabilised (-0.03 per cent), while there was a decline in livestock² production (-1.65 per cent). Producer prices increased by a mere 0.5 per cent, since the index of producer prices for plant production dropped by about 0.6 per cent for the first time in the 1990s.

1 The growth rate of total industrial production has been influenced considerably by the commencement (as from February 1998) and the expansion of natural gas distribution (the index previously comprised only the production and distribution of town gas).

2 Table III.4 presents the production of basic agricultural products.

TABLE III.5
PRODUCER PRICES AND INPUT PRICES (1990=100)

Products	Weights	1991	1992	1993	1994	1995	1996	1997	1998
		Percentage changes in producer prices							
Cereals and rice	9.75	9.0	6.6	3.5	4.3	4.5	0.8	0.9	0.6
Bulbs and roots	3.66	37.8	-4.3	16.4	27.2	6.6	3.7	6.2	5.5
Fresh vegetables	13.19	20.6	6.0	4.5	18.7	22.3	10.2	10.7	0.8
Fresh fruit	7.43	34.0	-17.4	9.7	33.8	16.5	11.7	23.8	-0.2
Citrus fruit	2.28	27.7	0.8	-3.5	19.2	15.6	7.0	-14.9	3.0
Dried fruit and nuts	3.86	21.2	4.9	12.0	13.3	9.7	1.8	6.7	2.7
Wine	2.80	25.2	12.6	-2.1	11.3	12.4	5.2	0.2	7.6
Seeds	0.26	13.0	5.0	-2.7	3.8	8.1	2.2	-0.2	-2.3
Pulses	0.63	8.0	13.2	5.0	11.1	15.6	5.5	-0.2	2.5
Olives and oil-products	11.49	40.1	-12.8	6.7	17.5	13.4	19.8	-15.0	-7.4
Industrial crops	13.13	20.3	9.5	0.9	9.1	4.0	12.0	4.5	-4.3
Fodder plants and hay	1.28	5.8	13.5	19.9	9.5	3.1	15.9	-5.4	-1.4
Flowers	1.26	46.3	36.1	4.4	19.1	8.6	-13.8	4.6	9.1
PLANT PRODUCTION	71.02	24.9	0.9	5.2	16.0	11.9	9.4	3.4	-0.6
Meat	12.54	12.9	15.1	3.0	6.2	4.4	9.9	2.3	-1.0
Poultry	2.99	15.1	7.7	6.2	1.0	4.9	1.4	2.1	2.6
Milk	9.87	4.3	11.0	21.2	25.8	2.0	-13.5	3.4	8.7
Eggs	2.33	32.9	0.1	3.8	7.0	6.3	12.8	8.9	6.7
Other	1.25	-10.1	15.6	8.8	22.2	13.2	7.0	3.2	1.8
LIVESTOCK PRODUCTION	28.98	10.8	11.6	9.4	13.2	4.0	0.2	3.3	3.4
GENERAL INDEX	100.00	20.8	3.7	6.4	15.2	9.6	6.9	3.4	0.5
Items	Weights	Percentage changes in input prices							
Seeds	5.17	21.4	13.1	3.5	2.8	11.1	8.8	2.6	2.3
Animals for rearing and reproduction	2.41	11.2	8.5	9.3	3.4	8.6	2.8	0.5	-0.3
Energy - lubricants	26.34	39.3	23.0	21.6	2.2	2.0	12.9	0.4	-5.8
Fertilisers	8.81	31.0	30.6	0.0	12.5	10.1	3.3	7.7	2.1
Pesticides	8.38	11.8	2.3	3.5	10.4	10.6	9.0	3.2	5.7
Animal feed	27.90	20.4	5.3	12.9	8.2	2.9	8.3	1.2	1.9
Agricultural tools and supplies	4.52	13.7	10.6	6.6	8.5	14.1	5.9	3.6	7.3
Maintenance and repair of machinery	8.42	16.5	12.4	11.5	13.4	9.6	10.1	4.0	6.9
Maintenance and repair of buildings	2.65	17.3	11.0	10.5	9.3	9.1	5.4	5.1	5.2
Miscellaneous expenses	5.40	18.8	11.3	4.4	10.8	8.3	3.4	10.8	-7.3
TOTAL	100.00	24.6	14.4	12.3	6.9	5.7	9.0	2.6	0.0

Source: NSSG.

Input prices declined marginally, mainly because of the fall in the energy-lubricants index (–5.8 per cent), which followed the general reduction in fuel prices (see Table III.5).

Although EU decisions concerning Structural Fund and Common Agricultural Policy budgets were more satisfactory than what was expected at the beginning of negotiations,¹ it is estimated that, in the medium term, further increases in the income of the Greek agricultural sector must come from the creation of more competitive farming concerns, which will be involved in an increasingly pressing international environment.² The effort to reduce production costs³ and the orientation of the agricultural sector towards improving quality⁴ are expected to contribute to this end.

2.3 Manufacturing

2.3.1. General developments

In 1998 the average⁵ annual growth rate of manufacturing production more than tripled relative to 1997 (1998: 3.4 per cent, 1997: 1.0 per cent). This reflects the sharp increase in consumer durables production,⁶ as well as the considerable recovery of consumer goods output. Capital goods also made a positive contribution, though their growth rate decelerated in 1998 (see Chart III.4).

It is estimated that the overall acceleration of manufacturing output growth is associated with both the improvement of competitiveness and other factors, such as the execution of significant procurement agreements between industry and the public sector, the

1 According to estimates by the Greek Minister of Agriculture (Athens daily *Naftemporiki*, 22 March 1999), the final decisions of the Council of EU Ministers of Agriculture will bring to Greece a yearly fiscal benefit of 48.3 billion drachmas over the period 2000–2006. By contrast, if certain initial proposals had been approved, the yearly losses of the Greek agricultural sector would have been very high.

2 The forthcoming enlargement of the EU to include Central and Eastern European countries, as well as the implementation of the new conceptual underpinnings of the CAP, for bringing institutional prices down to international levels and offsetting the loss by income subsidisation, are expected to influence significantly European agricultural production as a whole.

3 The cut in fuel tax for agricultural concerns is a measure that goes in the same direction.

4 Some of the practices that can be adopted are: the implementation of different production systems (e.g. “mild” production systems or eco-cultivation), quality control of products, promotion and establishment of reputation (for products from specific geographical areas), closer and more efficient cooperation between producers and manufacturers.

5 The faster growth of manufacturing was obvious only in the first half of the year, whereas in the second half the corresponding index recorded a marked slowdown. This pattern is also consistent with the evolution of the index of business expectations in manufacturing (IOBE), which followed a continuous downward course from May –when it reached a year-peak value (111.0), because of the rise in export expectations after the drachma’s devaluation in March –to December 1998, when it stood at 99.9 (see Chart III.3).

6 This category includes the branch of electrical machinery-appliances, whose output recorded a sharp increase, mostly because of the conclusion of contracts for the procurement of telecommunications material, in execution of significant procurement agreements between industry and the public sector. This branch accounted for more than one third of the increase in manufacturing output in 1998 (see Table III.6).

CHART III.3

OUTPUT AND BUSINESS EXPECTATIONS IN MANUFACTURING

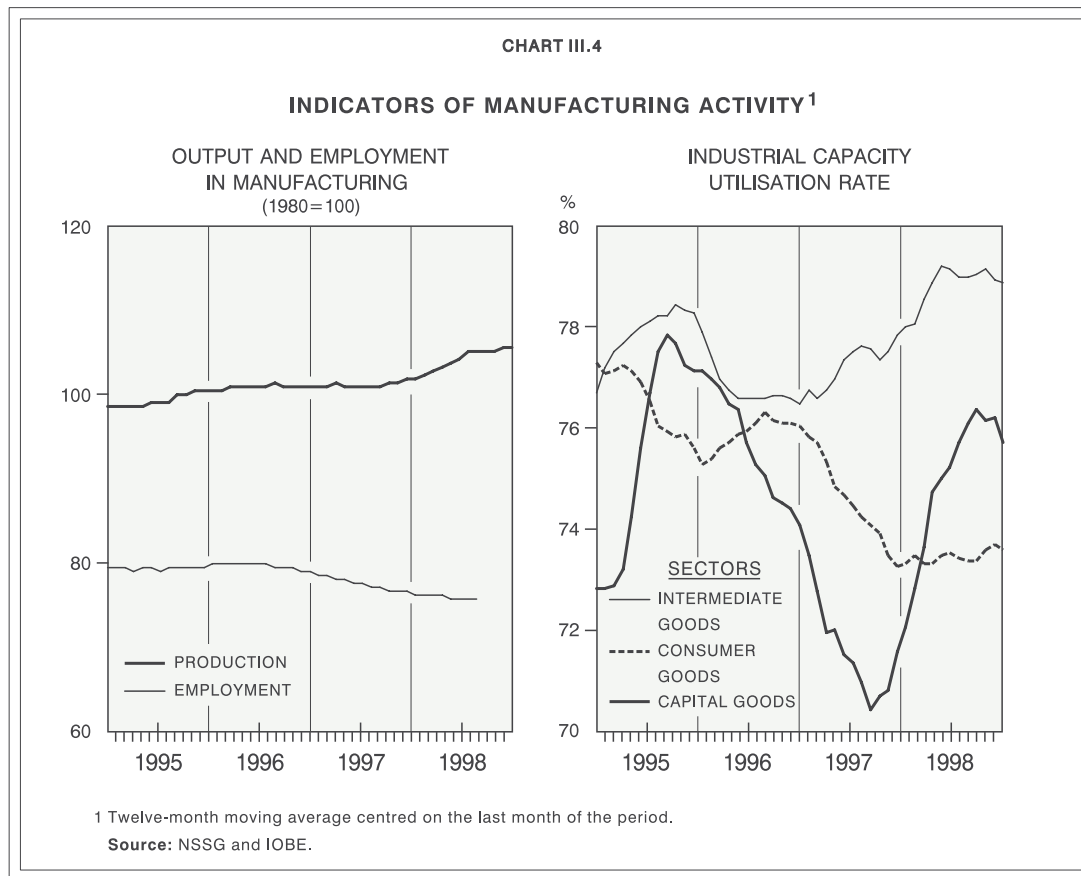
(JANUARY 1997 - MARCH 1999)



Source: NSSG (output) and IOBE (business expectations). The index of business expectations is compiled on the basis of business firms' i) estimates of total demand and stocks and ii) output forecasts for 3-4 months ahead.

strengthening of confidence after the entry of the drachma into the ERM, and the continuing expansion of Greek firms' export activity, especially towards non-EU markets. It is also estimated that the large increase in private investment in equipment in 1995-1998 has created the necessary conditions for the restructuring of the industrial base and the achievement of high growth rates in manufacturing (for further details, see Box III.1).

There are clear signs of improvement in the competitiveness of manufactured products during 1998. It is estimated that the real exchange rate of the drachma (calcu-



lated on the basis of unit labour costs in manufacturing) dropped by about 4 per cent in 1998.¹

The progress made in the competitiveness and export vigour of Greek manufacturing is also confirmed by external trade statistics compiled by the NSSG. According to these data, the drachma value of exports of manufactured goods, excluding fuels, increased in the January-September period of 1998 at an annual rate which was faster than in the corresponding period of 1997 (11.5 per cent against 1996: 9.6 per cent), while export growth in

¹ See also Chapter IV.2

BOX III.1**Investment activity and prospects in manufacturing**

Industrial investment played a prominent role in the increase in investment activity between 1995 and 1998¹. Under the Operational Plan for Industry, and especially on the basis of grants provided for in Articles 23a and 23b of Law 1892/90,² numerous manufacturing firms implemented investment and business plans aimed at restructuring production and enhancing flexibility and competitiveness. In many cases, investment expenditure, in the context set mainly by Article 23b, concerned the design and development of systems ensuring quality standards

INVESTMENT PLANS FOR 1995–1998

	1995		1996		1997		1998		1995 – 1998	
	23a ³	23b ⁴	23a	23b	23a	23b	23a	23b	23a	23b
Number of firms initially participating	63	61	86	113	48	217	30	298	227	689
Total budget (billion drachmas)	97.6	25.5	122.9	54.6	78.9	70.5	42.7	96.8	342.2	247.5
Investments completed	0	35	2	65	0	61	0	14	2	175

Source: Ministry of Development.

or the procurement of environment-friendly technologies. The table presents a classification, by type of investment (23a or 23b), of the investment plans which were approved and implemented in 1995 through 1998. It also depicts the total budget of these plans, on the basis of data compiled by the Ministry of Development.

According to data compiled by the Federation of Greek Industries (SEB),⁵ industrial investment expenditure came to 1,070 billion drachmas in 1994 and continued to grow, reaching a record level of 1,452.8 billion drachmas in 1997.³

The rise in industrial investment was also supported by the improvement of firms' profitability, as inferred from the analysis of firms' balance sheets and income statements covered by the ICAP sample survey, which comprises about 6,000 firms⁶ for the period 1993-1997. According to these data, the pre-tax profits of these firms increased by 251.4 per cent from

1 Investment is estimated to have risen cumulatively by 40 per cent over this period.

2 The provisions of these articles have been virtually integrated into the new law (2601/98) on development incentives.

3 Investment under Article 23a of Law 1892/90 concerned only business plans with a minimum total budget of 1 billion drachmas each (or 500 million drachmas, in the case of IT firms).

4 Investment under Article 23b of Law 1892/90 concerns various types of investment expenditure (e.g. acquisition of productive flexibility, realisation of quality standard ensuring systems, procurement and use of environment-friendly technologies, and so forth), with a minimum total budget of 50 million drachmas each.

5 See the Athens daily "Express", 25 December 1998.

6 See the Athens daily "Kerdos", 27 September 1998.

1993 to 1997, and their net profit margin improved steadily (1993: 2.96 per cent, 1997: 5.22 per cent).

All surveys¹ conducted in 1998 indicate that business investment in the manufacturing sector continued to increase that year. Thus, according to the biannual investment survey carried out by IOBE (October-November 1998), private investment expenditure is estimated to have risen by 17.3 per cent (at current prices), while a considerable increase (of 10.4 per cent) is forecast for 1999.² In addition, another ICAP survey on developments in Greek industry points to notable investment activity in the manufacturing sector in 1998, which is expected to be enhanced in 1999.² Lastly, data on committed funds for the execution of projects under the Operational Plan for Industry³ show that the absorption rate exceeded 50 per cent, as 450 billion drachmas had been disbursed by end-1998, compared with 262.1 billion drachmas in 1997, out of a total approved budget of 945 billion drachmas.

1 This is also corroborated by the fact that capital goods production increased by 2 per cent.

2 According to the survey "The Greek industry: Estimates for 1998 and expectations for 1999" which was conducted in November-December 1998, 62.9 per cent of the sample (i.e. 250 industrial firms) stated that they carried out fixed capital investment in 1998. Indeed, one in three investing firms increased its investment volume. As regards 1999, 47 per cent of the sample are planning to expand their investment activities and 33.2 per cent to maintain them at 1998 levels.

3 Interview given by the then Minister of Development to the Athens daily "Naftemporiki", 16 December 1998.

volume terms¹ remained high and overshot the increase in industrial output. Hence, while the rate of increase in exports of manufactured goods was negatively influenced by both the slowdown in world economic growth and the pricing policy² of export firms, the export performance index for manufacturing rose marginally.³ As regards imports of manufactured goods, it is estimated that the decrease in domestic demand — especially that for consumer goods — along with the increase of import prices in drachma terms, which resulted from the devaluation of the drachma in March 1998, led to a significantly slower increase in the value of imports (10.2 per cent in January-September 1998, compared with 17.6 per cent in the corresponding 1997 period), and to an even larger deceleration in the growth of manufactured imports in volume terms. However, manufactured imports retained their share⁴ in the domestic market, as it is estimated that, owing to investment demand and strong construction activity, imports of equipment and intermediate goods remained at high levels.

1 The appropriate sub-index of the NSSG's Wholesale Price Index served as a deflator.

2 Up to September 1998, export prices, in foreign currency, dropped at a slow rate, certainly not proportionate to the exchange rate adjustment. It is estimated that export firms reduced their prices, in foreign currency, immediately after the devaluation, but then increased temporarily their profit margins in drachmas and restored prices to pre-devaluation levels. The decrease in the relevant index was faster only in the last quarter of 1998.

3 The index of export performance for manufacturing as a whole (excluding fuels), which records the share of exports in total production, stood at 29.3 in January-September 1998, compared with 29.0 in the corresponding 1997 period.

4 The index of import penetration, which records the share of imports in total apparent consumption, remained unchanged in January-September 1998, compared with the corresponding 1997 period (51.3).

2.3.2 *Developments by branch of manufacturing*

Out of a total of 20 manufacturing branches, 10 recorded an increase in production and 10 a decrease. Electrical machinery-appliances, chemicals, and rubber-plastics showed the greatest dynamism, increasing by 22.9 per cent, 10.3 per cent and 9.7 per cent, respectively. By contrast, production fell significantly in the branches of “miscellaneous” manufacturing products, leather, and clothing-footwear (see Table III.6), where production was half (or even much less than) that in the base-year.¹

The implementation of the Operational Plan for Industry, the active involvement of the Hellenic Investment Centre (ELKE), the legislative settlement of issues associated with Industrial Areas, and a series of actions, such as the establishment of the “Industrial Change Offices”, the realisation of industrial networks, the subsidisation of young or female manufacturers and the provision of special funds to support investment by small and medium size firms, have contributed to ensuring better conditions for entrepreneurial capital activities in industry. At the same time, medium-size and, especially, large industrial firms whose shares have been listed on the Athens Stock Exchange, had the opportunity to raise substantial funds in the last two years and improve their financial position. It is estimated that the further improvement in macro-economic aggregates, together with the completion of large infrastructure investment and the implementation of new horizontal actions² in the context of the third CSF, will speed up restructuring and lead to the creation of powerful and competitive manufacturing entities.

Developments by branch of manufacturing activity were as follows (see Table III.7):

The maintenance of domestic demand for food products at a satisfactory level,³ combined with the rise of import prices in drachma terms — due to the devaluation of the drachma in March 1998 — proved beneficial to the branches of food and beverages, whose output increased by 3.7 per cent and 4.9 per cent, respectively.⁴ Although it is estimated that the execution of investment plans and the implementation of systems ensuring quality standards⁵ have strengthened the export orientation of these branches, the largest part of the rise in domestic demand seems to have been absorbed by the domestic market.⁶ It should be noted, however, that several firms in the food industry are proceeding to take strategic actions for establishing or absorbing subsidiaries in the whole region of the Balkans.

1 In 1998 the output index in these branches stood at 52.5, 34.9 and 41.0, respectively (1980=100).

2 These are expected to cover various fields, e.g. personnel training in innovative production methods, energy infrastructure, investment in new technologies, etc.

3 As reflected in the 2.7 per cent increase in the retail sales volume of food in 1998.

4 Compared with a decline of 3.3 per cent and 2.1 per cent, respectively, in 1997.

5 In this branch, the implementation of hygiene and quality-standard-ensuring systems has become a necessary precondition for export activity.

6 As suggested by the smaller share of import penetration in total domestic consumption (23.6 per cent in January-September 1998, compared with 25 per cent in the corresponding period of 1997) and by the drop in export performance (from 16.0 per cent in 1997 to 14.9 per cent in 1998).

TABLE III.6
MANUFACTURING PRODUCTION (1980=100)

	Weights (1980)	1994	Average annual percentage changes				1998 level (1980=100)
			1995	1996	1997	1998	
Manufacturing	100.0	1.0	2.1	0.6	1.0	3.4	105.4
Food	11.9	-1.1	2.0	-0.1	-3.3	3.9	133.2
Beverages	3.7	7.8	3.9	-6.0	-2.1	4.9	168.7
Tobacco	2.3	15.7	10.9	-1.2	-0.8	-5.1	127.7
Textiles	16.1	-0.5	-5.5	-4.6	1.4	-0.8	67.1
Footwear and clothing	6.1	-11.8	-9.8	-12.0	-3.1	-13.1	41.0
Wood and cork	2.2	-9.0	17.0	-1.9	-11.6	-8.3	57.0
Furniture	1.2	2.4	-4.7	-0.2	-0.1	-3.4	73.2
Paper	1.9	6.9	3.7	-5.0	-4.8	-3.3	148.1
Printing and publishing	2.6	-2.4	-0.7	8.4	-7.5	-4.4	77.0
Leather	0.8	-4.3	-8.4	-7.1	-11.8	-14.9	34.9
Rubber and plastics	3.9	9.4	-12.6	1.1	-0.4	9.7	133.3
Chemicals	7.8	1.9	10.8	7.9	2.0	10.3	174.7
Petroleum and coal products	2.8	12.3	4.3	7.0	-0.6	2.0	151.5
Non-metallic minerals	8.6	3.0	1.8	7.1	2.2	2.5	99.6
Basic metals	6.5	4.9	4.8	-3.7	10.2	2.4	116.6
Metallurgical products	6.4	-2.1	4.6	-1.5	8.2	-1.9	73.4
Machinery and appliances, excluding electrical	1.9	1.1	20.4	2.9	11.1	2.2	116.9
Electrical machinery and appliances	4.7	-1.5	3.0	6.7	12.7	22.9	158.0
Vehicles	8.0	-8.6	4.6	-1.1	-3.0	5.1	72.5
Miscellaneous	0.6	-11.1	14.2	79.8	-2.4	-44.2	52.5

Contributions by branch to changes in total
manufacturing production (in percentage points)

	1.0	2.1	0.6	1.0	3.4
Manufacturing					
Food	-0.18	0.32	-0.01	-0.52	0.58
Beverages	0.46	0.24	-0.38	-0.13	0.29
Tobacco	0.40	0.32	-0.04	-0.02	-0.15
Textiles	-0.06	-0.66	-0.52	0.15	-0.08
Footwear and clothing	-0.51	-0.37	-0.40	-0.09	-0.37
Wood and cork	-0.14	0.23	-0.03	-0.18	-0.11
Furniture	0.02	-0.05	0.00	0.00	-0.03
Paper	0.21	0.12	-0.16	-0.15	-0.09
Printing and publishing	-0.05	-0.01	0.17	-0.17	-0.09
Leather	-0.02	-0.04	-0.03	-0.04	-0.05
Rubber and plastics	0.48	-0.69	0.05	-0.02	0.45
Chemicals	0.20	1.12	0.89	0.24	1.25
Petroleum and coal products	0.42	0.16	0.27	-0.02	0.08
Non-metallic minerals	0.22	0.14	0.54	0.18	0.20
Basic metals	0.32	0.33	-0.26	0.68	0.18
Metallurgical products	-0.10	0.20	-0.06	0.36	-0.09
Machinery and appliances, excluding electrical	0.02	0.33	0.06	0.22	0.05
Electrical machinery and appliances	-0.07	0.15	0.34	0.68	1.37
Vehicles	-0.54	0.26	-0.06	-0.17	0.28
Miscellaneous	-0.04	0.04	0.26	-0.01	-0.25

Source: Calculations based on NSSG data.

TABLE III.7
IMPORT PENETRATION AND EXPORT PERFORMANCE
IN MAIN BRANCHES OF MANUFACTURING

Branches ¹	Percentage changes				Import penetration ³	Export performance ⁴
	Current prices		Gross production value	1980 prices		
	Imports ²	Exports ²		Gross production value		
Food-beverages (20,21)						
1995	9.5	23.5	8.5	2.3	24.1	17.0
1996	-1.6	6.5	4.4	-1.2	23.1	17.4
1997	13.6	-8.7	1.0	-3.1	24.9	15.7
1997 (Jan.-Sept.)	14.9	-11.6	0.3	-4.2	25.0	16.0
1998 (Jan.-Sept.)	4.0	3.4	10.9	6.1	23.6	14.9
Textiles, clothing-footwear, leather (23, 24, 29)						
1995	11.2	10.9	2.3	-7.0	61.9	65.9
1996	11.1	2.6	-2.8	-7.0	67.5	69.5
1997	18.8	15.2	3.4	-0.6	76.4	77.5
1997 (Jan.-Sept.)	17.6	11.8	0.0	-3.6	82.4	83.4
1998 (Jan.-Sept.)	7.4	-4.7	0.9	-4.4	79.6	78.8
Rubber and plastics, chemicals (30, 31)						
1995	34.6	25.8	11.2	3.0	54.2	14.1
1996	-4.1	12.4	10.8	6.0	50.7	14.3
1997	10.3	21.7	6.3	1.3	52.2	16.4
1997 (Jan.-Sept.)	14.8	21.7	4.7	-0.3	52.3	16.5
1998 (Jan.-Sept.)	11.3	11.3	17.4	12.2	50.7	15.6
Non-metallic minerals (33)						
1995	15.6	-8.4	8.7	1.8	23.2	21.1
1996	10.5	19.5	13.3	7.1	23.0	22.3
1997	9.5	11.7	7.7	2.2	23.5	23.1
1997 (Jan.-Sept.)	5.0	20.3	7.8	2.7	23.1	23.6
1998 (Jan.-Sept.)	3.0	-13.4	7.5	2.8	21.3	19.0
Basic metals and metallurgical products (34, 35)						
1995	32.7	25.9	15.9	4.8	50.0	35.0
1996	-3.0	-5.3	2.2	-2.9	47.7	32.4
1997	20.5	13.3	17.8	9.4	47.8	31.2
1997 (Jan.-Sept.)	17.0	11.9	19.7	11.2	47.8	31.4
1998 (Jan.-Sept.)	3.4	49.6	8.5	2.4	51.4	43.3
Machinery and appliances (36, 37)						
1995	12.7	41.1	19.0	7.4	78.5	37.7
1996	7.4	1.2	8.3	5.6	77.7	35.2
1997	27.4	31.8	20.2	12.3	79.5	38.6
1997 (Jan.-Sept.)	25.1	27.4	22.1	14.7	78.8	37.5
1998 (Jan.-Sept.)	21.2	19.7	22.4	17.0	78.4	36.6
Transportation equipment (38)						
1995	24.9	34.5	14.9	4.6	70.3	6.2
1996	9.5	5.7	7.1	-1.1	70.7	6.1
1997	17.5	64.4	-0.4	-3.0	74.8	10.1
1997 (Jan.-Sept.)	14.6	67.2	-1.7	-5.0	74.6	10.0
1998 (Jan.-Sept.)	6.7	23.0	14.4	5.0	73.5	10.8
Manufacturing (total, excluding oil)						
1995	19.9	18.7	11.3	2.1	49.0	27.5
1996	2.6	5.4	6.1	0.4	48.2	27.4
1997	18.2	11.3	6.5	1.1	51.2	28.6
1997 (Jan.-Sept.)	17.6	9.6	5.8	0.4	51.3	29.0
1998 (Jan.-Sept.)	10.2	11.5	10.4	4.4	51.3	29.3

1 The two-digit branch-code (according to the Greek Standard Industrial Classification) is listed in parentheses.

2 Customs statistics data.

3 Ratio of value of imports over the value of apparent consumption.

4 Ratio of value of exports over the gross value of production at current prices.

Source: Calculations based on NSSG data.

The decline in world demand for Greek clothing, footwear, leather and textiles led to a large decrease in exports of these items, and hence to a sharp drop (–4.4 per cent) in relevant output in January-September 1998. This development, which is clearly reflected in the drop of about 4.5 percentage points in export performance in the above period, compared with the corresponding period of 1997, underlines the fact that these branches were unable to benefit from the exchange rate adjustment in March 1998, in competing against countries with low labour costs. In the domestic market the deceleration in import growth¹ could not avert the appreciable fall in production, although it was accompanied by an increase in domestic demand, as suggested by retail sales growth (1.9 per cent) of clothing and footwear in 1998. A question that still needs to be answered, especially with regard to clothing and footwear, is whether Greek production should be oriented towards products with very low labour costs or, conversely, towards products incorporating higher value added (reflecting brand name adoption, advertisement and development of a large retail sales network).

The large increase in the production of rubber, plastics and chemicals² is estimated to have been absorbed rather by the domestic market than by foreign markets, as export growth decelerated, lagging behind the corresponding increase in production.³ At the same time, import penetration in these branches decreased, owing to the slower increase in imports (11.3 per cent in the January-September 1998 period, compared with 14.8 per cent in the corresponding 1997 period).

The export performance of non-metallic minerals was affected by both the turmoil in SE Asia and the devaluation of local currencies; as a result, in the January-September period of 1998 exports decreased by 13.4 per cent at current prices (compared with an increase of 20.3 per cent in the same period of 1997) and export performance dropped by at least three percentage points. Thus, increased output volume was mostly channelled to the domestic market, leading to a deceleration in import growth and a decrease in import penetration⁴ in the branch.

Basic metallurgy and metallurgical products recorded a sharp export growth in 1998.⁵ By operating modern plants, the major firms in these branches improved their competitiveness and financial results,⁶ benefiting, *inter alia*, from domestic demand, which is linked with increased construction and building activity. In particular, Greek aluminium

1 From 17.6 per cent in January-September 1997 to 7.4 per cent in the corresponding 1998 period (at current prices).

2 12.2 per cent in January-September 1998, compared with a decrease of 0.3 per cent, at constant prices, in the corresponding period of 1997 (at current prices: 17.4 per cent, compared with 4.7 per cent).

3 In January-September 1998, the increase in exports, at current prices, was at least 6 percentage points slower than production growth in the same period.

4 The growth rate of imports fell to 3 per cent, at current prices, in the January-September 1998 period (compared with 5 per cent in the corresponding period of 1997), while import penetration dropped by about two percentage points over the same period.

5 Exports grew, at current prices, by almost 50 per cent in January-September 1998, and output volume by 2.4 per cent. At the same time, the index of export performance rose by 12 percentage points relative to 1997, for the same period.

6 According to data published in the press, the 25 firms of the metallurgical industry which are listed on the Athens Stock Exchange exhibited a 12.8 per cent increase in turnover and a 25.2 rise in net pre-tax profits.

manufacturing has exhibited high growth rates and a strong export orientation in recent years, through, among other things, the promotion of competitive brandname products in both the domestic and the world market.¹

The large rise in the production of electrical machinery and appliances is associated directly with the procurement of telecommunications material by the Hellenic Telecommunications Organisation (OTE), while the value of exports grew at a slower, though still high rate (January-September 1998: 19.7 per cent, compared with 27.4 per cent in the same period of 1997). The growth of these branches in the last four years² is linked directly to domestic investment and construction demand and is therefore expected to be sustained to the extent that major projects and investment initiatives are implemented at a faster pace.

2.4 Mining and quarrying

In 1998 mining and quarrying output decreased, mostly as a result of reduced foreign demand, whereas the domestic construction industry increased demand for marble, stone and other building materials. According to NSSG data (see Table III.3), the slowdown in mining activity was almost entirely due to the considerable fall in crude oil production, which was not offset by increased output of lignite, marble, stone and other building materials, sulphur compounds, barytes and magnesite. Production of bauxite and of iron, nickel, chromium and manganese ore decreased.

More specifically, lignite³ extraction rose in 1998, as a result of the increased demand for electric power. Bauxite production declined, albeit at a slower pace than in 1997, because of the drop in bauxite exports to Russia, and the other countries of the former USSR, which are going through an economic crisis. Iron and nickel⁴ ore output fell sharply, owing to the decrease in external demand and the considerable fall in nickel ore prices in the world market.⁵ Indeed, provisional customs statistics compiled by the NSSG point to a large decrease (–65.2 per cent) in the volume of total nickel ore exports in January-September 1998, although the volume of exports to EU countries rose by 24.9 per cent.

Crude oil output continued to decline at a faster pace in 1998 and came to a halt in December. This was due to the decision of the Northern Aegean Petroleum Company

1 Especially in the case of aluminium “profile” output.

2 The production of non-electrical machinery-appliances increased by 40.7 per cent between 1994 and 1998, while that of electrical machinery-appliances by 52.4 per cent.

3 Lignite extraction stands at about 60 million tonnes per annum, which correspond — in terms of power supplied — to 7.3 tonnes of oil. Hence Greece holds the fifth position among lignite-producer countries.

4 It should be noted that the LARCO firm, whose production had peaked in 1997 (with nickel ore sales standing at 18,000 tonnes), reduced output to 15,000 tonnes in 1998, and has decided to reduce it further (by one third) in 1999.

5 The crisis in the nickel ore market was possibly accounted for by economic recession in Far East countries, which led to a decline in stainless steel output (this item absorbs the largest part of nickel production), and by increased exports of Russian nickel ore to the markets of West. As a result, nickel ore prices fell to a historical low (1.83 US dollars per pound) in 1998. However, a slight recovery is being observed in the first months of 1999.

(NAPC) to stop pumping out oil at the island of Thassos.¹ However, the first stage of geo-physical surveys to locate hydrocarbon deposits in Epirus and Northwestern Peloponnese was completed in 1998.²

The production of marble, stone and other building materials increased, though at a much lower rate than in 1997. This was linked with construction activity and, mostly, with the execution of the government's building programme in 1998. More specifically, production of stone and aggregates rose by 3.8 per cent, of gypsum by 12.6 per cent, and of kaoline and bentonite by 8.5 per cent. Provisional foreign trade statistics from the NSSG suggest that the export volume of some of these products increased considerably (bentonite exports: 60.1 per cent, gypsum exports: 33.1 per cent) in January-September 1998. By contrast, marble production fell by 7.7 per cent, thus offsetting a 7.3 per cent rise in 1997. Marble quarries face problems as the government is reluctant to issue or extend operating licences, in order to protect the environment.³

Finally, sulphur compounds and barytes production continued to grow at a high rate in 1998, after a strong recovery in 1997, which is linked with the fact that the Chalkidiki mines have resumed operation.⁴

2.5 *Electricity-natural gas*

The production of electricity and natural gas (see Table III.3), according to the relevant NSSG index, recorded a very large increase in 1998 (48 per cent), which came mainly from the impressive growth of the natural gas distribution index⁵ owing, to the inflow,

1 As from 1 December 1998, the NAPC, which is the sole oil producer in Greece, has shut down the North Prinos oil-drilling platform, owing to the decrease in the deposit and the gloomy prospects of oil prices in international markets. However, the Ministry of Development is making efforts to continue pumping until the deposit is completely exhausted.

2 It is also expected that the firm "Hellenic Petroleum S.A." will start drilling in four areas of Western Greece in the second half of 1999. In addition, a cooperation agreement was signed on 23 February 1999 between "Hellenic Petroleum S.A." and the Russian firm LUCOIL for the creation of a vertical consortium, with the aim of expanding oil sales in the SE European market and working oil wells in the former USSR.

3 In Eastern Attica, five quarries stopped working in early 1999, as their operating licences expired, and no other quarry sites have been fixed. However, a draft law by the Ministry of Development, concerning the designation of quarry sites, the creation of new ones and the validity of operating licences has been submitted to Parliament.

4 It should be noted, however, that investment realisation by TVX HELLAS, concerning two mines in the regions of Olympiada and Skouria in Chalkidiki, is not expected to start before early 2000, following completion of the procedures concerning the issue of operating licences for mines.

5 Formerly, the index included only the production and distribution of town gas. As from 21 January 1998 DEPA supplies about 8,000 households and commercial establishments in Athens. As regards the construction of new urban networks (Attica, Thessaloniki and Thessaly), DEPA has already initiated procedures for an international tender for the participation of private investors (up to 49 per cent) in the capital of the gas supply companies. It is expected that investors who will undertake to build town networks to distribute low-pressure natural gas to consumers will have been selected by end-May 1999.

as from early-1998, of Russian natural gas¹ into the existing network. This development contributed decisively (4.5 percentage points) to the acceleration of total industrial production growth. Electricity production also increased at a particularly high rate. Public Power Corporation (DEH) provisional data point to a 6.6 per cent increase in net electric power production in 1998, which reached 41,840.7 GWH. The increase was mainly (3.7 percentage points) due to the growth of power output from lignite-operated plants (+5.3 per cent), whose share in total electricity production thus remained very high (70 per cent).² Power output from diesel-operated plants recorded a small decrease (–0.3 per cent), while the decrease (–5.7 per cent) in output from hydroelectric plants was larger. By contrast, output from gas-operated plants rose steeply in 1998, owing to the conversion of the diesel-operated plant at Mikro Lavrio and of one more diesel-operated plant at Agios Georgios, Keratsini into gas-operated plants. Electricity production from renewable sources of energy also rose considerably to 42.7 GWH. Besides, in 1998 the first private wind farm³ was inaugurated and put into operation in Setia-Crete, while investors' interest remained strong in 1998.⁴ Furthermore, with a view to increasing operational flexibility and efficiency, DEH decided (August 1998) to establish a subsidiary entitled "DEH Ananeossimes", which, jointly with other companies, will operate small hydroelectric plants and wind farms.⁵

On the demand side, total electricity demand rose considerably faster (8.7 per cent) in 1998. The highest rate of increase was observed in demand for agricultural and commercial use, while all other uses, i.e. industrial and household uses, also grew substantially. Demand for agricultural use increased by 18.2 per cent, compared with last year. The already high growth of demand for commercial use accelerated notably (1998: 15.3 per cent, 1997: 9.5 per cent), contributing more than one third to the rise in total consumption. Furthermore, demand for household use recovered strongly (4.9 per cent, compared with 0.4 per cent in the previous year), while the rise in demand for electricity for industrial use was also impressive in 1998 (6.1 per cent). Two thirds of this increase, which

1 On 2 September 1998 an agreement was signed in Rome between DEPA and the Italian company ENI, on the interlinking, through a submarine pipe, of the Greek system of natural gas with the Italian and, hence, trans-European networks. With the 180 km long submarine pipe Greece obtains a new alternative source of procurement, apart from the Russian one, thus ensuring uninterrupted and smooth supply with natural gas.

2 The existence of considerable lignite deposits, which secure the provisioning of lignite-operated plants for more than 45 years, as well as the continuous effort to reduce production costs and improve environmental standards, create the conditions under which lignite will keep its key position in the electric power sector.

3 It is the wind-energy park constructed by the company "Rokas Aioliiki SA" (capacity of 10.2 MW).

4 Pursuant to Law 2244/94, in the 1995-1998 period, the Ministry of Development granted 56 installation licences for plants using renewable energy sources with a total capacity of 189.4 MW, while operation licences were granted to only seven enterprises, with total capacity of 13.3 MW, five of which (with total capacity of 11.8 MW) received them in 1998. It should be noted that, the Ministry of Development, in order to further deregulate the RES market, considers it advisable to amend Law 2244/94. In this context, a special schedule of rates on energy produced by RES, is being drawn up. Moreover, private energy investment amounting to 143.12 billion drachmas was incorporated in the context of measures 2.2 (Energy saving) and 3.2 (RES applications) under the Business Plan for Energy.

5 The drawing up of the Articles of Association for a profit-making company between "GENEP Energiaki SA" and DEH for the construction of a hydroelectric plant is under way.

is associated with the significant rise in manufacturing production, came from factories consuming low and medium voltage electricity (which rose by 8.8 per cent), while the demand of factories for high voltage electricity recorded a smaller increase (3.3 per cent). Finally, electricity consumption for other uses, mainly for lighting streets and squares, increased by 12 per cent.

The large gap between supply and demand for electric power led to a 45.9 per cent increase in net imports; consequently, the degree of the economy's self-sufficiency in electric power decreased, as indicated by the rise in the net imports/sales ratio (1998: 8.3 per cent, 1997: 6.2 per cent). This was due to the increase in demand during the peak season,¹ which, in recent years, burdens DEH with large expenses in order to meet short-term needs.

With regard to the country's energy potential, installed capacity increased by 291 MW in 1998 (thus, total installed capacity reached 10,416 MW).² It should be noted, however, that the combined cycle plant of "Megalo Lavrio", with a capacity of 570 MW, has been inaugurated and put into trial operation (it will be fully operational after the first quarter of 1999); together with the "Mikro Lavrio" plant and the plants at Keratsini, it will supply Attica with additional power (1,110 MW), which will strengthen and improve decisively the stability of the system. Besides, a series of other plants, which are expected to be brought into operation over the coming years,³ are at an advanced stage, while investment activity in 1999 is forecast to continue at a higher pace.⁴

Finally, national energy policy during the next decade, as indicated in the draft law on the deregulation of the electric energy market,⁵ focuses on the customer-consumer and combines state intervention, which ensures the supply of energy, with the deregulation of the market, so as to reduce production costs.

1 According to a proposal of the Federation of Greek Industries, a partial solution of the problem would be the conclusion of contracts with a power-cut clause for energy-consuming industries. In this case, these industries would allow DEH to reduce or cut power supply for a period agreed in advance and they would thus operate as reserve plants at no cost. Recently the Ministry of Development has announced acceptance of this proposal from 2000 onwards.

2 By incorporating in the system : the third plant (140 MW) of the hydroelectric complex of Thisavros, Drama, the plant of Pournari 2 (32.4 MW), two gas turbines in Crete with a total capacity of 118.8 MW and some smaller plants.

3 These works include the combined cycle natural gas-operated plant in Komotini (492 MW) and the hydroelectric complex of Nestos. Besides, a new lignite-operated plant (330 MW) was founded in Florina on 20 September 1998.

4 According to the Introductory Report on the Budget, in 1999 DEH will carry out investment amounting to 323 billion drachmas.

5 The draft law which provides for the gradual deregulation of the electric power market as from 19 February 2001 and adapts Greek legislation to the relevant EU Directive was approved by the Council of Ministers on 3 July 1998 and was made public. The key provisions of the Directive are the following: 1) The management of Greece's electricity sector will be assigned to the Regulatory Authority for Electricity (PAH) (i.e. the State and most likely DEH itself). This Authority will be competent for approving the pricing policy and issuing electricity production licences. 2) The management of DEH's transmission system will pass to an independent company under the name of "Manager of the Greek Electricity Transmission System SA". However, ownership of the system will remain with DEH. 3) Electricity to big consumers ("choosing clients") may be supplied by private individuals as well, on condition that they themselves own power production installations within the European Union, while ordinary consumers, such as households, will be supplied with power by DEH. 4) Only DEH and the Manager will have transmission and distribution licences.

3. SERVICES

Income from services increased in 1998 at a higher rate than in 1997 (3.6 per cent compared with 3.3 per cent), in response to steadily growing demand, particularly in telecommunications, banks and tourism. Also, the share of services in total GDP continued to expand (see Table III.2).

More specifically, income from transport-communications increased by 6 per cent, compared with 10.1 per cent in 1997. This development is associated with the rise in road and sea cargo transport (due to a growth of foreign trade), intense activity in telecommunications, and the recovery of tourism. Specifically, according to OTE data, the volume of telecommunications¹ increased by 5.0 per cent (see Chart III.5). The deregulation of telecommunications entails intensified competition, leading to better prices and services of higher quality.² Furthermore, the conversion of OTE's network into a digital one, which has reached 74 per cent and for 1999 is projected to reach 83-85 per cent, will contribute to the provision of new, high-quality services, while it is estimated that average revenue per telephone line will increase by at least 15 per cent.³ The continuous expansion of the mobile telephony market and keen competition upon entry of COSMOTE into the market create new opportunities and prospects for the Greek telecommunications market.⁴ By contrast, passenger transport by Olympic Airways dropped by 7.6 per cent.⁵ It should be noted that after the deregulation of air transport (April 1997), several private companies have got involved in the market and are trying to expand their respective share. Freight carried by the Hellenic Railways Organisation (OSE) also decreased (-2.8 per cent).⁶

Income from trade increased by 1.5 per cent in 1998, compared with 3.2 per cent in 1997. Demand in retail trade grew as demonstrated by the retail sales volume index compiled by the NSSG (+ 2.4 per cent). Additionally, according to the IOBE's quarterly survey of retail trade for 1998, the index of business expectations dropped slightly (-0.9 per cent), owing to a decline of estimates both on sales and the level of inventories. Nevertheless, the outlook for new orders was positive. The main characteristic in trade is the large number of shops,⁷ leading to intense competition, which is estimated to cause a shrinkage of about 20-25 per cent in the number of these firms when Greece enters the

1 On the basis of telephone units charged.

2 As from 1 March 1999, a reduction of about 4 per cent (weighted average) applies to OTE rates.

3 According to OTE's estimates, 1999 revenue will increase by 18 per cent and pre-tax profits by 16 per cent.

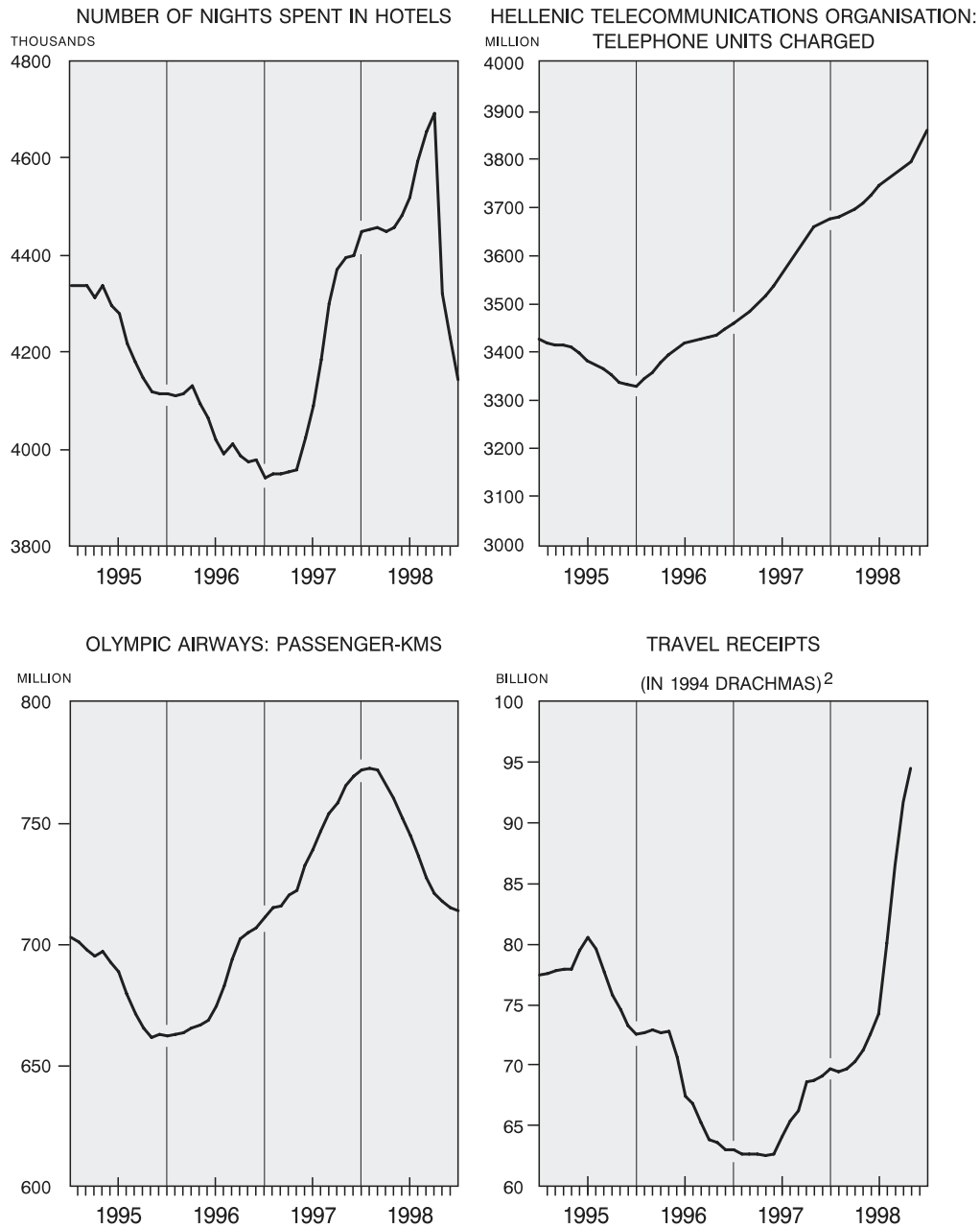
4 Mobile telephony now constitutes the most rapidly growing telecommunications market. The number of mobile telephony subscribers rose to 2 millions in 1998, compared with 800,000 in 1997 (increase of 150 per cent). According to an ICAP survey, the market penetration rate is expected to triple by 2000.

5 Passenger-kilometres.

6 Rail transport fell considerably in Greece, unlike Europe, where it is increasing at a satisfactory pace (implementation of large-scale projects – launching of high-speed trains). Besides, in 1999 it is expected that rail transport will be deregulated and EU railway firms in the public or private law, will be allowed to freely undertake cargo transport by rail.

7 About 17 firms correspond to 1,000 inhabitants, while the community average is 8.5 firms per 1,000 inhabitants, according to European Commission and OECD data.

CHART III.5

ACTIVITY INDICATORS FOR SERVICES¹

¹ Twelve - month moving average centred on the last month of the period.

² Data deflated by the CPI compiled by the NSSG. Figures for 1998 are not fully comparable with those for previous years.

Source: National Tourism Organisation (EOT), Hellenic Telecommunications Organisation (OTE), Olympic Airways (OA) and Bank of Greece.

euro area. At the same time, continuous acquisitions and mergers lead to the creation of large companies, while the utilisation of new technologies, such as electronic trade etc. is developing very fast. Also, the system of “franchising” is expanding rapidly into a large number of activities.¹

Income from banking and insurance continued to grow at a high rate in 1998 (8 per cent). Net bank profits increased significantly and business expanded. The Greek banking system pursues the creation of powerful business groups, through cooperation, alliances, acquisitions and mergers, in order to secure the competitiveness of the Greek financial system, in view of the introduction of the euro. The banking sector will be the first to shoulder the great cost of the adjustment required by the single European currency and the single market. At the same time, pressure on profit margins will intensify as a result of competition; hence, the development of new products and the expansion of the operations of Greek banks into new markets will constitute new sources of revenue. Besides, insurance companies are enjoying a continuous increase in operations (mainly in the branches of life and car insurance), while new prospects are being opened up for insurance companies owing to the compulsory insurance of major technical projects, particularly in the forthcoming five-year period, in view of the Olympic Games of 2004.² The institution of “bancassurance” is developing rapidly, since an increasing number of banks are turning to this products. Furthermore, private insurance has enormous room to expand, since the share of total insurance premia payments in GDP is only 1.8 per cent, compared with 7.3 per cent in the EU. Developments in the insurance market in recent years were chiefly characterised by mergers and acquisitions.³

GDP in “other services” increased faster in 1998 (by 10 per cent, compared with 7.7 per cent in 1997), mainly owing to the recovery of tourism, especially tourist arrivals.⁴ According to provisional data from EOT, the number of nights spent in hotels by foreign tourists increased by 2.4 per cent. Besides, travel receipts (at constant drachmas) grew by 39.5 per cent in the January-October period 1998.⁵ Domestic tourism also follows a steady upward course (6 per cent rise in the January-September 1998 period), with significant development prospects. The increase in demand for tourist services is attributable to economic conditions at home and abroad, but also to the upgrading of the tourist product, combined with competitive prices. Furthermore, the income level of

1 It is estimated that, if the current rate of expansion continues, in 2001 50 per cent of retail trade in the Greek market will be organised on the basis of franchising systems (according to an ICAP survey in cooperation with Arthur Andersen SA).

2 According to data from the Association of Greek Insurance Companies, its members accounted for more than 80 per cent of total operations in the period 1993-1997.

3 According to a Eurostat study, the number of EU insurance companies is steadily decreasing, while the turnover of the sector is increasing. This is due to mergers and acquisitions of companies, and not to cessation of operation.

4 However, the problems of Olympic Airways led to a reduction in tourism in 1998.

5 These data are not fully comparable with those of previous years, owing to the gradual introduction of the new methodology of balance of payments statistics.

visitors has risen considerably, as indicated by the increased occupancy of high class hotels.¹ The lengthening² of the tourist period, the provision of tourist services over a greater area, the modernisation of road, rail and air transport and, generally, the improvement of the quality of the services provided, in conjunction with the offer of competitive prices, constitute prerequisites for the further development of tourism in the years to come. Moreover, with a view to promoting alternative forms of tourism, EOT has incorporated a series of infrastructure projects in the programme funded by the 2nd CSF. These projects aim to promote mountain, ecological, cultural and therapeutic tourism. The new law (2601/98)³ on development incentives provides for considerable grants for the creation of alternative forms of tourism, such as self-contained conference centres that will not be accommodated in hotels. Adoption of the single currency will have a positive effect on tourism, since it will promote economic stability, eliminate foreign exchange risk and reduce the cost of currency exchange.

The 1.2 per cent rise in income from housing is associated with the increase in the volume of rented and owner-occupied dwellings, which are a source of income (rent or imputed income from owner-occupancy).

Finally, the 2 per cent decrease in income from public administration-national security and the 2 per cent increase in income from health-education are mostly related to government activity, budget execution and employment in the public sector.

4. EMPLOYMENT – UNEMPLOYMENT

The fast (and accelerating) growth of GDP in 1998 did not lead to a corresponding increase in employment. Nevertheless, the expansion of the tertiary sector, the significant rise in production, the strengthening of competitiveness and the special programmes implemented by the government in the context of the National Action Plan for Employment had positive effects.

More specifically, employment in manufacturing continued to decline (since this sector is being restructured under the pressure of international competition), but at a

1 According to statistics from the Association of Hoteliers of Athens, in 1998 the highest average occupancy rates were observed for A and B class hotels (59.7 per cent and 55.2 per cent, respectively), while occupancy in luxury hotels was 52.2 per cent. By contrast, the average annual occupancy rates for D and E class hotels did not top 25 per cent and 27.5 per cent, respectively.

2 The twelve-month tourist season, which applied for the first time in 1998 in Crete and Rhodes, did not have the expected results, mainly because it was not combined with the development of alternative forms of tourism. Owing to the particularly high seasonality of Greek tourism, in contrast with competitor countries, Greece has the lowest rate of bed use (about 95.7 overnight stays per bed, compared with an average 133.7 for competitor countries), according to a survey conducted on behalf of the Institute of Tourist Surveys and Forecasts (ITEP).

3 Greece does not have a self-contained conference centre. According to data arising from a survey by the Panhellenic Federation of Hoteliers, the conference market accounts for 10-14 per cent of total hotel bookings in Athens. Moreover, according to EOT estimates, conference tourism offers advantages (e.g. it yields twice as much revenue per capita, compared with mass tourism).

TABLE III.8
EMPLOYMENT OF BLUE- AND WHITE-COLLAR EMPLOYEES IN MANUFACTURING

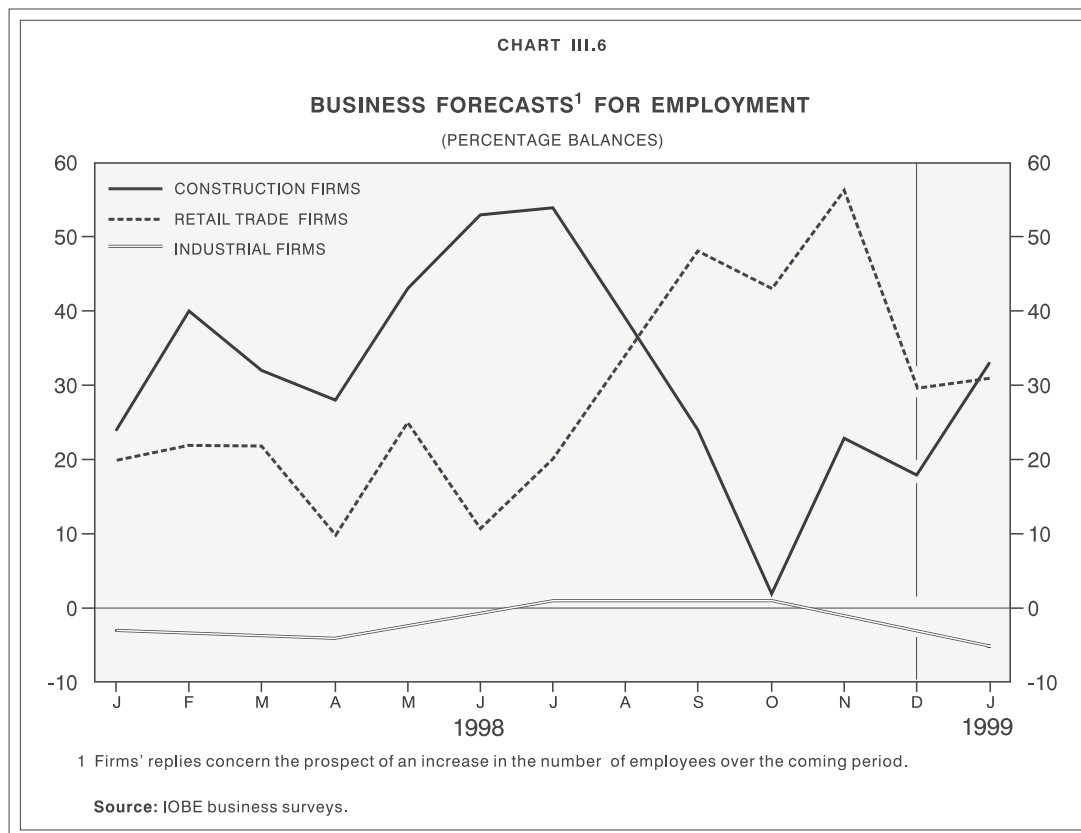
	Number of employees		Percentage changes		
	1996 (average level)	1997 (average level)	1996/1989 ¹	1997/1996	1998/1997 Jan. - Aug.
Food	48,744	48,091	-8.8	-1.3	1.5
Beverages	9,859	9,845	-5.8	-0.1	0.4
Tobacco	7,947	7,103	-9.1	-10.6	-6.0
Textiles	30,759	29,670	-43.3	-3.5	-6.7
Footwear and clothing	30,623	27,743	-41.1	-9.4	-1.6
Wood and cork	5,366	5,071	-20.7	-5.5	-3.1
Furniture	6,531	6,974	-5.9	6.8	6.9
Paper	9,191	9,069	-4.5	-1.3	-6.5
Printing and publishing	10,775	10,580	8.8	-1.8	3.1
Leather	2,281	1,979	-39.4	-13.3	-14.9
Rubber and plastics	11,938	12,078	-10.5	1.2	-2.4
Chemicals	21,475	20,720	-12.9	-3.5	-4.1
Petroleum and coal products	5,242	5,091	-8.9	-2.9	-3.3
Non-metallic minerals	17,909	17,285	-26.5	-3.5	-0.9
Basic metals	8,867	8,388	-7.4	-5.4	0.3
Metallurgical products	17,200	16,573	-18.3	-3.6	0.6
Machinery and appliances (excl. electrical)	8,251	8,482	-14.8	2.8	0.7
Electrical machinery and appliances	15,168	15,440	-8.2	1.8	4.3
Vehicles	27,067	25,450	-21.2	-6.0	-1.0
Miscellaneous	2,987	2,901	-8.0	-2.9	-1.2
Total	298,180	288,532	-21.2	-3.2	-1.1

	Contributions by branch to change in total employment in manufacturing (percentage points)		
Food	-1.24	-0.22	0.25
Beverages	-0.16	0.00	0.01
Tobacco	-0.21	-0.28	-0.16
Textiles	-6.21	-0.37	-0.69
Footwear and clothing	-5.65	-0.97	-0.15
Wood and cork	-0.37	-0.10	-0.05
Furniture	-0.11	0.15	0.16
Paper	-0.11	-0.04	-0.21
Printing and publishing	0.23	-0.07	0.11
Leather	-0.39	-0.10	-0.11
Rubber and plastics	-0.37	0.05	-0.10
Chemicals	-0.84	-0.25	-0.29
Petroleum and coal products	-0.14	-0.05	-0.06
Non-metallic minerals	-1.70	-0.21	-0.05
Basic metals	-0.19	-0.16	0.01
Metallurgical products	-1.02	-0.21	0.04
Machinery and appliances (excl. electrical)	-0.38	0.08	0.02
Electrical machinery and appliances	-0.36	0.09	0.23
Vehicles	-1.93	-0.54	-0.09
Miscellaneous	-0.07	-0.03	-0.01
Total	-21.22	-3.24	-1.14

¹ After 1989, employment trends were steadily downwards.

Source: Calculations based on NSSG data.

much slower pace than in 1997. Indeed, the number of wage-earners employed in manufacturing decreased at an average rate of 1.1 per cent in the first eight months of 1998, while in 1997 it had dropped by 3.2 per cent. The branches of food, electrical machinery and appliances, furniture and printing-publishing contributed positively to the increase in employment, while the contribution of the other branches – including not only declining traditional branches, but also certain dynamic ones based on the evolution of production – was negligible or negative (see Table III.8).

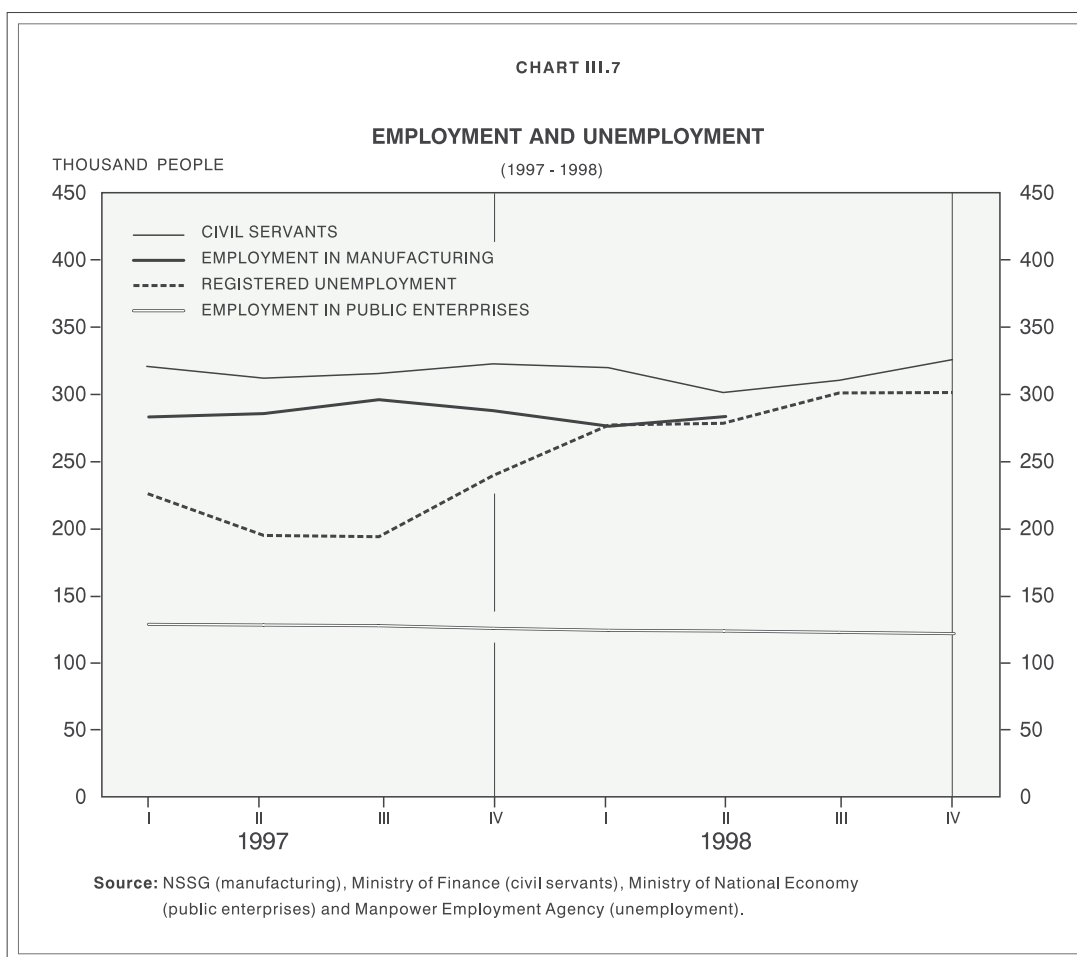


It is estimated that employment increased both in the construction industry, where the presence of immigrant workers – informally employed until recently – is significant, as well as in the ever-growing private sector services. It is characteristic that, as indicated by the IOBE surveys, the forecasts made by construction and retail-trade firms on the trend of employment were clearly positive in 1998 (see Chart III.6), while, according to currently available bank data, employment in the banking sector increased by 0.7-1 per cent during 1998.

On the other hand, as a result of the effort for fiscal stabilisation and consolidation of the public sector, average annual employment fell by 1.1 per cent in central government (compared with an increase of 1.1 per cent in 1997) and by 3.4 per cent in public enter-

prises (compared with a decrease of 1.2 per cent in 1997). Besides, it is estimated that the continuing restructuring of the primary sector has led to a sustained downward trend of employment in agriculture.

At the same time, the average rate of registered unemployment (Manpower Employment Agency – OAED – data) rose to 9.9 per cent in 1998 (compared with 7.9 per cent in 1997) and the average annual number of registered unemployed people



increased to 76,000 or 35.6 per cent (see Chart III.7). This rise mainly reflects the fact that the unemployed now have to register with OAED in order to participate in subsidised employment and training programmes. The Ministry of National Economy, taking this factor into account, estimates that the total unemployment rate fell to 10.1 per cent in 1998, (1997: 10.3 per cent) according to the NSSG's labour force survey (see Table III.9).¹ In any case, the level of this aggregate for 1998 and its development in 1999 will eventu-

¹ NSSG survey data for 1998 are not yet available.

ally depend on the extent to which the presence of immigrant workers — who are now legal or in the process of legalisation — has been or will be recorded by the NSSG labour force surveys. It should be recalled that the first stage (1 January – 1 June 1998) of the imple-

TABLE III.9
POPULATION, LABOUR FORCE AND EMPLOYMENT

	1997 (thous. people)	Annual percentage changes					
		1993	1994	1995	1996	1997	1998
Population (aged 14 or more) ¹	8,859.4	1.6	1.5	0.8	1.0	1.0	...
Participation rate ^{1,2}		48.5	48.7	48.9	49.2	48.5	...
Labour force ¹	4,294.4	2.1	1.8	1.3	1.6	-0.6	0.0
Employment: ¹	3,854.1	1.0	1.9	0.9	1.3	-0.5	0.2
– Primary sector ¹	765.0	-1.6	-0.5	-1.0	0.5	-2.7	...
– Secondary sector ¹	865.7	-10.0 ⁶	-0.5	-0.9	-0.1	-2.3	...
– Tertiary sector ¹	2,223.4	7.9 ⁶	3.9	2.4	2.1	1.1	...
Unemployment (as a percentage of labour force) ¹	(440.3)	(9.7)	(9.6)	(10.0)	(10.3)	(10.3)	(10.1)
Employment in:							
– Manufacturing ¹	558.7	-17.1 ⁶	-0.3	0.0	-3.0	-3.0	...
– Construction ¹	249.0	6.1	-0.1	-3.4	-0.2	-1.1	...
– Banks ³	60.3	0.0	5.3	4.0	2.8	1.0	0.7
– Civil service ⁴	316.1	4.2	-2.8	3.5	1.7	0.6	-1.6
– Public enterprises and entities ⁵	155.5	3.4	4.4	0.2	-0.3	-1.5	-3.1

1 NSSG, Labour Force Surveys: changes from second quarter to second quarter. For 1998, provisional estimates by the Ministry of National Economy.

2 Participation rate of population aged 14 or over in the labour force.

3 Data obtained from banks: December-on-December changes. For 1998, provisional estimate based on data for 10 banks.

4 Ministry of Finance (Introductory Report on the Budget): October-on-October changes (1997: September 1997 on October 1996, 1998: September 1998 on September 1997). Average annual employment is estimated to have increased by 2.2 per cent in 1994, 1.4 per cent in 1995, 2.5 per cent in 1996 and 1.1 per cent in 1997 and to have decreased by 1.1 per cent in 1998.

5 Ministry of National Economy: December-on-December changes (for 1998 public enterprises only). Average annual employment increased by 0.6 per cent in 1994, or by 4.8 per cent taking into account the reincorporation of the Athens bus system into the public sector. In 1995 average annual employment increased by 1.5 per cent, in 1996 it remained unchanged and in 1997 it fell by 0.6 per cent. If *only public enterprises* are taken into account, the corresponding rates are: +0.6 per cent, -1.3 per cent and -1.2 per cent, respectively (and -3.4 per cent for 1998).

6 Figures are not comparable with those for the previous year, because persons employed in vehicle and domestic appliance repairs (approximately 70,000) were “transferred” from manufacturing (secondary sector) to services (tertiary sector). If this is ignored, employment in 1993 fell by only 3 per cent in the secondary sector and by 7.1 per cent in manufacturing, while employment in the tertiary sector increased by only 4.2 per cent.

mentation of relevant legislation¹ was completed rather successfully. At that stage, 373,000² immigrant workers applied for a temporary stay permit (“white card”) and were recorded by the OAED services, while, according to certain estimates, the total number of

1 Presidential decrees 358 and 359 of 1997 (issued in line with Law 2434/96), as amended by presidential decrees 241 and 242 of 1998 and by Article 73 of Law 2676/98.

2 According to another count: 352,000.

immigrant workers overshoots — probably significantly — 500,000. Besides, the number of immigrants who submitted the required supporting documents¹ for the issuance of a stay permit of limited duration (“green card”) is estimated to reach 300,000 by the end of April 1999, which, after successive extensions, is the relevant deadline.

On the basis of available data, it is obvious that unemployment remains high in Greece, just as in Europe as a whole, although it has started to decline. According to the latest estimates of the European Commission,² the unemployment rate fell from 11.8 per cent in 1997 to 10.9 per cent in 1998 in the euro area and from 10.6 per cent to 10 per cent in the European Union, while in Greece it remained steady at 9.6 per cent (these estimates are based on Eurostat’s harmonised data). In 1999, unemployment is forecast to fall to 10.4 per cent in the euro area, 9.6 per cent in the European Union and 9.4 per cent in Greece.

Apart from the unemployment rate, another index, the “employment rate” — i.e. total employment as a percentage of population at working age (15-64 years old) — is used to assess the performance of an economy as regards the supply of jobs. According to the relevant report of the European Commission,³ in 1997 the employment rate in Greece was 56.8 per cent, compared with 60.5 per cent in the European Union, 74.0 per cent in the USA and 74.7 per cent in Japan. The evolution of this rate in Greece in the 11 years from 1986 to 1997 is of particular interest. In that period, the total employment rate fell slightly (from 57.3 per cent to 56.8 per cent), reflecting the considerable decline of the male employment rate (from 79.0 per cent to 74.9 per cent) and the increase in the female employment rate (from 37.4 per cent to 40.1 per cent). This development can be understood, if it is taken into account that in the same period male and female employment rates in the age groups of 15-24 and 55-64 years declined, mainly because of (i) the increased participation of young people in the secondary and university education, (ii) the high unemployment rate of young people, (iii) the rise in the number of pensioners aged 55-64 and (iv) economic restructuring, which, in conjunction with the fact that professional skills are rendered obsolete very rapidly, makes it extremely difficult for aged unemployed people to find a job. At the same time, it is characteristic that in the particularly productive ages (25-54 years) the male employment rate declined, which must be mainly associated with the structural weaknesses of the economy, while the female employment rate increased, as a result of the improvement of social conditions affecting the status of women.

The aforementioned data provide an outline of the problem. However, it must be stressed that in recent years progress is being made in crucial sectors, which — if continued — may allow a parallel (and medium-term) increase in the employment rate and a reduction in the unemployment rate. Specifically, clear progress in the sectors of mone-

1 Supporting documents include evidence that the payment of social security contributions has begun.

2 *Economic Forecasts* of the European Commission, March 1999.

3 *Report on employment rates in 1998*, COM (1998) 572 final, 14 October 1998.

tary stability and fiscal consolidation, in conjunction with the inflow of considerable funds from the Community Support Frameworks, which were channelled to investment projects, allowed the non-inflationary growth of the economy and, what is more, at a rate higher than the average in the European Union (see Chart II.3). Nevertheless, economic growth is a necessary, but not sufficient condition for an increase in employment. The fact, for example, that between 1988 and 1998 total employment rose only by about 200,000 people, while the unemployment rate increased by almost 2.5 percentage points, reflects the structural weaknesses characterising labour and goods markets. For this reason, the implementation of a structural adjustment policy has accelerated appreciably in the last three years, along with the conduct of special active labour market policies.

More specifically, in 1998 new structural arrangements were made for labour relations, mainly under Law 2639/98. The full operation of these arrangements in 1999 and 2000 will increase the flexibility of working time and contribute to reducing labour costs. In fact, Law 2639/98 extended the application of the provisions of Law 1892/90 on part-time employment and the rearrangement of working time; it also encouraged the conclusion of local employment accords, which may lead to greater flexibility of wages in high unemployment areas. Such accords have already been concluded in nine areas. Furthermore, the operation of "private offices of employment consultants"¹ (which will act as intermediaries for placing people in jobs) was allowed and special forms of employment were regulated (contracts for the provision of services or work, particularly in cases such as work at home, teleworking etc.). Finally, the law set up a Body of Labour Inspectors and introduced the provision of medical care to the jobless.

Besides, the legislation governing public utilities was amended by Law 2579/98, so as to facilitate, in the case of loss-making public enterprises, the revision of personnel regulations, with the aim of abolishing restrictive labour practices impeding an increase in productivity.² Furthermore, Law 2643/98 made more transparent and flexible the provisions on the recruitment, by private and public enterprises and by central government, of handicapped people and other protected categories. Finally, Article 63 of Law 2676/98 (concerning the organisational and operational restructuring of social security funds) stipulated disincentives for the employment of pensioners, with effect as from 2001.

Regarding active labour market policies (including hiring subsidies and training programmes, introduction of tax and other incentives to increase employment, more effective organisation of employment services etc.), the Ministry of Labour estimates that in 1998 the targets set were partly attained, while this year efforts are focused on the creation of 110,000 new jobs. It is characteristic that the 1999 programmes set clear and binding targets, in line with relevant EU guidelines. Specifically, (i) unemployed young people aged 18-29, provided that they have completed a month of registration in the lists of unemployed, will be offered, within a six-month-period, either a job or a post for

1 The presidential decree that will govern the operation of these offices has already been drawn up.

2 Article 31 paragraph 8 of Law 2579/98 amended Article 10 paragraph 4 of Law 2414/96.

acquiring working experience or a training post, (ii) for the unemployed aged 30-64, the same commitment will apply, provided that they have completed two months of registration in the lists of unemployed; the posts will be offered within a twelve-month-period. Besides, it is estimated that if the training programmes are also taken into account, active employment policies will benefit more than 200,000 people. Actually, the aim is to make gradually possible the participation of at least 20 per cent of the unemployed in training programmes (by the year 2000). At the same time, by the creation of 52 Employment Promotion Centres, job seekers will be provided with customised support, while inflows and outflows to and from the “tank” of unemployment will be more effectively monitored. It is also planned to operate 81 Information Offices for the Unemployed and Business Firms.¹

It is obvious that the effectiveness of these policies will depend on their cohesion, the participation of the social partners and the systematic control of their implementation. For this reason, EU Member States have committed themselves since 1998 to draw up and implement annual National Employment Action Plans, based on common guidelines defined on a yearly basis by the Council of Ministers. The government has already started preparing the National Plan for 1999, which will be discussed in June by the competent Community organs.

¹ The establishment and operation of such Offices (which provide their services free-of-charge) by local authorities, chambers of industry and small-scale industry, as well as trade unions and employers' associations (which conclude agreements with the Manpower Employment Agency), is stipulated by Article 15 of Law 2434/96 and regulated by a ministerial decision issued in December 1997. Several such agreements have already been signed.

IV. PRICES, WAGES AND BUSINESS PROFITS

1. PRICE DEVELOPMENTS

1.1 Summary

In 1998, inflation continued to drop. The twelve-month rate of increase in the Consumer Price Index (CPI) fell to 3.9 per cent in December (December 1997: 4.7 per cent). The average annual rate of inflation dropped to 4.8 per cent in 1998 as a whole, against 5.5 per cent in 1997.

The downward course of inflation, observed over the last years, continued up to February 1998, when the twelve-month CPI inflation decreased to 4.3 per cent. However, from March onwards, after the adjustment of the drachma's exchange rate upon entry into the Exchange Rate Mechanism (ERM) on 16 March 1998, inflation gradually accelerated and reached a year peak (5.3 per cent) in April and May. In June it began again to drop (except for September, when for conjunctural reasons it rose slightly to 5.2 per cent) to reach 3.9 per cent at year-end.

The drop in inflation over the last two years resulted from the restrictive macro-economic policy, more specifically the tight monetary policy, which continued after the entry of the drachma into the ERM, as well as from the drop in the fiscal deficit as a percentage of GDP. Besides, the substantial slowdown of unit labour cost growth in the whole economy¹ influenced decisively the course of inflation in 1998.

Moreover, the development of certain exogenous factors, such as the drop in raw material prices in the world market, the fall in fuel prices – in conjunction with cuts in their indirect taxation – and the increase in fruit and vegetable output, particularly during the summer months, had a favourable effect on inflation. At the same time, the promotion of “gentlemen's agreements” with business firms for the containment, reduction or restriction of price increases, the cut in indirect taxes on private passenger cars, as well as the policy of moderate increases in public utility rates, contributed to reducing significantly the inflationary impact from the drachma's exchange rate adjustment and to bringing inflation faster back to a downward course.

In 1998 inflation developed as follows:

- In the first two months of the year, the annual CPI growth decelerated by 0.4 percentage point, continuing the downward course observed over the last years.
- Over the next three months, annual CPI inflation increased by one percentage point. However, it should be pointed out that the total inflationary impact from the devaluation was larger. As detailed below, this impact was slightly greater

¹ The growth rate of unit labour costs in the whole economy fell to 4.2 per cent, from 7.2 per cent in 1997 and 9.9 per cent in 1996.

than 2.0 percentage points, but did not affect CPI inflation to an equal amount, as it was offset by the other anti-inflationary factors (monetary policy, labour cost developments etc.).

— In the last seven months of the year, the rate of CPI growth decelerated by 1.4 percentage points, owing to the *ad hoc* government measures and the restrictive monetary policy, which both offset the continuing inflationary impact of the devaluation.

1.2 Anti-inflationary factors after April-May 1998

The contribution of the major groups of goods and services to the 1.4 percentage point fall in the annual rate of inflation (CPI) between April and December was the following (see Chart IV.1):

a) The drop in *fuel* prices contributed by 0.71 percentage point.¹ The 39.4 per cent fall in the price of crude oil, in US dollar terms, in the world market, along with the cut in the Special Consumption Tax (SCT) — on gasoline since the end of September and on heating oil since mid-October — resulted in a drop of 15.1 per cent in fuel prices, included in the CPI basket, between December 1997 and December 1998, and a fall of 32.5 per cent in oil refinery prices included in the WPI.²

b) *Private sector services* contributed by 0.27 percentage point, owing to lower increases in rents, boat fares, recreation services and tuition fees.

c) The prices of *manufactured goods included in the CPI*, except food and fuels, contributed by 0.15 percentage point to the drop in the annual inflation rate. The 7.2 per cent reduction in passenger car prices in the last two months of the year, caused by the cut in the SCT since mid-November, was a major contributor; as a result, inflation slowed down by some 0.3 percentage point during that period.

This group of goods also includes durables and household articles, as well as clothing and footwear. The growth rates of the prices of these items remained almost unchanged or decreased marginally. Although markets for these goods are characterised by high import penetration and intense international competition and despite the drachma's appreciation after March, the prices of these goods remained at high levels.³

d) The slower growth of *fresh fruit and vegetable* prices contributed by 0.14 percentage point (see Box IV.1). Prices showed an upward trend in the first months of the year, owing to inadequate supply. Thereafter, however, as production improved and demand was met by imports, prices fell or were contained. The supply of these items

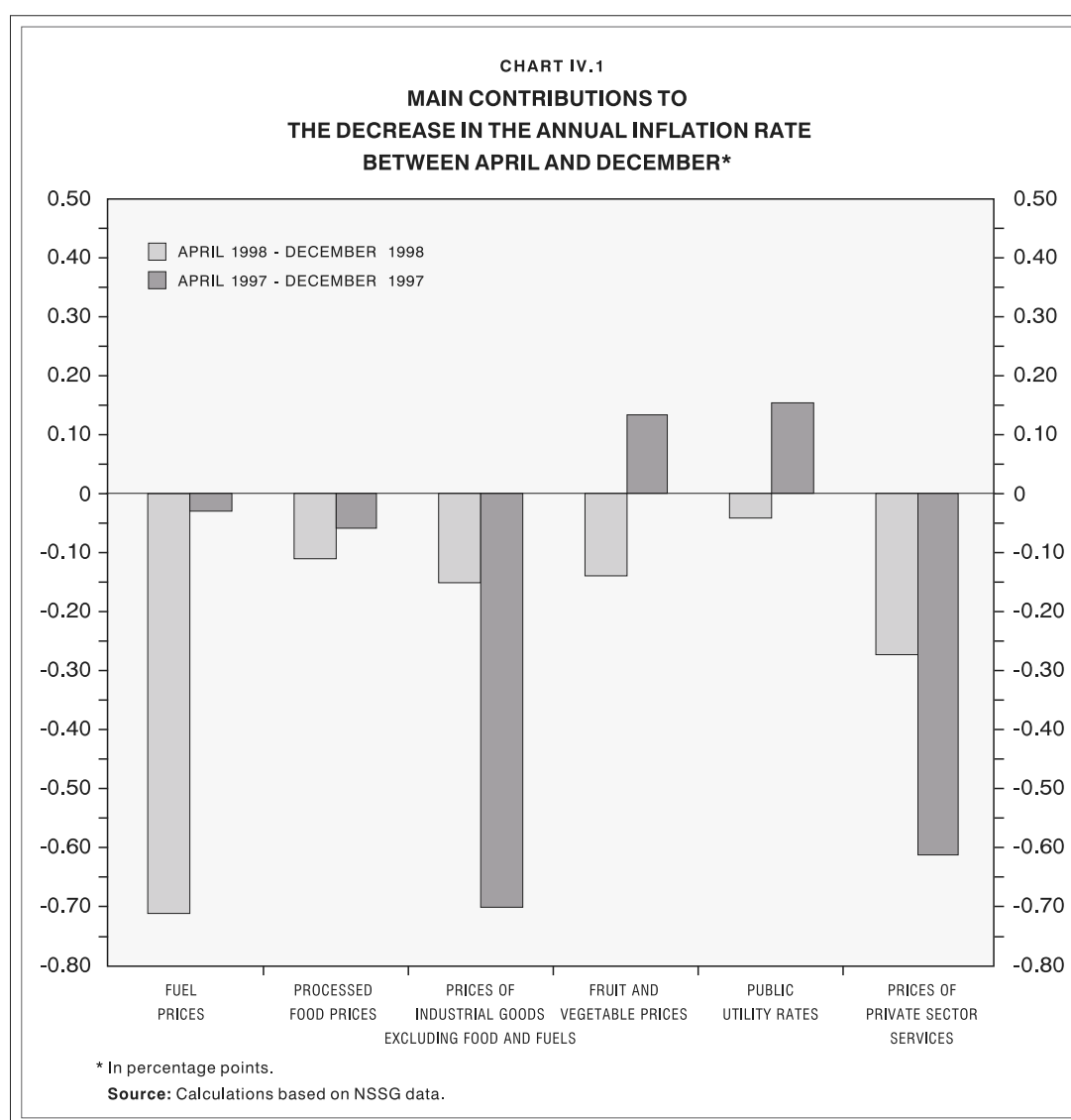
1 Half of this effect is attributed to the drop in the SCT on fuels.

2 New revised data by the National Statistical Service of Greece (NSSG).

3 Prices of durables and household articles, as well as of clothing and footwear, increased, on an annual basis, by 5.4 per cent in December 1998, compared with 5.2 per cent and 5.7 per cent, respectively, in April 1998, and on average by 5.6 per cent and 5.7 per cent, respectively, in 1998.

depends on unpredictable exogenous factors (weather conditions) and thus their prices are largely volatile.

e) *Processed food* contributed by 0.11 percentage point, with cereal products and meat playing the main role.



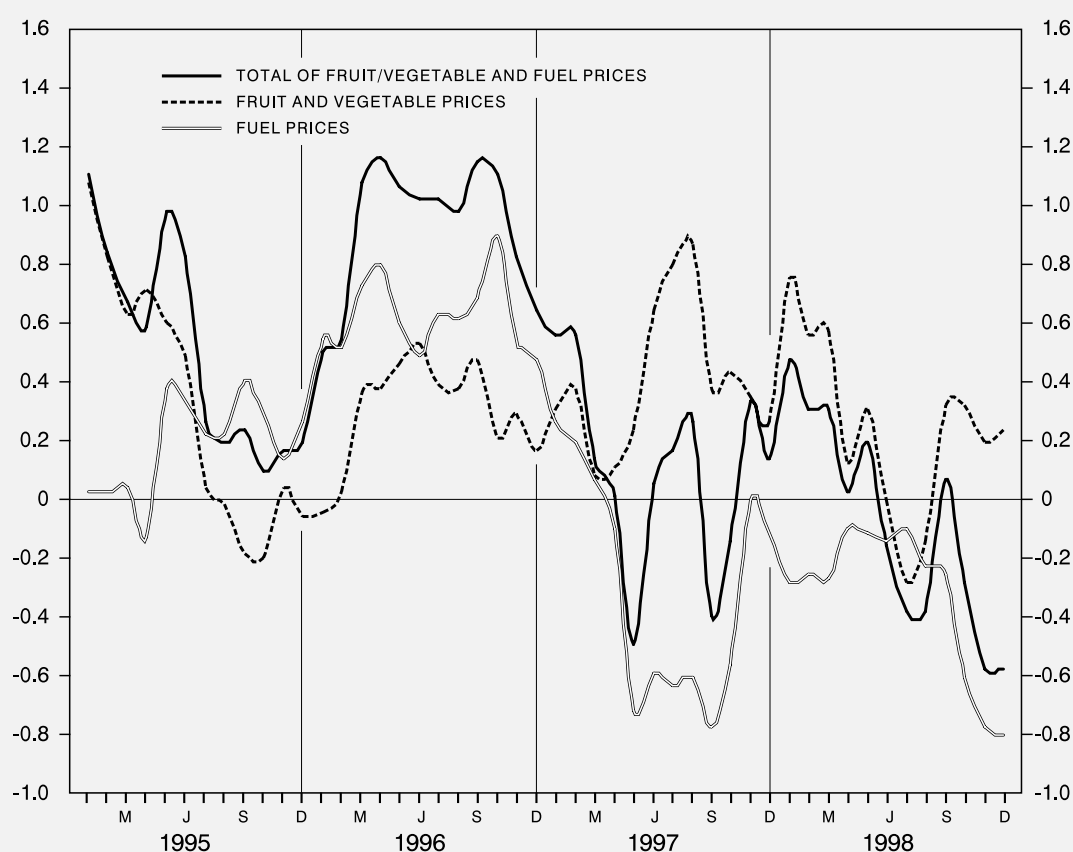
Price reductions in manufactured goods, excluding fuels, and in private sector services (categories b, c and e) were accounted for also by the “gentlemen’s agreements” between the Ministry of Development and industrial and commercial enterprises. The agreements provided for the reduction or containment of the prices of several consumer goods and services for a period of three to six months. However, their contribution to the drop of inflation in 1998 was smaller than expected.

BOX IV.1**Comparison between CPI and “core” inflation**

The effect of price developments of fresh fruit, vegetables and fuels on the general level of CPI inflation becomes evident from the fact that the share of these items in the consumer’s basket is 10.2 per cent, according to the family budget survey carried out by NSSG for 1994.

The supply of these items is determined to a great extent by unpredictable exogenous factors; thus their prices are highly volatile. Such factors are weather conditions, which affect fruit and

CONTRIBUTIONS OF CERTAIN FACTORS TO THE ANNUAL RATE OF CPI INFLATION*



* In percentage points.

Source: Bank of Greece.

vegetable output, or world market conditions, which determine fuel prices. Each item has a different effect on the CPI, as shown in the chart, which covers the period January 1995-December 1998. In several cases, the effects of these two items (fruit and vegetables on the one hand, fuels on the other) are mutually offset and thus the trend of inflation remains virtually stable.

More specifically, the effect of fresh fruit and vegetable prices on the annual CPI rate fluctuated between -0.2 and 1.1 percentage point up to the end of 1996 and, along with the →

→ large increases in fuel prices over the same period, it kept the general level of inflation high. However, the rapid drop in oil prices since October 1996 pushed downwards the general level of inflation, even though the parallel recovery in food and vegetable prices did not allow an even greater reduction.

On the contrary, when the effect of these factors is excluded, it is possible to measure the trend of core inflation, which seems to remain more stable over time, except for the period from April 1998 onwards, during which the devaluation of the drachma had an obvious impact.

f) The moderate pricing policy of *public enterprises*¹ contributed by 0.04 percentage point. On the whole, public utility rates increased at a much slower pace² than inflation, while in several cases they remained at the levels of 1997.

1.3 Prices of imported goods and exchange rate policy

The policy of stable exchange rate over the last years, except for the drachma's adjustment upon entry into the ERM in March, caused imported goods prices to increase at considerably lower rates than domestic product prices. This had a dampening effect on inflationary expectations, put pressure on firms to enhance competitiveness and contributed significantly to curbing inflation.

Since March 1998, however, the downward trend in the growth rate of wholesale prices of imports, as well as exports, came temporarily to a halt (for two to three months), owing to the corrective adjustment of the drachma's exchange rate³ (see Table IV.1).

Besides, the growth rate of prices of *goods except fruit-vegetables and fuels* (included in the CPI) accelerated by 2.5 percentage points between February and July. The largest part, roughly four fifths, of this speed-up is estimated to have been a result of the devaluation. However, this acceleration was later limited to approximately one percentage point, largely owing to the already mentioned anti-inflationary factors.

The devaluation in March affected inflation decisively throughout 1998. It influenced both the prices of imports and, through them, the prices of domestic goods and services, as well as firms' profit margins.

More specifically, according to a preliminary assessment based on the evolution up to December 1998 of the drachma's effective exchange rate, consumer prices and whole-

1 The average growth of public utility rates declined to 3.4 per cent in December 1998, from 4.3 per cent in April, on an annual basis.

2 Excluding fees paid to state-owned hospitals (increase of 25.8 per cent), urban transport (14.4 per cent) and Olympic Airways (9.4 per cent) fares and Hellenic Postal Service (ELTA) charges (7.8 per cent).

3 Indeed, the annual growth rate of import prices, excluding fuels, was 3.5 per cent in February 1998, peaked at 8.2 per cent in April and stabilised over the next months around 5.0-6.0 per cent, while the increase in export prices, excluding fuels, reached 6.1 per cent in May, from 3.2 per cent in February, eventually dropping to 4.4 per cent at year-end.

TABLE IV.1
INFLATION INDICATORS
(Annual percentage changes)

Year or quarter	Consumer Price Index								Wholesale Price Index ¹					
	GENERAL INDEX	Sub-indices							GENERAL INDEX	Sub-indices				
		Goods	Services	CPI excluding fruit, vege- tables & fuels	CPI excluding food & fuels	Food and non-alcoholic beverages	Fresh fruit and vegetables	Fuels		Final domestic products for home consumption			Exported products	Imported products
										Primary	Industrial	Industrial excluding fuels		
1991	19.5	17.8	22.7	18.6	18.8	19.3	22.6	28.2	16.7	23.0	17.7	...	10.7	14.6
1992	15.9	14.1	19.2	16.3	16.3	14.1	3.7	20.1	11.3	1.7	14.7	...	6.4	12.6
1993	14.4	11.9	19.0	14.8	15.0	12.7	1.5	16.8	11.9	5.4	13.5	...	11.3	12.2
1994	10.9	10.9	10.9	11.0	10.8	12.9	24.8	2.7	8.7	13.7	7.4	8.5	8.7	9.2
1995	8.9	7.5	11.4	9.4	9.6	8.4	8.2	2.8	7.8	5.1	8.1	8.7	10.2	7.0
1996	8.2	7.2	9.9	8.1	8.4	7.0	8.4	10.2	6.1	8.9	7.1	6.1	5.6	1.6
1997	5.5	3.7	8.4	6.0	6.8	4.1	11.0	-4.9	3.3	4.2	4.0	3.8	2.9	2.1
1998	4.8	3.9	6.2	5.3	5.7	4.4	7.0	-5.9	3.9	7.5	2.8	4.3	3.0	5.4
1995 a	10.6	9.6	12.2	10.4	10.5	13.5	22.7	0.5	9.9	15.9	8.9	9.2	10.9	8.1
b	9.8	8.4	12.2	9.7	10.0	10.5	15.5	3.0	8.2	7.0	8.3	8.9	9.6	7.5
c	8.6	7.2	11.1	9.1	9.2	6.6	-1.9	4.2	6.8	0.0	7.7	8.7	10.0	6.2
d	8.2	6.9	10.4	8.5	8.8	6.7	-2.0	3.7	6.5	-1.8	7.5	8.0	10.3	6.2
1996 a	8.6	7.4	10.4	8.7	9.0	6.6	2.9	10.1	6.6	3.1	7.5	7.1	8.1	5.0
b	8.6	7.8	10.0	8.4	8.6	8.3	11.7	9.9	6.7	13.5	6.8	6.3	6.6	1.5
c	8.0	7.3	9.3	7.7	8.0	7.7	13.6	9.8	6.3	14.3	6.7	5.6	5.2	0.9
d	7.6	6.3	9.7	7.4	7.9	5.5	6.2	10.9	5.0	5.0	7.3	5.6	2.7	-0.7
1997 a	6.4	5.0	8.6	6.7	7.3	4.4	6.6	2.8	2.4	0.2	5.2	4.5	0.3	-0.4
b	5.6	3.6	8.8	6.4	7.3	3.5	8.0	-7.3	2.7	-2.5	3.7	3.6	3.1	2.2
c	5.3	3.2	8.6	5.8	6.7	5.1	21.2	-10.0	4.5	11.7	4.1	3.9	5.2	3.1
d	4.9	3.1	7.6	5.3	5.9	3.5	9.9	-3.9	3.5	8.8	3.0	3.6	3.1	3.5
1998 a	4.4	3.4	6.0	4.5	5.0	4.9	16.8	-4.7	3.5	11.2	2.1	3.4	3.1	4.3
b	5.3	4.5	6.5	5.7	6.0	4.6	5.4	-2.2	5.1	3.4	4.1	5.0	5.8	7.1
c	5.1	4.3	6.4	5.9	6.2	3.8	-0.8	-3.4	3.5	1.7	3.0	4.7	2.5	5.4
d	4.3	3.2	5.8	5.2	5.5	4.4	6.8	-13.3	3.4	14.4	2.2	4.2	0.7	5.1

1 From 1997 onwards, new, revised, wholesale price index (1990=100).

Source: Calculations based on NSSG data.

TABLE IV.2
EXPECTED AND ESTIMATED IMPACT OF DRACHMA DEVALUATION
(Percentage points)

	Acceleration of twelve-month rates of change between February 1998 and:											
	April 1998	May 1998	June 1998	July 1998	Aug. 1998	Sept. 1998	Oct. 1998	Nov. 1998	Dec. 1998	Average of 9-month period Apr.-Dec. 1998	Jan. 1999	Feb. 1999
Appreciation of foreign currencies (inverse of the effective exchange rate)	9.0	5.8	3.7	1.7	2.3	4.3	4.7	3.5	2.9	4.2	1.0	0.8
Appreciation of the ECU or (from 1 January 1999) the euro (drachma/ECU or drachma/euro parity)	9.5	7.0	5.6	3.7	5.0	6.8	7.0	3.9	3.3	5.8	1.0	0.5
Expected ¹ impact of the appreciation of foreign currencies:												
– on import prices	9.0	5.8	3.7	1.7	2.3	4.3	4.7	3.5	2.9	4.2	1.0	0.8
– on consumer prices and domestic product prices	2.0	1.3	0.8	0.4	0.5	0.9	1.0	0.8	0.6	0.9	0.2	0.2
Estimated ² impact on:												
– CPI	1.0	1.0	0.9	0.8	0.7	0.9	0.4	–0.1	–0.4	0.6	–0.6	–0.6
– CPI excluding fresh fruit-vegetables and fuels (core inflation)	1.1	1.3	1.5	1.7	1.6	1.3	1.1	0.9	0.5	1.2	0.2	0.1
– CPI excluding fresh fruit-vegetables, fuels and public utility services	1.3	1.4	1.7	1.9	1.8	1.5	1.2	1.0	0.6	1.4	0.5	0.4
– CPI (goods only) excluding fresh fruit-vegetables and fuels	1.5	2.0	2.2	2.5	2.3	2.1	1.9	1.6	1.1	1.9	0.8	0.9
– Wholesale Price Index (WPI)	3.0	2.8	1.6	0.9	0.2	1.4	1.3	0.8	0.3	1.4	0.1	0.2
– WPI/domestic industrial products for home consumption	2.1	2.6	2.0	1.8	0.7	1.2	0.7	0.4	–0.1	1.3	0.5	0.6
– WPI/domestic industrial products for home consumption (excluding fuels)	1.4	2.4	2.0	1.8	1.3	1.6	1.3	1.3	0.9	1.6	0.9	0.9
– WPI/exports (industrial & primary products)	5.0	4.2	2.9	1.3	0.2	0.9	–0.7	–0.2	–2.2	1.3	–2.4	–1.3
– WPI/imports (industrial & primary products)	4.8	3.9	3.6	2.2	1.9	2.5	2.6	1.6	1.4	2.7	0.3	–0.4

1 The *expected* impact was calculated assuming constant profit margins (and taking into account that the share of imports in demand and consumption is estimated at about 22 per cent). Therefore, a larger (smaller) *estimated* impact would imply an increase (a decrease) in profit margins. For the WPI/imports, the expected acceleration of the twelve-month rate of change is assumed equal (100 per cent) to that of the appreciation of foreign currencies against the drachma, as measured by the twelve-month rate of change in the inverse of the effective exchange rate. For the other price indices, the expected acceleration is assumed equal to 22 per cent of the acceleration of the twelve-month rate of change in the inverse of the effective exchange rate.

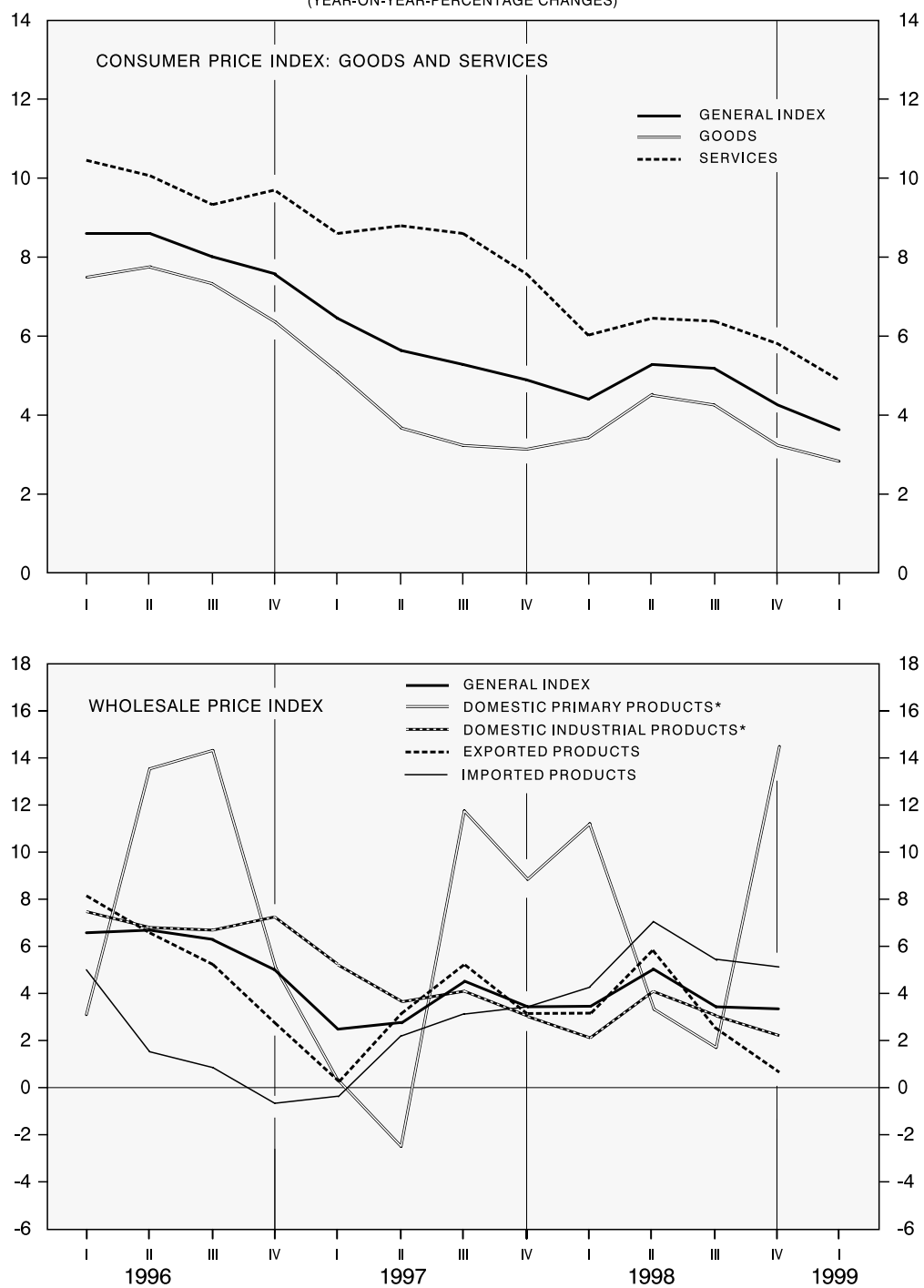
2 It should be recalled that the acceleration of the twelve-month rate of change in prices following the devaluation *underestimates* the impact of the devaluation, since it does not take account of the slowdown of inflation that was expected after February, but for the devaluation.

Source: Calculations based on Bank of Greece and NSSG data. For the WPI, revised data 1990=100.

CHART IV.2

PRICE DEVELOPMENTS

(YEAR-ON-YEAR-PERCENTAGE CHANGES)



sale prices, profit margins of business firms, excluding firms in wholesale import trade, increased on average in the period after the devaluation (April-December), thereby weakening the disinflationary process (see Table IV.2 and Chart IV.2). Nevertheless, over the last months of 1998 there were indications that profit margins of export firms were reduced, compared with February. On the contrary, in the case of domestic manufacturing firms which produce for home consumption, profit margins increased moderately after July, as indicated by the course of relevant prices (excluding fuels), but these margins remained at higher levels than before the devaluation.

The above indirect assessment of profit margin evolution is also confirmed by the annual income statements of firms listed on the Athens Stock Exchange. As shown by recent releases, in most cases profits increased noticeably more than sales in 1998.¹ Besides, the conclusion that price increases, which were faster than what was expected on the basis of the rise in the drachma costs of imported inputs, reflect an increase in profit margins is corroborated by the evolution of the other cost components: first, the growth rate of unit labour costs decelerated significantly and was slower than the growth rate of prices and, second, financing costs were reduced. Indeed, average annual interest rates on short- and long-term bank loans declined slightly in 1998, which entails a small drop (of 1-2 per cent) in annual financing costs. Moreover, while in 1998 the prices of domestic industrial products for home consumption and those of exported goods increased at an average annual rate of 2.8 per cent and 3.0 per cent,² respectively, unit labour costs in manufacturing are estimated to have risen by only 1.4 per cent (1997: 4.4 per cent). Besides, in the whole economy unit labour cost growth decelerated significantly and productivity continued to grow fast.³

1.4 Core inflation

The prices of industrial goods included in the CPI, except food and fuels, and more specifically the prices of clothing-footwear and of consumer durables, which were increasing in 1998 by an average 5.7 per cent and 5.6 per cent, respectively, remained at high levels. As a result, core inflation (as measured on the basis of the twelve-month growth rate in the *CPI excluding fresh fruit-vegetables and fuels*) overshot 5.0 per cent between April and November 1998. Actually, if the favourable evolution of public utility rates is not taken into account, the rate of increase in the resulting index exceeded, in certain cases, 6.0 per cent.

Besides, core inflation remained at high levels because of the large increases in the wholesale prices of *domestic industrial products* for home consumption, excluding fuels

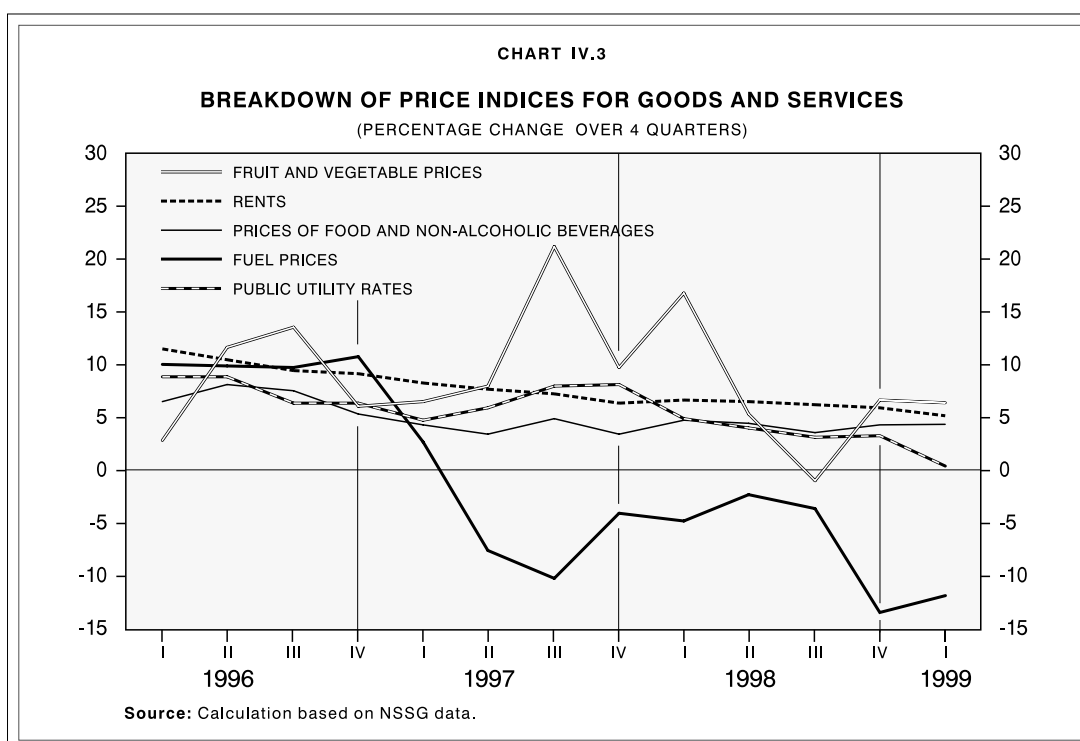
1 See below, Section 3.

2 Excluding fuels, the average twelve-month growth rate was even higher (4.3 per cent for domestic industrial goods and 4.6 per cent for exported goods).

3 See below, Section 2.

(annual rate of increase in December 1998: 4.0 per cent, against 3.8 per cent in December 1997). Most of these price increases were recorded in the period from February to December 1998, as suggested by the twelve-month rates of price increases in several sectors.¹ Similar developments were observed in *import prices, excluding fuels* (twelve-month growth rates, December 1998: 5.1 per cent, 1997: 3.5 per cent).²

It is a fact that the greatest part of wholesale price increases in both domestic industrial goods and imported goods, excluding fuels, was observed in the three-month



period of March through May and affected significantly core inflation up to August, because these increases were passed on with some delay to the final consumer.

Wholesale price increases for industrial goods, in conjunction with the high growth rate of 5.8 per cent in the prices of *private* sector services included in the CPI in December

1 Indicatively, the year-on-year rates of price increase in December 1998, compared with those in February 1998, were as follows for certain items: for printing materials, December 1998: 15.8 per cent, February 1998: 10.3 per cent, transport equipment, 13.8 per cent against 3.9 per cent, rubber and plastics, 8.0 per cent against 2.5 per cent, leather, 6.1 per cent against 3.8 per cent, timber, 6.0 per cent against 2.9 per cent, processed food, 3.5 per cent against 0.9 per cent, etc.

2 The main increases in these items, on the basis of twelve-month rates of price increases in the same period (February-December 1998), were related to tobacco products (December 1998: 12.3 per cent, February 1998: 11.3 per cent), paper-pulp and paper products (10.6 per cent against 2.0 per cent), timber (10.4 per cent against 8.4 per cent), furniture (7.6 per cent against 2.4 per cent), medical instruments (6.9 per cent against 3.3 per cent), leather (6.2 per cent against 5.7 per cent), manufactured metal products (6.3 per cent against 4.9 per cent), food-beverages (5.9 per cent against 4.4 per cent), spare parts and accessories of vehicles (5.6 per cent against 0.6 per cent) etc.

1998 (compared with an increase of only 3.4 per cent in public utility rates – see Chart IV.3), signalled the existence of inflationary pressures from almost the entire private sector, which raised core inflation to relatively high levels.

Thus, core inflation (see Chart II.2) recorded its peak acceleration (1.7 percentage points) between February (4.4 per cent) and July (6.1 per cent). This was due also to the fact that most firms increased their prices in line with the evolution of the drachma's effective exchange rate up to April. Nevertheless, it seems that after May and despite the drachma's appreciation, product prices were not adjusted downwards or, if so, the adjustment was minimal. This pricing policy widened profit margins and intensified inflationary pressures.

In the following months, however, core inflation gradually declined and was limited to 4.9 per cent in December, against 5.1 per cent in December 1997. This was due to the same factors which contributed to curbing inflation¹ –excluding, of course, price developments of fuels and fresh fruit-vegetables. (The effect of the latter prices over time and the correlation between core inflation and the CPI are detailed in Box IV.1).

1.5 The effect of demand on the deceleration of inflation

The deceleration of inflation in 1998, especially over the last months (after the *ad hoc* government measures), had a strong dampening effect on inflationary expectations of households and business firms and, in conjunction with the favourable development of underlying economic developments (containment of cost factors, appreciation of the drachma after May and slowing consumer demand growth), created the appropriate conditions for market forces to contribute to further disinflation.

Particularly regarding consumer demand, the growth of total private consumption slowed down in 1998 (1.8 per cent against 2.5 per cent), while the development of its components was characterised by lack of uniformity. Thus, the growth of retail sales volume and of import volume decelerated, the number of new passenger car registrations kept rising at high rates (only slightly lower than in 1997) and the index of retail trade expectations declined. However, in most cases where a deceleration or a decline was observed, it was smaller than expected, on the basis of the growth of households' real disposable income. This disproportion reflects the fact that the limited increase in real disposable income on the one hand was partly offset by the appreciation of households' assets and, on the other hand, led to increased recourse to consumer credit.²

Besides, the slower growth of the government's wage bill, which decreased as a percentage of GDP, combined with the large increase in direct tax revenue, which grew as a

¹ One of the underlying factors was the abatement of inflationary pressures in the world market, given that commodity prices, excluding fuels, in both US dollar (IMF data, *International Financial Statistics*, January 1999) and drachma terms, declined significantly over 1998 (in drachmas they dropped by 9.4 per cent, against a rise of 5.4 per cent in 1997, and in US dollars they decreased by 9.6 per cent, against a drop of 7.6 per cent in 1997).

² See Bank of Greece, *Monetary Policy 1998-1999*, March 1999.

percentage of GDP, contributed to the drop of the general government's deficit (on a national accounts basis) to 2.4 per cent of GDP in 1998, from 3.9 per cent in 1997. This decrease had also an autonomous restrictive effect on inflationary pressures.

According to another approach to the impact of demand on inflation, the difference between current and potential output in the whole economy as a percentage of potential output, i.e. "the output gap", kept narrowing in 1998 –on the basis of all available econometric estimates. However, according to most estimates, this difference remained negative, given that in 1998 current output was smaller than potential output. It should be noted, though, that the downward trend of the "output gap" over the last years may suggest inflationary pressures from the demand side. Nevertheless, the medium-term prospects for the development of the "output gap" are favourable.¹

1.6 Comparison of Greek inflation with that in euro-area countries and EU-15

According to the Maastricht Treaty, for the assessment of convergence in terms of price stability, inflation is measured on the basis of the Harmonised Indices of Consumer Prices (HICP), which were compiled uniformly, so as to be comparable. In December 1998, the annual growth rate of the HICP in Greece was 3.7 per cent (against 4.5 per cent in December 1997), while the average annual increase in 1998 came to 4.5 per cent (against 5.4 per cent in 1997). The respective euro-area rates (EU-11)² were 0.8 per cent and 1.1 per cent (see Charts II.1 and IV.4).

The inflation differential between Greece and the euro area³ fell to 2.9 percentage points at end-December 1998, from 3.0 percentage points in 1997, and to 3.4 percentage points on average, from 3.8 percentage points in 1997. However, the average inflation rate for Greece in 1998 (4.5 per cent) was higher than the reference value of the convergence criterion,⁴ which came to 2.2 per cent. Nevertheless, in March 1999 the inflation differential between Greece and the euro area declined to 2.2 percentage points (see Box IV.2 in Section 1.7).

Disinflation in euro area countries was mainly due to the large drop in energy prices,⁵ the significant reduction in the prices of commodities, excluding fuels in the world market,⁶ and the moderate rises in food and industrial product prices, excluding fuels.⁷ Moreover, the evolution of unit labour costs was particularly favourable (average rate of

1 See below, Section 1.7.

2 For EU-15 as a whole, the respective rates were 1.0 per cent and 1.3 per cent.

3 The differential between Greece and EU-15 dropped to 2.7 percentage points at the end of 1998, from 2.9 percentage points in 1997, and to 3.2 percentage points on average, from 3.7 percentage points in 1997.

4 The average inflation rate in 1998 was 0.7 per cent for the three best-performing countries, both in the euro area and the EU (France, Germany and Austria).

5 Oil prices in ECU terms reached a level approximately 45 per cent lower than at the end of 1997.

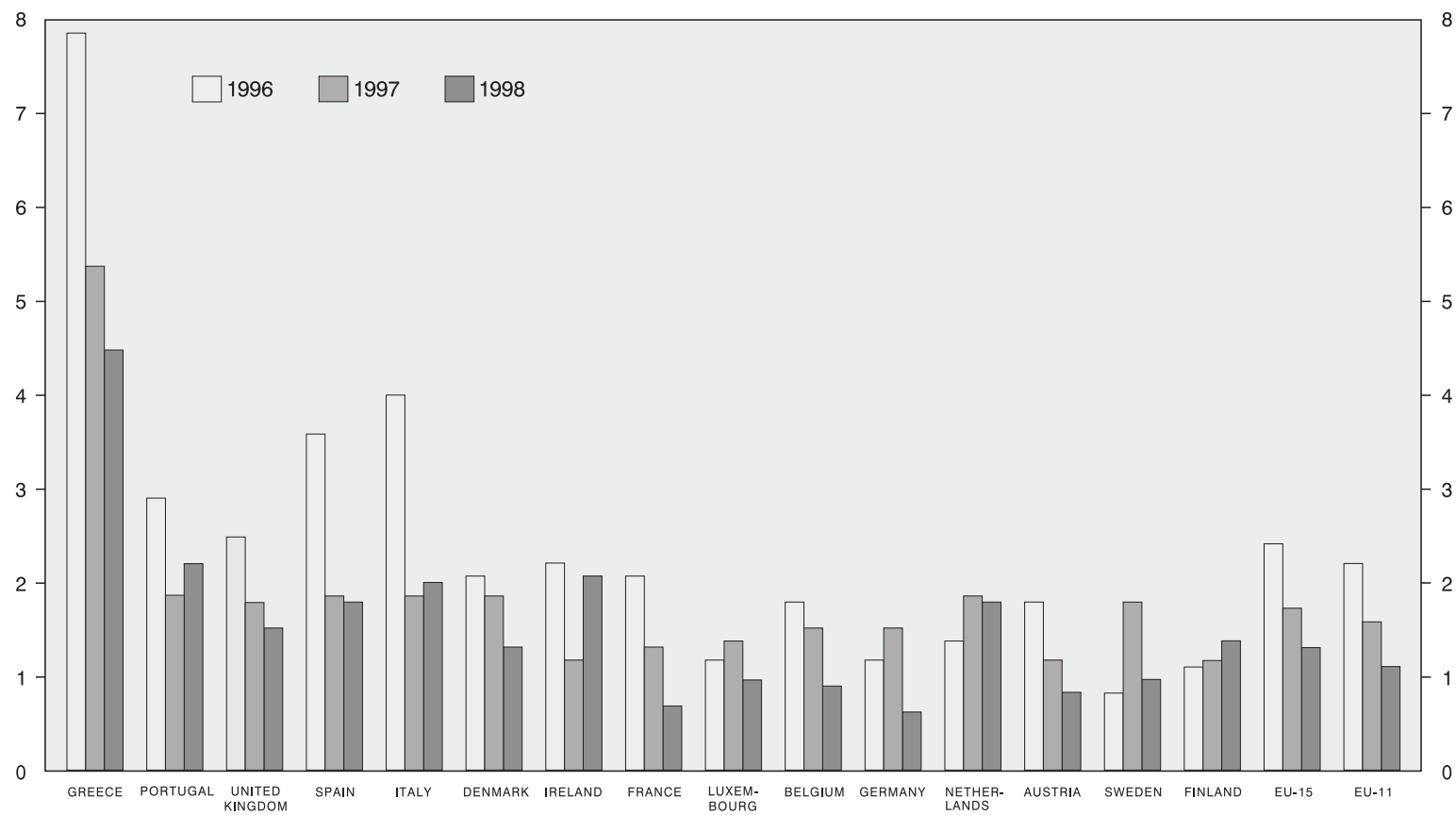
6 In ECU terms: –12.5 per cent in 1998, against 13.0 per cent in 1997.

7 In ECU terms: approximately 1.0-1.5 per cent.

CHART IV.4

INFLATION IN EU COUNTRIES ON THE BASIS OF HICPs

(AVERAGE ANNUAL PERCENTAGE CHANGE)



Source: Eurostat.

change year-on-year for the first nine months of 1998: –1.2 per cent, compared with +0.6 per cent for 1997 as a whole),¹ reflecting also the considerable increase in productivity (2.3 per cent in the first nine months of 1998, compared with 2.1 per cent in 1997 as a whole).²

1.7 Inflation prospects for 1999

Inflation continued to decelerate from the first months of 1999 onwards and is expected to decrease more sharply as the negative effects of the drachma's devaluation fade away. The main anti-inflationary factors at work in 1998 continue to do so in 1999 as well. Particularly:

- The strong anti-inflationary stance of monetary and exchange rate policies is maintained, in order for the fall in inflation to become permanent and sustainable.

- It is anticipated that the general government's deficit will drop further, to 1.9 per cent of GDP, while the generation of an increased primary surplus will significantly limit inflationary pressures from the demand side.

- Unit labour cost growth in the whole economy will decline to a level below 2.0 per cent, while in manufacturing it will fall to approximately 1.0 per cent, thanks, among other things, to the ongoing fast growth of productivity.

- Moreover, the *ad hoc* government measures, such as the “gentlemen's agreements”, which were taken over the last months of 1998 and will be continued in 1999, in conjunction with the 8.4 per cent cut in Public Power Corporation (DEH) rates as from January 1999 and the 3.8 per cent reduction in the Hellenic Telecommunications Organisation (OTE) rates as from March, will contribute significantly to an even larger decline in core inflation as well.

- Besides, pressures from domestic demand are expected to be checked, owing to both the policy of restraining credit expansion and the effect of certain factors which create the conditions for a quicker rise in potential output and thus for the interruption, in the medium term, of the trend of the “output gap” to narrow. Specifically, the faster growth of GDP over the last years is due to the rise of investment, which leads to an increase in the fixed capital stock of the economy and in productivity, while at the same time the number of immigrant workers is increasing, thus strengthening the labour force. Moreover, the structural changes under way, such as privatisations, interventions in the labour market, creation of infrastructure etc., have increased productive capacity. Thus, the fall in real interest rates, which may contribute to a quicker rise in consumer and investment demand, will be offset by the expanded productive capacity of the economy.

Nevertheless, significant uncertainties and unfavourable factors still exist, which may temporarily impede faster disinflation. One of these factors is the considerable

¹ ECB, *Monthly Bulletin*, March 1999.

² ECB, *Monthly Bulletin*, March 1999.

increase (of about 5 US dollars per barrel over the last two months) in crude oil prices in the world market owing to the OPEC agreement to limit supply, after the large drop observed in 1998. The effects of this development can be mitigated, if the disinflation dynamics observed, in conjunction with improved profitability last year and disinflation trends in most economies, particularly in the euro area, leads to a considerable abatement of inflationary expectations and influences favourably business firms' pricing policy, making possible the absorption of any short-term negative effect.

Uncertainties still exist with respect to agricultural product prices as well, which depend on the strong fluctuations of relevant supply, owing to the volatility of weather conditions and changes in export demand. Although agricultural product output and prices depend on many unpredictable factors, it is estimated that in 1999 they will improve, compared with 1998.

Moreover, there are external factors too, related to non-accelerating global economic growth, possible monetary crises which may affect the domestic economy as well, and recent developments in the Balkans. These factors may have affected the course of inflation.

Given the economic policy framework and the country's clear orientation towards joining EMU, inflation will continue to drop (in March inflation dropped to 3.4 per cent) and from April onwards it will decline below 3.0 per cent. It is estimated that in the following months inflation will stabilise around 2.0 per cent, so as to meet the relevant convergence criterion of the Maastricht Treaty at the beginning of 2000, when it will be assessed whether the Greek economy qualifies for joining EMU.

BOX IV.2

Comparison of HICPs in Greece and the European Union

The harmonised CPIs (HICPs) have been compiled on the basis of the international classification (COICOP/HICP),¹ so as to ensure comparability between EU Member States in the measurement of inflation. In addition, they were used by the ECB and the EU for the assessment of economic convergence in terms of price stability, for entry into EMU, according to the Maastricht Treaty. These indices differ from national CPIs with respect to both the coverage of goods and services (the consumer's "basket") and the share of each item in total consumption expenditure. They also differ as regards the population covered by each sample: the HICP covers the country as a whole (rural areas inclusive), while the national CPI covers only urban centres (see the first table of the Box, with weights).

The "basket" of goods and services included in the HICP represents 94.6 per cent of the respective national CPI. The main items excluded are the medicine and dentistry services, hospitalisation fees and tuition fees for primary and secondary schools and for vocational and technical schools. These items must be covered by all Member States from January 2000 onwards. →

¹ The classification of the items included in the harmonised indices is common for all Member States and is based on COICOP (Classification of Individual Consumption by Purpose), adapted to HICP requirements.

→ In March 1999, the HICP increased by 3.2 per cent, compared with a rise of 3.4 per cent in the national CPI, on an annual basis. Therefore, this rate was, on an annual basis, 0.2 percentage point lower than the respective CPI rate. This deviation was due, on the one hand, to

ITEMS AND WEIGHTS OF HICP AND CPI (GREECE)

Categories	Weights		Weight differential
	HICP	CPI	
All items	1,000.00	1,000.00	
Food and non-alcoholic beverages	234.97	205.67	29.30
Alcoholic beverages and tobacco	39.97	34.98	4.99
Clothing and footwear	119.30	111.13	8.17
Housing, water supply, electricity and fuels	138.17	135.85	2.32
Consumer durables, household articles, and services	90.60	83.90	6.70
Health	13.50	57.40	-43.90
Transportation	135.49	135.87	-0.38
Communications	19.53	18.10	1.43
Recreation, cultural activities	49.05	50.41	-1.36
Education	13.17	27.28	-14.11
Hotels, cafés and restaurants	86.20	82.88	3.32
Miscellaneous goods and services	60.04	56.53	3.51

Source: NSSG.

the narrower coverage of items by the HICP, compared with the CPI, and, on the other hand, to the fact that large groups of goods and services (e.g. food) have higher weights in the HICP, reflecting the different composition of household expenditure in rural areas. The largest →

DEVIATIONS BETWEEN HICP AND CPI (GREECE)
(Annual percentage changes, deviations in percentage points)

Period	Annual percentage changes		Deviation HICP – CPI	Deviation between HICP and CPI	
	HICP	CPI		due to weight differentials	due to differentials in coverage
1998 Jan.	4.26	4.40	-0.14	0.12	-0.26
Feb.	4.17	4.27	-0.10	0.11	-0.21
March	4.32	4.57	-0.25	0.13	-0.38
Apr.	5.11	5.34	-0.23	0.15	-0.38
May	5.02	5.29	-0.27	0.12	-0.39
June	4.86	5.20	-0.34	0.08	-0.42
July	4.78	5.10	-0.32	0.10	-0.43
Aug.	4.71	5.03	-0.32	0.11	-0.43
Sept.	4.99	5.22	-0.24	0.18	-0.41
Oct.	4.45	4.69	-0.23	0.21	-0.44
Nov.	3.99	4.22	-0.23	0.21	-0.44
Dec.	3.73	3.87	-0.14	0.26	-0.40
1998	4.53	4.77	-0.23	0.15	-0.38
1999 Jan.	3.50	3.70	-0.20	0.22	-0.41
Feb.	3.45	3.69	-0.24	0.18	-0.42
March	3.25	3.40	-0.15	0.14	-0.29

Source: Calculations based on NSSG data.

→ deviation was observed in the categories “Health”, “Food” and “Education” (see the first and the second table in the Box).

The second table details deviations between the HICP and the CPI from January 1998 through March 1999. The part of the deviation which was due to differences in weights fluctuated between 0.08 and 0.26 percentage point, while the part attributed to the fact that the HICP covers a smaller number of products moved between –0.21 and –0.44 percentage point. At average levels for 1998, the deviation between the two indices rose to 0.23 percentage point. The smallest deviation, 0.10 percentage point, was observed in February 1998 and the largest one, 0.34 percentage point, in June.

COMPARISON OF HICPs OF GREECE AND THE EURO AREA IN MARCH 1999

Categories	Percentage changes		Deviations from the euro area (percentage points)
	Greece	Euro area	
General index	3.2	1.0	2.2
Food and non-alcoholic beverages	4.2	1.1	3.1
Alcoholic beverages and tobacco	4.4	2.7	1.7
Clothing and footwear	5.4	1.0	4.4
Housing, water supply, electricity and fuels	0.5	0.6	–0.1
Consumer durables, household articles, and services	4.5	1.2	3.3
Health	–0.7	2.6	–3.3
Transportation	–1.8	0.2	–2.0
Communications	–4.8	–3.0	–1.8
Recreation, cultural activities	4.8	0.5	4.3
Education	4.6	2.7	1.9
Hotels, cafés and restaurants	7.4	2.2	5.2
Miscellaneous goods and services	4.2	1.4	2.8

Source: Calculations based on NSSG and Eurostat data.

The euro area HICP increased by 1.0 per cent in March 1999, on an annual basis, while in Greece it rose by 3.2 per cent. The third table of the Box presents the deviation in HICP growth between Greece and euro area countries, which was 2.2 percentage points in March and was mainly due to larger prices increases in Greece for food, clothing-footwear and consumer durables, as well as for private sector services. Of course, this deviation was largely accounted for by the different cost conditions prevailing in each case, as mentioned in Section 1.6.

2. WAGES AND SALARIES IN 1998

It is estimated that, in 1998, unit labour cost growth, which is determined by the wage policy pursued in central government, the outcome of collective bargaining in the business sector (i.e. in private and public enterprises and in banks) and the evolution of productivity, decelerated by approximately 3 percentage points in the whole economy and in manufacturing. In the latter sector, it actually dropped to very low levels (see Table IV.3). Average gross earnings in the whole economy grew significantly less than in 1997. This was due to a considerably slower increase in the central government’s wage bill per

TABLE IV.3
EARNINGS, UNIT LABOUR COSTS AND PRODUCTIVITY (1994 - 1998)
(Annual percentage changes)

	1994	1995	1996	1997	1998
TOTAL ECONOMY					
– Average gross earnings ¹ (nominal)	13.0	11.9	11.5	10.5	6.9
– Average gross earnings ¹ (real)	1.9	2.8	3.0	4.7	2.0
– Employees' average disposable income ¹ (nominal)	11.5	10.3	9.7	10.7	6.3
– Employees' average disposable income ¹ (real)	0.5	1.3	1.4	4.9	1.4
– Total compensation of employees ^{1,2} (real)	13.7	12.6	12.5	10.7	8.1
– Unit labour costs ^{1,3}	11.4	10.3	9.9	7.2	4.2
– Consumer price index ⁴	10.9	8.9	8.2	5.5	4.8
– Gross domestic product ⁵	2.0	2.1	2.4	3.2	3.7
BUSINESS SECTOR⁶					
– Total compensation of employees ¹	14.7	12.4	10.9	9.4	7.3
– Unit labour costs ¹	12.4	10.1	8.3	6.0	3.5
CIVIL SERVICE⁷					
– Average gross earnings of employees	9.4	12.3	14.9	13.5	9.3
– Total outlays for salaries and pensions	11.3	13.1	16.4	13.3	9.8
– Total outlays for salaries (excluding pensions)	11.8	13.9	17.8	14.7	8.1
PUBLIC ENTERPRISES					
– Average gross earnings of employees ⁸	18.8	10.9	14.1	11.0	7.2
– Total personnel outlays ⁸	25.3	11.6	12.6	9.7	3.6
– Monthly earnings of white-collar workers in electricity-water supply ⁴	11.0	11.2	14.0	9.9	9.0 ¹³
– Hourly earnings of blue-collar workers in electricity-water supply ⁴	16.1	15.8	8.7	10.4	11.9 ¹³
BANKS					
– Average gross earnings of employees ¹	14.4	15.4	13.4	9.7	7.3
– Total outlays for salaries ⁹	20.5	20.0	16.6	10.8	8.4
– Total compensation of employees ⁹	18.2	17.3	16.0	9.8	8.4
– Monthly earnings of employees ^{4,10}	17.5	13.1	12.7	9.4	11.6 ¹⁴
PRIVATE SECTOR					
– Minimum earnings ¹¹ (nominal)	12.6	9.4	8.2	8.0	5.4
– Minimum earnings ¹¹ (real)	1.5	0.5	0.0	2.4	0.6
– Average contractual earnings ¹²	12.5	10.1	8.6	8.2	5.9
– Average gross earnings ¹	12.9	11.2	8.8	8.8	6.2
– Total compensation of employees ¹	12.6	12.2	10.2	9.3	7.9
– Hourly earnings of blue-collar workers in manufacturing ⁴	13.1	13.2	8.6	8.9	4.8 ¹³
– Monthly earnings of white-collar workers in manufacturing ⁴	13.0	13.2	9.4	9.8	6.4 ¹³
– Output per hour worked (manufacturing) ⁴	3.9	2.0	1.1	4.4	6.0 ¹³
– Unit labour costs (manufacturing) ⁴	8.7	11.0	7.5	4.4	-1.1 ¹³
– Weekly earnings of blue-collar workers in mining ⁴	15.3	14.0	12.7	12.2	7.2 ¹³
– Monthly earnings of white-collar workers in mining ⁴	12.9	11.3	11.7	14.3	16.1 ¹³
– Monthly earnings of employees in retail trade ⁴	13.3	12.8	9.7	12.0	10.5 ¹³
– Monthly earnings of employees in wholesale trade ⁴	15.3	15.3	9.9	10.5	5.9 ¹³

1 Bank of Greece estimates.

2 NSSG and Ministry of National Economy estimates of the growth in total compensation of employees (December 1998-March 1999): 1994: 12.9 per cent, 1995: 15.3 per cent, 1996: 14 per cent, 1997: 11.5 per cent, 1998: 7.3 per cent.

3 NSSG and Ministry of National Economy estimates of the rate of increase in unit labour costs (as defined by the Ministry of National Economy): 1994: 10.7 per cent, 1995: 11.6 per cent, 1996: 10.6 per cent, 1997: 7.1 per cent, 1998: 2.8 per cent. On the basis of NSSG and Ministry of National Economy data but using the definition adopted by the Bank of Greece, the above figures become: 1994: 10.7 per cent, 1995: 12.9 per cent, 1996: 11.3 per cent, 1997: 8 per cent, 1998: 3.5 per cent.

4 Calculations based on NSSG survey data.

5 NSSG and Ministry of National Economy estimates (December 1998-March 1999).

6 The business sector comprises public enterprises, banks and private business firms.

7 Estimates based on data from the Ministry of Finance and Introductory Reports on the Budget. Data for 1997 have been adjusted to ensure comparability.

8 Estimates based on Ministry of National Economy data.

9 Data from annual profit and loss accounts (1994-98).

10 October-on-October rates of change.

11 National General Collective Labour Agreement.

12 Calculations based on data from collective labour agreements at branch or trade (occupational) level.

13 Change in January-June 1998 over the corresponding period of 1997.

14 April-on-April rate of change.

person and to the appreciably smaller rise in average gross earnings in private and public enterprises and in banks.

It should be pointed out that increases in civil servants' earnings had been determined upon submission of the budget for 1998, i.e. before the drachma's devaluation in March, while two-year labour agreements had been signed in banks and in most public enterprises in 1997. In the private sector, collective bargaining on minimum wages and contractual earnings at branch or occupational level was completed after the devaluation and moderate increases were agreed upon, a fact which reflects both the moderation of workers' wage demands, due to their stronger confidence in the prospect of disinflation, as well as the effect of anti-inflationary monetary policy on the behaviour of social partners. Lastly, the significant rise in productivity for a second consecutive year also contributed to the relatively slow growth of unit labour costs.

In particular, it is estimated that in the whole economy, average gross pre-tax earnings rose by 6.9 per cent, compared with 10.5 per cent in 1997. As dependent employment must have increased by 0.5-1.0 per cent, it is estimated that total outlays for the compensation of employees (which are also affected by changes in civil servants' pensions and in employers' social security contributions) increased by 8.1 per cent, compared with 10.7 per cent in 1997. Since GDP grew by 3.7 per cent (1997: 3.2 per cent), unit labour costs in the whole economy rose by 4.2 per cent, against 7.2 per cent in 1997.¹ The growth of unit labour costs in the business sector (which comprises private and public enterprises and banks) is estimated to have decelerated from 6.0 per cent in 1997 to 3.5 per cent in 1998 and in manufacturing from 4.4 per cent to 1.4 per cent. In real terms, the disposable income of an employee with average earnings, as calculated approximately, increased by 1.4 per cent in 1998, compared with 4.9 per cent in 1997.² As regards productivity, GDP per employee increased by 3.5 per cent in the whole economy, against 4.4 per cent in 1997, while in manufacturing output per person hour is estimated to have risen by 4.1 per cent, against 4.4 per cent in 1997. It is also worth mentioning that, in the first five years (1994-1998) of implementation of the Convergence Programme, average real pre-tax earnings in the whole economy increased at an estimated average annual rate of 2.9 per cent and the average real disposable income of wage-earners rose at a corresponding annual rate of 1.9

1 Unit labour costs are defined here as the ratio of total compensation of employees to GDP (at constant prices of the previous year). These estimates differ slightly from those of NSSG and the Directorate of Macroeconomic Analysis of the Ministry of National Economy. According to the latter, on a national accounts basis, "compensation of employees" increased by 13.5 per cent in 1997 and 7.3 per cent in 1998, while unit labour costs rose by 7.1 per cent in 1997 and 2.8 per cent in 1998. It should be recalled that NSSG and the Ministry of National Economy adopt a different definition of unit labour costs, i.e. the ratio of total compensation of employees *per employed wage earner* to GDP (at constant prices of the previous year) *per employed person*.

2 The calculation takes into account the evolution of income tax and employees' social security contributions for a wage earner with average earnings and a typical family. Income tax is that withheld during the year from an employee's compensation, less any tax refunds from the previous year (paid during the current year). The fact that in 1998 the income tax scale remained unchanged and, at the same time, the system of tax withholding for wages and salaries was changed, led to an increase in wage-earners' income tax burden.

per cent, equal to the average annual growth rate of productivity (GDP per employee) in the same period. (Box IV.3 presents the evolution of the tax burden on wage-earners and other categories of taxpayers over the last years, on the basis of detailed personal income tax data).

Data on labour dispute settlement and on the evolution of strike activity indicate that collective bargaining and a mild climate kept prevailing in labour relations in 1998.

BOX IV.3

Evolution of declared personal income, personal income tax and personal tax burden: financial years 1990-1998

This Box presents personal income tax data, by professional group, for financial years 1990-1998 (income earned in years 1989-1997). These data are released by NSSG and are derived from the elaboration of all the data of income tax returns submitted for the corresponding financial years, which regard income earned over the previous calendar year. For a better understanding of the data depicted in the tables below, the following should be taken into account: First, the number of tax returns increases over time, mainly because legislation constantly broadens the tax basis, making it obligatory for an ever-increasing number of population groups to submit tax returns (farmers, persons over 25 years, etc.). It is characteristic, and should be taken into account in the data analysis, that the new persons required to submit tax returns usually belong to the lowest tranche of income distribution. Second, declared family income is considered to be that derived from any source and gained by each spouse and the children under age (provided the latter do not bear any separate tax liability), less the expenditure for gaining this income. Third, the breakdown of tax returns by professional group is made by tax offices, on the basis of the taxpayer's profession recorded in the return. If taxable income is derived from more than one sources, account is taken of the taxpayer's main job and the source of the largest part of his income. Consequently, each of these returns can include income from various sources, both for the liable person and for, mainly, the spouse and the children under age, if any.

In the first table, taxpayers were divided in six major professional groups. The first group covers persons whose income comes exclusively from real estate, land rents or movable assets. The share of this group in the sum total of taxpayers increases over time, from 8.3 per cent in financial year 1990 to 12.0 per cent in 1998, while its average tax burden as a percentage of declared income is higher (by more than one percentage point) than that of the sum total of taxpayers for all the years of the period. The second group comprises taxpayers whose income stems to its largest part from commercial, industrial, small-scale manufacturing and other entrepreneurial activity. It is characteristic that the number of taxpayers in this group, after a slight increase in the period 1990-1996, has been declining since then: as a result, the share of this group in the whole of taxpayers is decreasing steadily, from 25.2 per cent in 1990 to 21.4 per cent in 1994 and 15.4 per cent in 1998. In the →

→ PERSONAL INCOME TAX DATA BY PROFESSIONAL GROUP (FINANCIAL YEARS 1990-1998)									
Professional group	Financial year								
	1990	1991	1992	1993	1994	1995	1996	1997	1998
A. Taxpayers (thousand persons)									
<i>All groups</i>	2,521.5	2,655.4	2,904.2	3,096.4	3,218.7	3,840.1	3,986.3	4,268.6	4,435.4
Rentiers	210.4	222.8	257.3	281.4	293.8	410.0	428.1	502.6	533.1
Traders, manufacturers	635.4	655.2	677.3	687.1	689.2	704.5	711.7	709.5	696.2
Farmers etc.	48.4	56.7	84.2	108.7	121.8	300.7	328.1	363.2	371.6
Employees	1,095.1	1,151.3	1,258.7	1,333.6	1,379.0	1,466.2	1,507.8	1,554.5	1,628.5
Self-employed	101.8	106.3	110.5	116.3	120.6	127.0	131.9	134.6	138.2
Pensioners	430.5	463.1	516.2	569.2	614.3	831.6	878.8	1,004.2	1,067.9
B. Declared family income (billion drachmas)									
<i>All groups</i>	3,675.2	4,594.5	5,627.6	6,473.2	7,435.6	9,748.1	11,074.8	12,494.3	14,480.0
Rentiers	153.1	185.5	232.9	286.8	332.9	436.3	495.0	558.3	648.9
Traders, manufacturers	696.0	864.1	1,048.2	1,124.1	1,303.4	2,103.9	2,356.2	2,556.4	2,800.0
Farmers etc.	27.6	37.1	66.7	99.1	128.4	242.6	311.7	364.5	435.0
Employees	1,912.0	2,388.7	2,900.7	3,328.6	3,766.5	4,431.5	4,973.7	5,556.8	6,529.0
Self-employed	225.5	282.1	339.6	404.5	476.4	636.7	728.1	821.1	961.2
Pensioners	661.1	837.1	1,039.6	1,230.1	1,428.0	1,897.0	2,210.1	2,637.1	3,048.3
C. Average declared family income (thousand drachmas)									
<i>All groups</i>	1,457.5	1,730.2	1,937.8	2,090.6	2,310.1	2,538.5	2,778.2	2,927.0	3,264.7
Rentiers	727.6	832.8	905.1	1,019.1	1,132.9	1,064.2	1,156.3	1,110.8	1,217.3
Traders, manufacturers	1,095.4	1,318.7	1,547.6	1,636.0	1,891.3	2,986.3	3,310.8	3,603.1	4,021.9
Farmers etc.	570.4	653.7	792.0	911.4	1,054.1	806.7	950.1	1,003.8	1,170.6
Employees	1,746.0	2,074.8	2,304.5	2,495.9	2,731.3	3,022.4	3,298.7	3,574.7	4,009.3
Self-employed	2,214.6	2,652.3	3,073.3	3,477.0	3,951.4	5,012.6	5,520.3	6,101.2	6,957.2
Pensioners	1,535.6	1,807.5	2,013.9	2,161.3	2,324.5	2,281.2	2,515.0	2,626.0	2,854.5
D. Total tax									
<i>All groups</i>	314.9	419.8	508.1	273.4	362.8	501.1	652.5	858.6	1,094.2
Rentiers	15.1	19.4	26.0	16.4	21.0	27.3	34.2	44.8	53.8
Traders, manufacturers	79.7	103.1	126.6	57.4	73.3	131.5	165.9	206.1	249.9
Farmers etc.	0.8	1.3	2.1	2.3	3.2	4.6	6.8	9.8	12.3
Employees	133.4	182.3	214.7	118.9	161.0	195.9	261.8	354.0	477.2
Self-employed	32.9	44.0	55.4	33.1	44.8	69.8	86.4	110.1	139.5
Pensioners	53.0	69.7	83.5	45.3	59.6	72.0	97.3	133.8	161.5
E. Average tax (thousand drachmas)									
<i>All groups</i>	124.9	158.1	175.0	88.3	112.7	130.5	163.7	201.1	246.7
Rentiers	71.7	87.2	100.9	58.3	71.5	66.5	79.9	89.1	101.0
Traders, manufacturers	125.4	157.3	186.9	83.6	106.4	186.6	233.1	290.5	358.9
Farmers etc.	17.5	23.2	25.0	21.0	26.2	15.4	20.8	27.1	33.2
Employees	121.8	158.3	170.5	89.1	116.8	133.6	173.7	227.7	293.0
Self-employed	322.9	414.1	501.4	284.2	371.3	549.5	655.1	817.8	1,009.6
Pensioners	123.1	150.6	161.7	79.6	96.9	86.6	110.7	133.2	151.3
F. Average tax burden as a percentage of declared income									
<i>All groups</i>	8.6	9.1	9.0	4.2	4.9	5.1	5.9	6.9	7.6
Rentiers	9.9	10.5	11.1	5.7	6.3	6.2	6.9	8.0	8.3
Traders, manufacturers	11.4	11.9	12.1	5.1	5.6	6.2	7.0	8.1	8.9
Farmers etc.	3.1	3.5	3.2	2.3	2.5	1.9	2.2	2.7	2.8
Employees	7.0	7.6	7.4	3.6	4.3	4.4	5.3	6.4	7.3
Self-employed	14.6	15.6	16.3	8.2	9.4	11.0	11.9	13.4	14.5
Pensioners	8.0	8.3	8.0	3.7	4.2	3.8	4.4	5.1	5.3

Source: Calculations based on NSSG data (for the period 1990-1997), Data Processing Centre of the Ministry of Finance (for 1998). →

→ third group belong farmers, live-stock producers, fishermen and those employed in forestry. The number of taxpayers is very small, compared with the persons employed in the respective economic branches, but it has increased almost eight times in the period 1990-1998, while the tax burden of this group remains the smallest among all professional groups. Wage earners are the largest group of taxpayers throughout the period reviewed, although their share in the sum total of taxpayers is decreasing over time. The next larger group of taxpayers is that of pensioners, whose share in the whole of taxpayers, contrarywise to wage earners, is ever increasing. Lastly, the self-employed account for 3.1 per cent to 4.0 per cent of the total number of taxpayers in the period under review, while their average tax burden over the last years is almost twice as high as the corresponding burden for taxpayers as a whole.

The sum total of declared family income increased considerably in financial years 1990-1998, even in real terms. It grew at relatively faster rates for farmers, self-employed and pensioners and at lower rates in the case of wage earners (excluding 1998). The highest average family income, throughout financial years 1990-1998, was declared by the self-employed, who are usually followed by wage earners and traders-manufacturers. By contrast, the smallest average income, far behind that of the other groups, was declared by farmers and rentiers. It is characteristic that, for financial year 1998, the income of the self-employed was more than double the average income of all taxpayers and nearly six times as high as the income of farmers and rentiers. It should also be pointed out that divergences between these incomes seem to broaden continuously in the period 1990-1998. The relative position, in terms of average declared income, of the group of traders improved significantly and steadily throughout the reviewed period, while just the opposite occurred for pensioners: While the average income of traders increased from 75.2 per cent of average total income in 1990 to 123.2 per cent in 1998, the corresponding income of pensioners decreased from 105.4 per cent in 1990 to 87.4 per cent of average total income in 1998.

The sum total of personal tax payable increased in the last five years at annual rates higher than 27.4 per cent, in nominal terms. During the same period, significant rises, although at rather slower rates because of the increase in the number of taxpayers, were also observed in average tax (per tax return). However, it is characteristic that tax revenue and average tax almost halved between the financial years 1992 and 1993, as a result of the extensive tax reform introduced by Law 2065/92 ("Reform of direct taxation, and other provisions"). This reform brought about radical changes in the taxation of natural and legal persons' income: direct taxation was considerably simplified and tax rates were substantially cut. In the last four years, the average tax paid by the self-employed was more than four times as high as the average tax for taxpayers as a whole, while, in the case of traders-manufacturers, this tax exceeded by approximately 45 per cent the average tax of taxpayers as a whole. By contrast, over the same period, the average tax paid by farmers and rentiers barely reached 13 per cent and 45 per cent, respectively, of the average tax for taxpayers as a whole. →

→ PERSONAL INCOME TAX DATA BY FAMILY INCOME BRACKET (FINANCIAL YEARS 1993-1998)						
Income brackets (thousand drachmas)	Financial year					
	1993	1994	1995	1996	1997	1998
A. Taxpayers (thousand persons)						
Up to 1,000	868.1	808.8	997.9	945.0	1,026.3	969.5
1,000 – 2,000	958.8	943.3	949.2	947.1	972.2	963.5
2,000 – 3,000	603.1	639.3	702.6	695.3	687.0	679.5
3,000 – 4,000	295.4	348.0	461.2	512.8	537.4	535.7
4,000 – 5,000	170.7	194.3	267.8	304.3	343.2	397.6
5,000 – 6,000	96.5	125.7	176.8	195.9	213.4	255.8
6,000 – 7,000	45.7	68.8	112.7	138.5	150.5	169.3
7,000 or more	58.2	90.5	171.9	247.5	338.7	464.4
<i>Total</i>	<i>3,096.4</i>	<i>3,218.7</i>	<i>3,840.1</i>	<i>3,986.3</i>	<i>4,268.6</i>	<i>4,435.4</i>
B. Declared family income (billion drachmas)						
Up to 1,000	414.3	381.6	410.4	376.9	385.9	359.8
1,000 – 2,000	1,406.0	1,389.1	1,406.2	1,413.4	1,457.4	1,459.7
2,000 – 3,000	1,474.4	1,570.9	1,742.9	1,725.1	1,700.7	1,671.4
3,000 – 4,000	1,017.6	1,198.1	1,591.2	1,773.1	1,868.0	1,870.0
4,000 – 5,000	761.3	867.1	1,194.1	1,356.9	1,528.7	1,776.6
5,000 – 6,000	525.2	686.3	966.6	1,071.3	1,166.8	1,396.7
6,000 – 7,000	294.4	443.5	727.7	895.9	974.7	1,095.8
7,000 or more	579.9	899.0	1,708.9	2,462.1	3,412.2	4,849.9
<i>Total</i>	<i>6,473.2</i>	<i>7,435.6</i>	<i>9,748.1</i>	<i>11,074.8</i>	<i>12,494.3</i>	<i>14,480.0</i>
C. Average declared family income (thousand drachmas)						
Up to 1,000	477.3	471.9	411.2	398.9	376.0	371.1
1,000 – 2,000	1,466.5	1,472.6	1,481.5	1,492.4	1,499.1	1,515.0
2,000 – 3,000	2,444.7	2,457.3	2,480.8	2,481.0	2,475.7	2,459.9
3,000 – 4,000	3,445.4	3,442.9	3,450.2	3,457.7	3,475.9	3,490.9
4,000 – 5,000	4,459.9	4,462.2	4,459.4	4,459.1	4,454.7	4,468.1
5,000 – 6,000	5,445.2	5,459.2	5,467.3	5,468.9	5,467.7	5,461.0
6,000 – 7,000	6,437.9	6,441.7	6,457.7	6,470.9	6,474.9	6,471.1
7,000 or more	9,967.2	9,931.5	9,938.9	9,948.0	10,075.4	10,443.2
<i>Total</i>	<i>2,090.6</i>	<i>2,310.1</i>	<i>2,538.5</i>	<i>2,778.2</i>	<i>2,927.0</i>	<i>3,264.7</i>
D. Total tax (billion drachmas)						
Up to 1,000	5.9	6.4	4.0	4.8	9.3	12.7
1,000 – 2,000	18.7	19.3	10.1	10.7	14.2	17.7
2,000 – 3,000	33.3	37.2	29.9	30.5	33.5	35.7
3,000 – 4,000	36.4	45.5	51.2	59.0	67.2	68.2
4,000 – 5,000	34.0	42.0	53.7	65.9	82.2	97.2
5,000 – 6,000	29.6	39.9	53.5	65.0	80.6	103.3
6,000 – 7,000	22.2	32.7	48.6	62.1	75.0	92.6
7,000 or more	93.3	139.8	250.1	354.5	496.6	713.3
<i>Total</i>	<i>273.4</i>	<i>362.8</i>	<i>501.1</i>	<i>652.5</i>	<i>858.6</i>	<i>1,140.6</i>
E. Average tax (thousand drachmas)						
Up to 1,000	6.8	7.9	4.0	5.1	9.0	13.1
1,000 – 2,000	19.5	20.5	10.7	11.3	14.6	18.3
2,000 – 3,000	55.1	58.3	42.5	43.8	48.8	52.5
3,000 – 4,000	123.4	130.8	111.1	115.1	125.0	127.3
4,000 – 5,000	199.2	216.1	200.6	216.5	239.4	244.3
5,000 – 6,000	307.1	317.1	302.3	332.0	377.7	403.9
6,000 – 7,000	485.0	475.3	431.4	448.5	498.3	546.5
7,000 or more	1,603.5	1,543.9	1,454.5	1,432.4	1,466.3	1,535.9
<i>Total</i>	<i>88.3</i>	<i>112.7</i>	<i>130.5</i>	<i>163.7</i>	<i>201.1</i>	<i>257.2</i>
F. Average tax burden as a percentage of declared income						
Up to 1,000	1.4	1.7	1.0	1.3	2.4	3.5
1,000 – 2,000	1.3	1.4	0.7	0.8	1.0	1.2
2,000 – 3,000	2.3	2.4	1.7	1.8	2.0	2.1
3,000 – 4,000	3.6	3.8	3.2	3.3	3.6	3.6
4,000 – 5,000	4.5	4.8	4.5	4.9	5.4	5.5
5,000 – 6,000	5.6	5.8	5.5	6.1	6.9	7.4
6,000 – 7,000	7.5	7.4	6.7	6.9	7.7	8.4
7,000 or more	16.1	15.5	14.6	14.4	14.6	14.7
<i>Total</i>	<i>4.2</i>	<i>4.9</i>	<i>5.1</i>	<i>5.9</i>	<i>6.9</i>	<i>7.9</i>

Source: Calculations based on NSSG data (for the period 1993-1997), Data Processing Centre of the Ministry of Finance (for 1998). →

→ The chart depicts the average tax burden, as a percentage of declared family income, of both taxpayers as a whole and each individual professional group referred to in the first

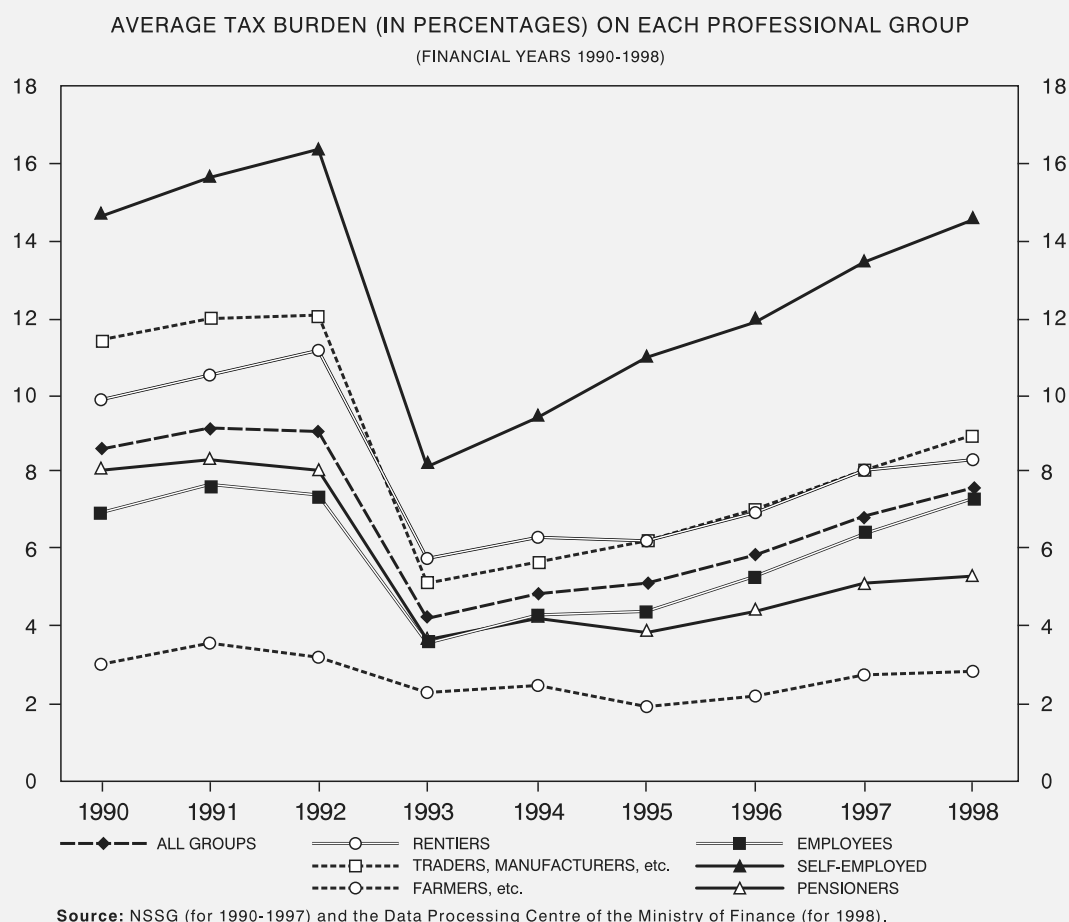


table of the Box. The average tax burden of the self-employed, particularly after 1993, is almost twice as high as the tax burden of taxpayers as a whole. Traders and rentiers, unlike all the other groups of taxpayers, have an average tax burden higher than that of taxpayers as a

According to Ministry of Labour data, 292 collective labour agreements were signed in 1998 (against 286¹ in 1997) and 58 arbitration decisions (against 52 in 1997)² were issued by OMED, while the number of working hours lost because of strikes remained stable (1.5 million hours, i.e. roughly as many as in 1997, according to revised data).

1 In last year's Annual Report it was wrongly stated that in 1997 338 collective labour agreements were signed. (In fact, this number represented the sum total of collective agreements and arbitration decisions).

2 According to the Mediation and Arbitration Organisation (OMED) record, the number of arbitration decisions was 65 in 1997 and 64 in 1998. The difference is due to the fact that some decisions are submitted to the Ministry of Labour with a delay (or they may not be submitted at all).

Developments in wages and salaries in 1998 by category of workers were as follows:

In central government, civil servants' salaries increased by 2.5 per cent since 1 January 1998, under Article 10 of Law 2606/98, while, according to the Introductory Report on the Budget for 1998, central government outlays for salaries (all items) were projected to increase by 3.7 per cent (outlays for salaries and pensions by 4.0 per cent). The actual increase, according to estimates by the State General Accounting Office (March 1999), was 8.1 per cent and 9.8 per cent, respectively. The actual growth rates include the carry-over from 1997 and the impact of "seniority", while they have been influenced by the effect of the devaluation (on salaries paid abroad), the impact from special arrangements agreed in 1996-1997 (Laws 2448/96, 2521/97, 2530/97) for school-teachers, the members of the Armed Forces, the judiciary, and university teachers, as well as by the implementation of salary-scales for physicians employed by the National Health System and for the diplomatic staff (Law 2606/98).¹ As the average annual decrease in employment was 1.1 per cent, the central government's wage bill per person is estimated to have increased by 9.3 per cent in 1998, against 13.5 per cent in 1997.

In public enterprises, the average annual increase in contractual earnings in 1998, on the basis of collective agreements for the Hellenic Telecommunications Organisation (OTE) and the Public Power Corporation (DEH), is estimated at 4.7-5.4 per cent,² which means that actual earnings must have increased by an average annual 7-7.5 per cent in 1998, compared with 11 per cent in 1997. Given that average annual employment in public enterprises decreased by 3.4 per cent in 1998, it is inferred that salary outlays increased by only 3.6 per cent (while in 1997, according to Ministry of National Economy estimates, they had risen by 9.7 per cent).³

In banks, it is estimated that the average annual increase in contractual earnings reached 4.3 per cent⁴ in 1998, compared with 7.5 per cent in 1997. Owing to "seniority" and certain individual arrangements per bank, actual earnings increased more. According to the annual income statements published so far, outlays for salaries and employers' social security contributions increased by 8-8.5 per cent. Since employment grew by 0.7-1.0 per cent, actual earnings rose by 7-7.5 per cent, compared with 9.7 per cent in 1997.

1 Besides, the growth rate of pension outlays has been affected by back payments, owing to pension "reclassification" under the new pay-scale (Law 2592/98).

2 In most cases, pay rises were granted in two instalments, of the order of 2-2.5 per cent as from 1 January 1998 and 2-2.5 per cent as from 1 July 1998. Besides, two-year (1997-1998) collective agreements were in force in certain public enterprises (e.g. the Hellenic Telecommunications Organisation –OTE, the Hellenic Railways Organisation –OSE, the Hellenic Postal Service –ELTA, the Water Supply and Sewerage Company –EYDAP, the Electric Railways for Athens-Piraeus –HSAP), while a two-year (1998-1999) agreement was signed in Public Power Corporation –DEH.

3 The estimate for the increase in actual earnings in public enterprises in 1998 does not seem to be confirmed by the NSSG sample survey on earnings in electricity and water supply enterprises. According to this survey, monthly salaries of white-collar workers, which are the main personnel category, increased by 9.0 per cent in the first half of 1998, compared with the corresponding period in 1997 (hourly earnings of blue-collar workers in the same enterprises increased by 11.9 per cent in the same period).

4 Pay rises were, on average, 1.6 per cent as from 1 January 1998, 1.6 per cent as from 1 July 1998 and 1.1 per cent as from 1 November 1998.

In the private sector, contractual earnings in 1998 increased considerably less than in 1997, as a result, in most cases, of the two-year collective labour agreements for 1998-1999 signed after the drachma's devaluation in March 1998. In detail, the average annual increase in minimum wages and salaries reached 5.4 per cent (against 8.0 per cent in 1997) and the respective rise in contractual earnings at branch level came to 5.9 per cent (1997: 8.0 per cent). Besides, a significant slowdown was observed in the December-on-December growth rate: from 7.7 per cent in 1997 to 4.8 per cent in 1998 for minimum earnings¹ and from 7.8 per cent to 5.3 per cent for contractual earnings at branch level. The average annual increase of actual earnings in the private sector² has evolved similarly, as it is estimated to have come to 6.2 per cent, against 8.8 per cent in 1997.³ More specifically, it is estimated that, in manufacturing, hourly earnings of blue-collar workers have increased by 5.6 per cent in 1998 (1997: 8.9 per cent) and the monthly earnings of white-collar workers by 6.6 per cent (against 9.8 per cent in 1997). Thus, given that productivity rose at a high rate (similar to that in 1997), it is estimated, as already mentioned, that unit labour cost growth decelerated by 3 percentage points (from 4.4 per cent in 1997 to 1.4 per cent in 1998 – see Chart IV.5).⁴ This resulted in a fall of about 4 per cent in the drachma's real effective exchange rate⁵ (as calculated on the basis of unit labour costs in manufacturing) in 1998 (after a constant rise in the preceding four-year period),⁶ not only owing to the devaluation in March 1998 but also because the positive differential in the rates of change in unit labour costs between Greece and its trading partners was reduced to a third.

With regard to 1999, unit labour cost growth is estimated to decelerate to below 2 per cent in the whole economy and reach the low level of 1 per cent in manufacturing. Indeed, monthly salaries of civil servants were increased by 2 per cent from 1 January 1999, while the government budget provides for a considerable slowdown in the growth of outlays for earnings of central government personnel (from an actual 8.1 per cent in 1998 to 3.5 per cent in 1999, or from 9.8 per cent to 3.8 per cent if pension outlays are also taken

1 According to the National General Collective Labour Agreement 1998-1999, minimum earnings increased by 2.5 per cent from 1 January 1998 (a corrective rise of 0.2 per cent was also granted for 1997) and by 2 per cent from 1 July 1998, while they were raised by 1.4 per cent from 1 January 1999 and will increase by 1.4 per cent from 1 July 1999. A corrective rise of 0.4 per cent was also granted from 1 January 1999, since inflation in December 1998 (3.9 per cent) exceeded the threshold set by social partners (3.5 per cent). Further, if inflation overshoots 2 per cent in December 1999, a corrective rise will be granted from 1 January 2000.

2 This rate reflects, in addition to contractual rises, employer-employee agreements at business or individual level, as well as changes in employment structure.

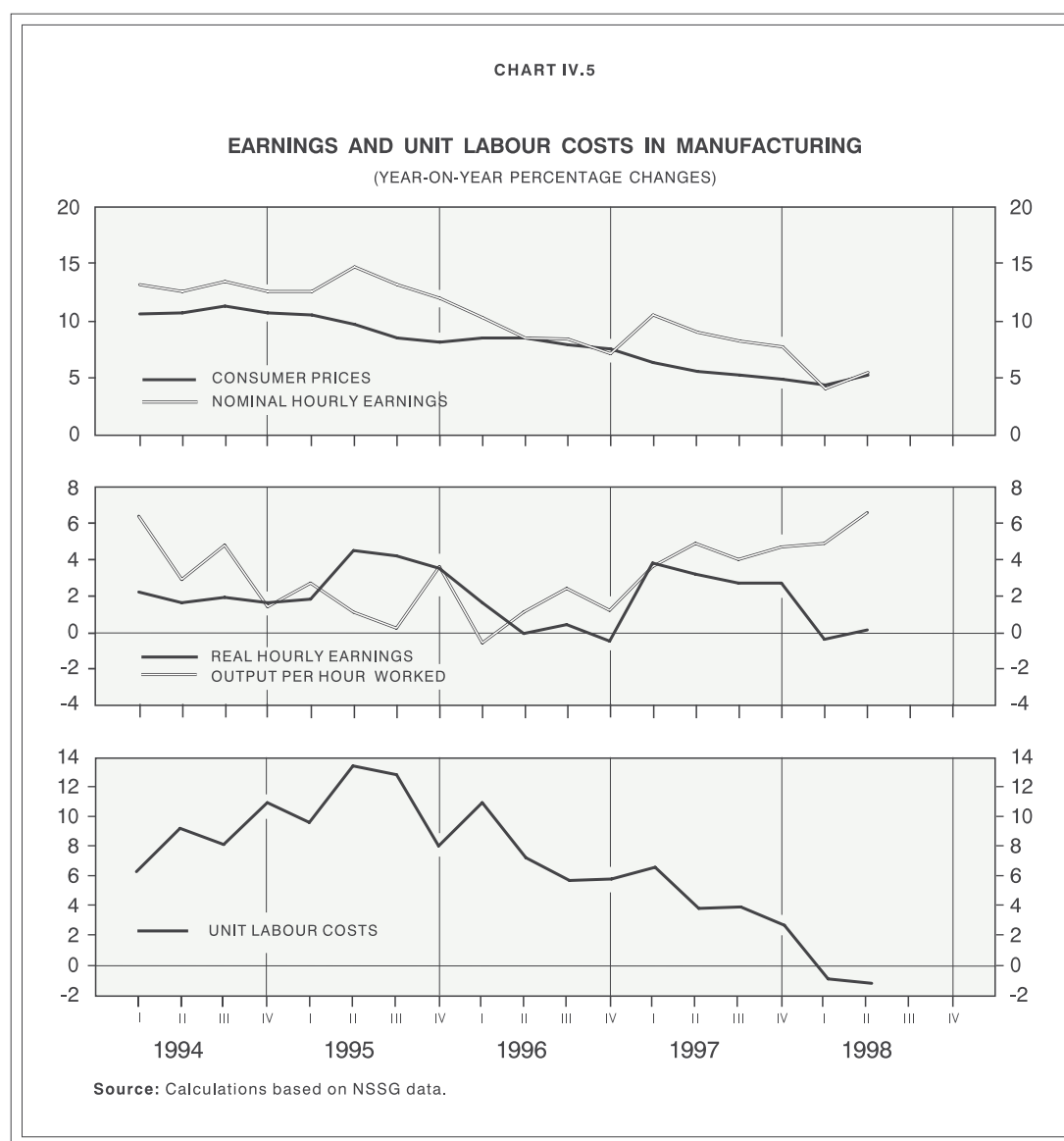
3 According to NSSG sample surveys, the twelve-month rate of change in earnings in the first half of 1998 was considerably lower (in most cases) than the corresponding rate in the first half of 1997.

4 Indeed, in the first half of 1998, the twelve-month rate of increase in unit labour costs in manufacturing was (for the first time since 1973) negative (-1.1 per cent).

5 It should be mentioned that the drop (rise) in the real effective exchange rate is equivalent to an improvement (a deterioration) of competitiveness.

6 This particular measure of the real effective exchange rate, after having dropped in the three-year period 1991-1993 and having risen in the four-year period 1994-1997, decreased in 1998 and almost returned to the level of 1990, thus suggesting that the cumulative loss of competitiveness between 1990 and 1997 was (almost fully) offset.

into account). In the private sector, the rise in nominal earnings, according to the two-year collective labour agreements signed in 1998, will be clearly smaller than in that year. For example, the average annual increase in minimum earnings will be limited to 3.5 per cent, from 5.4 per cent in 1998. At the same time, the growth rate of productivity is expected to



remain at high levels (approximately 3 per cent). Furthermore, it should be mentioned that the significant deceleration of inflation over the last months of 1998 led to a corrective rise of only 0.4 per cent (i.e. less than expected) as from 1 January 1999 in the contractual earnings of private sector employees, while it certainly contributes to the containment of wage demands of those categories of employees whose pay rises have not yet

been determined for 1999 and, thus, to the conclusion of collective labour agreements which will support the anti-inflationary effort.

It is therefore estimated that the average pre-tax earnings in the whole economy will increase by 3.8 per cent in 1999 and, in real terms, by 1-1.5 per cent. However, the growth rate of wage earners' disposable income is forecast to decelerate in 1999, compared with 1998 (accordingly affecting consumer demand), whereas it is expected to accelerate in 2000. This forecast is based on the fact that the income tax relief measures which are being examined by the government (and being discussed in the context of the social dialogue that began at end-February) will of course apply to revenue which will be earned in 1999, but they will favourably affect wage earners'¹ disposable income in 2000, when taxpayers will receive the resulting tax refunds.

3. BUSINESS PROFITS

Business profits increased significantly in 1998, according to all available indications.

Indeed, a comparison of the evolution of consumer and wholesale prices of various categories of goods with the evolution of cost factors (unit labour costs, raw material and imported input prices, as well as financing costs) suggests that profit margins of domestic industrial and commercial firms increased over the year.²

Besides, according to the income statements published so far (mainly of firms whose shares are listed on the Athens Stock Exchange), profits increased faster than both inflation and business firms' revenue (turnover), a fact which confirms the widening of profit margins.

This widening reflects the pricing policy of firms in the period following the drachma's devaluation in March, but it is also partly related with the improvement of capital structure, namely the increase in the ratio of own-to-total assets, which was the result of substantial fund-raising from the Stock Exchange throughout 1998.

¹ For the method of calculation of this aggregate, see footnote 2 on page 109.

² See above, Section 1 of this chapter.

V. MONETARY POLICY AND MONETARY AND CREDIT DEVELOPMENTS IN 1998

1. MONETARY POLICY OBJECTIVES FOR 1998

In announcing its monetary policy objectives for 1998, the Bank of Greece stated that its primary goal was to achieve price stability by the end of 1999. Price stability is considered to be attained when annual increases in prices do not exceed 2 per cent. Achieving this goal is also necessary in order to satisfy the inflation criterion of the Maastricht Treaty.

To attain price stability, the Bank adopted as an intermediate target the relative stability, throughout the year, of the exchange rate of the drachma within the framework of the Exchange Rate Mechanism (ERM) of the European Monetary System, which the drachma joined on 16 March 1998 at a central rate of 357 drachmas per ECU and with the standard fluctuation band of ± 15 per cent. However, an appreciation of the drachma was not ruled out, should the conduct of anti-inflationary policy lead to such an outcome. Moreover, the Bank had announced indicative forecasts of 6-9 per cent for the growth rate of broad money (M3) and 4-6 per cent for total credit expansion; these were deemed consistent with the attainment of the inflation target and were based on certain assumptions regarding the stability of money demand and the share of the domestic private non-bank sector in financing the public deficit.¹

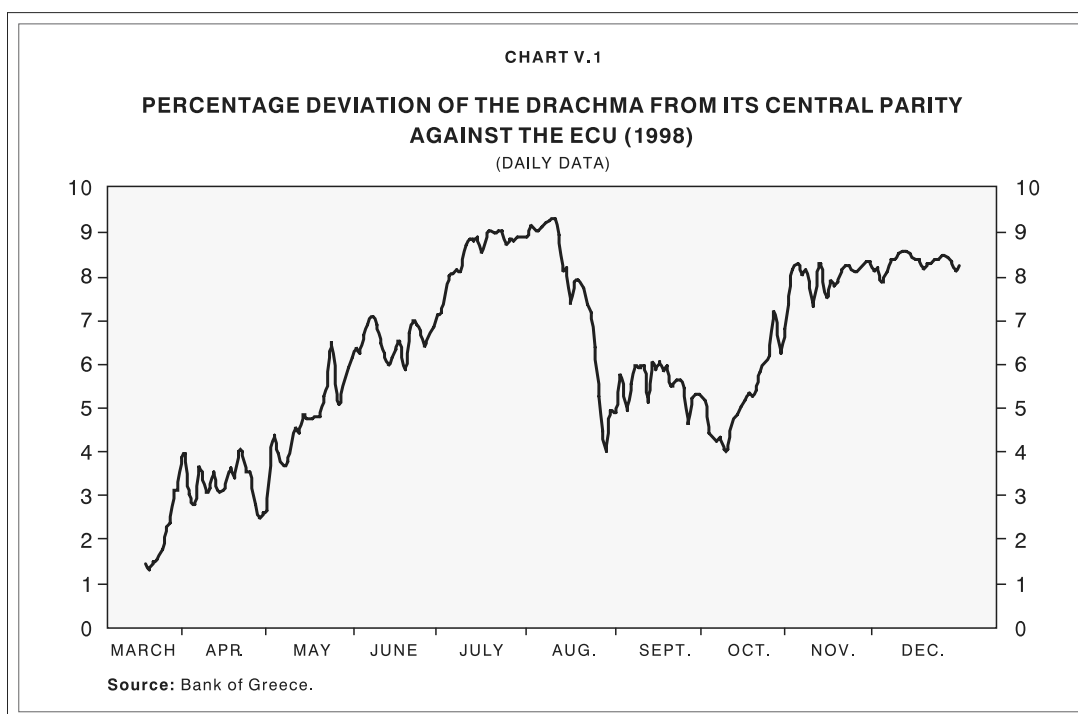
As mentioned above, inflation, after a pick-up following the drachma's devaluation in March 1998, resumed its downward course from June onwards, falling to 3.9 per cent in December 1998, from 4.7 per cent a year earlier.

From January 1998 and until the drachma's entry into the ERM, the exchange rate of the drachma against the ECU remained broadly stable, supported by the high interest rates of the Bank of Greece. The pressures exerted at times in the foreign exchange market, owing to the resurgence of the turmoil in Southeastern Asia and to expectations that the drachma would join the ERM in May 1998, had a rather weak impact on the exchange rate. The Bank of Greece, after the entry of the drachma into the ERM and its simultaneous devaluation, pursued a policy of slow reduction in its key rates. As a result, real interest rates remained at high levels, the drachma appreciated within the ERM and monetary and credit expansion was restrained. Thus, inflationary pressures caused by the devaluation were mitigated and inflation resumed its downward course. Indeed, following its entry into the ERM, the drachma tended to appreciate and remained strong until the year-end.

The Greek currency appreciated gradually after joining the ERM; its rate of appreciation stood at around 9 per cent in early August (see Chart V.1), before falling to 4 per

¹ See Bank of Greece, *Monetary Policy 1997-1998* (April 1998) p. 33.

cent towards the end of August, because of capital outflows due to the monetary turmoil in Russia and the ensuing disturbance in world markets. The Bank of Greece signalled its anti-inflationary policy through relatively heavy intervention in the foreign exchange market at the end of August and in early September, but the rate of appreciation of the drachma remained broadly unchanged until mid-October, when the impact of the Russian turmoil on world markets was reduced. Thereafter, the appreciation of the drachma against



its central rate vis-à-vis the ECU accelerated again and reached 7-8.5 per cent in the November-December 1998 period, while the Bank of Greece was absorbing substantial liquidity to mitigate these upward pressures. The strength of the exchange rate of the drachma reflected market confidence in the convergence of the Greek economy and in the monetary policy pursued.

2. MONETARY DEVELOPMENTS

2.1 Money stock M3 and liquidity indicator M4

Broad money (M3) — which comprises currency in circulation, private deposits in drachmas, repos and bank bonds — increased by 1,863 billion drachmas in 1998, compared with 1,821 billion in 1997, and its annual growth rate was reduced to 8.9 per cent in

December 1998 from 9.6 per cent in December 1997. The twelve-month rate of increase in M3 decelerated considerably from the beginning of 1998 onwards, and in the January-October period it remained subdued, well below the forecast range for 1998 (6-9 per cent). The restrained growth of M3 was related to the replacement of M3 components by other assets not included in M3, such as financial derivatives, mostly of short maturities, gov-

TABLE V.1
MONEY STOCK AND LIQUID ASSETS¹

	Outstanding balances on 31 Dec. 1998* (billion drachmas)	Annual changes					
		Billion drachmas			Per cent		
		1996	1997	1998*	1996	1997	1998*
1. Currency in circulation, M0	2,229.3	77.8	241.3	46.6	4.2	12.4	2.1
2. Private deposits	18,775.0	2,064.8	1,560.1	300.1	13.9	9.2	1.6
2.1 Sight	2,309.2	321.1	213.7	488.9	25.0	13.3	26.9
2.2 Savings	13,751.4	1,756.3	1,133.7	416.1	16.8	9.3	3.1
2.3 Time	2,714.4	-12.6	212.7	-604.9	-0.4	6.8	-18.2
3. Money stock narrowly defined, M1 (1 + 2.1)	4,538.5	398.9	455.0	535.5	12.7	12.8	13.4
4. Repurchase agreements with the private sector (repos) and bank bonds	1,685.0	-517.8	19.6	1,516.4	...	...	...
5. Broad money stock, M3 (1 + 2 + 4)	22,689.3	1,624.8	1,821.0	1,863.1	9.3	9.6	8.9
6. Privates investments in Greek government securities maturing in up to one year	3,451.7	1,121.9	-2,224.0	-955.3	20.4	-33.5	-21.7
7. Liquidity indicator, M4 (5 + 6)	26,141.0	2,746.7	-403.0	907.8	12.0	-1.6	3.6
Broader liquidity indicator, M4N²	34,007.1	3,797.1	2,233.7	3,124.1	15.3	7.8	10.1

1 Drachma deposits and liquid assets of the private non-bank sector.

2 Comprising M4, residents' foreign exchange deposits and money market fund (MMF) units. M4N is calculated by aggregating the banking sector and MMFs, which together constitute the monetary financial sector of the economy.

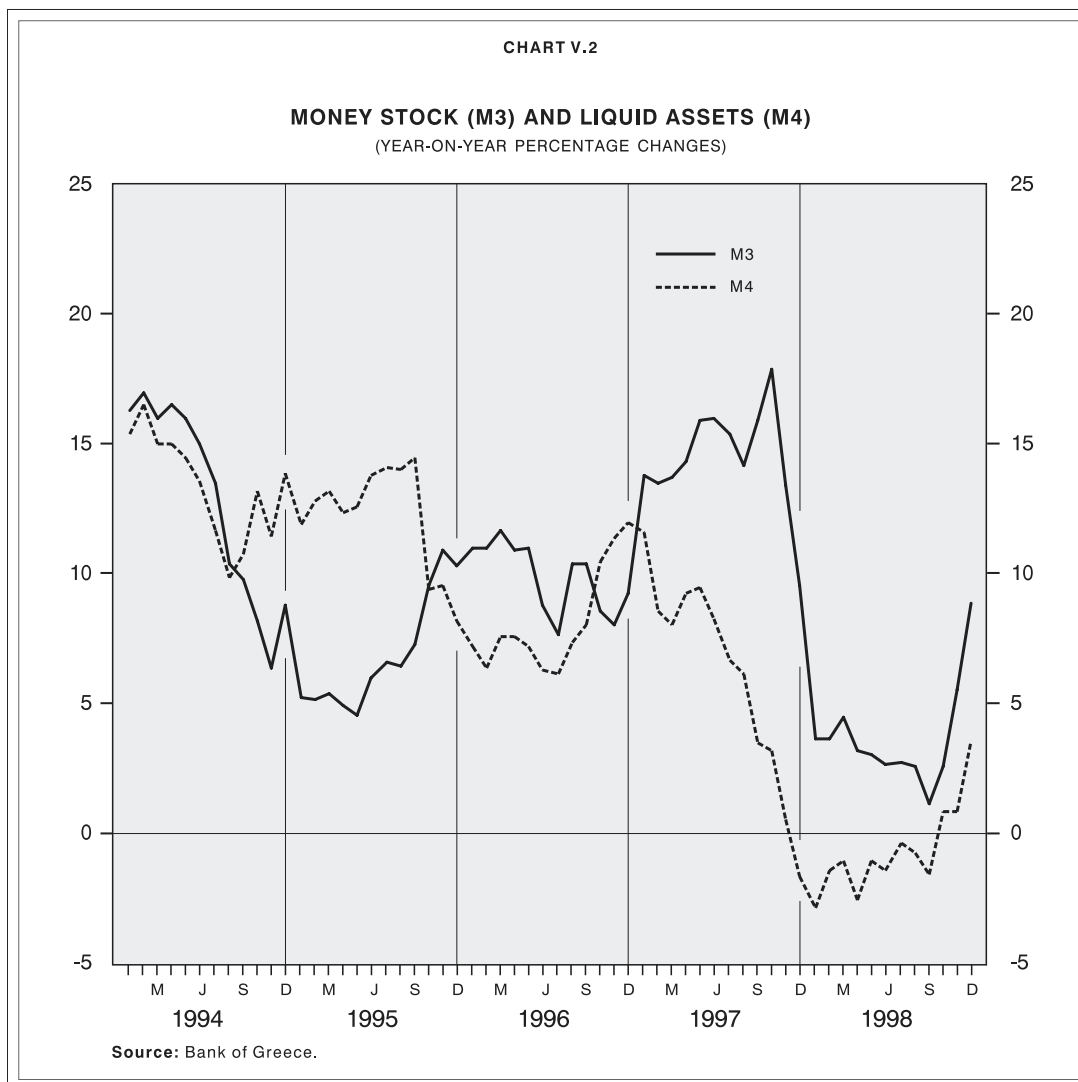
* Provisional data.

Source: Bank of Greece.

ernment securities with a maturity of over one year and Greek residents' foreign exchange deposits, which have been fully deregulated since August 1997. In November and December 1998 the twelve-month growth rate of M3 rose to 5.6 per cent and 8.9 per cent, respectively, reflecting a shift of savers to repos, after the taxation of repo yields was abolished in September 1998. This acceleration also reflected the substantial portfolio shifts to financial assets not included in M3 that had occurred in the corresponding months of 1997, after the monetary turmoil in Southeastern Asia in late October 1997, which strongly affected the Greek money and foreign exchange markets.

Regarding the individual components of M3, the growth of currency in circulation and private deposits in drachmas decelerated significantly, while repos grew at a very fast pace towards the end of the year.

In greater detail, currency in circulation increased by 47 billion drachmas or 2.1 per cent in 1998 (1997: 241 billion or 12.4 per cent). Its average growth rate came to about 7.5



per cent in the January-July 1998 period, but fell to much lower levels for the rest of the year.

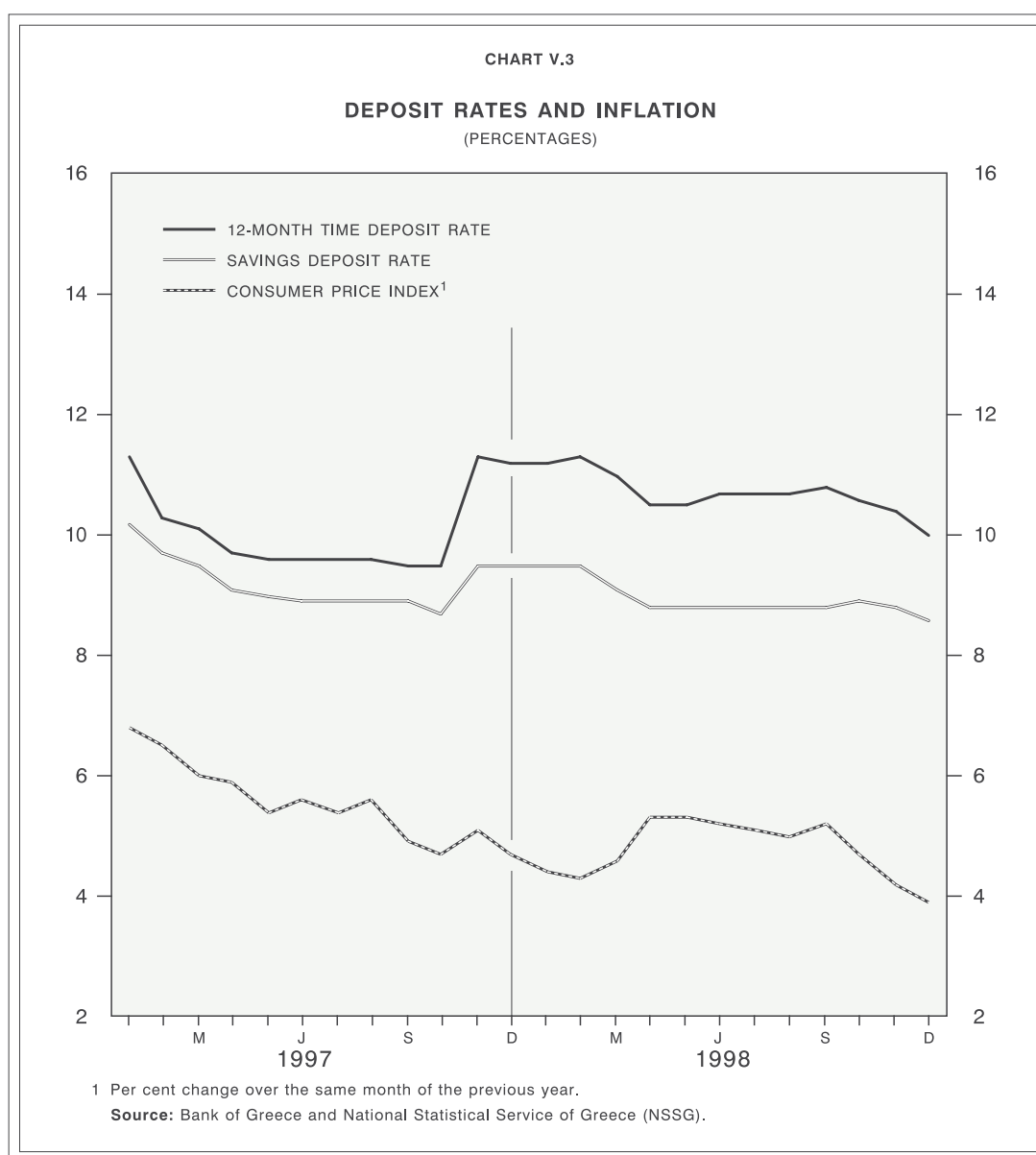
Private deposits in drachmas increased by 300 billion drachmas or 1.6 per cent, compared with a rise of 1,560 billion or 9.2 per cent in 1997 (see Table V.1). This sharp drop stemmed from savings and time deposits, while sight deposits increased much faster than in 1997. In the January-August 1998 period, the growth rate of private deposits in

drachmas remained at rather low levels (2-4.5 per cent), while in the next three months their twelve-month rate of change was negative, as these deposits fell by about 670 billion drachmas over that period. This reduction was related to the abolition of taxation of repo yields as from September 1998 and the shift of funds to repos. Sight deposits grew considerably faster (26.9 per cent) in 1998, compared with 13.3 per cent in 1997. Their twelve-month rate of change was very low in January (1.3 per cent) and turned negative in February (-2.2 per cent), while in the March-October 1998 period it averaged about 9.5 per cent. Sight deposits recorded a substantial further increase in the last two months of the year. Their course during 1998 was largely associated with the considerable growth of transactions in the Athens Stock Exchange after the drachma's entry into the ERM and increased market confidence in the convergence prospect of the Greek economy. It should be noted in this respect that the average monthly value of stock market transactions rose from 333 billion drachmas in the first two months of 1998 to 1,465 billion in the March-July period and came to 1,676 billion in the November-December 1998 period.

The rate of increase in savings deposits fell to 3.1 per cent in 1998, from 9.3 per cent in 1997. Their twelve-month rate of change did not fluctuate noticeably and remained subdued throughout the year (ranging from 0.5 per cent to 3.1 per cent), except in September and October when it was negative (-1.7 per cent and -2.1 per cent, respectively). These low rates reflected private investors' preference for more profitable instruments (such as financial derivatives, fixed-rate government securities with maturities of more than one year, and repos, after the taxation of their yields was abolished). The interest rate on savings deposits declined by 0.4 percentage point in March and by a further 0.3 percentage point in April and remained almost unchanged at 8.8 per cent until the end of November. In December it fell further by 0.2 percentage point. The real interest rate on savings deposits remained unchanged between the beginning and the end of 1998, as the gradual deceleration of inflation from June onwards offset the drop in the nominal rate. However, in the April-September 1998 period, after the devaluation of the drachma in March 1998 and the effect this had on inflation, the real rate on savings deposits was about one percentage point lower than at the end of 1998.

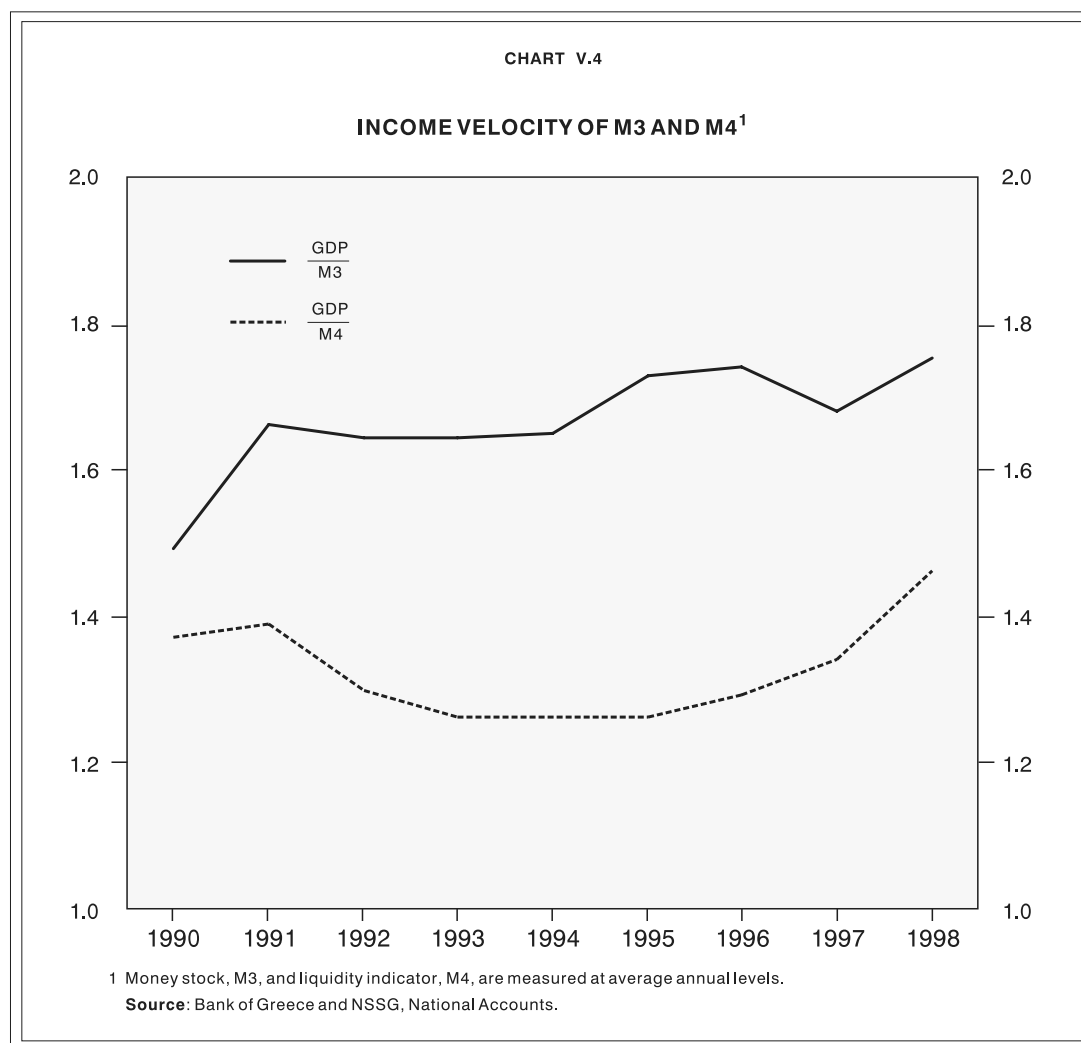
Time deposits declined by a significant 18.2 per cent in 1998, compared with an increase of 6.8 per cent in 1997. They grew at an average twelve-month rate of 8.5 per cent in the first quarter of the year, as their interest rates, especially for short maturities, rose in the first two months of 1998, owing to pressures on the drachma due to the turmoil in Southeastern Asia in late 1997. Nevertheless, after the drachma's entry into the ERM in March 1998 and the stepwise drop in interest rates, the twelve-month growth rate of time deposits began to decelerate gradually until end-August, while from September up to end-December 1998 time deposits were reduced to levels lower than in the corresponding period of 1997, resulting in negative rates of change. This development was connected with a shift of funds from this type of deposits to financial derivatives, foreign exchange deposits, government bonds, equity shares and, from September 1998 onwards, to repos.

Investment in repos and bank bonds recorded a very large increase in 1998 (1,516 billion drachmas, compared with 20 billion in 1997). This increase stemmed almost exclusively from repos, after the abolition of taxation of their yields in September 1998, as mentioned above. In the September-December 1998 period, repos increased by 1,426 billion



drachmas. A considerable part of this increase concerned investment by mutual funds, especially money market funds. In the past years, a large-scale substitution between various types of liquid assets was observed, significantly affecting the annual rates of change in those monetary aggregates which do not include all types of these assets. The main fac-

tors underlying these shifts were the taxation of repo yields in May 1994 and its abolition in September 1998, as well as the liberalisation in August 1997 of foreign exchange deposits held by Greek residents with domestic credit institutions. These factors affected M3 and rendered its relationship to GDP less stable, thus considerably reducing the usefulness of M3 as a monetary policy indicator.



As the twelve-month rates of M3 growth were at low levels almost throughout 1998, the average growth rate of M3 fell short of the rate of increase in GDP; as a result, income velocity of M3 rose slightly in 1998 and stood at roughly 1995-96 levels (see Chart V.4).

M3 growth was positively affected by total credit expansion, which remained at 1997 levels (9.7 per cent). As analysed in the next section, the behaviour of total credit expansion reflects the sluggishness of credit expansion both to the public sector (1998: 7.1

per cent, 1997: 7.1 per cent) and to the private sector (1998: 15.2 per cent, 1997: 15.3 per cent).

The external sector also contributed to liquidity creation (262 billion drachmas) in 1998, while in 1997 it made a negative contribution of 607 billion. This development is associated with the large inflow of funds from abroad after the drachma joined the ERM in March 1998; these funds were directed mainly towards the bond market, as the convergence prospects of the Greek economy improved considerably. Inflows intensified in the last two months of 1998 and the first months of 1999 and led to offsetting interventions by the Bank of Greece in the domestic money market, with a view to avoiding a sharp drop

TABLE V.2
FACTORS AFFECTING MONEY STOCK, M3
(Billion drachmas)

	1996	1997	1998*
A. CREDIT TO PUBLIC SECTOR (1-2)	193.0	1,491.9	1,722.0
1. <u>Net borrowing requirement¹</u>	<u>3,306.2</u>	<u>2,141.9</u>	<u>1,882.0</u>
a. Central government ²	(3,870.1)	(2,619.8)	(2,382.0)
b. Public entities	(-647.4)	(-345.3)	(-535.0)
c. Public enterprises	(83.5)	(-132.6)	(35.0)
2. <u>Financing of public deficit by domestic non-bank sector</u>	<u>3,113.2</u>	<u>650.0</u>	<u>160.0</u>
B. CREDIT TO PRIVATE SECTOR	1,299.9	1,571.9	1,840.0
1. Loans and advances	(1,414.0)	(1,476.7)	(1,690.0)
2. Securities	(-114.1)	(95.2)	(150.0)
C. FOREIGN SECTOR	525.0	-606.6	262.0
D. OTHER ITEMS	-393.1	-636.2	-1,960.9
CHANGE IN MONEY STOCK, M3	1,624.8	1,821.0	1,863.1

1 Including foreign borrowing by public enterprises and public entities.

2 Including capitalised and accrued interest on consolidation loans.

* Provisional data.

Source: Bank of Greece.

in interest rates and upholding the anti-inflationary monetary policy stance. Lastly, the large negative contribution of “other items” to M3 change in 1998 reflected the considerable amounts of equity raised by banks through the Stock Exchange and a rise in their reserves, as well as an increase in banks’ “other liabilities”, which substituted for M3 components.

The broader liquidity indicator M4 which, apart from M3, includes private holdings of government paper maturing in up to twelve months, rose by 3.6 per cent in 1998, compared with a 1.6 per cent decrease in 1997. In the January-September 1998 period, M4 remained at a level lower than in the corresponding months of 1997; thus, its twelve-month rate of change was negative in that period. In the last quarter of 1998, however, the

rate of change in M4 accelerated and turned positive, reflecting the faster growth of M3, while net holdings of Treasury bills were considerably smaller than in the corresponding 1997 period. The negative twelve-month rates of change in M4 for most of 1998, as had been the case in the last two months of 1997, were related to subdued sales of Treasury bills, in the context of the government's policy of prolonging the average maturity of public debt. In fact, private investments in Treasury bills during 1998 fell short by about 930 billion drachmas of corresponding redemptions, while net private investments in government bonds amounted to about 1,090 billion drachmas.

2.2 New liquidity indicator, M4N

The restructuring of the domestic private sector's portfolio of liquid assets in recent years caused, as mentioned above, considerable fluctuations, especially in 1998, in M3 and M4 (which were used as monetary policy indicators) and rendered volatile the relationship of these aggregates with GDP and the level of prices. Apart from deposits, this restructuring regarded other types of investment, such as mutual fund units, financial derivatives and foreign exchange deposits. As a result, M3 and M4 gradually ceased to be reliable indicators of monetary policy stance and stopped offering useful evidence on the evolution of liquidity in the economy. This is the reason why the Bank of Greece recently constructed a new indicator (M4N) which has a broader coverage, provides clearer information and has a more stable relationship with GDP than the previous indicators, because substitution between certain categories of liquid assets occurs within this new indicator, thus leaving it unaffected.

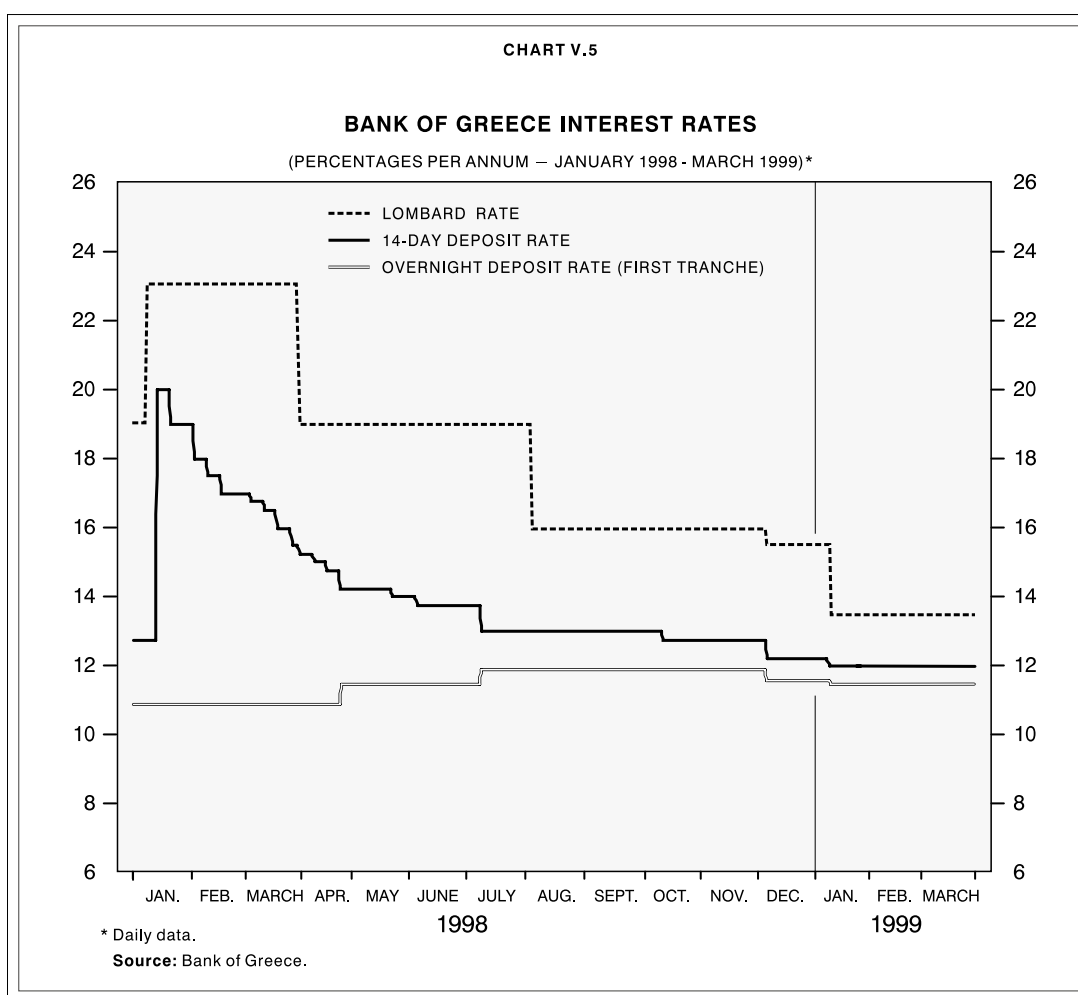
The broader monetary aggregate M4N includes M4 components (currency in circulation, drachma deposits, repos, bank bonds and private investments in government paper maturing in up to twelve months) and, in addition, residents' foreign exchange deposits and money market fund (MMF) units held by the private sector. It should be noted that M4N does not include (i) the following assets held by MMFs: drachma and foreign exchange deposits, repos, bank bonds and government paper maturing in up to twelve months and (ii) MMF units held by banks. These items are netted out in the procedure of consolidation of credit institutions' and MMFs' financial statements; these entities together constitute Monetary Financial Institutions, according to the classification by the ECB and Eurostat.

The twelve-month rate of change in M4N accelerated to 10.1 per cent in December 1998 (December 1997: 7.8 per cent, December 1996: 15.3 per cent), while its average annual rate of change slowed down to 10 per cent in 1998, from 11.8 per cent in 1997.

As mentioned in Chapter II, the Bank of Greece will now monitor this new aggregate and it has set an indicative forecast of a 7-9 per cent increase for 1999.

2.3 Interest rates and the interbank money market

The Bank of Greece continued to employ interest rate policy in 1998 as a major instrument of its anti-inflationary policy and, by extensive interventions in the money market, tried to restrain liquidity creation and credit expansion to levels compatible with its policy stance.



At the beginning of 1998, owing to pressures on the exchange rate of the drachma, the Bank of Greece raised the interest rate on lending to credit institutions against collateral of government securities (Lombard rate) from 19 to 23 per cent and reduced by 50 per cent the maximum amount of such credit that each bank may receive. At the same time, the interest rate on 14-day deposits was set at high levels and stood at 16.75 per cent at the beginning of March 1998.

After the drachma's entry into the ERM, the Bank of Greece pursued a policy of gradual cuts in its intervention rate for liquidity absorption, so as to secure the anti-inflationary stance of monetary policy after the temporary acceleration of inflation due to the drachma's devaluation in March. In particular, the interest rate on 14-day deposits, which is the main instrument of the Bank's intervention in the interbank market, was gradually lowered to 12.75 per cent in mid-October, from 16.75 per cent before the devaluation, while the Lombard rate came to 16 per cent after successive cuts of 4 percentage points at end-March and of 3 percentage points at the beginning of August 1998. Moreover, the Bank raised the interest rate of the first tranche of the deposit facility by 0.60 percentage point (to 11.50 per cent) in April 1998 and by a further 0.40 percentage point (to 11.90 per cent) in July.¹ These adjustments aimed to rationalise the relationship between interbank market intervention rates, by narrowing their differential.

The key intervention rates of the Bank of Greece were further reduced in December 1998 and January 1999. The rate on 14-day deposits was cut by a total of 0.75 percentage point to 12 per cent, the rate of the first tranche of the deposit facility by 0.40 percentage point to 11.50 per cent and the Lombard rate by a cumulative 2.5 percentage points in total, to 13.50 per cent. In adjusting these rates, the Bank took into account the 0.6 percentage point drop in core inflation in November-December 1998, the new conditions that emerged in money and capital markets and, in particular, the lowering of the corresponding interest rates by many European central banks.

In the first months of 1998 and up to the drachma's entry into the ERM, interest rates stood at relatively high levels, as pressures on the drachma did not allow the normalisation of money market conditions. The credibility of the monetary policy pursued and the prospect of Greece joining EMU were boosted after the drachma entered the ERM and was devalued by 12.30 per cent. This resulted in considerable capital inflows and a drop in interest rates (owing to a decrease in the risk premiums incorporated in them). These capital inflows were mainly channelled to purchases of government bonds in the secondary market and of corporate shares, or to the interbank market, and contributed to an increase in foreign exchange reserves, which reached \$20.4 billion at end-March 1998 (compared with \$15.1 billion at end-February). The Bank of Greece, through interventions in the interbank market, absorbed the excess liquidity created by these inflows.

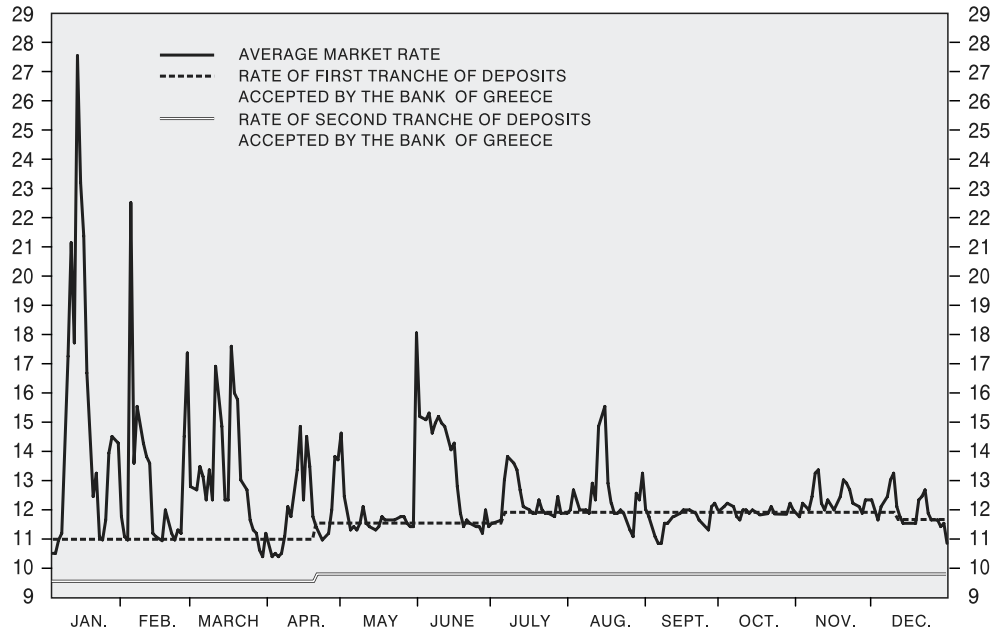
The decrease in interest rates, following the entry of the drachma into the ERM, was larger for interbank rates; at end-March, short-term interbank rates were 3-5 percentage points lower than before the devaluation. In the period from April to mid-August, interbank rates remained almost stable, with minor fluctuations. The monetary crisis in Russia in late August 1998 led to a temporary (for about two weeks) sharp increase in interbank rates. For maturities of up to two months this increase reached 6-7 percentage points, while for longer maturities it was smaller by about 2 percentage points. This devel-

¹ The interest rate of the second tranche was increased by 0.15 percentage point (to 9.75 per cent) in April 1998 and it has since stood at this level.

CHART V.6

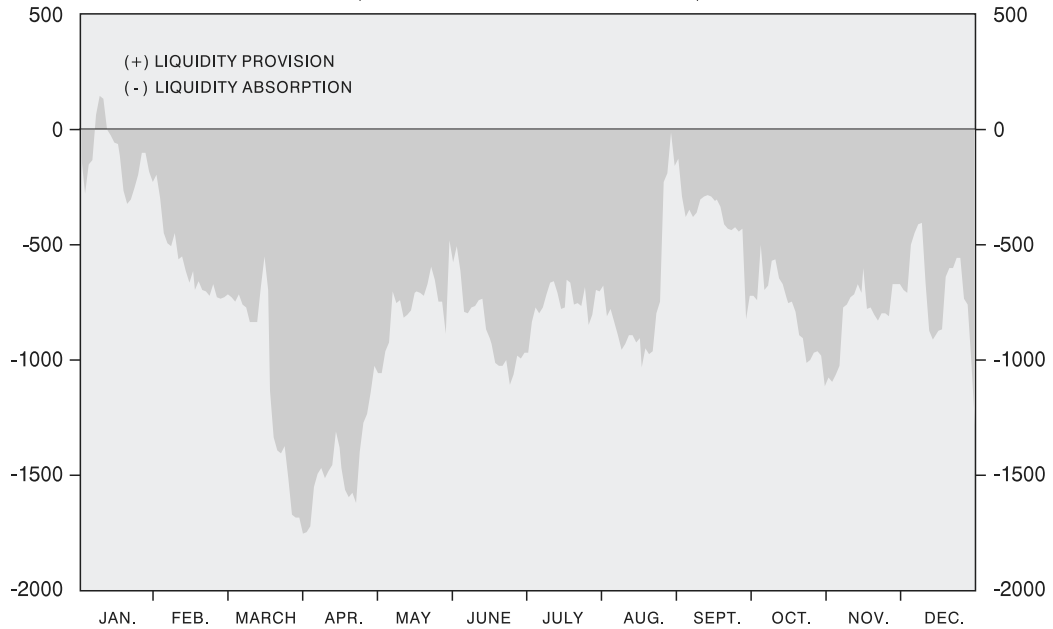
OVERNIGHT INTERBANK INTEREST RATES IN 1998

(PERCENTAGES PER ANNUM)



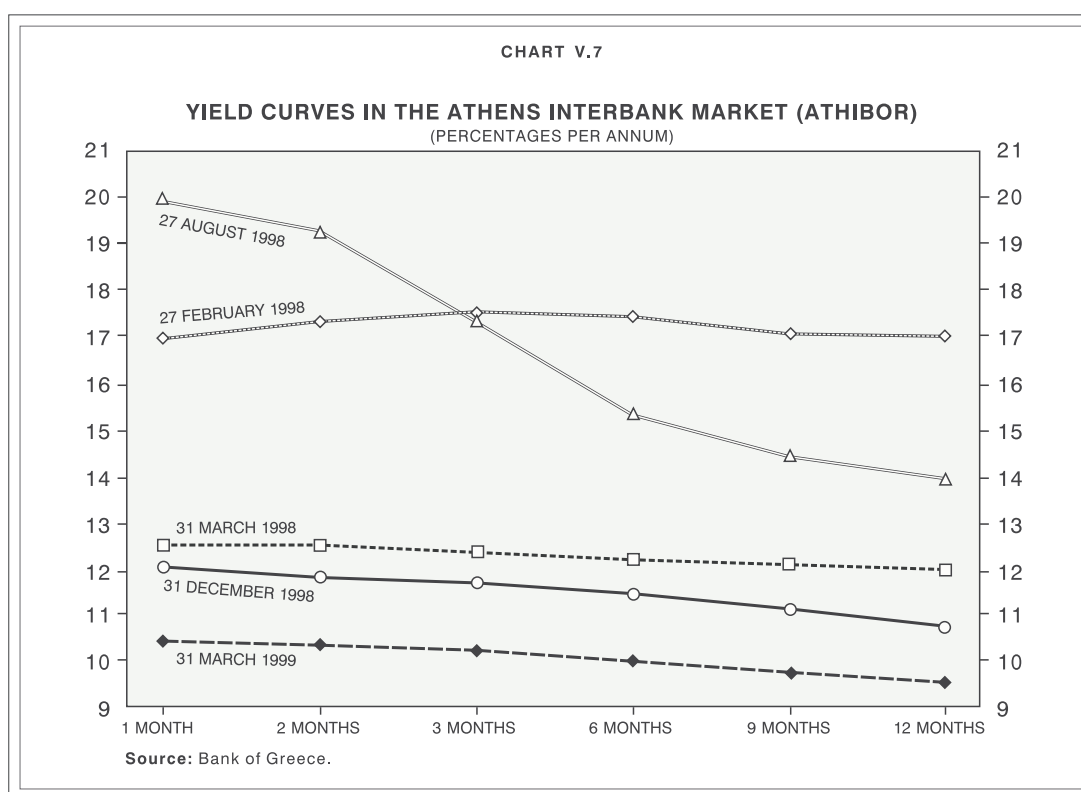
BANK OF GREECE INTERVENTIONS IN THE INTERBANK MARKET IN 1998 (ALL MATURITIES)

(DAILY BALANCES, BILLION DRACHMAS)



Source: Bank of Greece.

opment is related to the decrease in liquidity due to capital outflows which occurred in late August, as foreign investors liquidated part of their holdings of Greek government paper, in order to acquire additional liquidity to cover their losses in the Russian market. In order to deal with the shortage of liquidity and bring interest rates back to lower levels, the Bank of Greece carried out currency swap operations (dollars against drachmas) thereby boosting bank liquidity by about 250 billion drachmas. Rather than increasing interest rates, the central bank judged it necessary to restore liquidity at previous levels, as pressures stemmed from the bond market and did not reflect speculative positions against the drachma. When conditions in the foreign exchange market came back to normal and liq-



uidity was restored, interbank rates gradually fell and by the beginning of November they were 0.5-0.7 percentage point lower than before the Russian crisis; they remained at approximately the same levels until the end of 1998.

The further deceleration of inflation in the early months of 1999 and the improved outlook for Greece entering the euro area in 2001 led to increased capital inflows in the January-February 1999 period and exerted downward pressures on interbank rates. At end-March 1999, interbank rates were 1.5 percentage points lower than at end-1998, while the Bank of Greece considerably increased liquidity absorption, from an average of 700 billion drachmas in December 1998 to about 1,500 billion drachmas in the first quarter of 1999.

After the devaluation of the drachma and its entry into the ERM in March 1998, the interbank market yield curve exhibited a downward slope, while previously the downward slope was limited to longer maturities. This slope became steeper during the period of pressures on the bond market in August 1998. As pressures abated in early September, the curve gradually flattened out and shifted downwards. The shift continued in the first months of 1999, while the downward slope remained (see Chart V.7), suggesting market expectations of a further deceleration of inflation and a drop in interest rates over the next twelve months, thus reflecting the credibility of the anti-inflationary policy pursued.

Lastly, in early April 1999, in the context of its anti-inflationary policy aimed at containing monetary and credit expansion, the Bank of Greece held liquidity-absorbing variable-rate tenders for the acceptance of three-month deposits from credit institutions, given that part of the excess liquidity in the interbank market had acquired a structural character. At the same time, and in view of the country's entry into the euro area in 2001, the use of this instrument gives credit institutions the opportunity to familiarise themselves with the three-month tenders used by the European Central Bank.

3. CREDIT DEVELOPMENTS

3.1 Total credit expansion

Total credit to the public and the private sector rose by 9.7 per cent, i.e. at the same rate as in 1997, compared with a forecast of 4-6 per cent for 1998. Credit expansion to each of the two sectors remained unchanged. It should be noted, however, that total credit expansion has been strongly affected by the devaluation of the drachma, which led to an increase in the drachma value of foreign currency loans. Net of valuation differences, total credit expansion was limited to 9 per cent, i.e. was slightly lower than in 1997.

In greater detail, credit expansion to the public sector stood at 1997 levels (7.1 per cent). However, the public sector borrowing requirement, on a cash basis, fell to 1,882 billion drachmas in 1998, compared with 2,142 billion in 1997 (see Table V.2). More specifically, the borrowing requirement of the central government dropped to 2,382 billion drachmas in 1998, compared with 2,620 billion in 1997, while the financial surplus of public enterprises and entities was slightly higher in 1998 (1998: 500 billion drachmas, 1997: 478 billion).

The stagnation of credit expansion to the public sector, in spite of the decrease in its deficit, is attributable to changes in the composition of its financing. Net sales of government paper to the domestic non-bank sector fell to 160 billion drachmas in 1998, from 650 billion in 1997, reflecting the reduced issues of Treasury bills in 1998, along with the fact that the public is not sufficiently familiar with long-term bonds. As a result, the domestic non-bank sector contributed to the financing of the central government deficit by 7 per cent in 1998, compared with 25 per cent in 1997 and 80 per cent in 1996. Non-res-

idents, anticipating considerable capital gains in view of the country's entry into the euro area, purchased drachma-denominated government bonds, thereby financing a considerable part of the deficit. This led to an increase in the liquidity of the economy, given that such purchases are mostly financed by the domestic banking system, either through drachma-denominated loans or through currency swap agreements. In the former case, the monetary impact is practically the same as with direct financing of the government by the banking system, while in the latter case there is a direct increase in both the monetary base and liquidity.

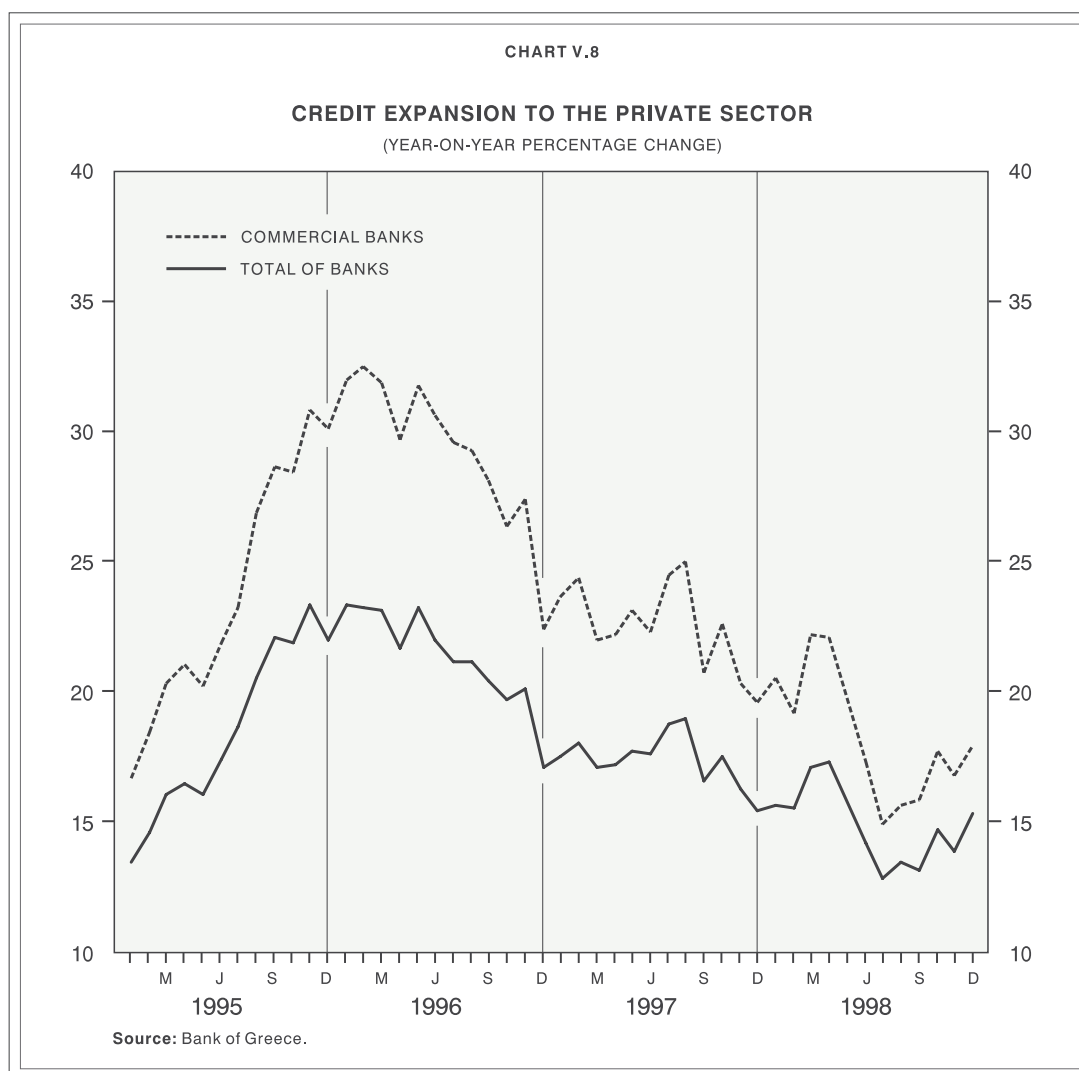
3.2 Financing of the private sector

Total credit to the private sector increased by 1,690 billion drachmas or 15.2 per cent in 1998, compared with an increase of 1,477 billion or 15.3 per cent in 1997. Thus, credit expansion remained at 1997 levels. However, as mentioned above, the change in the outstanding balance of loans, on the basis of which credit expansion is calculated, was strongly affected in 1998 by the drachma exchange rate, given that in recent years a considerable part of bank loans to enterprises has been denominated in foreign currency. The entry of the drachma into the ERM in March 1998 and its simultaneous devaluation led to a large increase in the outstanding balance of foreign currency loans, in drachma terms. Net of valuation differences, estimated at 220 billion drachmas, credit expansion fell to 1,470 billion drachmas or 13.2 per cent in 1998, i.e. was lower than in 1997.

The twelve-month credit expansion, net of valuation differences, showed a considerable slowdown in the January-August 1998 period and gradually fell to 12.5 per cent. However, this tendency was reversed in the last quarter of the year and, as a result, in December 1998 the twelve-month growth rate stood, as mentioned above, at 13.2 per cent. The significant increase in activity in many sectors of the economy contributed to maintaining credit expansion at relatively high levels. It should be noted that the manufacturing production index rose by 3.2 per cent in 1998, compared with only 1 per cent in 1997. Keener competition between banks — especially as regards consumer and housing loans — and the drop in both nominal and real interest rates also contributed to the increase in loans. However, the positive trend of the Athens Stock Exchange contained demand for loans, as it favoured fund-raising from the capital market. The funds raised by private enterprises (excluding banks and investment firms) from the capital market rose to 223 billion drachmas, compared with 100 billion in 1997.

The currency composition of loans was affected by developments in the drachma exchange rate. In 1998, drachma-denominated loans increased by 1,315 billion drachmas or 15.6 per cent, compared with 1,052 billion or 14.3 per cent in 1997. By contrast, the increase in foreign currency loans decelerated and reached 375 billion drachmas or 13.7 per cent in 1998 (and, net of valuation differences, 155 billion or 5.7 per cent), compared with 424 billion drachmas or 18.3 per cent in 1997 and 844 billion or 57.4 per cent in 1996.

It should be noted that in 1998, for the first time since 1990, the rate of increase in drachma loans was higher than that for foreign currency loans (see Table V.3). This was due to the significant substitution of drachma loans for foreign currency loans, a process which started in mid-1997 and intensified after the devaluation in March 1998. In this respect, it is worth mentioning that in the April-September 1998 period, the twelve-month rate of



change in foreign currency loans was negative, i.e. outstanding loans in foreign currency were lower than in the corresponding 1997 period, with repayments being higher than new loans. However, as from October 1998, when the crisis in Russia was defused and foreign exchange markets returned to normal, demand for foreign currency loans demonstrated a strong recovery, which led to an acceleration of total credit expansion to the private sector in the last quarter of 1998. At end-1998, foreign currency loans accounted for 24.3 per

TABLE V.3
BANK CREDIT TO THE PRIVATE SECTOR
(Change in outstanding balances)

Year	T o t a l			Breakdown by maturity				Breakdown by currency			
				Long-term		Short-term		Drachmas		Foreign currency	
	Billion drachmas	Per cent	Per cent of GDP	Billion drachmas	Per cent	Billion drachmas	Per cent	Billion drachmas	Per cent	Billion drachmas	Per cent
1990 ¹	647.5	16.5	4.9	295.9	16.7	351.6	16.4	588.7	15.6	58.8	40.1
1991 ¹	732.0	16.4	4.5	237.0	11.6	495.0	20.6	593.2	13.9	138.8	72.6
1992 ¹	878.4	17.1	4.7	198.6	8.8	679.8	23.7	718.1	14.9	160.3	48.6
1993 ¹	672.9	11.5	3.2	188.9	7.7	484.0	14.3	526.4	9.9	146.5	29.9
1994 ¹	827.2	13.8	3.5	240.8	9.3	586.4	17.2	547.8	10.2	279.4	43.9
1995	1,503.3	22.0	5.7	513.2	18.2	990.1	24.7	949.0	16.1	554.3	60.5
1996 ¹	1,414.0	17.0	4.8	443.5	13.3	970.5	19.4	570.0	8.3	844.0	57.4
1997 ¹	1,476.7	15.3	4.8	636.3	16.9	840.4	14.2	1,052.3	14.3	424.4	18.3
1998*	1,690.3	15.2	4.8	660.2	15.0	1,030.1	15.3	1,315.5	15.6	374.8	13.7

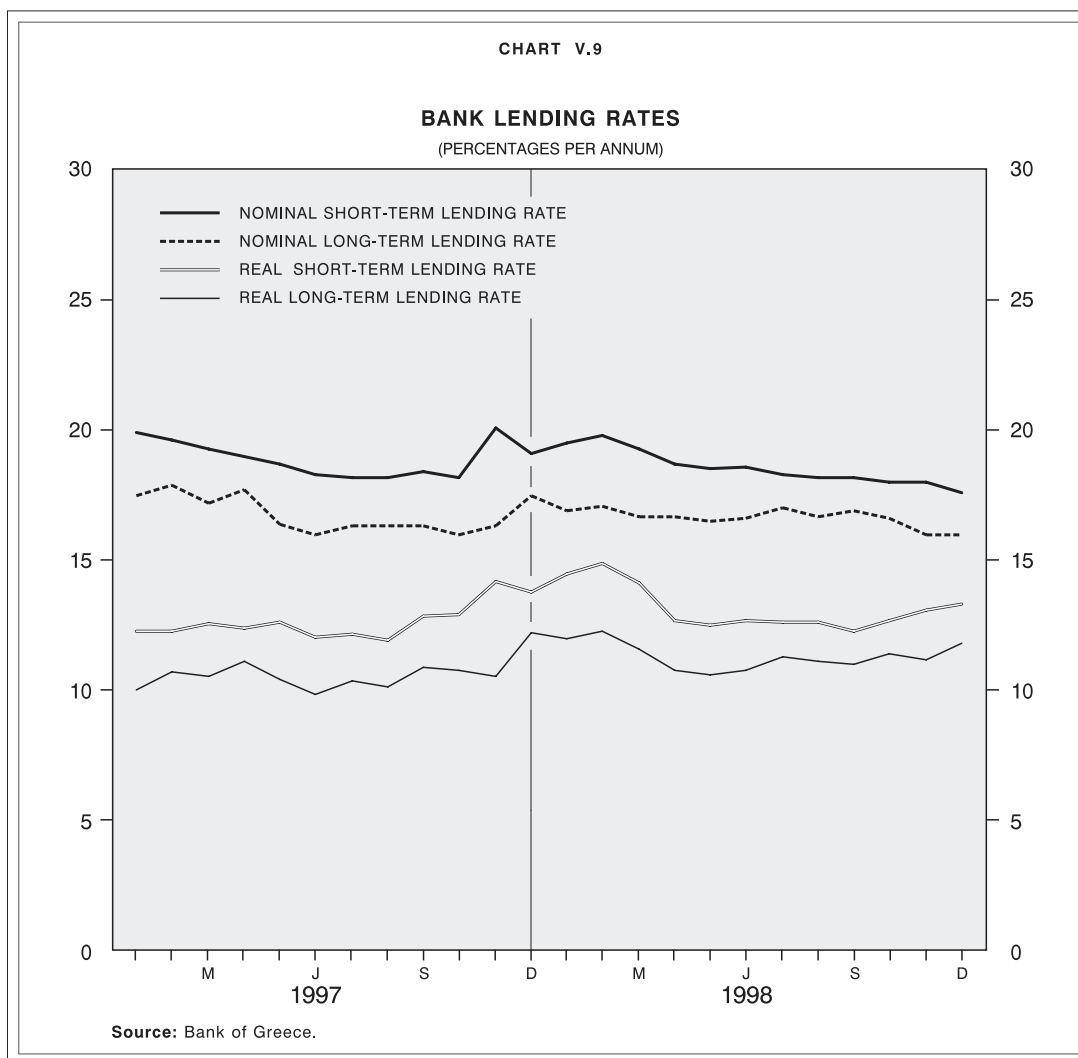
1 Excluding the effect of the conversion of state-guaranteed loans into government bonds, because the relevant guarantees were called in.

* Provisional data.

Source: Bank of Greece and NSSG, National Accounts.

cent of total credit to the private sector, compared with 24.6 per cent at end-1997 and 23.9 per cent at end-1996.

The breakdown of foreign currency loans by currency changed considerably in 1998. Specifically, outstanding loans in ECU represented 8.9 per cent of total foreign currency loans at end-1998, compared with 22.1 per cent at end-1997, in Deutschemarks 11.8 per cent (1997: 15.2 per cent), in US dollars 17.6 per cent (1997: 20.8 per cent), in



Japanese yen 39.6 per cent (1997: 19.8 per cent) and in other currencies 22.2 per cent (1997: 22.1 per cent). In other words, borrowers turned from the ECU, the Deutschemark and the US dollar to the Japanese yen. This is probably related to expectations of a depreciation of the yen as a result of the unsatisfactory performance of the Japanese economy. On the other hand, the appreciation of the drachma above its central ERM rate may have created expectations for a future appreciation of euro area currencies.

Nominal short-term interest rates on corporate loans increased slightly in the first quarter of the year, but later fell gradually and averaged 17.6 per cent in December 1998, compared with 19.1 per cent in December 1997. This decline was faster than the deceleration of inflation in the December 1997-December 1998 period. Thus, real short-term interest rates, as derived from the current inflation rate, fell by 0.6 percentage point. As regards other lending rates, the interest rates on long-term corporate loans fell by 1.5 percentage points in 1998 (December 1998: 16 per cent, December 1997: 17.5 per cent). Housing loan rates also fell by 1.5 percentage points. Interest rates on consumer loans showed a larger decrease (2-2.5 percentage points), owing to strong competition between banks in this area. It should be noted that interest rates on bank credit to enterprises fell more than deposit rates and the spread between them narrowed slightly to 9.3 percentage points in December 1998 from 9.5 percentage points in December 1997.

The credit expansion of commercial banks¹ decelerated, while that of specialised credit institutions was faster than that of 1997, although it fell considerably short of the average rate for the credit system as a whole.

Specifically, commercial banks' credit to the private sector rose by 1,341 billion drachmas or 17.9 per cent in 1998, compared with an increase of 1,221 billion drachmas or 19.5 per cent in 1997. This slowdown was accounted for entirely by foreign currency loans, while drachma-denominated loans increased at the same rate as in 1997. In greater detail, the increase in drachma loans amounted to 983 billion drachmas or 20.0 per cent in 1998, compared with 815 billion or 19.8 per cent in 1997, while the increase in foreign currency loans was limited to 358 billion drachmas or 14.0 per cent in 1998, compared with 406 billion or 18.8 per cent in 1997. The twelve-month rate of change in drachma loans was higher than that of foreign currency loans, resulting in a further decline of the share of the latter in total lending by commercial banks to 33.1 per cent in December 1998, from 34.2 per cent and 34.4 per cent at end-1997 and end-1996, respectively.

The slowdown in the credit expansion of commercial banks was associated with the small increase in credit extended by the three major state-controlled banks. These banks in general had a considerably below average credit expansion, compared with either commercial banks or the banking system as a whole. This development, combined with the privatisation of three banks, resulted in a decrease in the share of state-controlled banks in total credit to the private sector, which stood at 30.7 per cent in December 1998, compared with 36.6 per cent in December 1997 and, most notably, in total commercial bank credit (December 1998: 44.6 per cent, December 1997: 54.5 per cent).² By contrast, the rate of increase in credit extended by private commercial banks was well above the commercial banks' average and their share in total credit to the private sector rose to 28.0 per cent, while their share in commercial bank lending stood at 40.7 per cent in December

1 For the sake of comparability with 1997 figures, commercial bank credit does not include loans extended by the National Mortgage Bank.

2 The share of the three banks under state control which were privatised in 1998 was 4.1 per cent of the total of the credit system and 6.0 per cent for commercial banks.

1998, compared with 31.3 per cent in December 1997. The number of branches of private commercial banks also increased substantially to 710 at end-1998, compared with 436 at end-1997. The privatisation of three state-controlled banks, with a total of 167 branches, played a decisive role in this development.

Credit expansion of foreign banks' branches was slightly higher than the average of all commercial banks; thus their share in the private sector's financing by commercial

TABLE V.4
THE GREEK BANKING SYSTEM

	1997				1998			
	Number of		Percentage of		Number of		Percentage of	
	Institutions	Branches	Private sector's deposits*	Credit to private sector	Institutions	Branches	Private sector's deposits*	Credit to private sector
I. Commercial banks	49	1,912	72.7	67.2	54	2,095	75.1	68.8
a. Three largest state-controlled banks	3	1,068	41.0	30.0	3	1,116	39.6	27.8
b. Other state-controlled banks	5	284	4.5	6.6	2	123	1.8	2.9
c. Private banks	11	436	17.6	21.0	14	710	24.5	28.0
d. Branches of foreign banks	23	103	9.4	9.0	23	115	9.0	9.4
e. Cooperative banks	7	21	0.2	0.5	12	31	0.2	0.7
II. Specialised credit institutions	7	487	27.3	32.8	7	505	24.9	31.2
a. Agricultural Bank	1	231	11.7	17.2	1	242	10.2	16.0
b. Mortgage banks**	2	110	5.2	9.1	2	114	5.1	8.4
c. Investment banks	2	14	0.2	2.5	2	15	0.6	2.5
d. Postal Savings Bank	1	128	9.2	1.4	1	130	7.9	1.5
e. Deposit and Loans Fund	1	4	1.0	2.6	1	4	1.1	2.8
T o t a l	56	2,399	100.0	100.0	61	2,600	100.0	100.0

* In drachmas and foreign exchange.

** National Mortgage Bank of Greece and Aspis Housing Bank.

Source: Bank of Greece.

banks increased slightly, while their share in total financing by the banking system as a whole rose to 9.4 per cent in 1998 from 9.0 per cent in 1997. These figures, however, mask considerable differences across individual foreign banks, with the most dynamic among them (the ones which compete over a significant market share) recording a rapid credit expansion. Finally, credit extended by cooperative banks rose at a much faster rate than the average and their share in total credit improved, although it remains very low (1998: 0.7 per cent, 1997: 0.5 per cent). It is worth noting that 12 cooperative banks with 31 branches were operating at end-1998, compared with 7 banks with 21 branches at end-1997.

Credit extended by specialised credit institutions rose by 349 billion drachmas or 9.5 per cent in 1998, compared with 256 billion or 7.5 per cent in 1997. This acceleration reflected the high credit expansion of the smaller specialised credit institutions, while

credit extended by the Agricultural Bank of Greece (ATE), the National Mortgage Bank (EKTE) and the Hellenic Industrial Development Bank (ETBA) increased at a slow pace.

More specifically, credit extended to the private sector by ATE increased by 135 billion drachmas or 7.1 per cent, compared with 120 billion or 6.7 per cent in 1997. The relatively slow credit expansion of ATE led to a further reduction of its share in total credit to the private sector to 16.0 per cent in 1998 (1997: 17.2 per cent, 1996: 18.5 per cent). However, new loans extended by ATE increased considerably, compared with 1997 (1998: 798 billion drachmas, 1997: 707 billion) and, therefore, the limited increase in outstanding loans should be attributed to larger repayments in 1998. New loans to cooperatives and to the non-agricultural sector increased, while loans to other sectors remained at 1997 levels. In particular, new loans to the non-agricultural sector — as a percentage of new loans to the private sector — increased considerably and reached 20.4 per cent in 1998, compared with 16.4 per cent in 1997 and 17.6 per cent in 1996.

Credit expansion of EKTE, which, after its merger with the National Bank of Greece (ETE), no longer exists as an independent institution, declined considerably. Estimates of EKTE's lending derived from the consolidated balance sheet of ETE at end-1998 suggest that credit extended by EKTE increased by 42 billion drachmas or 4.3 per cent in 1998, compared with 80 billion or 8.9 per cent in 1997. Despite the strong credit expansion of the private housing bank, the share of mortgage banks in total bank credit to the private sector decreased (1998: 8.4 per cent, 1997: 9.1 per cent).

Credit expansion of the Deposits and Loans Fund and the Postal Savings Bank to the private sector — mainly housing loans to civil servants — grew at a high rate in 1998 (1998: 113 billion drachmas or 25.6 per cent, 1997: 89 billion or 25.4 per cent). Their share in total credit to the private sector increased to 4.3 per cent in 1998, compared with 4.0 per cent in 1997. Finally, credit expansion of investment banks recovered (1998: 36 billion drachmas or 13.0 per cent, 1997: -54 billion or -16.1 per cent).

3.3 Sectoral breakdown of credit to the private sector

A sectoral analysis of credit expansion (see Table V.5) points to a small deceleration of credit to trade, housing and agriculture and to a steep decline in credit to shipping and leasing companies. By contrast, credit extended to consumers, industry, small-scale industry and tourist enterprises grew at an accelerating rate.

In greater detail, credit to industry, in spite of the high profitability of that sector in 1998, rose by 140 billion drachmas or 5.7 per cent (1997: 97 billion or 4.1 per cent). The acceleration of credit expansion to industry stemmed mainly from a recovery in long-term credit, after two years of continuous slowdown, and was linked with a considerable acceleration of industrial production (the manufacturing production index rose by 3.2 per cent in 1998, compared with 1.0 per cent in 1997) and a significant increase in investment. It should be noted that in 1998 industrial firms raised 175 billion drachmas through the

TABLE V.5
CHANGE IN TOTAL BANK CREDIT BY SECTOR

	Outstanding balances on 31 Dec. 1998* (billion drachmas)	Changes in outstanding balances					
		Billion drachmas			Per cent		
		1996 ¹	1997 ¹	1998*	1996 ¹	1997 ¹	1998*
I. PRIVATE SECTOR	12,836.1	1,414.0	1,476.7	1,690.3	17.0	15.3	15.2
Long-term loans	5,068.9	443.5	636.3	660.2	13.3	16.9	15.0
Short-term loans	7,767.2	970.5	840.4	1,030.1	19.4	14.2	15.3
1. Agricultural	1,144.5	56.6	30.8	26.1	5.5	2.8	2.3
Long-term loans	698.7	36.4	53.7	14.9	6.1	8.5	2.2
Short-term loans	445.8	20.2	-22.9	11.2	4.6	-5.0	2.6
2. Large-scale manufacturing and mining	2,600.0	254.7	97.0	140.1	11.7	4.1	5.7
Long-term loans	517.2	-66.5	-15.0	31.0	-11.6	-3.0	6.4
Short-term loans	2,082.8	321.2	112.0	109.1	20.0	6.0	5.5
3. Small-scale manufacturing	810.0	48.5	66.6	84.5	7.9	10.1	11.6
Out of "earmarked" funds	314.7	-15.4	-7.9	4.1	-4.6	-2.5	1.3
4. Trade	2,785.0	305.5	426.5	468.1	19.3	22.6	20.2
Domestic	2,252.6	238.9	366.3	415.2	19.4	24.9	22.6
Import	377.0	60.2	45.9	36.1	25.7	15.6	10.6
Export	82.3	4.3	4.8	3.6	6.2	6.5	4.6
Tobacco	73.1	2.1	9.5	13.2	4.4	18.8	22.0
5. Other	5,496.6	748.7	855.8	971.5	25.6	23.3	21.5
– Housing	2,320.0	335.4	370.0	395.6	27.5	23.8	20.6
– Tourism	513.5	40.5	25.6	48.8	10.2	5.8	10.5
– Shipping	524.8	32.9	103.5	34.3	9.3	26.7	7.0
– Consumer credit	1,010.0	151.4	157.1	278.4	35.8	27.3	38.1
– Leasing companies	148.8	9.6	57.2	14.2	14.2	73.9	10.5
– Other	979.5	178.9	142.4	200.2	38.8	22.4	25.7
II. PUBLIC SECTOR	1,769.0	128.2	70.0	62.0	7.6	4.2	3.6
Public enterprises	848.6	108.2	84.8	173.6	18.6	13.8	25.7
Public entities	520.4	-4.3	-15.1	-38.5	-0.6	-2.5	-6.9
Special management accounts of the state	400.0	24.3	0.3	-73.1	5.4	0.1	-15.5
T o t a l	14,605.1	1,542.2	1,546.7	1,752.3	15.4	13.6	13.6

1 Excluding the effect of the conversion of state-guaranteed loans into government bonds, because the relevant guarantees were called in.

* Provisional data.

Source: Bank of Greece.

Athens Stock Exchange, compared with 55 billion in 1997. This was a positive development, since it strengthened the capital base of enterprises, improved the ratio of their own funds to bank loans and reduced their financial costs.

In the case of small-scale industry, credit expansion showed a small acceleration (1998: 85 billion drachmas or 11.6 per cent, 1997: 67 billion or 10.1 per cent), which was financed out of banks' own funds, given that the "special fund" has been exhausted. In 1998, the share of the manufacturing sector (large and small scale industry) in credit expansion to the private sector rose slightly to 2 percentage points in a total of 15.2 points, compared with 1.7 points in a total of 15.3 points in 1997.

Credit expansion to the agricultural sector decelerated (1998: 26 billion drachmas or 2.3 per cent, 1997: 31 billion or 2.8 per cent). Thus, the contribution of agriculture to total credit expansion fell to 0.2 percentage point in 1998 from 0.3 percentage point in 1997. This slowdown was linked with the drop in the growth rate of agricultural production to 1.5 per cent in 1998, compared with 1.7 per cent in 1997. Long-term agricultural credit declined significantly; by contrast, short-term credit to the agricultural sector recovered.

Credit to trade grew at a lower rate (1998: 468 billion drachmas or 20.2 per cent, 1997: 427 billion or 22.6 per cent) but remained at relatively high levels. As a result, the share of trade in credit expansion to the private sector reached 4.2 percentage points, compared with 4.4 points in 1997. More specifically, credit expansion to all sectors of trade, with the exception of tobacco trade, showed a deceleration, which was particularly marked in import trade. It should be noted that commercial firms, unlike industrial firms, raise limited amounts of capital through the Stock Exchange (1998: 27 billion drachmas, 1997: 9 billion) and rely mainly on the banking system for financing their activities.

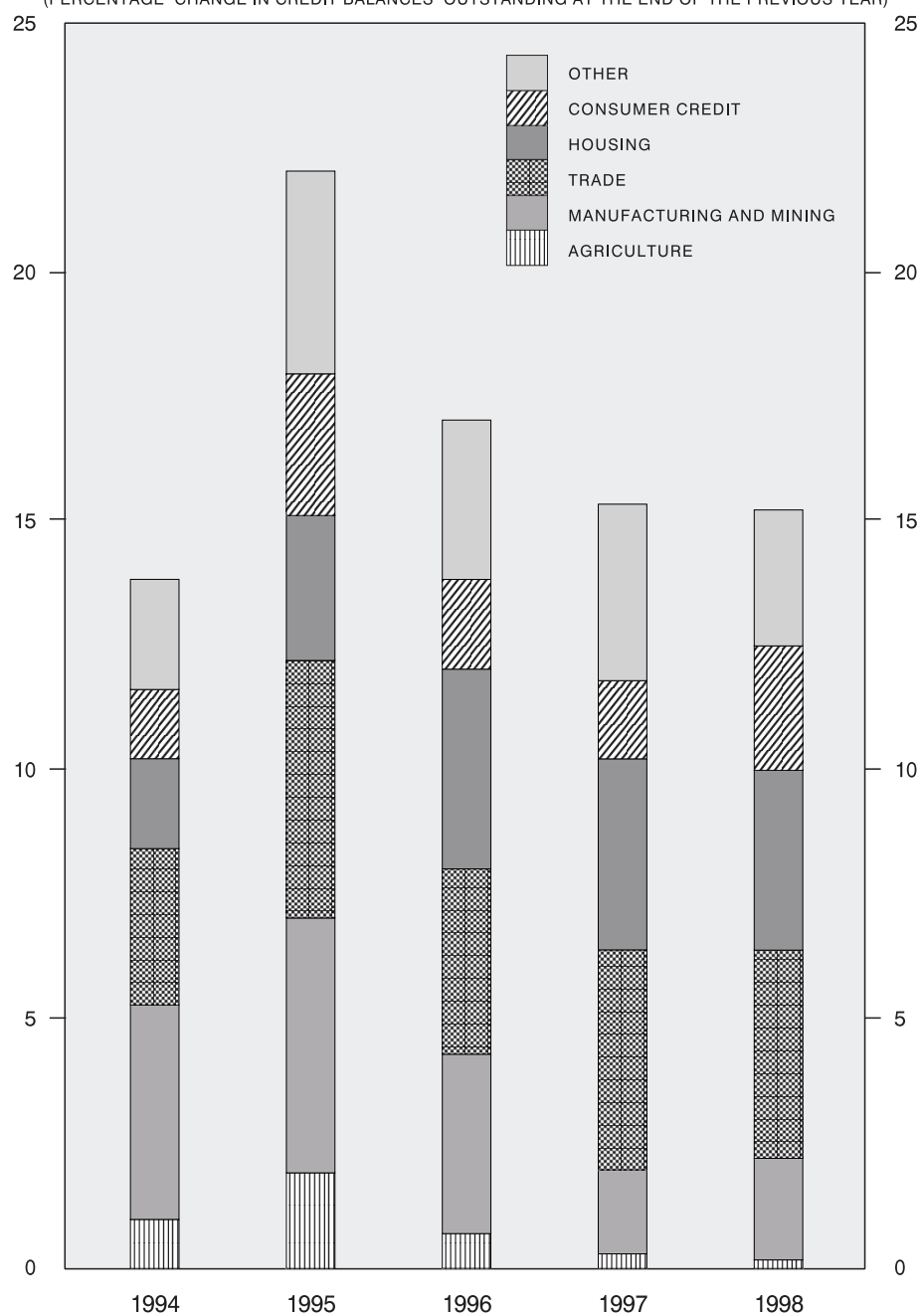
Housing credit continued to grow at high rates, but decelerated further (1998: 396 billion drachmas or 20.6 per cent, 1997: 370 billion or 23.8 per cent). The increase in housing loans is due to the intense construction activity observed in recent years. It should be noted that, on the basis of building permits issued, private construction activity rose by 9.4 per cent in 1998 (1997: 5.7 per cent), while, as suggested by national accounts data, private investment in dwellings rose by 8.5 per cent in 1998 (1997: 10.9 per cent). Housing loans constitute a considerable part of total bank credit (18.1 per cent in 1998 and 17.3 per cent in 1997) and attract the keen interest of banks, which promote new housing credit products and enter into strong competition with each other. The merger of ETE and EKTE in September 1998 is expected to bring about considerable developments in the field of housing credit. It should be noted that, according to EKTE data, over the past four years borrowers have shifted from fixed-rate loans to floating-rate loans, a fact which should be attributed to the public's expectations of a further decline in interest rates in the context of the convergence of the Greek economy towards euro area countries.

The growth rate of consumer credit accelerated substantially (1998: 278 billion drachmas or 38.1 per cent, 1997: 157 billion or 27.3 per cent) and was the highest among all types of credit. In greater detail, loans against supporting documents, which finance the purchase of consumer durables, increased considerably (1998: 115 billion drachmas or

CHART V.10

BREAKDOWN OF CREDIT TO THE PRIVATE SECTOR BY BRANCH OF ECONOMIC ACTIVITY

(PERCENTAGE CHANGE IN CREDIT BALANCES OUTSTANDING AT THE END OF THE PREVIOUS YEAR)



Source: Bank of Greece.

53.5 per cent, 1997: 25 billion or 12.9 per cent). The growth of this type of loans related to developments in the production of consumer durables, which showed a large increase (1998: 23.8 per cent, 1997: 6.7 per cent), and it was the key factor underlying the rise in manufacturing output in 1998. By contrast, personal loans — which have the highest interest rates — increased at a considerably slower pace (1998: 71 billion drachmas or 29.2 per cent, 1997: 80 billion or 48.8 per cent). Loans granted through credit cards also grew at a rate higher than in 1997 (1998: 33.7 per cent, 1997: 23.9 per cent), while the number of credit cards rose by 180,000, compared with an increase of 170,000 in 1997. As a result, the average outstanding balance of credit per card reached 250,000 drachmas, compared with 196,000 drachmas in 1997. The contribution of consumer credit to credit expansion reached 2.5 percentage points in 1998 in a total of 15.2 points, compared with 1.6 in a total of 15.3 points in 1997. At end-1998, credit extended to households (the total amount of housing and consumer loans) rose to 25.9 per cent of total credit to the private sector, compared with 23.8 per cent in 1997 and 22.0 per cent in 1996.

In spite of fast growth in recent years, consumer credit in Greece still accounts for a rather small proportion of bank lending. Consumer credit stands at 2.8 per cent of GDP, while in many EU countries it exceeds 5 per cent.¹ However, aggregate data for the entire banking system mask the fact that the share of consumer loans in the credit portfolio of certain banks is very high. It should be noted that in April 1999, in the context of its anti-inflationary policy, the Bank of Greece took steps to constrain credit expansion of banks in 1999. These measures concern consumer credit and loans to domestic and import trade on the one hand and the total of other types of loans to the private sector as well as to public enterprises and entities, on the other hand. Furthermore, given that credit risk on consumer loans differs from that on business and housing loans, in early 1999 the Bank of Greece set new regulations on banks' provisions, which stipulate that, in the case of consumer loans, provisions must be 30 per cent higher, reflecting the increased risk that these loans carry.

Credit to shipping companies, which had increased at a high rate last year, fell substantially (1998: 34 billion drachmas or 7.0 per cent, 1997: 103 billion or 26.7 per cent). Credit extended to the tourist industry accelerated, but remained at relatively low levels (1998: 49 billion drachmas or 10.5 per cent, 1997: 26 billion or 5.8 per cent). Credit expansion to leasing companies decelerated substantially, which was partly due to the fact that these companies raise funds through the Stock Exchange.

1 According to 1997 data, consumer credit as a percentage of GDP in EU countries was: Belgium 3.6 per cent, Germany 11 per cent, Spain 6.2 per cent, Ireland 7.9 per cent, Netherlands 9.6 per cent, Portugal 5.6 per cent, Sweden 14 per cent, United Kingdom 8.3 per cent. (Source: national central banks for consumer loans and Eurostat for GDP).

APPENDIX TO CHAPTER V

CHRONOLOGY OF MAIN MONETARY POLICY AND BANKING SUPERVISION MEASURES

1998

8 January

Effective from 9 January 1998, the Bank of Greece raises its Lombard rate to 23 per cent from 19 per cent. The maximum borrowing per credit institution under this facility is lowered by 50 per cent.

23 January

Credit institutions may deposit with the Bank of Greece their holdings in foreign exchange, deriving from deposits (which they can now manage freely under Bank of Greece Governor's Act 2416/28 July 97) or from any other source, under terms and conditions to be laid down by the Bank of Greece.

12 February

The Bank of Greece introduces an integrated framework for the reporting of assets and liabilities by credit institutions, in accordance with current requirements for the conduct of monetary policy and for reporting to the European Central Bank and international economic and monetary organisations.

14 January-11 March

During this period, the Bank of Greece absorbs liquidity through regular tenders for accepting 14-day deposits. The intervention rate is gradually reduced from 20 per cent (14 January 1998) to 16.5 per cent (11 March 1998).

30 March

Effective from 31 March 1998, the Bank of Greece lowers its Lombard rate from 23 per cent to 19 per cent. The maximum borrowing per credit institution under this facility is restored to the level in effect before 9 January 1998.

In addition, effective from 31 March 1998, the interest rate on the debit balances of credit institutions' current accounts with the Bank of Greece is lowered from 24 per cent to 22 per cent and the 0.2 percentage point daily surcharge is abolished.

9 April

Effective from 10 April 1998, the Bank of Greece abolishes its standing facility for the discounting of bills of exchange and promissory notes. This facility had not been used for a long time.

22 April

Effective from 23 April 1998, the interest rates of the deposit facility are raised to 11.5 per cent for the first tranche and 9.75 per cent for the second tranche, from 10.9 per cent and 9.6 per cent, respectively.

28 April

As provided for in Article 4 of Law 2548/1997 “Provisions relating to the Bank of Greece”, the Bank submits to the Greek Parliament and the Council of Ministers a report on monetary policy for 1997 and 1998. The full text of the report is issued in a separate bulletin, bearing the title “*Monetary Policy 1997-1998*”.

11 May

Further to Law 2548/1997 “Provisions relating to the Bank of Greece”, Law 2609/1998 ratifies the addition, amendment or abolition of certain articles of the Statute of the Bank of Greece, decided upon by the extraordinary General Meeting of the Bank’s shareholders on 22 December 1997, with a view to ensuring full compatibility of the Bank’s Statute with Maastricht Treaty requirements and the Statute of the European Central Bank.

2 June

Effective from 1 July 1998, the redeposit requirement, with the Bank of Greece, on seamen’s and emigrants’ foreign exchange deposits with credit institutions operating in Greece is reduced to 60 per cent from 70 per cent. The commission paid on these redeposits by the Bank of Greece is lowered from 1.2 per cent to 1.0 per cent per annum.

3 June

— Following successive cuts, the intervention rate of the Bank of Greece on the acceptance of 14-day deposits stands at 13.75 per cent, compared with 16 per cent on 18 March 1998.

— The Bank of Greece establishes the institutional framework for the operation of, and prudential supervision on, Mutual Guarantee Companies.

29 June

The ceiling beyond which any increase in the participation of credit institutions in financial firms requires the approval of the Bank of Greece is raised from 1 to 2 per cent of the credit institution's own funds and from the amount of 200 million drachmas to 700 million drachmas, respectively. Should the increase in the credit institution's current participation not exceed 5 percentage points over each calendar year, no prior approval by the Bank of Greece is required, provided that the amounts previously mentioned are not exceeded.

8 July

- The intervention rate of the Bank of Greece on the acceptance of 14-day deposits is lowered from 13.75 to 13 per cent.
- Effective from 9 July 1998, the interest rate for the first tranche of the deposit facility is raised from 11.5 per cent to 11.9 per cent.

31 July

- Total borrowing under the Bank of Greece Lombard facility and its allocation are determined as follows: An amount of 200 billion drachmas is allocated to credit institutions on the basis of their respective quotas in the first tranche of the deposit facility, plus an amount of 300 million drachmas per credit institution, plus a further 10 billion drachmas if the institution is a Primary Dealer.
- As of 5 August 1998, the Bank of Greece lowers its Lombard rate to 16 per cent from 19 per cent.

14 October

The intervention rate of the Bank of Greece on the acceptance of 14-day deposits is lowered to 12.75 per cent from 13 per cent.

27 November

As provided for in Article 4 of Law 2548/1997, the Bank of Greece submits to the Greek Parliament and the Council of Ministers a report on monetary policy, which is supplementary to the annual report submitted on 28 April 1998. The full text of the report is issued in a separate bulletin, bearing the title "*Monetary Policy-Interim Report 1998*".

9 December

- The intervention rate of the Bank of Greece on the acceptance of 14-day deposits is lowered to 12.25 per cent from 12.75 per cent.

- The interest rate for the first tranche of the deposit facility is lowered to 11.6 per cent from 11.9 per cent.
- The Bank of Greece Lombard rate is lowered to 15.5 per cent from 16 per cent.

22 December

– Effective from 4 January 1999, the operating rules of the “EURO-HERMES” Real Time Gross Settlement System for Payments in euro are put into force. Furthermore, the operating rules of the “HERMES” Real Time Gross Settlement System for Payments in drachmas are approved and expected to be put into force in the near future.

– Effective from 4 January 1999, in the context of operation of the “EURO-HERMES” Real Time Gross Settlement System for Payments in euro, the Bank of Greece offers credit institutions operating in Greece non-interest bearing intraday financing in euro, on collateral of securities considered eligible by the European Central Bank for the operational needs of TARGET.

1999

12 January

- Effective from 13 January 1999, the intervention rate of the Bank of Greece on the acceptance of 14-day deposits is lowered to 12 per cent from 12.25 per cent.
- Effective from 14 January 1999, the interest rate for the first tranche of the deposit facility is lowered to 11.5 per cent from 11.6 per cent.
- Effective from 14 January 1999, the Bank of Greece Lombard rate is lowered to 13.5 per cent from 15.5 per cent.
- Effective from 14 January 1999, the overdraft rate is lowered to 20 per cent from 22 per cent.

29 January

With the aim of improving the quality and further enhancing the soundness of banks’ loan portfolios, the Bank of Greece establishes a general framework of minimum quantitative criteria for assessing the adequacy of provisions made by credit institutions for claims arising from lending.

16 April

With a view to further enhancing its anti-inflationary policy, the Bank of Greece decides that the following amounts shall be deposited with it in a non-interest bearing account for a period of six months:

i) Any amount of the commercial, housing and cooperative banks' total outstanding balance of consumer credit and loans to the domestic and import trade which exceeds the corresponding total balance outstanding on 31 March 1999 by:

3.5 per cent or 150 million drachmas on 30 June 1999,

5.5 per cent or 250 million drachmas on 30 September 1999 and

9.5 per cent or 400 million drachmas on 31 December 1999, whichever is the highest in all cases.

ii) Any amount of the banks' total outstanding balance of loans, other than the above, to the private sector and public enterprises and entities which exceeds the corresponding total balance outstanding on 31 March 1999 by:

3.5 per cent or 200 million drachmas on 30 June 1999,

5.5 per cent or 300 million drachmas on 30 September 1999 and

9.5 per cent or 550 million drachmas on 31 December 1999, whichever is the highest in all cases.

VI. THE CAPITAL MARKET

1. INTRODUCTION

Activity in the capital market increased in 1998, though with marked fluctuations. More specifically, sales of government paper in the primary market fell slightly short of 1997 levels, with the interest rates on these securities fluctuating along a downward course. Transactions in the secondary market for government paper increased significantly, as a result of the operation of the Electronic Secondary Securities Market (HDAT), while the prices of these securities also rose, owing to increased demand by domestic and foreign investors. It should be noted that the differential between yields from 10-year fixed-rate bonds in Greece vis-à-vis comparable yields in Germany fell substantially and by end-1998 had reached half of the level observed at end-1997.

All stock market aggregates improved sizeably in 1998. The prices of shares traded on the Athens Stock Exchange (ASE) increased at a rate that not only exceeded the corresponding rate observed in all other European stock exchanges, but also ranked second worldwide.¹ This was largely a result of placements by foreign institutional investors. Finally, the value of mutual funds' assets continued to rise at a fast pace.

2. THE MARKET FOR GOVERNMENT PAPER

2.1. The primary market

The total value of government paper issued in 1998 decreased, compared with 1997. However, the favourable conditions created in the capital markets by the drachma's entry into the ERM on 16 March 1998 and the operation, from May onwards, of HDAT enabled the State to reduce the costs of issuing government securities and prolong their average maturity. More specifically, the total nominal value of the Treasury bills and government bonds issued in 1998 amounted to 10,032 billion drachmas, against 10,419 billion in 1997. As in previous years, the government securities issued in the primary market in 1998 comprised Treasury bills with a 3-, 6- and 12-month maturity and drachma-denominated fixed-rate bonds with a 3-, 5-, 7- and 10-year maturity, but also included new types, such as fixed-rate bonds with a 2- and 15-year maturity, tax-exempt savings bonds² with a 2-year maturity, as well as 3- and 5-year bonds convertible into shares (privatisation certificates). It should be noted that the September, October and November 1998 issues of savings bonds combine a small nominal value and high liquidity and were thus mainly

¹ In US dollar terms.

² Savings bonds are tax-exempt so long as they are not liquidated before maturity. The tax rate applied to the interest on the remaining types of government securities was raised to 10 per cent in 1998, from 7.5 per cent in 1997.

intended for small savers.¹ Finally, the October 1998 issues of drachma-denominated privatisation certificates with a 3-year maturity and of euro-denominated privatisation certificates with a 5-year maturity are convertible into public enterprises' shares.

The total nominal value of Treasury bill issues in 1998 rose to 4,665 billion drachmas, from 4,458 billion in 1997. Twelve-month Treasury bills accounted for roughly 73 per cent of all 1998 Treasury bill issues, the remainder being almost equally divided between Treasury bills with a 3- and a 6-month maturity. The average maturity of Treasury bills issued in 1998 thus fell to 10 months, from 11.4 months in 1997. The nominal value of government bonds issued in the primary market² fell to 5,367 billion drachmas in 1998, from 5,961 billion in 1997. A breakdown of the total value of 1998 bond issues by maturity indicates that 10-year bonds ranked first (31 per cent of the total), followed by 7-year bonds (23 per cent), 15-year bonds (14 per cent), 3-year bonds (13 per cent), 5-year bonds (11 per cent) and, finally, 2-year bonds (8 per cent). Based on this distribution, the average maturity of 1998 bond issues rose to 7.9 years, from 5.4 years in 1997.

In 1998, demand for government securities in the primary market³ exceeded supply. This holds for both Treasury bills and, especially, bonds. More specifically, the total demand for government securities issued through auctions was almost twice (1.9 times) the relevant supply, while the total demand for bonds was more than double (2.2 times) the supply.

After monetary turmoil broke out in the SE Asian market in October 1997 and interest rates began to rise, the government substantially reduced issues of long-term securities in the primary market and increased issues of Treasury bills. Interest rates on these securities (especially those with a 3- and 6-month maturity) remained relatively high through mid-March 1998, until the drachma joined the ERM. The average weighted interest rate on 12-month Treasury bills at the first auction in early January 1998 reached 11.4 per cent, while the interest rate on the next two issues of 3- and 6-month Treasury bills at the end of January was 13.9 per cent and 13.8 per cent, respectively. The entry of the drachma into the ERM caused an immediate drop of 2 percentage points in the interest rate on 12- and 3-month Treasury bills issued in the primary market and of roughly 2.5 percentage points in the 6-month Treasury bill rate. The interest rates on Treasury bills at subsequent auctions showed minor fluctuations through August, but then rose sharply in September 1998, as a result of the Russian crisis. As soon as pressures subsided and money market conditions began to return to normal, Treasury bill rates fell and by year-end stood slightly below their end-March level. Minor fluctuations, along a downward trend however, were also recorded in the average weighted interest rates on government bonds sold by auction. More specifically, the first issue of government bonds to the primary market, launched in early February 1998, consisted in reopening the 10-year bond issue launched

1 Savings bonds are issued at par to private individuals (Greek residents) up to 15 million drachmas per investor (per issue). These bonds are not tradeable in HDAT.

2 The nominal value of privatisation certificates totalled 340 billion drachmas in 1998.

3 As of 1997, new government securities are issued in book-entry form and are sold through competitive-bid auctions.

in June 1997 at an average weighted interest rate of 8.9 per cent. Two-year bonds were then issued at end-February 1998 at an average weighted rate of 14.2 per cent. The 10-year bonds issued at end-March 1998 at an average weighted rate of 7.9 per cent signalled the beginning of a downward course along which long-term bond rates would evolve throughout the rest of the year. Only those issues that immediately followed the Russian crisis had slightly higher interest rates.

2.2 The secondary market

The development of an organised secondary market for government securities, with sufficient liquidity, width and depth is a *sine qua non* for the effective operation of the primary market for these securities. The Electronic Secondary Securities Market (HDAT) began operating at the Bank of Greece in May 1998. It is a fully automated system, which covers the over-the-counter secondary market for government securi-

BOX VI.1

Electronic Secondary Securities Market (HDAT)

The Bank of Greece launched HDAT in May 1998. HDAT transactions are concluded on line and in real-time and cover the over-the-counter secondary market for Greek government securities. The system is quote-driven, based on binding quotations entered by participants, in particular by Primary Dealers, depending on their rights and obligations. These quotes must meet the operating rules of the screen-based system with respect to minimum lot size, maximum spread between bid and ask prices, the obligation to maintain quotes throughout the business day, etc. Furthermore, quotes must be two-sided, i.e. for both purchase and sale of government paper, thus ensuring market stability and transparency, while averting possible collusion. HDAT's connection to electronic information providers contributes to the internationalisation of Greece's securities market, which now ranks among the most modern ones.

All tradeable Greek government securities in book-entry form have, regardless of maturity, been listed in HDAT: Treasury bills, fixed- and floating-rate bonds (except savings bonds), zero-coupon bonds, CPI-indexed bonds, bonds with a foreign currency clause and strips. At the end of March 1999, a total of 173 issues were listed in HDAT.

Multiple benefits ensue from HDAT's operation. First, by contributing to a more efficient management of public debt and to a reduction in interest rates, HDAT helps to contain government deficits. Furthermore, as an observer of HDAT, the Ministry of Finance has direct access to such market environment information as the demand and supply of securities, prices and volumes traded, and other necessary data for a more rational management of public debt. In addition, HDAT ensures that the valuation of portfolios carried out by mutual funds, insurance companies and, generally, by all the companies required by law to mark-to-market →

→ their government securities portfolios, is based on reliable and representative market prices. After HDAT was launched, Law 2651/1998 stipulated that portfolio valuation must be carried out at HDAT prices. Pursuant to this law, the Bank of Greece, since 15 March 1999, has been issuing the daily Bulletin “Treasury Securities Bid Prices” with the prices of all government securities in circulation.

HDAT’s members are the Bank of Greece, all the Greek credit institutions, branches of foreign banks in Greece and the Ministry of Finance via the Bank of Greece. On 31 March 1999, HDAT counted 39 members (22 Greek credit institutions and 17 branches of foreign banks). Fourteen of them (8 Greek and 6 foreign) have been appointed Primary Dealers and are obliged to enter to HDAT binding quotes throughout the day.

Apart from credit institutions operating in Greece, foreign credit institutions as well as institutional investors (both Greek and foreign) also play an active role in the Greek government securities market. It should be noted that currently foreign credit institutions and institutional investors can only access HDAT through its members. It is expected that granting these credit institutions and institutional investors direct access to HDAT would facilitate the market’s further expansion and increase its liquidity, thus reducing yields and, consequently, further cutting the costs of financing government deficits. Their request to be granted access to the system is therefore being examined favourably.

In addition, the spread between bid and ask prices for each quote entered into HDAT cannot exceed 50 basis points. This spread, however, has narrowed significantly for all types of securities that are tradeable in HDAT and is often contained below the determined cap. This is another indication of the market’s maturity, of the increased marketability of Greek securities and, consequently, of the reduction in the liquidity risk in the market, as investors can liquidate their portfolios immediately and at no substantial cost.

The introduction in HDAT of repurchase agreements (repos) and of the credit risk management system has been scheduled for the first half of 1999. Trading in these products is expected to attract more investors and to increase the inflow of capital to the Greek government securities market, thus boosting trading volume accordingly. Meanwhile, apart from the automatic securities’ lending mechanism, which is already provided by the Bank of Greece Securities Settlement System (BOGS), the introduction of new products is expected to provide additional risk management tools, thus helping to reduce systemic risk.

ties in book-entry form and also ensures the primary market’s automation. This market is mainly characterised by the transparency and safety of transactions, as well as by a high degree of liquidity. These features ensure reliable prices for government securities traded in the secondary market.¹ The issuance of government securities in book-entry form con-

¹ According to Law 2651/1998, all enterprises required by law to mark-to-market their government securities portfolio must do so on the basis of the prices of these securities in HDAT (see also Joint Decision No. 8614/B.422/5 March 1999 of the Minister of National Economy and the Minister of Finance).

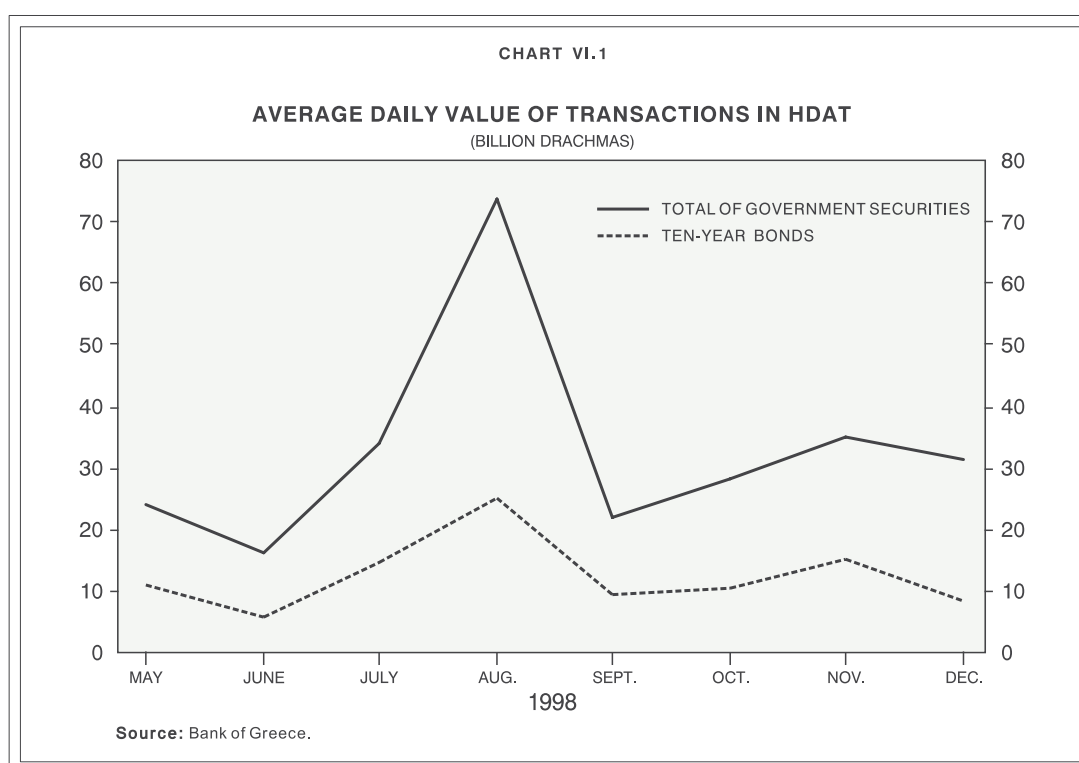
TABLE VI.1
VALUE AND STRUCTURE OF HDAT TRANSACTIONS IN GOVERNMENT SECURITIES

Period	Average daily value of total transactions (billion drachmas)	Percentage share in the total value of transactions					
		Treasury bills	Government bonds				
			3-year	5-year	7-year	10-year	15-year
1998 May	24.1	2.2	1.0	8.5	41.2	45.6	1.5
June	16.0	3.6	7.7	11.0	42.3	34.2	1.2
July	33.9		7.4	7.4	25.4	42.6	17.2
Aug.	73.5		4.1	8.3	32.6	33.8	21.2
Sept.	22.2		1.0	6.6	29.9	43.0	19.5
Oct.	28.1		1.9	17.6	36.8	36.2	7.5
Nov.	35.0		0.1	11.8	21.4	44.1	22.6
Dec.	31.4		1.7	15.5	36.6	27.1	19.1
1999 Jan.	108.4		0.5	10.2	15.1	45.7	28.5
Feb.	134.6		5.0	7.2	24.5	41.9	21.4
March	179.4		4.6	10.7	17.1	40.2	27.4

Source: Bank of Greece.

tributes to the growth and sound operation of the secondary market, by ensuring increased competition and transparency. Furthermore, the institution of the Primary Dealer, launched by the Bank of Greece in February 1998, has contributed to the smooth operation both of the secondary and of the primary market for government paper. It should be noted that the number of Primary Dealers participating in HDAT increased to 14 (8 domestic and 6 foreign banks) in February 1999 from 9 in February 1998.

The average daily value of transactions within HDAT stood at 33 billion drachmas from May to December 1998, before surging to an impressive 143 billion drachmas in the first quarter of 1999 (see Table VI.1 and Chart VI.1). This was largely accounted for by trad-

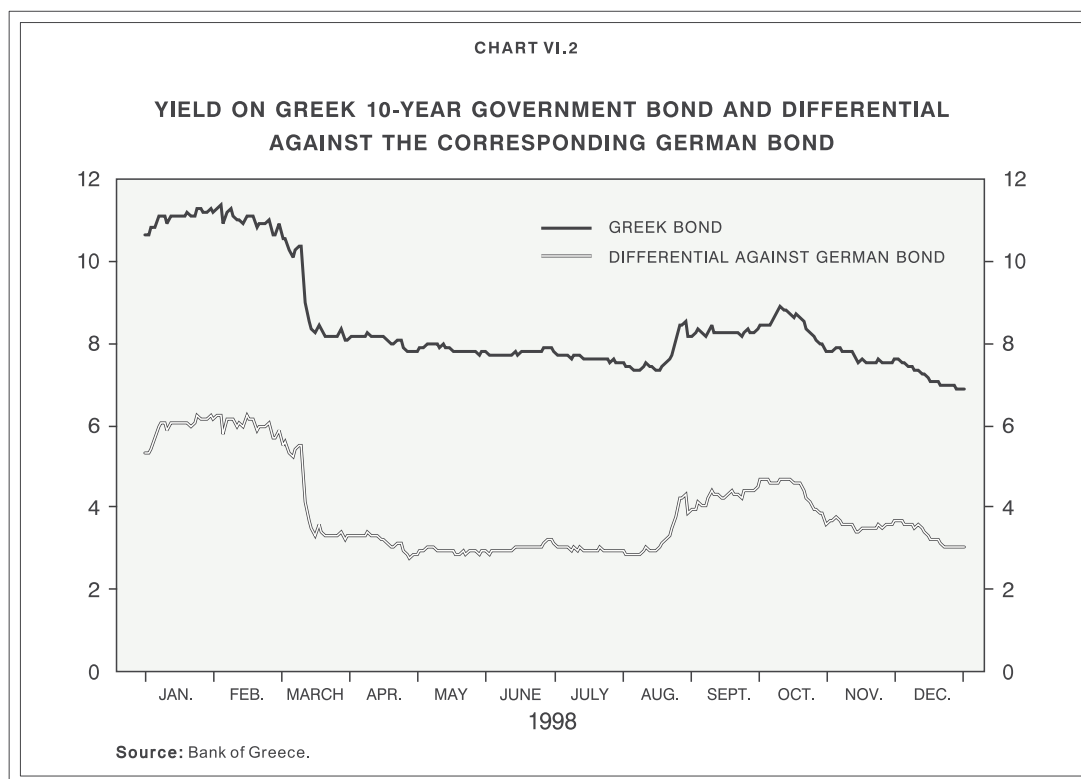


ing in long-term securities, i.e. 10-, 7- and 15-year bonds, and to a lesser extent by trading in 5- and 3-year bonds. In the second half of 1998, however, there was no trading in Treasury bills. More specifically, trading in 10-, 7- and 15-year bonds accounted for 38 per cent, 32 per cent and 16 per cent, respectively, of all transactions in 1998 (see Table VI.1). Moreover, trading in 10- and 15-year bonds increased in the first months of 1999. These developments reflect the higher yields of Greek securities over those of comparable securities issued in euro area countries, as well as market confidence in the prospects of Greece entering the euro area and the subsequent convergence of interest rates on Greek securities.

Government paper yields in the secondary market registered a general downward trend in 1998, though with marked fluctuations. More specifically, yields remained rela-

tively high from the beginning of the year until the drachma entered the ERM in mid-March, as a result of the continued pressure in money and foreign exchange markets exerted by the resurgence of the monetary turmoil in SE Asia in October 1997. Thus, the yield of 12-month Treasury bills rose from 11.4 per cent at the beginning of January to 12.9 per cent in early March 1998, while the yield of the 10-year bond, which serves as the reference rate in meeting the long-term interest rate criterion set by the Maastricht Treaty, amounted to 10.6 per cent (see Chart VI.2).

Immediately following the drachma's entry into the ERM, government securities yields decreased significantly (by roughly 1.5 percentage points), owing to the increased



demand for these products — mainly by foreign but also by domestic investors — triggered by the reduction in the risk premium incorporated in their yields. Until the end of 1998, with the sole exception of the mid-August to mid-October period, government paper yields followed a downward course. More specifically, the 10-year bond yield stood at about 7.3 per cent in mid-August and at 6.9 per cent at end-December 1998, while the interest rates on securities with other maturities followed a similar course. The pressure exerted in the money and capital markets in mid-August as a result of the Russian crisis also caused a rise in bond market rates. This increase lasted through mid-October, at which time market conditions began to return to normal. Bond yields gradually fell and in mid-November had returned to pre-turmoil levels.

In addition, the differential between 10-year fixed-rate bond yields in Greece and Germany fell from about 6 percentage points at the beginning of 1998 to around 3 percentage points in mid-August 1998. After the Russian crisis, it increased to 4.7 percentage points in mid-October, before resuming a downward course until end-December, at which time it levelled off at 3 percentage points (see Chart VI.2). Throughout 1998, there was also a substantial drop in the yields both from the above German bonds (2.3 percentage points) and, in general, from the long-term bonds issued in euro area countries (around 2.5 percentage points). This favourable development was due to: the drop in inflation in euro area countries, the expectation of even lower inflation and the gradual elimination, in some of these countries, of the exchange risk premium incorporated in the yields. More specifically, the increase in the yield differential between the Greek 10-year bond and the German equivalent during the Russian crisis can be attributed both to the rise in Greek bond yields and to the decrease in the comparable German bond yield (this being the result of the portfolio restructuring that institutional investors often resort to in times of monetary turmoil, by increasing their placements in bonds of developed capital markets).

3. THE STOCK MARKET FOR FIXED-INCOME SECURITIES

Transactions in fixed-income securities on the ASE increased impressively in 1998, but nevertheless remained subdued, compared with the value of government securities in circulation and particularly with the level of transactions within HDAT. Trading in fixed-income securities rose to 124 billion drachmas in 1998, from 16 billion in 1997 and 3 billion in 1996. This was mainly due to the launching, in April 1998, of the Fixed-Income Securities Market (AASE), even though trading in this type of securities had started to recover in mid-1997, after a relatively long period of a downward trend. The rise observed in total transactions in these securities was mainly accounted for by trading in drachma-denominated government bonds (62 per cent of total trading). Of the remaining types of securities, only corporate bonds amounted to a trading level worthy of note.

4. THE MARKET FOR SHARES

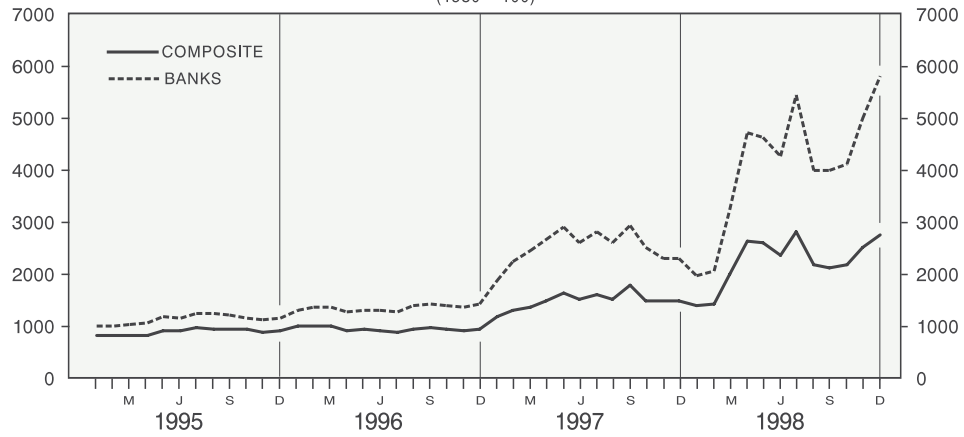
The market for shares was characterised in 1998 by an impressive rise in share prices and the value of transactions, as well as by increased fund-raising.

These aggregates, however, fluctuated significantly over the year. More specifically, from January to mid-March 1998, the stock market was stagnant, owing to the impact of the monetary turmoil that had broken out in SE Asia in October 1997 (see Chart VI.3). With the drachma's entry into the ERM and its devaluation (in mid-March 1998), both share prices and the value of transactions registered a strong upswing, which, in spite of some fluctuations, persisted through August. The crisis that struck the Russian economy

CHART VI.3

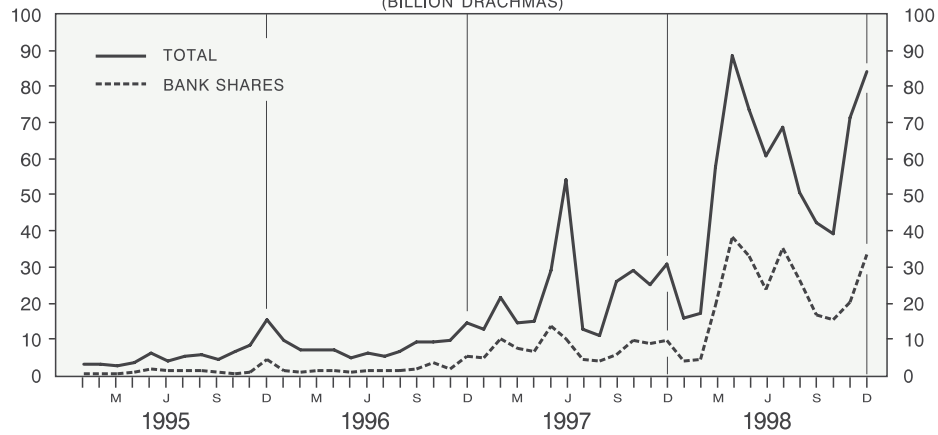
SHARE PRICE INDICES OF THE ATHENS STOCK EXCHANGE

(1980 = 100)



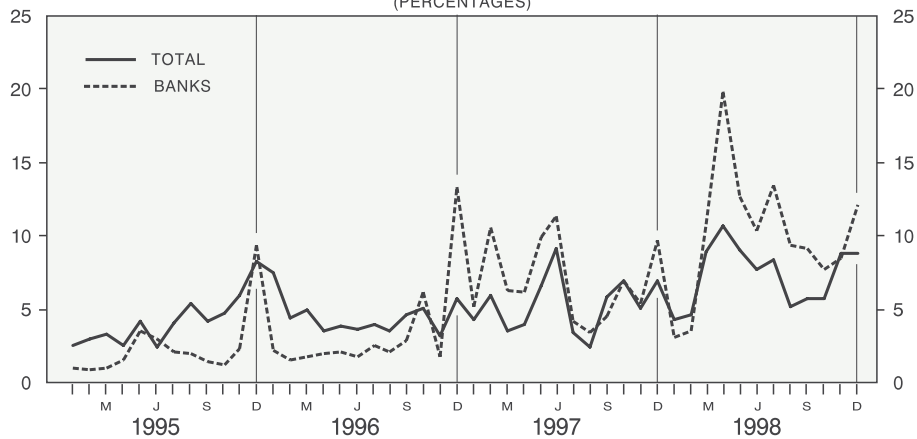
AVERAGE DAILY VALUE OF TRANSACTIONS

(BILLION DRACHMAS)



MONTHLY MARKETABILITY OF SHARES

(PERCENTAGES)



Source: Athens Stock Exchange and Bank of Greece.

at the end of August and adversely affected all stock markets had a similar effect on the Greek stock market, as reflected by the fall in all its aggregates from end-August to mid-October. Until end-1998, however, stock market aggregates made a significant recovery, which continued in the early months of 1999.

The composite share price index rose by 85 per cent from end-December 1997 to end-December 1998 and on average increased by 72 per cent over 1997 (see Table VI.2). The share price index dropped to its lowest level (1,380.1 points) on 29 January 1998 and peaked (2,825.5 points) on 21 July 1998. The value of transactions, after remaining relatively low from the beginning of January through mid-March, swung sharply upwards until end-April, declined from May to October, but then made an impressive comeback in the last two months of the year (see Chart VI.3). The average daily value of transactions in 1998 more than doubled, compared with 1997 (1998: 56.1 billion drachmas, 1997: 23.4 billion). The average monthly marketability of shares (number of shares traded to total number of shares listed) also increased, from 5.4 per cent in 1997 to 7.3 per cent in 1998 (see Chart VI.3).

Stock market developments were favourably affected, first and foremost, by the entry of the drachma into the ERM in March 1998 and by the prospects of Greece joining the euro area. Other beneficial factors were the downward trend of nominal interest rates, the rise in the profits of most listed firms and the drop in inflation, particularly in the last quarter of 1998.

The total value of stock market trading rose to 14,084 billion drachmas in 1998, from 5,802 billion in 1997 and 1,990 billion in 1996 (see Table VI.3). This development was largely due to the impressive increase in trading in shares of banks (192 per cent) and commercial and industrial firms (177 per cent), while trading in the shares of other sectors, except construction firms (–14 per cent), also rose significantly. A breakdown of the value of share trading by sector reveals that in 1998 the percentage accounted for by transactions in shares of banks, commercial and industrial firms and “other” firms, as well as in shares of the parallel market, increased. By contrast, the percentage of other sectors decreased (except for that of the leasing sector, which remained unchanged). This substantial growth of trading on the stock market was due to increased demand, both by institutional investors and savers. By way of example, it should be noted that the placements by mutual funds and portfolio investment companies in shares listed on the ASE rose to 867 billion drachmas at end-1998, from 402 billion at end-1997. Furthermore, according to available data, trading in shares by a number of large credit institutions both of the public and of the private sector was also high. Finally, increased trading was also carried out by foreign institutional investors, since, on the basis of available data, it is estimated that the net inflow of foreign funds was high in 1998, while a small net capital outflow had taken place in 1997.

The significant rise in share prices, combined with the listing of shares on the ASE both by new and by listed companies, led to an increase in the total market capitalisation of shares. More specifically, at end-1998, the market capitalisation of listed shares came

TABLE VI.2
STOCK MARKET AGGREGATES

Year	Share price indices ^{1,5} (1980 =100)		Average daily value of transactions ² (billion drachmas)	Market capitalisation ¹ (billion drachmas)			Market capitalisation (percentage of GDP)			Funds raised through the Athens Stock Exchange ⁴ (billion drachmas)		
	Composite	Banks		Shares	Bonds ³	Total	Shares	Bonds	Total	Listed companies	New companies	Total
1995	914.2	1,160.3	5.6	4,026	17,082	21,108	15	64	79	65	22	87
1996	933.5	1,413.8	8.0	5,945	17,535	23,480	20	59	79	42	93	135
1997	1,479.6	2,303.3	23.4	9,811	13,735	23,546	30	42	72	515	20	535
1998	2,737.6	5,799.4	56.1	22,839	22,801	45,640	64*	64*	128*	494	333	827

1 Year-end.

2 Shares.

3 Bonds comprise Greek Treasury bills and government bonds (drachma-denominated and with a foreign currency clause), bank bonds and corporate bonds.

4 Subscriptions to new capital are entered on the last day of the subscription period. Data for 1998 include private investments.

5 The indices are revised yearly.

* Provisional data.

Source: Athens Stock Exchange and Bank of Greece, as well as Ministry of National Economy (for GDP).

to 22,839 billion drachmas, compared with 9,811 billion in 1997 and 5,945 billion in 1996 (see Table VI.2). As a result, the market capitalisation of shares rose to 64 per cent of GDP in 1998, from 30 per cent in 1997 and 20 per cent in 1996. A breakdown by sector indicates that sharp rises in market capitalisation were recorded by banks (increase of 180 per cent to a level of 7,281 billion drachmas by end-1998), industrial firms (+105 per cent, to 5,976 billion), commercial firms (+197 per cent, to 1,827 billion drachmas) and telecommunications (+115 per cent, to 5,677 billion drachmas).

Recourse by firms to fund-raising from the stock market in order to finance investment projects and increase own funds was much higher than in 1997 (see Table VI.2). In particular, the total amount of funds raised through the stock market rose to 827 billion drachmas in 1998 (1997: 535 billion), with 51 already listed firms in 1998 (against 43 in 1997) accounting for 494 billion drachmas (1997: 515 billion drachmas) and 24 new firms (1997: 13) accounting for the remaining 333 billion (1997: 20 billion). 8 banks absorbed 210 billion drachmas, while 6 banks had raised a similar amount in 1997. Significantly high, also, was the recourse of industrial firms (1998: 175 billion drachmas, 1997: 55 billion drachmas) and investment companies (1998: 60 billion drachmas, 1997: 17 billion drachmas). Furthermore, the significant rise in fund-raising by new companies in 1998 was largely due to the amount of some 170 billion drachmas raised through the stock market by a private telecommunications company, while the number of industrial and commercial firms, as well as of passenger shipping companies, with listed shares on the ASE, also increased.

The rise in the composite share price index was mainly due to the increase in bank share prices and, to a lesser extent, to the rise in other share prices. From end-1997 to end-1998, bank share prices increased by 151.8 per cent and on average by 111 per cent. In the course of 1998, bank share prices fluctuated significantly, as reflected in the large difference between growth rates at the beginning and the end of the year and between average growth rates (see Chart VI.3). The average daily value of transactions in bank shares also rose impressively to 23 billion drachmas in 1998, from 2 billion in 1996 and 8 billion in 1997. In addition, the average monthly marketability of bank shares remained high, rising to 10.1 per cent in 1998 from 7 per cent in 1997 (see Chart VI.3). These stock market aggregates for the banking sector were, in addition to the general factors previously mentioned, favourably affected by the rise in profits from listed bank shares and by structural changes in the sector, which basically consisted of mergers and take-overs. More specifically, pre-tax profits of listed banks¹ increased by 58.3 per cent in 1998, i.e. faster than in 1997 (31.8 per cent). As for the structural changes that took place, three banks (two of which were under state control) with listed shares were taken over by private banks, while one state-controlled bank merged with another bank, which is also under state control.

Portfolio investment company share prices increased by 46.7 per cent between the end of 1997 and the end of 1998 and by 52 per cent on average. This was due to the sig-

1 Excluding Bank of Greece profits.

TABLE VI.3
VALUE AND STRUCTURE OF STOCK MARKET TRANSACTIONS
(Billion drachmas)

	1995		1996		1997		1998	
	Value of trans- actions	Percentage of total	Value of trans- actions	Percentage of total	Value of trans- actions	Percentage of total	Value of trans- actions	Percentage of total
Shares	1,408.5	99.8	1,989.9	99.8	5,802.0	99.7	14,083.6	99.1
Main market	1,257.7	89.1	1,817.5	91.1	5,540.3	95.2	13,322.5	93.7
– Banks	292.4	20.7	486.3	24.4	1,950.0	33.5	5,697.2	40.1
– Leasing	10.4	0.7	6.7	0.3	30.3	0.5	77.1	0.5
– Insurance	16.5	1.2	45.5	2.3	145.9	2.5	181.0	1.3
– Investment	29.3	2.1	34.0	1.7	127.9	2.2	241.5	1.7
– Construction	286.4	20.3	238.7	12.0	360.4	6.2	310.7	2.2
– Commercial and industrial	523.2	37.1	792.0	39.7	1,643.9	28.3	4,550.7	32.0
– Telecommunications	–	–	62.6 ²	3.1 ²	1,007.3	17.3	1,473.2	10.4
– Holdings	69.2	4.9	119.8	6.0	158.6	2.7	340.6	2.4
– Other	30.3	2.1	31.9	1.6	116.0	2.0	450.4	3.1
Parallel market	150.8	10.7	172.4	8.7	261.7	4.5	761.1	5.4
Bonds¹	2.2	0.2	3.2	0.2	18.5	0.3	128.4	0.9
T o t a l	1,410.7	100.0	1,993.1	100.0	5,820.5	100.0	14,212.0	100.0

1 Comprising Treasury bills and government bonds (drachma-denominated and with a foreign currency clause), bank bonds, corporate bonds and bonds of international organisations.

2 Value and percentage of total transactions for the period 19 April 1996 - 31 December 1997.

Source: Athens Stock Exchange.

nificant growth of these companies' profits, mainly because of the steep rise in share prices on the Greek and foreign stock exchanges. More specifically, portfolio investment company profits¹ increased at a very high rate (132 per cent) in 1997, which persisted through 1998 (122 per cent). In the last two years, these companies shifted their portfolio investments to shares listed on the ASE. These investments therefore accounted for 75 per cent of the total in 1998 (60 per cent at end-1996). The percentage of investments in foreign securities, on the other hand, decreased (1998: 6 per cent, 1996: 15 per cent).

Leasing company share prices rose by 32.3 per cent, compared with end-1997, and by 14.7 per cent on average. This relatively limited rise was due to the low (pre-tax) profitability of these companies in the past two years (1998/1997: 67 per cent, 1997/1996: -69 per cent).

Finally, industrial firms' share prices rose by 46.8 per cent, compared with the end of 1997, and by 55.5 per cent on average. This favourable outturn was due to the reasons mentioned above, particularly the high rate of increase (28 per cent) in pre-tax profits² of industrial firms in the first half of 1998. On the basis of published balance sheets, it is estimated that the growth rate of these firms' profits remained high throughout 1998. Among individual industries, the profits of textile, metallurgical, tobacco and wood product manufacturing companies registered sharp rises in the first half of 1998.

5. THE MUTUAL FUNDS MARKET

The value of mutual funds' assets rose by 1,748 billion drachmas (or 23.9 per cent) to 9,073 billion in 1998 (see Table VI.4), owing to an increase in both the prices and the number of units in circulation. Increased demand for mutual fund units was met primarily through units that were already on the market at the end of 1997 and, to a lesser extent, through the launching, in 1998, of a substantial number of new mutual funds. More specifically, 26 new mutual funds were established (8 of the money-market type, 6 of the bond type, 6 of the equity type and 6 of the balanced funds type). The total asset value of these new mutual funds amounted to 262 billion drachmas at end-1998, accounting for roughly 15 per cent of the rise in the asset value of all mutual funds. It should, nevertheless, be noted that 7 mutual funds (5 of the bond type and 2 balanced funds) ceased operating in 1998, while 14 mutual funds changed their investment scope. As a result of these developments, the total number of mutual funds stood at 181 at end-December 1998, compared with 162 in 1997 (see Table VI.4).

A breakdown of mutual fund aggregates by category of fund reveals that: first, the rise in total assets was primarily due to a corresponding increase (of 1,535 billion drachmas) in the assets of money-market funds and, to a lesser extent, to a rise in the assets of

1 After taxes and Board members' fees.

2 Manufacturing companies with shares listed on the main market of the ASE.

mutual funds of the equity, balanced and special type. By contrast, the assets of bond-type funds decreased by 309 billion drachmas. It should be stressed that this category of assets has been declining since November 1997, owing to the negative impact that the monetary turmoil of October 1997 had on the domestic market for Greek government securities (see Chart VI.4). Second, the impressive upswing, from mid-March 1998 onwards, in the prices of shares already listed on the ASE is largely responsible for the substantial increase in the

TABLE VI.4
MUTUAL FUNDS: NUMBER AND ASSETS
(Assets value in billion drachmas)

Type of mutual fund	1997 ¹		1998 ¹		Percentage of total assets	
	Number	Assets value	Number	Assets value	1997	1998
Money-market	35	4,451	44	5,986	60.8	66.0
Domestic	30	4,396	39	5,966	60.1	65.8
Foreign	3	3	2	1	—	—
International	2	52	3	19	0.7	0.2
Bond-type	66	2,013	67	1,704	27.5	18.8
Domestic	43	1,953	42	1,553	26.7	17.1
Foreign	14	53	13	105	0.7	1.2
International	9	7	12	46	0.1	0.5
Equity-type	34	240	41	494	3.3	5.4
Domestic	29	232	34	476	3.2	5.2
Foreign	3	6	4	12	0.1	0.1
International	2	2	3	6	—	0.1
Balanced	25	617	28	859	8.4	9.5
Domestic	20	591	20	754	8.0	8.4
Foreign	1	—	2	2	—	—
International	4	26	6	103	0.4	1.1
Special type	2	4	1	30	—	0.3
Domestic	1	2	—	—	—	—
Foreign	1	2	1	30	—	0.3
International	—	—	—	—	—	—
Total	162	7,325	181	9,073	100.0	100.0

¹ Year-end.

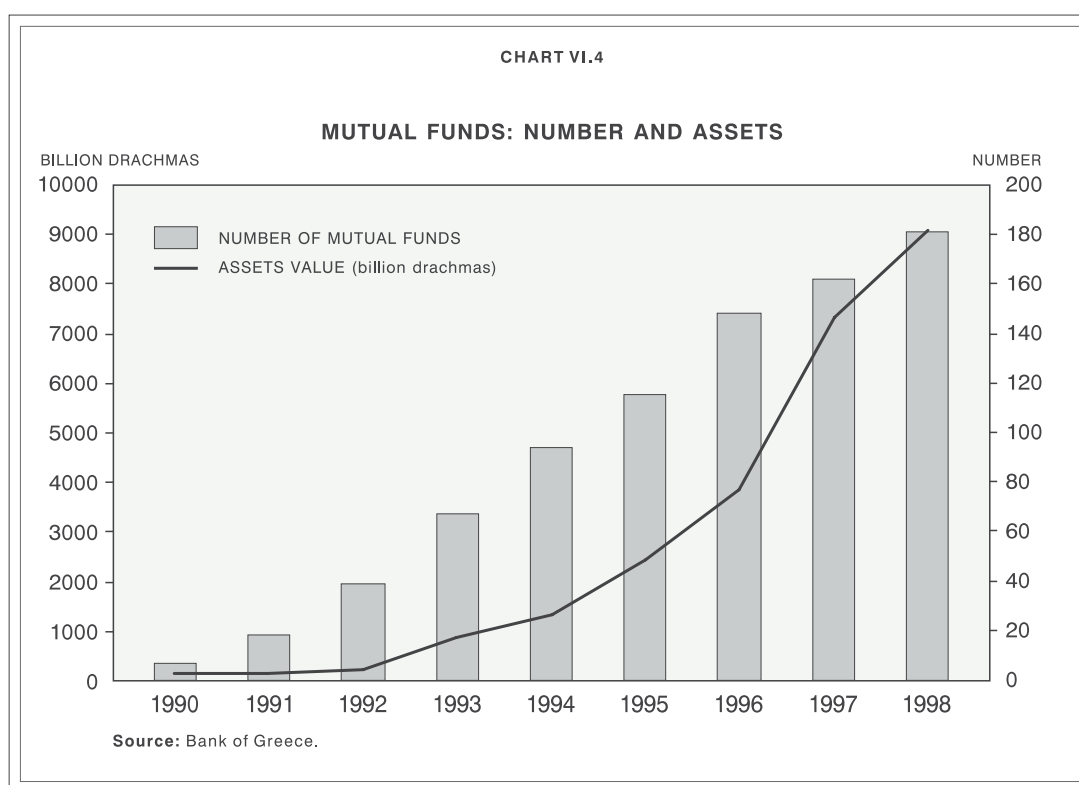
Source: Bank of Greece.

unit prices of mutual funds, particularly of the equity type as well as the balanced type. In contrast, the rise in the prices of bond and money-market fund units was restrained. Third, the strong demand, especially by small investors, for units of mutual funds of the equity and balanced types during 1998 led to an increase (of 106 per cent and 39 per cent, respectively) in the assets of these funds and in the share they represent in total mutual fund asset value (to 5.4 and 9.5 per cent at the end of 1998, from 3.3 and 8.4 per cent, respectively, in 1997). Finally, the share of total mutual fund assets accounted for by money-mar-

ket type funds rose to 66 per cent at end-1998 from 60.8 per cent in 1997. This shows that savers continued, to a large extent, to prefer mutual fund units that combine low yields and low risk (e.g. money-market funds).

The monetary turmoil caused by the Russian crisis at end-August 1998 is not considered to have had a negative impact on Greece's mutual fund market, since mutual funds assets, in particular those of money-market and bond types, were reinforced with capital flows which, even if only temporarily, shifted from the stock and the government securities markets during this crisis.

The investment pattern of mutual funds evolved somewhat differently in 1998 than the year before, with a stronger preference for investments in the Greek and foreign



money markets and in the stock market. More specifically, the increase of 1,748 billion drachmas in mutual fund assets in the twelve months to December 1998 (see Table VI.5) mainly stemmed from investment in securities with a repurchase agreement (repos) (691 billion drachmas), in synthetic currency swaps (606 billion), in shares (334 billion) and in drachma deposits (256 billion). On the other hand, investment in drachma-denominated government bonds (288 billion drachmas) decreased. The substantial rise in mutual-fund investments in repos was due to the abolition, in September 1998 (pursuant to paragraph 12, Article 10 of Law 2642/98), of the 15 per cent tax on income from repos (see paragraph 1, Article 12 of Law 2238/94). It is also worth noting that the substantial increase in drach-

ma deposits was mainly due to the rise in the drachma deposits of domestic balanced mutual funds, which is interpreted as an intention to restructure their investment portfolios. At end-1998, 37 per cent (1997: 49 per cent) of all mutual fund portfolios was made

TABLE VI.5
PORTFOLIO STRUCTURE OF MUTUAL FUNDS
(Billion drachmas)

	1997 ¹	1998 ¹	Change
Domestic investment	7,102	8,701	1,599
– Deposits and cash	153	409	256
– Repos	89	780	691
– Synthetic currency swaps	2,974	3,580	606
– Greek government bonds	3,603	3,315	–288
– Shares listed on the ASE	283	617	334
Foreign investment	74	205	131
Other	149	167	18
Total	7,325	9,073	1,748

1 At year-end.

Source: Bank of Greece.

up of Greek government securities, 40 per cent (1997: 41 per cent) of synthetic currency swaps, 9 per cent (1997: 1 per cent) of repos, 7 per cent (1997: 4 per cent) of shares listed on the ASE and the rest of other categories of investment.

VII. PUBLIC FINANCE

1. THE PUBLIC SECTOR BORROWING REQUIREMENT AND ITS FINANCING

The process of fiscal consolidation continued successfully in 1998. As a result, the general government deficit, on a national accounts basis, fell to 2.4 per cent of GDP, which was lower than the reference value (3 per cent) of the relevant convergence criterion laid down in the Maastricht Treaty. The progress made is also reflected in the reduction of the general government deficit, on both an accrual and a cash basis (see Table VII.1), as well as in the reduction of the debt-to-GDP ratio for the second consecutive year (see Section 2.4). As stipulated in the Treaty, this continuous decline in the debt-to-GDP ratio also satisfies the second fiscal criterion, i.e. the public debt criterion.

TABLE VII.1
GENERAL GOVERNMENT DEFICITS
(Percentage of GDP)

	1994	1995	1996	1997	1998*
General government					
National accounts data ¹ - <i>convergence criterion</i>	10.0	10.3	7.5	3.9	2.4
On an accrual basis ^{2,3}	10.1	8.5	7.0	5.4	3.1
Borrowing requirement (on a cash basis) ^{2,4}	9.4	9.0	10.2	6.8	5.1

1 Including public enterprises' and entities' debt assumed by central government.

2 Excluding capitalised interest.

3 Ministry of Finance and Bank of Greece data.

4 Including expenses for the acquisition of assets, which, according to the established international practice, are deducted from the two indicators mentioned above.

* Provisional data.

Source: Bank of Greece, Ministry of Finance and Ministry of National Economy – National Accounts Service.

According to national accounts data, the deficit of general government, which comprises central government, social security funds, local authorities (OTA) and other public entities (but not public enterprises), fell by 1.5 percentage points, from 3.9 per cent of GDP in 1997 to 2.4 per cent in 1998. This development meets the relevant criterion for joining Economic and Monetary Union as well as the target of the updated Convergence Programme. Based on national accounts data, this is the most representative and internationally comparable measure of the deficit; it is therefore uniformly compiled by all EU Member States, in order to assess the course of fiscal adjustment.

The second measure also covers general government, but is based on accrual data, as regards central government, and on estimates as regards the surplus of all social security funds and other public entities.

The general government borrowing requirement, as shown by cash flows to and from the banking system, declined also by 1.7 percentage points of GDP. It should be

pointed out that certain transactions are taken into account in the deficit on a national accounts or accrual basis (e.g., “expenditure for the acquisition of assets”), but are included in the borrowing requirement, which is therefore larger than the respective national accounts- and accrual-based deficit.

The public sector borrowing requirement

According to available provisional data, the net borrowing requirement of the public sector, on a cash basis (excluding capitalised interest), continued the downward trend of recent years and fell to 5.2 per cent of GDP, from 6.4 per cent in 1997 and 10.5 per cent in 1996 (see Table VII.2). This positive development was mainly due to the fact that, compared with 1997, the general government deficit as a percentage of GDP decreased by 1.3 percentage points, whereas the surplus of public entities grew by 0.5 percentage point. By contrast, public enterprises recorded a small deficit, compared with a surplus in 1997.

The central government borrowing requirement, as a percentage of GDP, fell from 7.9 per cent in 1997 to 6.6 per cent in 1998. This development was entirely due to the reduction of the ordinary budget borrowing requirement (3.4 per cent of GDP compared with 5.1 per cent in 1997). By contrast, both the cash deficit of the public investment budget and the deficit of special management accounts increased in comparison with 1998.

As already mentioned, the ordinary budget borrowing requirement declined by 1.7 percentage points, a fact attributed to the particularly positive course of revenue, which for the first time in years overshot budget forecasts, in spite of cuts in indirect taxation in autumn (e.g. reduction in liquid fuel tax rates, special consumption tax on cars etc.). By contrast, ordinary budget expenditure showed a small overrun compared with budget forecasts. Lastly, it should be noted that, on a cash basis, 1998 expenditure included interest payments of 205 billion drachmas outstanding from 1997, while corresponding 1998 expenditure, paid in 1999, amounted to 118 billion drachmas. Thus, the net burden for 1998 was 87 billion drachmas.

The borrowing requirement of the public investment budget (PIB), as a percentage of GDP, increased slightly compared with the previous year (1998: 3.0 per cent, 1997: 2.7 per cent). This widening of the deficit is attributable to the considerable growth of payments for large-scale projects underway and it would have been larger if expenditure had not been contained and revenue¹ had not been higher than budget forecasts. Lastly, it should be noted that public investment expenditure also includes payments amounting to 487 billion drachmas for increases in the share capital of public enterprises (i.e. “acquisition of financial assets”).

The net borrowing requirement of the special management accounts of the State (DIDAGEP) also increased from 25 billion drachmas in 1997 to 80 billion in 1998.

¹ Higher than forecast PIB revenue (calculated by the EU in ECU) resulted from the devaluation of the drachma.

TABLE VII.2
PUBLIC SECTOR NET BORROWING REQUIREMENT
(Billion drachmas)

	1993	1994	1995	1996	1997	1998*
1. Central government ¹	2,709.4	2,762.2	2,964.9	3,690.9	2,584.7	2,357.0
Percentage of GDP	12.8	11.5	11.0	12.4	7.9	6.6
– Government budget	2,581.4	2,716.8	2,909.6	3,676.9	2,559.7	2,277.0
(Ordinary budget)	(2,145.6)	(2,153.1)	(2,328.8)	(2,990.7)	(1,663.6)	(1,210.0)
(Public investment budget)	(435.8)	(563.7)	(580.8)	(686.2)	(896.1)	(1,067.0)
– Special management accounts of the State	128.0	45.4	55.3	14.0	25.0	80.0
(Oil account)	(1.1)	(–)	(–)	(–)	(–)	(–)
(DIDAGEP** etc.)	(126.9)	(45.4)	(55.3)	(14.0)	(25.0)	(80.0)
2. Public entities ²	–295.0	–516.5	–546.4	–647.4	–345.3	–535.0
Percentage of GDP	–1.4	–2.2	–2.0	–2.2	–1.0	–1.5
– Financing of social security funds	26.2	–28.5	22.0	12.2	2.2	–11.5
– Financing of local authorities	10.1	8.2	7.3	31.0	5.9	–8.0
– Financing of other entities	66.6	48.1	12.6	–47.5	–23.3	–20.5
– Liquid assets	–397.9	–544.3	–588.3	–643.1	–330.1	–495.0
General government (1+2)	2,414.4	2,245.7	2,418.5	3,043.5	2,239.4	1,822.0
Percentage of GDP	11.4	9.4	9.0	10.2	6.8	5.1
3. Public enterprises	–6.4	204.8	–0.7	83.5	–132.6	35.0
Percentage of GDP	0.0	0.9	0.0	0.3	–0.4	0.1
– Financing of public utilities	80.6	129.6	–7.2	57.5	–115.6	30.0
– Financing of other enterprises	–61.8	–2.3	–2.9	15.7	18.4	10.0
– Liquid assets	–25.2	77.5	9.4	10.3	–35.4	–5.0
Public sector (1+2+3)	2,408.0	2,450.5	2,417.8	3,127.0	2,106.8	1,857.0
Percentage of GDP	11.4	10.2	9.0	10.5	6.4	5.2
Public sector (including capitalised interest)	2,768.4	2,710.6³	2,502.1⁴	3,306.0	2,141.8	1,882.0
Percentage of GDP	13.1	11.3	9.3	11.1	6.5	5.3

1 Results from the respective accounts with the Bank of Greece, the Agricultural Bank and commercial banks.

2 Estimates on the basis of their investment in securities and bank deposits and the change in their liabilities to the banking system.

3 Including 129 billion drachmas of accrued interest.

4 To prevent double reckoning, 129 billion drachmas of accrued interest, which were paid in 1995 but appear in the results of 1994, have been deducted (see footnote 3).

* Provisional data.

** Agricultural Markets Management Service.

Source: Bank of Greece.

TABLE VII.3
SOURCES OF FINANCING THE PUBLIC SECTOR BORROWING REQUIREMENT
(Billion drachmas)

	1993		1994		1995		1996		1997		1998*	
	Amount	Percentage of total	Amount	Percentage of total	Amount	Percentage of total	Amount	Percentage of total	Amount	Percentage of total	Amount	Percentage of total
BORROWING IN DRACHMAS	1,643.4	68.2	2,160.6	88.2	1,954.5	80.8	2,834.0	90.6	967.0	45.9	-41.0	-2.2
– Treasury bills and bonds purchased by banks and specialised credit institutions	394.5	16.4	450.2	18.4	327.4 ¹	13.5	-168.0 ¹	-5.4	94.4 ¹	4.4	-677.0 ¹	-36.5
– Treasury bills and bonds purchased by domestic non-bank sector	1,031.5	42.8	1,621.6	66.2	2,088.0 ¹	86.4	3,113.0 ¹	99.6	650.0 ¹	30.8	160.0 ¹	8.6
– Loans and advances from specialised credit institutions and commercial banks	237.8	9.9	74.1	3.0	-22.9	-0.9	41.0	1.3	-4.0	-0.1	278.0	15.0
– Bank of Greece ²	-20.4	-0.8	14.7	0.6	-438.0	-18.1	-152.0	-4.9	226.6	10.8	198.0	10.7
BORROWING IN FOREIGN CURRENCY³	764.6	31.8	289.9	11.8	463.3	19.2	293.0	9.4	1,139.9	54.1	1,898.0	102.2
TOTAL BORROWING	2,408.0	100.0	2,450.5	100.0	2,417.8	100.0	3,127.0	100.0	2,106.9	100.0	1,857.0	100.0

1 Sales of securities also in the secondary market.

2 As from 1 January 1994, the respective figure no longer concerns financing by the Bank of Greece but changes in the credit balance of the government's cash account with the Bank.

3 Including purchases of drachma-denominated government securities by non-residents, which were largely financed by Greek banks.

* Provisional data.

Source: Bank of Greece.

The cash surplus of public entities rose by 0.5 percentage point of GDP (1998: 1.5 per cent, 1997: 1.0 per cent). This development is attributable both to the restrained rate of increase in operating expenditure of the major social security and welfare funds (Social Insurance Fund–IKA, Farmers’ Insurance Fund–OGA, Seamen’s Pension Fund–NAT), owing to the tight incomes policy (pensions rose slightly above inflation) and the curtailment of medical expenses (list of “approved” medicines, etc.), as well as to the effort to increase revenue (curbing of contribution evasion).

By contrast, public enterprises recorded a small cash deficit of 35 billion drachmas in 1998, compared with a surplus of 133 billion drachmas in 1997. This development is associated with the increase in investment expenditure and the considerably lower rate of increase in revenue, compared with the previous year, despite the higher rates of increase in revenue of the two major enterprises, the Hellenic Telecommunications Organisation–OTE and the Public Power Corporation–DEH.

Net PSBR financing (see Table VII.3) evolved smoothly and allowed a drop in interest rates during the year, with the exception of a very short period (late August–early September) owing to the Russian crisis. As in 1997, net PSBR was financed mainly by the issue of medium- and long-term drachma-denominated fixed-interest-rate bonds, a large part of which was purchased by non-residents, using drachmas borrowed from Greek banks. Given that the acquisition of government paper by non-residents is registered as foreign borrowing (see Table VII.3), the latter appears to have financed the entire PSBR, whereas debts were actually repaid in drachmas. It should also be recalled that between autumn 1997 and mid-March 1998, the State had turned to foreign borrowing, mainly owing to high domestic interest rates. Financing of a large part of the deficit by non-residents, by borrowing from Greek banks, contributed to the creation of liquidity in the economy and significantly affected the conduct of monetary policy.

Increased demand for bonds by non-residents also allowed a decline of 677 billion drachmas in government paper (Treasury bills and bonds) held by domestic credit institutions.

The effort to prolong the average maturity of public debt continued in the course of 1998, with the substitution of long-term bonds for Treasury bills. Thus, at end-1998 average maturity increased to 5-6 years, while Treasury bills fell to 5,314 billion drachmas, from 6,800 billion in 1997 and 10,012 billion in 1996.

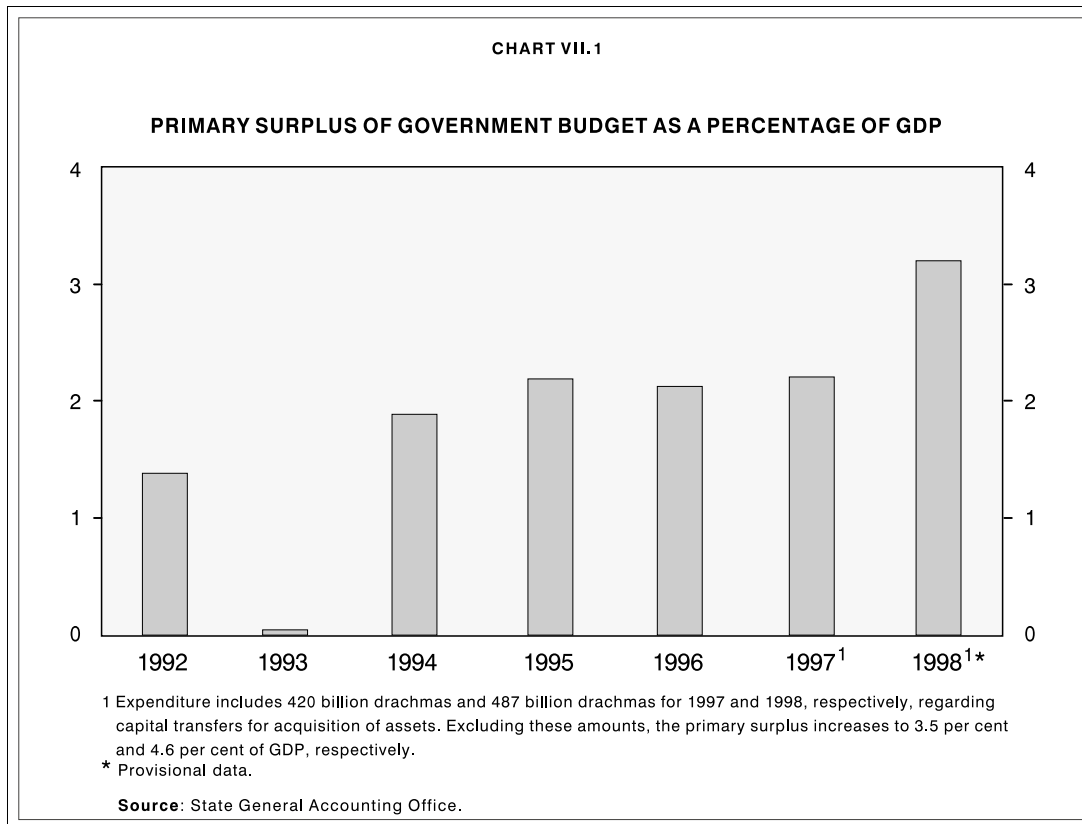
Finally, to finance part of its borrowing requirement, the State drew 198 billion drachmas out of its deposits with the Bank of Greece.

2. FISCAL AGGREGATES

2.1 *The central government budget*

According to provisional data from the State General Accounting Office, the net deficit of the government budget decreased to 5.9 per cent of GDP in 1998, from 7.6 per cent in 1997 and 9.7 per cent in 1996 (see Table VII.9). For the first time in 1998, the fall

in the deficit exceeded budget forecasts by 0.1 percentage point of GDP. This is attributable to increased government budget receipts, as well as to the curtailment of public investment budget expenditure, which offset overruns recorded in ordinary budget outlays.



The increase in government budget revenue beyond relevant forecasts, in conjunction with overruns in interest payments, raised the primary surplus to 3.2 per cent of GDP, compared with 2.2 per cent in 1997 and 2.1 per cent in 1996 (see Chart VII.1). The primary surplus of the government budget is larger by 0.2 percentage point than that forecast in the 1998 budget.

Revenue

Ordinary budget revenue (see Table VII.4) increased by 12.2 per cent, compared with 14.7 per cent in 1997, and amounted to 9,500 billion drachmas, exceeding relevant budget forecasts by 124 billion drachmas. This favourable development is entirely attributable to the increased yield of direct taxes (26.6 per cent rise instead of the budget target of 12.4 per cent). By contrast, indirect tax revenue and non-tax revenue recorded a short-fall. The satisfactory course of ordinary budget revenue in 1998 was determined mainly by:

(i) tax reforms in 1998, chiefly those associated with the withholding and advance payment of income tax, (ii) economic developments in 1998, notably the increased car sales and the very large increase in stock market transactions, following the devaluation of the drachma, and (iii) increased revenue from profits of public entities in which the State participates (e.g. Bank of Greece, OTE etc.). By contrast, certain indirect taxes were reduced in autumn 1998, leading to a 30 billion drachma loss in respective revenue.

Specifically, direct tax revenue rose by 26.6 per cent (19.5 per cent in 1997 and 8.6 per cent in 1996), amounting to 3,501.9 billion drachmas. This rate was higher than the budget target (12.4 per cent) and the nominal GDP growth rate (8.9 per cent). The result of this development was that the share of indirect tax revenue in total tax revenue came closer to that of the other EU countries and was 40.3 per cent (or 9.8 per cent of GDP), compared with 36.4 per cent in 1997 and 35 per cent in 1996. As mentioned above, this favourable development was associated with structural changes in income tax collection, the higher rate of tax withholding at source, certain increased rates in corporate income tax (Law 2579/98), as well as greater efforts to curb tax evasion.

Revenue from personal income tax rose by 19.9 per cent, compared with 27.3 per cent in 1997, and reached 1,555.1 billion drachmas, overshooting the budget forecast of 1,377 billion drachmas by 178 billion drachmas. This favourable development resulted from: (i) the increase in the income tax withheld from wage earners and pensioners (1998: 38.2 per cent, 1997: 30.5 per cent), which from the beginning of 1998 is calculated on the basis of the tax scale, just as before 1992, (ii) increased withholding due to the rise in pensioners' and civil servants' income (personnel outlays rose by 9.9 per cent in 1998, compared with a budgeted 2.9 per cent, due to the introduction of new pay scales for certain categories of employees and the payment of arrears to pensioners), (iii) the reduction, from 5 per cent to 2.5 per cent, of the discount for timely payment of tax, (iv) the imposition of withholding with 5 to 15 per cent rates on pensions granted by supplementary insurance funds, (v) the rise from 15 per cent to 20 per cent in the tax withholding from the self-employed, (vi) the increase from 50 per cent to 55 per cent in the "advance payment" based on the 1998 tax, (vii) the increase of about 10 per cent in certain indicators of imputed income such as cars, yachts etc., and viii) the change in the way imputed income from owner-occupied dwellings is calculated (Law 2579/98). It should also be noted that, from 1st January 1998, tax withheld by firms is paid to internal revenue offices every two months instead of three, as was done until the end of 1997. As a result of this last change, revenue from tax withholding in 1998 represented a 13 months' yield instead of the usual 12 months' yield. By contrast, revenue from personal income tax was negatively affected by the indexation of the tax scale for 1997 incomes by 5.5 per cent and the transfer of two categories of revenue from personal income tax to corporate income tax.

From the above it is evident that a large part of the increase in income tax revenue was due to the fact that revenue was "carried forward" by one year *ad infinitum*. This holds in the majority of the above cases, as well as for the payment of tax withheld every two

TABLE VII.4
ORDINARY BUDGET REVENUE
(Billion drachmas)

	Annual aggregates				Percentage changes		
	1995	1996	1997	1998*	1996/95	1997/96	1998*/97
I. DIRECT TAXES	2,132.7	2,316.1	2,767.1	3,501.9	8.6	19.5	26.6
1. Income tax	1,655.9	1,886.4	2,300.3	2,994.3	13.9	21.9	30.2
– Personal	861.1	1,018.9	1,297.5	1,555.1	18.3	27.3	19.9
– Corporate	459.7	522.1	641.8	1,008.5	13.6	22.9	57.1
– Special categories of income tax	335.1	345.4	361.0	430.7	3.1	4.5	19.3
(tax on shipping)	(4.2)	(4.2)	(4.2)	(6.3)	(0.0)	(0.0)	(50.0)
(tax on deposit interest income)	(289.5)	(294.2)	(305.6)	(362.4)	(1.6)	(3.9)	(18.6)
2. Wealth taxes	80.0	78.9	123.8	126.5	–1.4	56.9	2.2
3. Direct taxes collected on behalf of third parties	2.1	2.1	1.4	1.7	0.0	–33.3	21.4
4. Tax arrears	224.2	151.4	120.0	138.2	–32.5	–20.7	15.2
5. Extraordinary and other direct taxes	170.5	197.3	221.6	241.2	15.7	12.3	8.8
II. INDIRECT TAXES	3,834.9	4,299.9	4,833.9	5,182.4	12.1	12.4	7.2
1. Customs duties and special contributions on imports-exports	52.0	51.6	58.8	64.2	–0.8	14.0	9.2
2. Consumption taxes on imports	325.3	360.8	439.3	490.6	10.9	21.8	11.7
– VAT (non-EU imports)	222.1	239.4	302.5	319.2	7.8	26.4	5.5
– Cars	92.6	111.1	123.5	158.9	20.0	11.2	28.7
– Special consumption tax	8.2	8.1	11.4	11.2	–1.2	40.7	–1.8
– Other taxes on imports	2.4	2.2	1.9	1.3	–8.3	–13.6	–31.6
3. Consumption taxes on domestic products	3,067.7	3,430.2	3,776.2	4,038.5	11.8	10.1	6.9
– Turnover tax	31.6	39.3	39.9	45.0	24.4	1.5	12.8
– VAT	1,710.9	1,914.6	2,146.0	2,370.0	11.9	12.1	10.4
– Fuels	757.6	834.5	849.0	840.9	10.2	1.7	–1.0
– Tobacco	372.0	405.5	458.6	513.0	9.0	13.1	11.9
– Road duties	76.0	80.4	97.8	90.2	5.8	21.6	–7.8
– Special levies and contributions on cars	56.6	69.5	77.3	78.3	22.8	11.2	1.3
– Other ¹	63.0	86.4	107.6	101.1	37.1	24.5	–6.0
4. Transaction taxes	329.2	391.0	475.1	518.0	18.8	21.5	9.0
– Capital transfers	93.7	107.2	163.0	166.8	14.4	52.1	2.3
– Stamp duties	194.3	234.6	259.1	289.5	20.7	10.4	11.7
– Banking transactions	41.2	49.2	47.7	46.5	19.4	–3.0	–2.5
– Licence fees for gambling			5.3	15.2			186.8
5. Other indirect taxes	60.7	66.3	84.5	71.1	9.2	27.5	–15.9
III. TOTAL TAX REVENUE	5,967.6	6,616.0	7,601.0	8,684.3	10.9	14.9	14.3
Non-tax revenue (revenue from privatisation)	760.2 (21.0)	768.1 (–)	866.4 (–)	815.7 (–)	1.0 (–)	12.8 (–)	–5.9 (–)
IV. TOTAL ORDINARY BUDGET REVENUE	6,727.8	7,384.1	8,467.4	9,500.0	9.8	14.7	12.2

1 Including the special consumption tax on domestic products.

* Provisional data.

Source: Ministry of Finance, State General Accounting Office.

months instead of the previous three. As a result of the latter measure only, revenue increased by about 75 billion drachmas.

Revenue from corporate income tax increased by 57.1 per cent, compared with 22.9 per cent in 1997, and reached 1,008.5 billion drachmas, overshooting the budget forecast of 801 billion drachmas by 207 billion drachmas. This positive development is attributable to: (i) the transfer of two categories of revenue from personal income tax to corporate income tax, (ii) the raising from 0.2 per cent to 0.3 per cent of tax on the net assets of mutual funds management companies, (iii) the one-off 17.5 per cent tax on 40 per cent of tax-free reserves of banks and other corporations, (iv) the 40 per cent tax (instead of 35 per cent) on sociétés anonymes with registered shares not listed on the Athens Stock Exchange, (v) the increase in the advance payment of tax by corporations from 50 to 55 per cent and, exceptionally, by banks to 60 per cent, and (vi) the increased profits of most firms. Finally, as in previous years, the tax paid by OTE under this category was increased, amounting to 17.6 per cent of corporate income tax receipts.

As in the case of personal income tax, many of the above increases in revenue from corporate income tax led to the “carrying forward” of revenue by one year.

As a result of this rearrangement, revenue from personal and corporate income tax in 1999 is projected to decline by 6.0 per cent compared with 1998. In particular, personal income tax receipts will be 7.3 per cent less than in 1998. Overall, positive deviations in income tax receipts in 1998 totalled 393 billion drachmas or 15.1 per cent of the budgeted amount, which was a high overrun, considering that most of the above measures were known when the 1998 budget was being drawn up.

Revenue from the taxation of interest income increased by 18.6 per cent, compared with 3.9 per cent in 1997, and reached 362.4 billion drachmas. Revenue under this category was favourably influenced by: (i) the increase from 7.5 to 10 per cent in the tax rate on the yield of government paper, (ii) the abolition of tax exemption of interest on deposits in drachmas convertible into foreign currency, as well as of interest on deposit accounts of non-residents in drachmas, and (iii) the increase, although limited, in deposits with commercial banks.

Revenue from taxes on inheritances, gifts and parental donations recorded a small increase of 2.2 per cent, compared with an increase of 56.9 per cent in 1997. This development was partly expected since, following an announcement that the “objective” prices of real estate would be raised as from 1 January 1998, gifts and parental donations increased considerably in the last months of 1997. On the other hand, this category of revenue has been favourably influenced by the tax levied on large real estate.

Revenue from “direct-tax arrears” increased by 15.2 per cent, compared with a decrease in the previous two years. The increase is attributable to the collection of assessed tax arrears by the State under Law 2648/98, as well as to more efficient tax controls by the Ministry of Finance during 1998. Finally, “other direct tax” revenue, which includes civil servants’ social security contributions, increased by 8.8 per cent, compared with 12.3 per cent in 1997. This development was due mainly to the payment of retro-

spective pensions, which had an incremental effect on personnel outlays, but not on social security contributions.

Revenue from indirect taxes rose by 7.2 per cent and totalled 5,182.4 billion drachmas, compared with a budget forecast of 5,397 billion. The growth rate of indirect tax receipts was not only lower than in the previous two years (1997: 12.4 per cent, 1996: 12.1 per cent), but also fell short of the budget target by 4 percentage points. This development corresponds to an income “elasticity” of revenue less than unity, following the satisfactory values recorded in the previous years (1998: 0.81, 1997: 1.20, 1996: 1.15). This was partly due to the reduction of the special consumption tax on liquid fuels and cars in autumn 1998, which led to a revenue loss of about 30 billion drachmas. But even if this revenue is added, elasticity increases to 0.88, which is still well below unity. Moreover, if the greatly increased yield from the tax on stock market transactions is taken into account, which is a new tax and should not be considered, then income elasticity drops to 0.80.

The shortfall of about 215 billion drachmas in revenue from indirect taxes, along with the greatly increased yield of 391 billion drachmas from direct taxes, implies that the generally good course of revenue is mainly due to the measures taken in connection with direct taxation, and not to the considerable containment of tax evasion.

Revenue from VAT on imports from non-EU countries increased by 5.5 per cent, compared with 26.4 per cent in 1997. This is attributable to the small increase in imports from third countries, as well as to some of the cuts in special consumption taxes in autumn 1998, to the extent that the respective products came from third countries.

The rate of increase in revenue from the special consumption tax on passenger cars accelerated to 28.7 per cent in 1998, from 11.2 per cent in 1997. Revenue in this category was influenced positively by the increase in car sales and negatively by the reduction in the total tax burden (special consumption tax plus registration levy) on cars in the last two months of 1998. The “other consumption taxes” on imports fell, as the special consumption tax on bananas was abolished on 21 September 1998.

Revenue from VAT on domestic goods, including VAT on imports from EU countries, increased by 10.4 per cent (1997: 12.1 per cent, 1996: 11.9 per cent) and totalled 2,370 billion drachmas. This rate was not only lower than in previous years, but also fell 3 percentage points short of the budget target. Revenue under this category was influenced positively by the increase in economic activity (3.7 per cent growth of real GDP) and negatively by the reduction in special consumption taxes on cars and fuels and the smaller than in 1997 rise in the drachma value of imports from EU countries.

Receipts from the special consumption tax on liquid fuels decreased by 1 per cent, compared with an increase of 1.7 per cent in 1997 and 10.2 per cent in 1996. This fall is attributable to the reduction of the special consumption tax in the last quarter of 1998 in all categories of liquid fuels (except diesel), including heating oil, as well as to the favourable weather conditions that prevailed in the country both in the early months and in autumn 1998, leading to a drop in heating oil consumption. It should be noted that,

after the latest arrangements, the difference in the special consumption tax between heating oil and diesel oil amounts to 61 drachmas per litre (about 90 drachmas in the retail price), a development that requires close monitoring of the two fuels to secure the distinction between the two uses.

Revenue from tobacco tax grew by 11.9 per cent, compared with 13.1 per cent in 1997 and 9.0 per cent in 1996. This was mainly due to an increase of 5.3 per cent in tobacco consumption in 1998.

Revenue from road duties fell by 7.8 per cent, compared with a rise of 21.6 per cent in 1997. The decline was due to the fact that 1998 revenue comprised duties collected only in December 1998, whereas in 1997 almost the whole amount of receipts from road duties was included in that year's revenue.

Revenue from capital transfer taxes (mainly real estate transfers) increased by 2.3 per cent, compared with 52.1 per cent in 1997 and 14.4 per cent in 1996. Receipts in this category were negatively influenced by increased payments of this tax in 1997, which was due to the hastening of transfers pending the adjustment of the "objective" prices of real estate as from 1 January 1998. As from the same date, this category includes revenue from the 0.3 per cent tax levied on stock market transactions. Revenue from this source amounted to about 43 billion drachmas, compared with a budget forecast of 10 billion.

Revenue from stamp duties increased by 11.7 per cent, compared with 10.4 per cent in 1997, and reached 289.5 billion drachmas. This category of revenue was influenced by the increase in certain stamp duties (Law 2579/98) and the duty imposed on mobile telephony, while receipts from stamp duty on rents decreased.

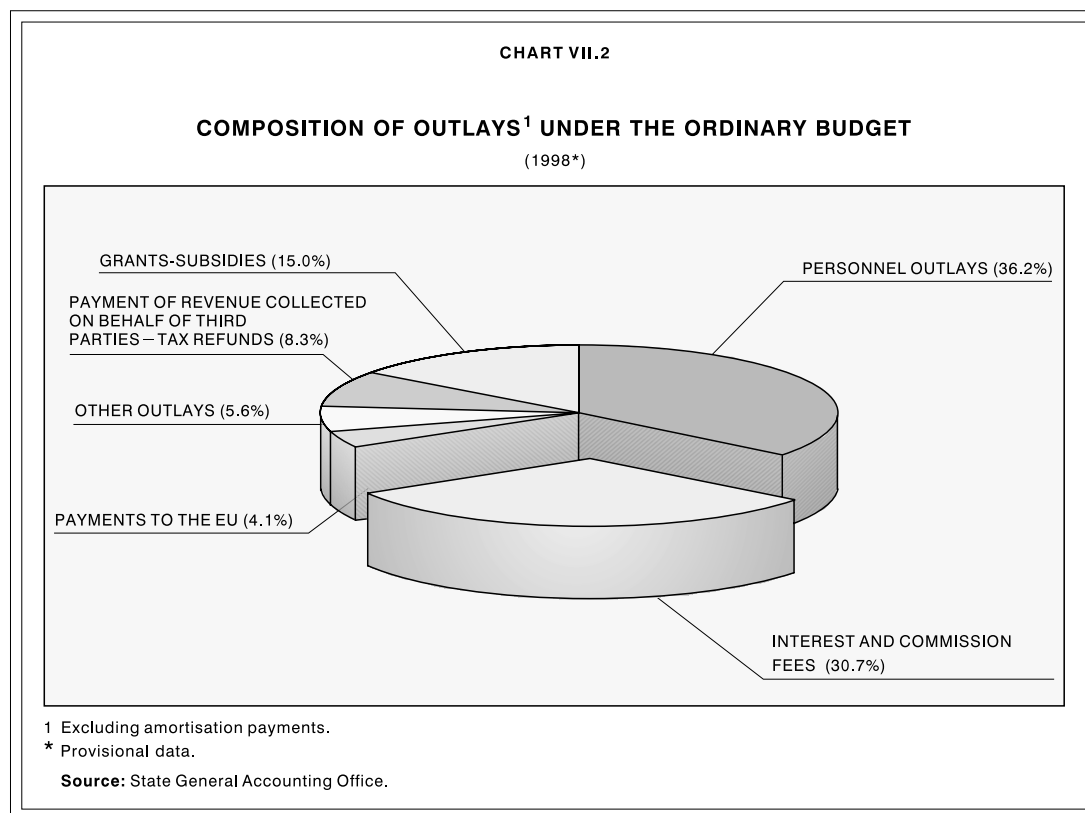
Revenue from the special tax on bank transactions (EFTE) fell by 2.5 per cent (1997: -3.0 per cent), as the tax rate was cut from 4 to 3 per cent on 1 September 1997 (Law 2515/97) and interest rates were gradually reduced.

Finally, in 1998 non-tax revenue fell by 5.9 per cent and amounted to 815.7 billion drachmas, in contrast to 1997 when, owing to the inclusion of new categories in non-tax revenue, there was an increase of 12.8 per cent. Revenue in this category was negatively affected once again by a considerable delay in inflows from the EU Social Fund. Specifically, receipts from the EU amounted to 31.9 billion drachmas, i.e. less than half the budget forecast. Consequently, the share of non-tax revenue in total ordinary budget revenue fell to 8.6 per cent, compared with 10.2 per cent in 1997. As in previous years, non-tax revenue was favourably influenced by the receipt of a dividend from the profits of the Bank of Greece (94.5 billion drachmas compared with 31.2 billion drachmas in 1997) and OTE (74.5 billion drachmas), the receipt of 65 per cent of the profits of the Postal Savings Bank (27 billion drachmas), and the share of the government in the profits of the Deposits and Loans Fund (23 billion drachmas).

Revenue under the public investment budget increased by 27.2 per cent, compared with 26.5 per cent in 1997 and 64.7 per cent in 1996, and reached 913 billion drachmas. This revenue overshot budget forecasts by 23 billion drachmas, owing to the devaluation of the drachma, as EU budget appropriations were expressed in ECU and not in drachmas.

Expenditure

The execution of the 1998 budget would have been more successful if expenditure had not exceeded relevant forecasts. Specifically, ordinary budget expenditure in 1998 rose by 5.8 per cent compared with the previous year and amounted to 10,647 billion drachmas, whereas the budget had forecast a rise of 3.6 per cent and expenditure amounting to 10,424 billion drachmas. The 223 billion overrun in ordinary budget expenditure was offset partly by curtailing public investment budget outlays and partly by extra rev-



enue. However, despite the overrun, government budget expenditure was limited to 35.1 per cent of GDP, compared with 35.7 per cent in 1997 and 36.4 per cent in 1996.

The overrun was recorded mainly in primary expenditure, with only 24 per cent being due to interest payments. Since the overrun was caused partly by unforeseen factors, e.g. the devaluation, there was no way to prevent it.

The largest category of expenditure, personnel outlays, increased by 9.9 per cent, compared with 15.7 per cent in 1997, and amounted to 3,859 billion drachmas. Despite the deceleration of the rate of increase, personnel outlays recorded for the fourth consecutive year an overrun of 207 billion drachmas compared with budget forecasts (see Chart VII.3). Consequently, personnel outlays rose by 70.1 per cent in the four-year period

TABLE VII.5
OUTLAYS UNDER THE ORDINARY BUDGET AND THE PUBLIC INVESTMENT BUDGET
(Billion drachmas)

	Annual aggregates				Percentage changes		
	1995	1996	1997	1998*	1996/95	1997/96	1998*/97
I. OUTLAYS UNDER THE ORDINARY BUDGET ^{1,2}	8,879.6	9,727.4	10,064.3	10,647.0	9.5	3.5	5.8
1. Personnel outlays ²	2,563.5	3,035.2	3,512.8	3,859.0	18.4	15.7	9.9
2. Interest payments ³ (interest payments related to the national defence debt) ⁴	3,355.8	3,501.1	3,216.2	3,273.0	4.3	-8.1	1.8
3. Payments to the European Union	311.9	355.1	376.8	434.0	13.8	6.1	15.2
4. Payment of revenue collected on behalf of third parties	455.6	470.1	508.2	608.7	3.2	8.1	19.8
5. Tax refunds	235.7	306.4	291.1	272.0	30.0	-5.0	-6.6
6. Interest rate subsidies	19.1	19.6	20.4	3.0	2.7	4.0	-85.3
7. Subsidies to farmers ⁵	147.7	176.2	126.1	101.0	19.3	-28.5	-19.9
8. Grants ⁶	1,254.0	1,455.7	1,445.4	1,495.3	16.1	-0.7	3.5
9. Guarantees	39.4	2.0	1.1	1.0	-94.9	-42.9	-12.4
10. Other ⁷	496.8	486.5	566.2	600.0	-2.1	16.4	6.0
Minus allowances not included in the budget		80.5					
II. OUTLAYS UNDER THE PUBLIC INVESTMENT BUDGET	962.0	1,095.0	1,626.5	1,881.0	13.8	48.5	15.7
1. Project implementation	704.3	715.4	664.0	739.0	1.6	-7.2	11.3
2. Grants	253.7	369.6	953.0	1,130.0	45.7	157.8	18.6
3. Administration	4.1	10.0	10.0	12.0	146.5	0.0	20.0
III. TOTAL I + II	9,841.6	10,822.4	11,690.8	12,528.0	10.0	8.0	7.2
a. Primary expenditure under the government budget	6,485.8	7,321.3	8,474.6	9,255.0	12.9	15.8	9.2
b. Primary expenditure under the ordinary budget	5,523.8	6,226.3	6,848.2	7,374.0	12.7	10.0	7.7
Amortisation payments (amortisation payments related to the national defence debt) ⁴	2,773.5	3,638.2	3,589.4	3,472.0	31.2	-1.3	-3.3
	(58.8)	(121.0)	(124.0)	(236.0)	(105.6)	(2.5)	(90.3)

1 Excluding amortisation payments.

2 Excluding an amount of 50 billion drachmas for the year 1995, which represented allowances paid to certain categories of civil servants from sources not included in the ordinary budget. By contrast, 1996 includes an amount of 80.5 billion drachmas.

3 Including "other expenditure" related to public debt servicing.

4 As of 1994, this category includes only interest and amortisation payments which continue to be effected by the Ministry of National Defence. Interest and amortisation payments related to the national defence debt and taken over by the Ministry of Finance are included in the main categories of the corresponding items.

5 Including expenditure for investment projects of the ordinary budget (1996: 82.8 billion drachmas, 1997: 7.9 billion).

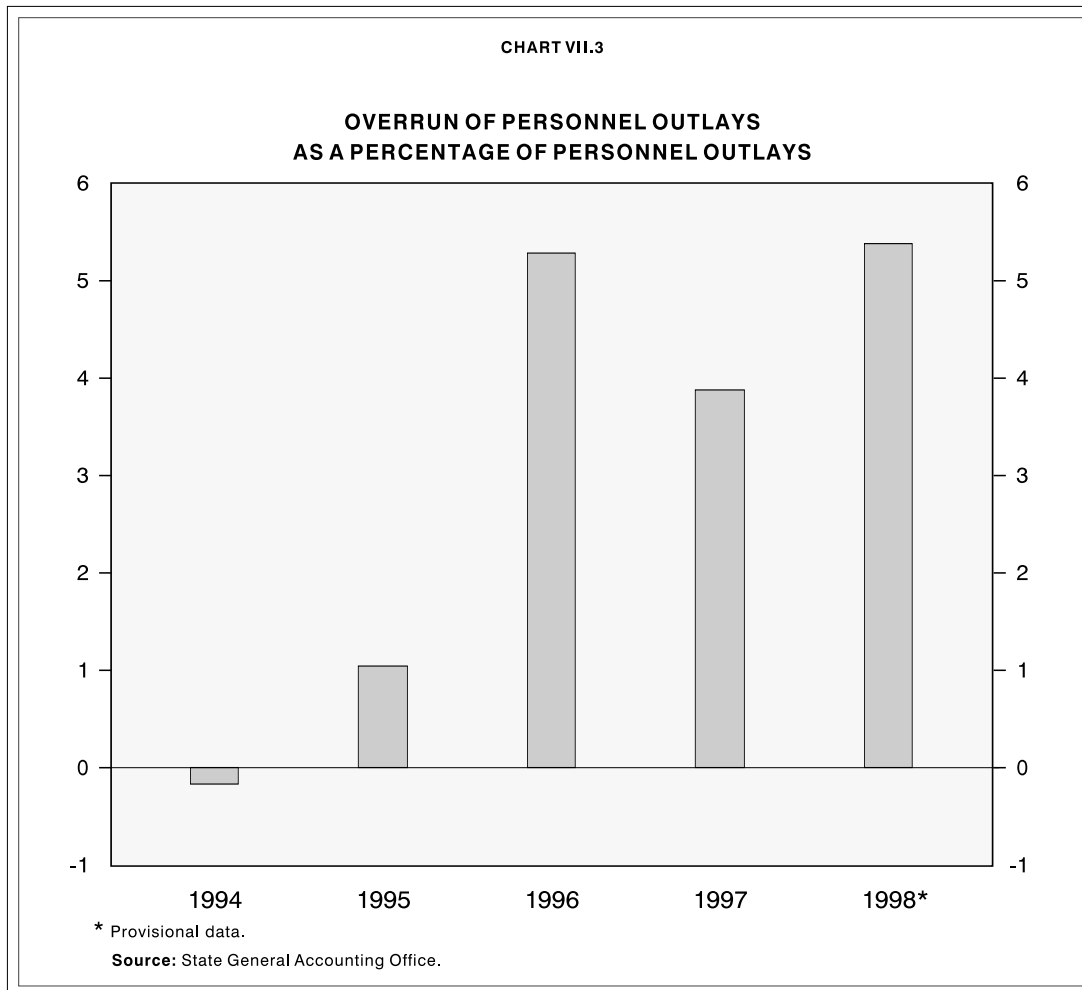
6 Including expenditure for investment projects of the ordinary budget (1996: 78.1 billion drachmas), while as of 1997 the corresponding expenditure appears under the Public Investment Budget. As from 1996, this item also includes grants to social security funds.

7 Including expenditure for investment projects of the ordinary budget (1996: 18 billion drachmas).

* Provisional data.

Source: Ministry of Finance, State General Accounting Office.

1995-1998 (average annual rate of change 14.2 per cent), while an increase of only 1.4 per cent is projected for 1999. The increase in personnel outlays in 1998 was due to the application of special wage schedules as from 1st January for Ministry of Foreign Affairs employees, military personnel, National Health System (NHS) physicians, judiciary personnel etc., with retrospective payment of wages. It was also due to the increase in civil servants' pensions, which were paid retrospectively at mid-year. A small part of the



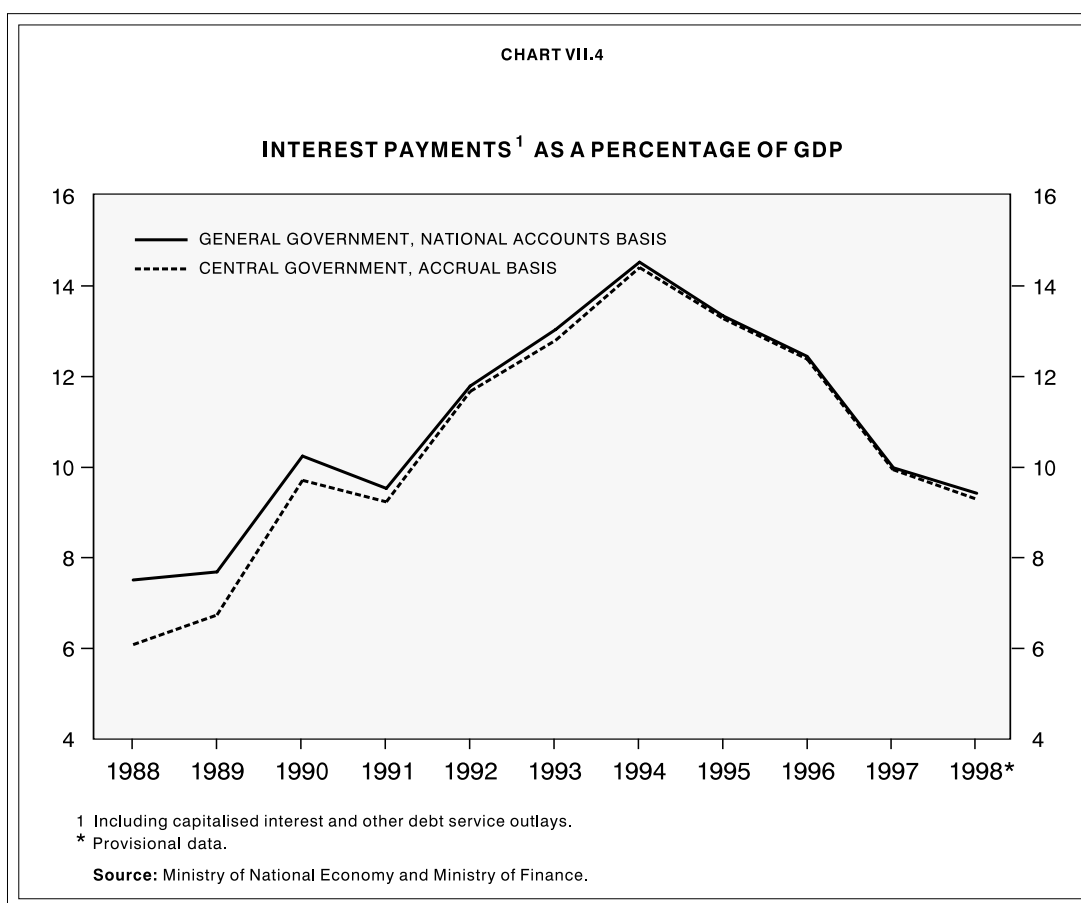
increase in these outlays was due to the devaluation of the drachma, which led to an increase in allowances and medical expenses of civil servants incurred abroad.

Interest payments increased by 1.8 per cent relative to those of 1997 and amounted to 3,273 billion drachmas. In relation to the budget, they recorded a 53 billion drachma overrun, which was partly due to increased interest on foreign debt, after the devaluation of the drachma in March 1998, and partly to the reduction of interest rates on Treasury bills at a slower pace than budgeted. Furthermore, interest payments in 1998 increased owing to the extensive substitution of bonds for twelve-month

Treasury bills during 1997, a practice which was continued, though to a lesser extent, in 1998.

It is worth noting that personnel outlays and interest payments in 1998 absorbed 75.1 per cent of ordinary budget revenue.

Payments to the European Union grew by 15.2 per cent compared with 1997 and reached 434 billion drachmas, almost as much as budgeted. This substantial rise was due to the expansion of the EU budget in 1998.



Payments of revenue to third parties grew by 19.8 per cent and amounted to 609 billion drachmas, recording an overrun of 63 billion drachmas above budget forecasts. This development is mainly attributable to increased payments to local authorities (owing to increased revenue from income tax), even though payment of 25 per cent of the revenue from road duties to local authorities and of 25 per cent of this revenue to other entities was suspended by Law 2469/97 for two years (1997 and 1998).

By contrast, outlays for tax refunds fell by 6.6 per cent in 1998 compared with 1997 and were contained at 272 billion drachmas, 11 billion less than budgeted. These outlays, however, are expected to increase considerably (14 per cent) in 1999.

Payments for the subsidisation of interest rates plummeted, from 20 billion drachmas in 1997 to 3 billion in 1998, as many subsidies were met by the larger amounts of contributions under Law 128/75. These contributions were increased and extended to loans in foreign currency as from September 1997 (Law 2515/97).

Payments for agricultural subsidies decreased for the second consecutive year and were limited to 101 billion drachmas, owing to the transfer of budget items concerning agricultural investment programmes to the public investment budget.

Payments for grants increased by 3.5 per cent compared with 1997 and amounted to 1,495 billion drachmas, 26 billion less than budgeted. This was partly due to the transfer of budget items from this category to the public investment budget, as these outlays concern the State's share in increasing the capital of certain public enterprises.

Finally, "other outlays" increased by 6 per cent compared with 1997 and amounted to 600 billion drachmas, overshooting budget forecasts by 42 billion drachmas. The overrun was mainly due to increased payments for imports from abroad and personnel travel abroad, following the devaluation of the drachma. It was also due to the financing of new liabilities.

Expenditure under the public investment budget grew by 15.7 per cent (48.5 per cent in 1997) and amounted to 1,881 billion drachmas. In comparison with the budget, investment expenditure was curtailed by 124 billion drachmas to offset the overrun in ordinary budget expenditure. Despite these cuts, however, there was a marked acceleration in the growth rate of payments for major infrastructure projects.

2.2 Social security and welfare funds

According to data from the Introductory Report on the Budget for 1999, the financial results of the seven major social security and welfare funds tended to stabilise in 1998 (see Table VII.6).

The total revenue of these funds increased by 10.5 per cent, compared with 12.4 per cent in 1997, and amounted to 2,365 billion drachmas. The deceleration of the growth rate of total revenue in 1998 was mainly due to the limited increase in revenue of IKA and OGA, while the growth rate of revenue of the Manpower Employment Agency (OAED) and the Workers' Housing Organisation (OEK) recorded a considerable acceleration. Total expenditure (on both the operating and the capital account) of the major social security and welfare funds rose by 10.8 per cent, compared with 14.4 per cent in 1997, and came to 3,584 billion drachmas. The deceleration of the growth rate of total expenditure more than offset the deceleration of the growth rate of revenue and is mainly attributable to the limited increase in IKA and OGA pensions and to the containment of the outlays of these funds for medical care (implementation of a mandatory list of "approved" medicines as from 1 April 1998, abolition of the contribution to the Greek National Drug Organisation and containment of operating costs).

Consequently, the total deficit of the consolidated operating and capital account of the major social security and welfare funds rose by 11.7 per cent and reached 1,174 billion drachmas, compared with 1,051 billion in 1997. As a per cent of GDP, the total deficit remained virtually unchanged at 3.3 per cent, compared with 3.2 per cent in 1997.

About 73 per cent of this deficit was financed out of the ordinary budget and the public investment budget. Specifically, grants out of the ordinary budget to the seven major funds totalled 773 billion drachmas (IKA: 208 billion, OGA: 427 billion, NAT: 118 billion), compared with 753 billion in 1997 (IKA: 225 billion, OGA: 405 billion, NAT: 94 billion). On the other hand, grants out of the public investment budget fell to 87 billion drachmas, from 90 billion in 1997.

Owing to the small increase in grants, the widening of the total deficit led to a 72.8 per cent increase in the net borrowing requirements of these funds to 269 billion drachmas in 1998 from 156 billion in 1998. This development signals the need to strengthen measures already taken to contain operating costs, improve the contribution collection mechanism, and speed up procedures for modernising and ensuring the viability of the social security system.

As regards IKA, according to the Introductory Report on the Budget for 1999, there was a considerable deceleration in the growth rate of revenue under the operating

BOX VII.1

The problem of social insurance

Despite the measures taken since the beginning of the 1990s, the existing pension system is not sustainable either in the medium or in the long term. The main reasons for this conclusion are the demographic problem and the generosity of insurance benefits.

The ageing of the population is a global phenomenon and a problem faced by many countries. According to OECD data, however, the problem in Greece is more acute. Pensioners in this country now exceed 2.2 million people, or 60 per cent of the active population. Thus, the dependency ratio is among the highest in OECD countries and is expected to rise substantially after 2000 and particularly after 2005.

In view of international experience, the pension system in Greece gives the impression of being comparatively generous. This impression is based not only on the level of pensions in relation to earnings in active service, but also on the "ease" with which the right to receive a pension is established, as defined by the following parameters of the system:

a) High replacement rate (of salaries by pensions). In Greece this rate is at present 80 per cent of earnings, excluding benefits from subsidiary insurance funds, while in the majority of countries worldwide it is 60 to 65 per cent. Furthermore, the basis on which this rate is calculated is (at worst) the average of salaries received in the last five years of active service (formerly two years or the last month). This fact contributes to the granting of high pensions, since earnings in the last years of service are usually higher in Greece. Thus, main pensions in →

→ this country (in relation to earnings in active service) are among the highest in OECD countries, perhaps with the exception of people who entered the labour market after 1st January 1993.

b) 33 per cent of pensioners in Greece receive pensions from two or more sources.

c) Moreover, the right to a "full pension" is relatively easy to establish, at most after 35 years of service, compared with 38 in France, 40 in Germany and 49 in the Netherlands. Retirement preconditions are particularly favourable for women in Greece, especially those with underage children.

d) The fact that the replacement rate (80 per cent) is high and the required years of service are few is evident also from the accumulation rate of insurance rights (i.e. the 80 per cent/35 ratio), which ranges from 2.286 to 3 annually in Greece, while in the other OECD countries it ranges from 0.5 to 1.5.

e) The existence of the "lump sum" retirement allowance for many categories of insured, which effectively leads to an increase in pensions.

f) The fact that 40 per cent of those insured by IKA fall into the category of "arduous and unhygienic" occupations. This results in reducing by 5 years the age at which the right to receive a pension can be established.

g) Finally, the right to a "minimum pension" can be established very easily (13.5 years of service, recently raised to 15 years) and the amount is very high in relation to the contributions paid. This fact also leads to increased contribution evasion.

The generosity of the system is also reflected in the amount of accumulated claims of those insured by pension funds. According to OECD data, insurance funds' liabilities in Greece exceed 150 per cent of GDP and are among the highest in the OECD area.

Not only benefits, but also contributions to social security funds are very high in Greece, particularly after the 1990-1992 reform. This fact, combined with the very low competitiveness of the Greek economy and the heavy competition it will face after joining EMU, and with the globalisation of economic activity, leaves no room for a further increase in social security contributions (with the exception of certain isolated cases).

Besides, it should be taken into account that, after the entry of Greece into EMU, the Stability and Growth Pact provides essentially for an effectively balanced budget, while efforts aimed at a further reduction in the debt-to-GDP ratio must continue. In this context, the scope, if any, for financing insurance funds out of the ordinary budget would be extremely limited.

From the above it is obvious that in the medium and long term it is difficult to maintain the present situation and immediate reforms are required. These reforms would necessarily be oriented towards reducing benefits and introducing stricter eligibility criteria. Owing to the nature of the problem and the considerable time lags before the various measures can take effect, the sooner these reforms are made the more effective and painless they will be.

Sources: 1. OECD, *Economic Surveys: Greece, 1997*.

2. World Bank, *Averting the Old Age Crisis*, Oxford University Press, 1994.

TABLE VII.6
FINANCIAL RESULTS OF SOCIAL SECURITY FUNDS¹
AND THEIR FINANCING
(Billion drachmas)

	1996	1997	1998*	Budget for 1999	Percentage changes		
					1997/96	1998*/97	1999/98*
A' Operating account							
1. Revenue	1,905.4	2,141.0	2,364.9	2,631.8	12.4	10.5	11.3
2. Expenditure	2,707.0	3,132.7	3,421.8	3,620.0	15.7	9.2	5.8
3. Result (1 – 2)	<u>-801.6</u>	<u>-991.7</u>	<u>-1,056.9</u>	<u>-988.2</u>	<u>23.7</u>	<u>6.6</u>	<u>-6.5</u>
B' Capital account							
4. Revenue	–	–	–	–	–	–	–
5. Expenditure	120.2	101.1	162.2	150.9	-15.9	60.4	-7.0
(Investment)	(47.1)	(46.8)	(100.6)	(98.6)	(-0.6)	(115.0)	(-2.0)
(Working capital)	(24.1)	(54.3)	(61.5)	(51.5)	(125.3)	(13.3)	(-16.3)
(Other)	(49.0)	(0.0)	(0.1)	(0.8)	(-100.0)	(-)	(700.0)
6. Result (4 – 5)	<u>-120.2</u>	<u>-101.1</u>	<u>-162.2</u>	<u>-150.9</u>	<u>-15.9</u>	<u>60.4</u>	<u>-7.0</u>
7. Special resources	<u>46.8</u>	<u>41.4</u>	<u>45.0</u>	<u>65.9</u>	<u>-11.5</u>	<u>8.7</u>	<u>46.4</u>
TOTAL RESULT (3+6+7)	<u>-875.0</u>	<u>-1,051.4</u>	<u>-1,174.1</u>	<u>-1,073.2</u>	<u>20.2</u>	<u>11.7</u>	<u>-8.6</u>
FINANCING							
8. Grants	<u>800.7</u>	<u>895.5</u>	<u>904.9</u>	<u>941.5</u>	<u>11.8</u>	<u>1.0</u>	<u>4.0</u>
(Ordinary budget)	(720.5)	(753.4)	(772.7)	(784.0)	(4.6)	(2.6)	(1.5)
(Public investment budget)	(50.1)	(90.0)	(87.0)	(96.6)	(79.6)	(-3.3)	(11.0)
(European Union etc.)	(30.1)	(52.1)	(45.2)	(60.9)	(73.1)	(-13.2)	(34.7)
9. Depreciation	<u>0.3</u>	<u>0.3</u>	<u>0.3</u>	<u>0.3</u>	<u>–</u>	<u>–</u>	<u>–</u>
10. Net borrowing requirement	<u>74.0</u>	<u>155.6</u>	<u>268.9</u>	<u>131.4</u>	<u>110.3</u>	<u>72.8</u>	<u>-51.1</u>
TOTAL FINANCING	<u>875.0</u>	<u>1,051.4</u>	<u>1,174.1</u>	<u>1,073.2</u>	<u>20.2</u>	<u>11.7</u>	<u>-8.6</u>
11. Amortisation payments	131.8	136.7	52.7	81.8	3.7	-61.4	55.2
12. Gross borrowing requirement (10+11)	205.8	292.3	321.6	213.2	42.0	10.0	-33.7

1 Including 7 social security funds [Social Insurance Fund (IKA), Seamen's Pension Fund (NAT), Farmers' Insurance Fund (OGA), Manpower Employment Agency (OAED), Workers' Housing Organisation (OEK), Workers' Fund and National Welfare Organisation (EOP)].

* Estimates.

Source: Ministry of National Economy.

account (1998: 5.9 per cent, 1997: 10.8 per cent) and an even greater decline in the growth rate of expenditure under the same account (1998: 7.4 per cent, 1997: 14.5 per cent). Hence, the operating deficit of IKA widened by 11.8 per cent (27.6 per cent in 1997) and reached 548 billion drachmas. Specifically, the fact that revenue grew faster than inflation, particularly at a time of decelerating inflation, was a positive development that largely reflected the efforts made to reduce contribution evasion. On the other hand, the deceleration of the growth rate of operating expenditure is attributable to the tight incomes policy, the curbing of medical care expenses, as well as the overall containment of other operating expenditure.

The operating deficit of OGA also showed a limited rate of increase (1998: 3.8 per cent, 1997: 5.1 per cent) and is expected to have reached 394 billion drachmas in 1998, compared with 379 billion in 1997. This was due to developments in both the revenue and the expenditure of OGA. Specifically, in 1998 revenue increased at a lower rate than in 1997, owing to the excessive rise in revenue in 1997, which resulted from the transfer, on accounting terms, of part of the 1998 grants (37.8 billion drachmas) to 1997 OGA's own revenue. Had this transfer not taken place, the growth rate of revenue for 1998 would appear much higher. The 1998 increase is justified on two accounts: first, there was an increase in the contributions to the Farmers' Main Insurance Fund, a fund which was established by Law 2458/97 to replace as from 1 January 1998 the Supplementary Insurance Fund, and, second, the revenue in 1998 increased excessively because the contributions of the abolished branch of Supplementary Insurance concerning 1997 were collected in 1998, as a result of the transitional adjustment. On the other hand, expenditure appears to be restrained due to the tight incomes policy, the containment of medical care outlays and the fact that the benefits introduced by Law 2458/97 were postponed until 1999, because the relevant computerised programmes and the other approval procedures were delayed.

Finally, the operating deficit of the Seamen's Pension Fund (NAT) is estimated to have increased by 11.5 per cent, reaching 131 billion drachmas, compared with an increase of 12.5 per cent in 1997. This increase did not lead to new borrowing, as it was financed entirely by government grants.

2.3 Public enterprises

The surplus in the operating account of public enterprises, on an accrual basis, recorded an increase in 1998, which, however, was more than offset by the capital account balance, ultimately leading to a substantial rise in net borrowing requirements. This is indicated by the Introductory Report on the Budget for 1999 and Ministry of National Economy data, as summarised in Table VII.7. The growth rate of total expenditure (under the operating and capital accounts) of public enterprises accelerated in 1998 (16.8 per cent), compared with 1997 (15.2 per cent), and overshoot by 7.9 percentage points the increase in nom-

TABLE VII.7
FINANCIAL RESULTS OF PUBLIC ENTERPRISES ¹ AND THEIR FINANCING
(Billion drachmas)

	1996	1997	1998*	Budget for 1999	Percentage changes		
					1997/96	1998*/97	1999/98*
A' Operating account							
1. Revenue	3,368.6	3,568.2	3,912.1	4,274.5	5.9	9.6	9.3
2. Expenditure	3,098.9	3,391.5	3,721.9	3,946.1	9.4	9.7	6.0
3. Result (1 – 2)	269.7	176.7	190.2	328.4	–34.5	7.6	72.7
B' Capital account							
4. Revenue	–	–	–	–	–	–	–
5. Expenditure	1,303.6	1,678.2	2,198.2	2,442.4	28.7	31.0	11.1
(Investment)	(1,052.1)	(1,316.7)	(1,692.5)	(2,079.3)	(25.1)	(28.5)	(22.9)
(Working capital)	(84.6)	(47.8)	(174.4)	(25.1)	(–43.5)	(264.9)	(–85.6)
(Other)	(166.9)	(313.7)	(331.3)	(338.0)	(88.0)	(5.6)	(2.0)
6. Result (4 – 5)	–1,303.6	–1,678.2	–2,198.2	–2,442.4	28.7	31.0	11.1
7. Special resources ²	258.1	670.3	747.2	579.9	159.7	11.5	–22.4
TOTAL RESULT (3+6+7)	–775.8	–831.2	–1,260.8	–1,534.1	7.1	51.7	21.7
FINANCING							
8. Grants	508.6	372.7	404.5	492.7	–26.7	8.5	21.8
(Ordinary budget) ³	(38.1)	(–10.7)	(–3.5)	(21.6)	–	–	–
(Public investment budget)	(323.5)	(346.1)	(348.4)	(411.6)	(7.0)	(0.7)	(18.1)
(European Union etc.)	(147.0)	(37.3)	(59.6)	(59.5)	(–74.6)	(59.8)	(–0.2)
9. Depreciation	304.4	374.6	467.4	487.9	23.1	24.8	4.4
10. Net borrowing requirement	–37.2	83.9	388.9	553.5		363.5	42.3
TOTAL FINANCING	775.8	831.2	1,260.8	1,534.1	7.1	51.7	21.7
11. Amortisation payments	271.2	399.6	317.2 ⁴	434.3 ⁴	47.3	–20.6	36.9
12. Repayment of credits	20.2	15.4	12.3 ⁴	15.0 ⁴	–23.8	–20.1	22.0
13. New suppliers' credits	29.5	52.6	89.3	34.0	78.3	69.8	–61.9
14. Gross borrowing requirement (10+11+12–13)	224.7	446.3	629.1	968.8	98.6	41.0	54.0

1 Including the public enterprises mentioned in the Introductory Report on the 1999 Budget.

2 Special resources include advances and participations by Public Power Corporation consumers, lump-sum payments by Hellenic Telecommunications Organisation subscribers, participation of individuals in Water Supply and Sewerage Company projects, and own assets (from surpluses) of certain public enterprises.

3 Grants from the ordinary budget to those public enterprises which ran a deficit, minus the surpluses of certain public enterprises (Soccer Pools Organisation, Duty Free Shops and Greek Horse Races Organisation).

4 Amortisation payments and credit repayments for 1998 estimates and the 1999 Budget totalled 329.5 and 449.3 billion drachmas, respectively. Owing to a lack of data, these amounts are distributed over the above-mentioned periods according to Bank of Greece estimates.

* Estimates.

Source: Ministry of National Economy.

inal GDP. The acceleration stemmed mainly from expenditure under the capital account, particularly from the substantial increase in investment for the third consecutive year, as well as the steep rise in working capital. The growth rate of expenditure under the operating account remained almost unchanged relative to the previous year and GDP. Specifically, while the growth rate of expenditure on fuels remained stable, the growth rates of expenditure for the payment of wages and other expenses declined considerably, offsetting the increases in the respective growth rates for asset depreciation and interest payments. Primary expenditure (i.e. total expenditure net of interest payments) increased by 16.8 per cent in 1998, compared with 15.3 per cent in 1997. Revenue under the operating account grew faster in 1998 (9.6 per cent) than in 1997 (5.9 per cent) but slower than total expenditure. Revenue therefore increased to 3,912 billion drachmas from 3,568 billion in 1997.

As a result of these developments, the total deficit of the consolidated operating and capital account increased considerably to 1,261 billion drachmas, compared with 831 billion in 1997. The deficit stemmed entirely from the capital account and would have been larger if it were not partly offset by a surplus in the operating account, including special resources, which increased relative to the previous year (1998: 747 billion drachmas, 1997: 670 billion). The increase was mainly due to the Hellenic Railways Organisation (OSE), the Hellenic Telecommunications Organisation (OTE), the Public Petroleum Corporation (DEP), the Public Gas Corporation (DEPA) and the Public Power Corporation (DEH). Of the total deficit, 32 per cent was financed by grants from the public investment budget and the European Union and 37 per cent by depreciation allowances. This led to a considerable increase in the net borrowing requirement from 84 billion drachmas in 1997 to 389 billion in 1998.

The aggregate income of the Olympic Airways (OA), the Athens Urban Transport Organisation (OASA), the Athens and Piraeus Water Supply and Sewerage Company (EYDAP) and the Hellenic Aerospace Industry (EAB) grew at a much lower rate than in 1997 (1998: 3.2 per cent, 1997: 16.6 per cent). The growth rate of income earned by the smaller public enterprises, which accounted for 39 per cent of total revenue also fell (1998: 3.4 per cent, 1997: 5.7 per cent). By contrast, the aggregate income of OTE, DEH and OSE recorded a considerable increase (1998: 16.9 per cent, 1997: 3.7 per cent).

In particular, the growth rate of OTE revenue recorded a significant acceleration compared with the previous year (1998: 25.4 per cent, 1997: 7.5 per cent), as a result mainly of the considerable expansion of digital technology from the beginning of the year and the increase in demand for telecommunications services in the second half of 1998. The rate of increase in DEH revenue was higher than that in 1997 (1998: 8.8 per cent, 1997: 0.4 per cent), owing to increased consumption of electricity (mainly for use in industrial and professional activities) and the rise of 3 per cent in electricity rates in the second half of the year. OSE revenue increased appreciably by 6.5 per cent in 1998, compared with a marginal decline of 0.8 per cent in the previous year, which was due to the increase in transport volume (mainly to the smooth running of the "Intercity" line) and the restructuring of timetables (reduction of non-profitable passenger and freight transport).

The growth rate of Olympic Airways revenue recorded a considerable decline compared with the previous year (1998: 2.9 per cent, 1997: 16.2 per cent), owing to the number of flights cancelled and the decline in passenger traffic.

The growth rate of OASA revenue declined slightly (1998: 9.8 per cent, 1997: 10.8 per cent), because of the smaller (and delayed by two months compared with the previous year) increase in fares (20 per cent as from 17 August 1998), the reduction to 5,000 drachmas in the price of the passengers' monthly pass for OASA buses and trolley cars (whereas the price remains unchanged at 8,000 drachmas for the other means of mass transport) and the marginal decline in passenger traffic.

Finally, EYDAP revenue decreased, compared with a rise in the previous year (1998: -1.4 per cent, 1997: 17 per cent), in spite of increased water consumption, which led to a rise in the average price of water. This development was due to the fact that the company's income grew by 8.5 billion drachmas in 1997 (interest payments in connection with the financing of flood control and biological treatment projects), compared with only 1.5 billion drachmas in 1998.

Operating costs of public enterprises grew by 9.7 per cent, compared with 9.4 per cent in 1997. This marginal acceleration of the growth rate, which falls short of the rise in revenue, is basically attributable to outlays for fuel and interest payments. Interest payments, in particular, rose by 15.5 per cent and reached 231 billion drachmas, compared with 200 billion in 1997.

Consequently, the operating account of public enterprises recorded a larger surplus than in 1997 (1998: 190 billion drachmas, 1997: 177 billion). This development reflected an increase in the surpluses of OTE (1998: 304 billion drachmas, 1997: 300 billion) and EYDAP (1998: 12.5 billion drachmas, 1997: 9.2 billion). By contrast, there was a drop in the surplus of DEH (1998: 17 billion drachmas, 1997: 93.1 billion drachmas) and of the other enterprises (1998: 80.9 billion drachmas, 1997: 93.1 billion). The deficit of OASA widened (1998: 95.3 billion drachmas, 1997: 94.7 billion drachmas), while that of OSE fell somewhat but was still high (1998: 133.5 billion drachmas, 1997: 148.9 billion drachmas).

Capital account expenditure, on the other hand, grew by 31 per cent, compared with 28.7 per cent in 1997. This was mainly due to increased investment outlays (1998: 28.5 per cent, 1997: 25.1 per cent) and expenditure for working capital (1998: 264.9 per cent, 1997: -43.5 per cent). By contrast, other outlays increased only slightly (1998: 5.6 per cent, 1997: 88 per cent).

2.4 Public debt

Apart from the attainment of budget targets and the fulfilment of the Maastricht Treaty deficit criterion, the debt-to-GDP ratio also declined considerably in 1998, for the second consecutive year, and it is quite likely that the public debt criterion was also met.

According to available provisional data, the consolidated debt of general government fell in 1998 by 3.3 percentage points (compared with 2.8 points in 1997) and was limited to 106.1 per cent of GDP, in spite of the drachma devaluation in March, which led to an increase of external debt (in drachma terms).

This development is attributable both to a continuous improvement in the main determinants of public debt as a percentage of GDP (interest rates, primary surpluses, GDP growth) and to the other factors causing a direct increase in debt (calling-in of guarantees, capitalisation of interest etc.). Moreover, in 1998, there was also considerable repayment and prepayment of debt.

TABLE VII.8
CONSOLIDATED DEBT OF GENERAL GOVERNMENT*
(Billion drachmas)

	1995	1996	1997	1998**
Treasury bills and short-term bonds	7,120	7,229	4,721	3,558
Medium-term and long-term bonds	12,362	15,284	19,175	21,796
Other medium-term and long-term loans	10,121	10,810	11,946	12,506
Total	29,603	33,323	35,842	37,860
Percentage of GDP	110.1	112.2	109.4	106.1
– domestic debt ¹	23,004	26,087	27,512	28,711
(of which: Bank of Greece debt)	(3,909)	(3,987)	(4,056)	(4,133)
– external	6,599	7,236	8,330	9,149

1 Including drachma securities held by non-residents.

* According to the definition in the Maastricht Treaty.

** Provisional data.

Source: Ministry of Finance and Bank of Greece.

Specifically, the steady decline of interest rates on government borrowing for the fourth consecutive year, the existence of primary surpluses in the government budget for seven consecutive years (with a considerable increase in the primary surplus in 1998), as well as the continuous acceleration of GDP growth since 1994, have led to a weakening of debt dynamics, its stabilisation and eventually the reduction in the debt-to-GDP ratio (see Table VII.8 and Chart VII.5).

At the same time, the direct increase in public debt owing to factors other than the annual deficit, such as interest capitalisation, calling-in of guarantees, assumption of the debt of other public sector entities, etc., has been limited to a very large extent and this has helped to reduce the debt-to-GDP-ratio (see Box VII.2). The exchange rate policy pursued from summer 1994 onwards also contributed to the decline of the debt-to-GDP ratio, whereas the drachma devaluation in March 1998 added almost 2 percentage points to the ratio.

BOX VII.2**The decline in the debt-to-GDP ratio**

The continuous improvement in the three main determinants of the debt-to-GDP ratio (i.e. primary surpluses, interest rates and real rate of growth) led to a gradual weakening of the dynamics of debt, its stabilisation, and, ultimately, its decline. Furthermore, over the last two years, other factors usually causing a direct increase in debt evolved favourably and contributed to its reduction, as a percentage of GDP.

As shown in the table, the deficit of general government (on a national accounts basis) recorded a considerable decline in 1997 and 1998, contributing directly to debt containment (also indirectly, through the creation of a larger primary surplus). Moreover, capitalisation of

FACTORS AFFECTING GENERAL GOVERNMENT DEBT¹
(Billion drachmas)

	1996	1997	1998
Outstanding debt	33,323	35,842	37,860
<i>as a percentage of GDP</i>	<i>112.2</i>	<i>109.4</i>	<i>106.1</i>
– General government deficit ²	2,226	1,270	849
– Expenditure for the acquisition of public enterprises' assets	200	420	487
– Assumption of debt on behalf of third parties other than general government	156	274	–
– Contribution to the increase in the capital stock of banks and entities	148	136	165
– Debt retirement through the Public Portfolio Management Company (DEKA S.A.)	–	–	–667

1 Comprising only the major direct factors.

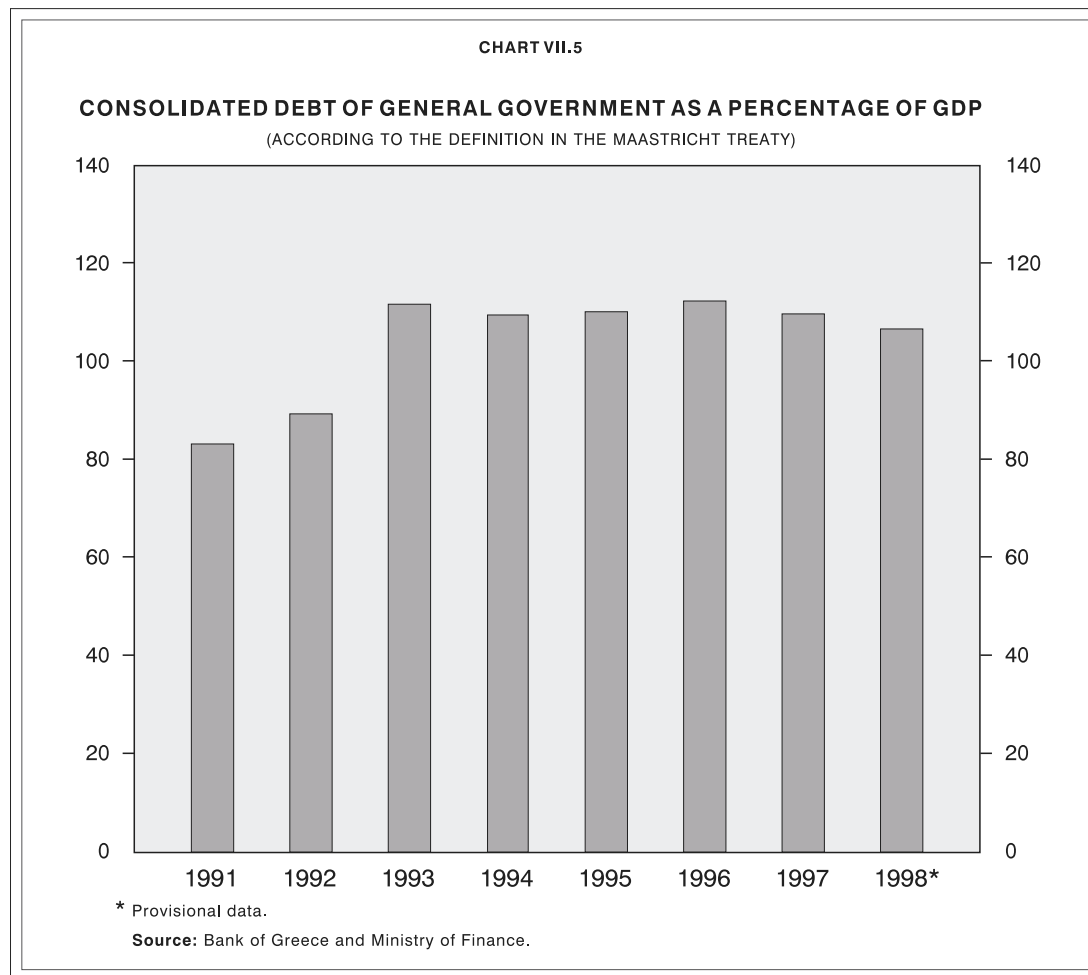
2 Data on a national accounts basis.

Source: Ministry of National Economy and Ministry of Finance.

interest, included in this deficit, decreased drastically in the last two years, from 179 billion drachmas in 1996 to 33 billion in 1997 and 27 billion in 1998, thereby contributing towards reducing both the deficit and debt. The assumption of debt from the calling-in of guarantees, capital increases etc. grew in 1997 compared with 1996, but decreased considerably in 1998 (from 410 to 165 billion drachmas). It should be noted that in 1998, using privatisation proceeds, there was a prepayment and repayment of debt amounting to 667 billion drachmas, a fact that contributed significantly (by 1.9 percentage point of GDP) to the reduction of debt. By contrast, outlays for assets (capital transfers), which are not included in the deficit on a national accounts basis but are included in public debt, increased in 1997 and 1998 and contributed to the increase in debt.

Besides, for the first time in 1998, debt amounting to 667 billion drachmas was repaid and prepaid, through DEKA SA, using 1998 privatisation proceeds.

As in 1997, debt structure changed significantly in 1998, owing to the policy aimed at lengthening average debt maturity (with the substitution of bonds for Treasury bills, and the issue of 10-year and 15-year securities), as well as to the vivid interest of foreign investors in purchasing long-term fixed-interest government securities, in order to realise capital gains. Furthermore, 1998 was characterised by the intro-



duction of new types of securities, e.g. two-year tax-free savings bonds and privatisation certificates (tax-free securities offering holders the option of conversion into shares of public enterprises or redemption at maturity). Hence, on 31st December 1998, 75.8 per cent of the debt was in drachmas¹ and 24.2 per cent in foreign currencies. It is also estimated that about 81 per cent of the debt consists of negotiable government securities,

¹ Including drachma-denominated securities purchased by non-residents.

while the balance is made up of bonds which are not directly negotiable in the secondary market.

Finally, as regards term structure, at end-1998 about 9 per cent of the debt represented short-term liabilities (of one year or less), 57 per cent medium- and long-term liabilities (two-year to thirty-year bonds), and 34 per cent medium- and long-term loans and other liabilities.

3. THE BUDGET FOR 1999

3.1 The central government budget

The fulfilment of the Maastricht Treaty fiscal criteria in 1998 allowed the reorientation of the economic policy priorities for 1999 towards a further deceleration of inflation and the satisfaction of the relevant criterion.

In this respect, the targets of the 1999 central government budget are not as ambitious as in 1997 and 1998. The budget deficit on an accrual basis is forecast to decline only marginally from 5.9 per cent of GDP in 1998 to 5.7 per cent in 1999 (see Table VII.9). If outlays for the acquisition of assets are deducted, then the budget deficit is projected to decline from 4.2 per cent in 1998 to 4 per cent in 1999. The latter aggregate, on a national accounts basis and at general government level, corresponds to 2.4 per cent of GDP in 1998 and to 1.9 per cent in 1999. Furthermore, the primary surplus of the government budget is expected to decline marginally compared with 1998 (1998: 3.2 per cent of GDP, 1999: 3.1 per cent of GDP).

Budget revenue, following the large increase of 1998 (13.4 per cent), is expected to rise by 6.5 per cent only. Also, the growth rate of expenditure will fall to 5.7 per cent from 7.2 per cent in 1998. The containment of the growth rate of expenditure will stem primarily from interest payments, which are projected to increase by 2.4 per cent. Primary expenditure is expected to rise by 6.9 per cent, mainly owing to a large increase in investment budget expenditure which, however, does not entirely concern fixed capital formation. Primary expenditure under the ordinary budget is also projected to increase faster (4.4 per cent) than interest payments.

Regarding the ordinary budget, revenue is projected to rise by only 5.6 per cent, compared with 12.2 per cent in 1998, for the reasons mentioned in Section 2.1 above, and amount to 10,030 billion drachmas. This limited increase implies an income "elasticity" of 0.86, compared with 1.37 in 1998 and 1.43 in 1997. However, it should be noted that, in the context of efforts to slow down inflation, special consumption taxes on liquid fuels (except diesel oil) and cars have been reduced since last autumn. VAT on electricity bills was also reduced on 1 January 1999. These changes are expected to lead to a loss of tax revenue in 1999, which is estimated at 180 billion drachmas and has been taken into account in drawing up the budget.

TABLE VII.9
REVENUE, EXPENDITURE AND DEFICIT UNDER THE OVERALL GOVERNMENT BUDGET
(Billion drachmas)

	1995	1996	1997	1998*	Budget for 1999	Percentage changes			Budget for 1999/98*
						1996/95	1997/96	1998*/97	
Revenue	7,072.3	7,951.6	9,185.4	10,413.0	11,090.0	12.4	15.5	13.4	6.5
1. Ordinary budget	6,727.8	7,384.1	8,467.4	9,500.0	10,030.0	9.8	14.7	12.2	5.6
— Direct taxes	(2,132.7)	(2,316.1)	2,767.1	3,501.9	3,474.0	(8.6)	(19.5)	(26.6)	(-0.8)
— Indirect taxes	(3,834.9)	(4,299.9)	(4,833.9)	(5,182.4)	(5,614.5)	(12.1)	(12.4)	(7.2)	(8.3)
— Other revenue	(760.2)	(768.1)	(866.4)	(815.7)	(941.5)	(1.0)	(12.8)	(-5.9)	(15.4)
2. Public investment budget	344.5	567.5	718.0	913.0	1,060.0	64.7	26.5	27.2	16.1
Expenditure	9,841.6	10,822.4	11,690.8	12,528.0	13,245.0	10.0	8.0	7.2	5.7
1.1 Ordinary budget ¹	8,879.6	9,727.4	10,064.3	10,647.0	11,050.0	9.5	3.5	5.8	3.8
Less: interest payments ²	(3,355.8)	(3,501.1)	(3,216.2)	(3,273.0)	(3,350.0)	(4.3)	(-8.1)	(1.8)	(2.4)
1.2 Primary ordinary budget expenditure	5,523.8	6,226.3	6,848.1	7,374.0	7,700.0	12.7	10.0	7.7	4.4
2. Public investment budget ^{3,4}	962.0	1,095.0	1,626.5	1,881.0	2,195.0	13.8	48.5	15.6	16.7
Net deficit (-) / surplus (+)	-2,769.3	-2,870.8	-2,505.4	-2,115.0	-2,155.0	3.7	-12.7	-15.6	1.9
Percentage of GDP	-10.3	-9.7	-7.6	-5.9	-5.7				
1. Ordinary budget	-2,151.8	2,343.3	-1,596.9	-1,147.0	-1,020.0				
2. Public investment budget	617.5	-527.5	-908.5	-968.0	-1,135.0				
Primary deficit (-)/surplus (+)⁴	586.5	630.3	710.8	1,158.0	1,195.0				
Percentage of GDP	2.2	2.1	2.2	3.2	3.1				
ELEGEP** (Revenue=Expenditure)	712.6	859.0	819.0	810.0	973.0	20.5	-4.7	-1.1	20.1
Amortisation payments ²	2,773.5	3,638.2	3,589.0	3,472.0	3,731.0	31.2	-1.4	-3.3	7.5

1 Excluding amortisation payments.

2 Including, respectively, interest and amortisation payments related to the national defence debt.

3 Expenditure for 1995 does not include: a) transfer to the Hellenic Telecommunications Organisation of the proceeds of a 48.5 billion drachma loan concluded on its behalf between the European Investment Bank and the Greek State, and b) outlays of 19 billion drachmas for the increase of the Olympic Airways' share capital (Law 2271/1994).

4 Expenditure for 1997, 1998 and 1999 includes 420 billion drachmas, 487 billion drachmas and 620 billion drachmas, respectively, which concern capital transfers for the acquisition of assets. If these amounts are deducted, the primary surplus for 1997, 1998 and 1999 rises to 3.5 per cent, 4.6 per cent and 4.8 per cent of GDP, respectively.

* Provisional data.

** Special Accounts of Guarantees of Agricultural Products.

Source: Ministry of Finance, State General Accounting Office.

TABLE VII.10
FINANCIAL ACCOUNT OF GREECE WITH THE EUROPEAN UNION
(Billion drachmas)

	Annual aggregates					Percentage changes			
	1995	1996	1997	1998*	Budget for 1999	1996/95	1997/96	1998/97	Budget for 1999/98
<i>A. Receipts from the European Union</i>	<u>1,404.3</u>	<u>1,762.7</u>	<u>1,671.7</u>	<u>1,698.4</u>	<u>2,305.4</u>	<u>25.5</u>	<u>-5.2</u>	<u>1.6</u>	<u>35.7</u>
1. Refund to cover cost of collecting the Union's "own resources" (10 per cent of collected resources)	5.1	5.0	5.6	6.1	6.3	-2.0	12.0	8.9	3.3
2. Social Fund	66.5	69.1	89.5	81.4	286.7	3.9	29.5	-9.1	252.2
3. EAGGF - Guidance Section	95.5	98.2	105.1	87.3	94.6	2.8	7.0	-16.9	8.4
4. Integrated Mediterranean Programmes	0.3	11.6	-	-	-	-	-	-	-
5. Regional Fund	432.6	571.5	475.1	539.3	665.0	32.1	-16.9	13.5	23.3
6. EAGGF - Guarantee Section	748.6	875.3	838.6	813.7	1,015.8	16.9	-4.2	-3.0	24.8
7. Other receipts	8.0	14.2	5.1	4.2	3.0	77.5	-64.1	-17.6	-28.6
8. Cohesion Fund	41.8	112.9	144.1	157.3	221.0	170.1	27.6	9.2	40.5
9. Receipts from EFTA countries	2.4	1.3	2.8	2.4	1.0	-45.8	115.4	-14.3	-58.3
10. Fisheries Fund	3.5	3.6	5.8	6.7	12.0	2.9	61.1	15.5	79.1
<i>B. Payments to the European Union</i>	<u>310.0</u>	<u>348.2</u>	<u>375.2</u>	<u>455.2</u>	<u>435.0</u>	<u>12.3</u>	<u>7.8</u>	<u>21.3</u>	<u>-4.4</u>
1. Agricultural levies and duties	3.0	2.4	3.2	2.9	2.8	-20.0	33.3	-9.4	-3.4
2. Sugar levies	4.4	3.9	3.1	4.1	4.0	-11.4	-20.5	32.3	-2.4
3. Customs duties under the Common External Tariffs provision	43.8	44.6	49.9	53.8	46.1	1.8	11.9	7.8	-14.3
4. Contribution on the basis of revenue from VAT	177.1	181.7	177.8	188.0	190.0	2.6	-2.1	5.7	1.1
5. Contribution on the basis of GDP	56.6	89.5	123.5	172.6	162.4	58.1	38.0	39.8	-5.9
6. Other contributions	19.1	21.5	12.7	24.4	18.0	12.6	-40.9	92.1	-26.2
7. Contribution to the European Development Fund	6.1	3.5	4.5	5.3	8.7	-42.6	28.6	17.8	64.2
8. Payments due to unrealised projects	-	1.1	0.5	4.1	1.0	-	-	-	-
9. Contribution to the food aid programme	-	-	-	-	2.0	-	-	-	-
<i>Net receipts from the European Union (A-B)</i>	<u>1,094.3</u>	<u>1,414.5</u>	<u>1,296.5</u>	<u>1,243.2</u>	<u>1,870.4</u>	<u>29.3</u>	<u>-8.3</u>	<u>-4.1</u>	<u>50.5</u>

* Provisional data.

Source: Ministry of Finance, Directorate of Fiscal Relations with the EU and other international organisations.

Apart from the aforementioned reductions, no other changes are anticipated. Revenue is expected to be favourably influenced by the steps taken at end-1998 to collect assessed revenue in arrears, as well as by the curtailment of tax evasion and smuggling through the reorganisation of auditing mechanisms and other services at the Ministry of Finance, combined with the completion of computerisation of tax offices.

Ordinary budget expenditure is expected to rise by 3.8 per cent in 1999 (compared with 5.8 per cent in 1998) and reach 11,050 billion drachmas. Primary expenditure, as mentioned above, will increase at a faster rate (4.4 per cent), while interest payments will go up by only 2.4 per cent.

Overall, 1999 expenditure is extremely reduced and, on the basis of past experience, it is estimated that it will be difficult to be contained at budgeted levels. This view is supported by the fact that 1998 expenditure eventually reached a level slightly higher than estimated when drawing up the 1999 budget. It should also be noted that the reserve in the 1999 budget is only 35 billion drachmas, compared with 100 billion up to 1997, when budget aggregates were much smaller. The reserve will therefore be unable to absorb unforeseen expenditure and the latter will probably lead to a budget overrun.

Public investment budget expenditure is projected to increase by 16.7 per cent in 1999 (15.6 per cent in 1998) and reach 2,195 billion drachmas. This amount includes capital transfers of 620 billion drachmas to public enterprises. Of total investment outlays, 77.5 per cent will be used to finance projects co-financed by EU structural funds, while the remainder will be used for projects fully financed out of national resources. Public investment budget revenue is expected to rise by 16.1 per cent in 1999, compared with 27.2 per cent in 1998 and 26.5 per cent in 1997.

The acceleration of the growth rate of expenditure and the deceleration of the growth rate of revenue are expected to lead to an increase in the investment budget deficit (on an accrual basis) from 2.7 per cent of GDP in 1998 to 3 per cent in 1999.

Finally, net EU transfers are expected to increase by 50.5 per cent and reach 1,870 billion drachmas in 1999, after two years of continuous small decline (see Table VII.10). The reversal of the downward trend and the large increase in net transfers will stem from the accelerated absorption from the EU, as well as from Greece's slightly reduced contributions, relative to 1998. The acceleration of receipts is expected to stem mainly from the Social Fund (252.2 per cent rise), the Cohesion Fund (40.5 per cent), the EAGGF – Guarantee Section, i.e. from income grants to farmers (24.8 per cent), and the Regional Fund (23.3 per cent).

3.2 The budget of public enterprises and social security and welfare funds

According to the Introductory Report on the Budget for 1999 (see Table VII.6), the seven major social security and welfare funds are expected to record a considerable decline in their total deficit (on an accrual basis) – compared with a rise in 1998 – and

receive increased grants, thereby reducing their net borrowing requirements. Specifically, while their total deficit is expected to reach 1,073 billion drachmas, recording an 8.6 per cent decrease compared with 1998, their net borrowing requirements are expected to be contained at 131 billion drachmas, i.e. 51.1 per cent less than in 1998. The deficit-to-GDP ratio is budgeted at 2.8 per cent.

The projected containment of the overall deficit of the seven major funds is mainly based on the continuing efforts against contribution evasion (under Law 2556/24 December 1997), on the rationalisation of the expenses and pricing policy for drugs, on the increase in employment and on more effective control of hospital fees.

The total deficit of the seven major funds will be partly financed by increased grants to these funds, which will reach 942 billion drachmas in 1999, compared with 905 billion in 1998. As mentioned above, this development, combined with the containment of the deficit, will reduce their borrowing requirements to 131 billion drachmas in 1999, from 269 billion in the previous year.

According to the Introductory Report on the Budget (see Table VII.7), the total deficit of public enterprises is expected to rise from 1,261 billion drachmas in 1998 to 1,534 billion in 1999, owing to a considerable reduction (of 167 billion drachmas) in special resources and a 244 billion increase in the capital account deficit, compared with 1998.

By contrast, the operating account surplus is expected to rise to 328 billion drachmas, from 190 billion in 1998. This is due to the expected deceleration of the rate of increase in operating expenses to 6 per cent compared with 1998, i.e. a rate considerably lower than the growth rate of revenue, which is expected to increase almost as much as in 1998 (9.3 per cent). On the other hand, the projected 11.1 per cent increase in the capital account deficit is considerably lower than last year's and is attributable to a reduction in all categories of expenditure under this account, working capital expenditure in particular (1999: 25 billion drachmas, 1998: 174 billion).

The increase in the total deficit of public enterprises is expected to lead to an increase in their net borrowing requirements, despite considerably larger grants. Specifically, total grants are projected to reach 493 billion drachmas, compared with 405 billion in 1998, owing to the forecast increase in grants mainly out of the public investment budget (1999: 412 billion drachmas, 1998: 348 billion) and secondly out of the ordinary budget. As the increase in the total deficit is not fully financed by larger grants, net borrowing will rise to 554 billion drachmas, compared with 389 billion in 1998.

APPENDIX TO CHAPTER VII

FISCAL POLICY MEASURES¹

In 1998, as in 1997, various administrative issues were settled and laws enacted in previous years were put into effect with a view to curbing tax evasion and increasing tax revenue. The tax laws enacted in the course of 1998 and early 1999 aim in the same direction, while it is also sought to lower inflation.

Specifically, under Law 2642/98 “Register of companies engaged in building, converting, repairing and maintaining vessels, and other provisions”, income from repos was exempted from income tax as from 17 September 1998.

Law 2648/98 — “Tariff and tax arrangements, amendment to the tax procedure code, and other provisions” — settles Ministry of Finance organisational issues concerning the Financial and Economic Crimes Police (SDOE) and provides facilities for the payment of overdue taxes to the government. In particular, assessed taxes which were overdue by 17 September 1998 may be paid in up to 18 two-monthly instalments. If the whole amount due is paid by 31 December 1998, there is a 35 per cent discount on the surcharge imposed for delayed payment. Also, overdue taxes of free professionals are rescheduled and the same applies to those taxpayers whose firms were attacked by anarchist groups. Other provisions of the same law include: the abolition, as from 21 September 1998, of the special consumption tax (100 drachmas per kg) imposed on imported and domestic bananas; the increase, as from 1 January 1999, from 30 to 40 per cent, in the exemption from the special consumption tax on diesel oil for agriculture; the increase in various dues and fees on bills of exchange, promissory notes etc.; and the abolition of the Exchangeable Property and Refugees Rehabilitation Fund (TAPAP), the revenue of which will henceforth be collected by the State.

The same law provides for a decrease, as from 24 September 1998, in the special taxes imposed on oil products. More specifically: (i) the rate of the special consumption tax on unleaded gasoline up to 96.5 octanes is reduced from 111,000 to 103,000 drachmas per kilolitre, while for the category over 96.5 octanes it is reduced from 121,000 to 113,000 drachmas per kilolitre, and (ii) the rate of the special consumption tax on high-compression leaded gasoline is reduced from 127,000 to 119,000 drachmas per kilolitre.

Finally, Law 2682/99 — “Settlement of matters concerning the taxation of vehicles, and other provisions” — abolishes the special consumption tax on automobiles and reduces VAT on electricity consumption. Specifically, as from 16 November 1998, the special consumption tax on automobiles is abolished, while classification fees are increased significantly. As from 1 January 1999, VAT on power consumption is reduced from 18 to 8

¹ The measures taken in early 1998 (Law 2579/1998) with a major effect on last year's revenue were presented in the Annual Report for 1997.

per cent, while the taxation of interest from government bonds held by non-residents is abolished. Lastly, as from 31 December 1998, the special consumption tax on diesel oil is raised from 77,000 to 83,000 drachmas per kilolitre.

VIII. BALANCE OF PAYMENTS

1. INTRODUCTION

In 1998 the current account deficit was significantly reduced and net capital inflows increased much faster than in 1997. Current account developments resulted from both the decrease in the trade deficit¹ and the increase in the surplus on invisibles. Thus, the cur-

TABLE VIII.1
BALANCE OF PAYMENTS

	January - December (million US dollars)			Percentage changes		January - December (billion drachmas)			Percentage changes	
	1996	1997	1998*	1997/96	1998/97	1996	1997	1998*	1997/96	1998/97
Import bill	24,135.5	23,644.1	23,246.9	-2.0	-1.7	5,829.0	6,467.5	6,882.2	11.0	6.4
Export receipts	5,769.9	5,373.3	5,566.0	-6.9	3.6	1,385.1	1,462.2	1,635.4	5.6	11.8
Trade balance (percentage of GDP)	-18,365.6 (14.9)	-18,270.8 (15.2)	-17,680.8 (14.6)	-0.5	-3.2	-4,443.9	-5,005.3	-5,246.8	12.6	4.8
Non-oil trade balance	-16,137.7	-16,067.2	-16,383.3	-0.4	2.0	-3,904.1	-4,406.4	-4,863.2	12.9	10.4
Oil trade balance	-2,227.9	-2,203.6	-1,297.6	-1.1	-41.1	-539.8	-598.9	-383.6	11.0	-35.9
Invisible receipts	20,444.1	19,967.5	21,793.5	-2.3	9.1	4,907.3	5,438.8	6,397.7	10.8	17.6
Invisible payments	6,617.7	6,540.3	7,756.7	-1.2	18.6	1,599.0	1,792.8	2,295.4	12.1	28.0
Balance on invisibles	13,826.4	13,427.2	14,036.8	-2.9	4.5	3,308.3	3,646.0	4,102.3	10.2	12.5
Current account balance (percentage of GDP)	-4,539.2 (3.7)	-4,843.6 (4.0)	-3,644.0 (3.0)			-1,135.6	-1,359.3	-1,144.5		
Net capital movement	8,657.4	111.8	8,527.7			2,028.1	-85.4	2,482.9		
Errors and omissions	77.5	186.7	-428.5			89.1	143.9	-40.3		
Valuation adjustment	-754.0	-1,302.1	399.8			25.8	331.3	73.3		
Overall balance	3,441.7	-5,847.2	4,855.0			1,007.4	-969.5	1,371.4		
Foreign exchange reserves (end of period)	19,177.3	13,336.5	18,191.2			4,737.2	3,769.0	5,140.3		

* Provisional data.

Source: Bank of Greece.

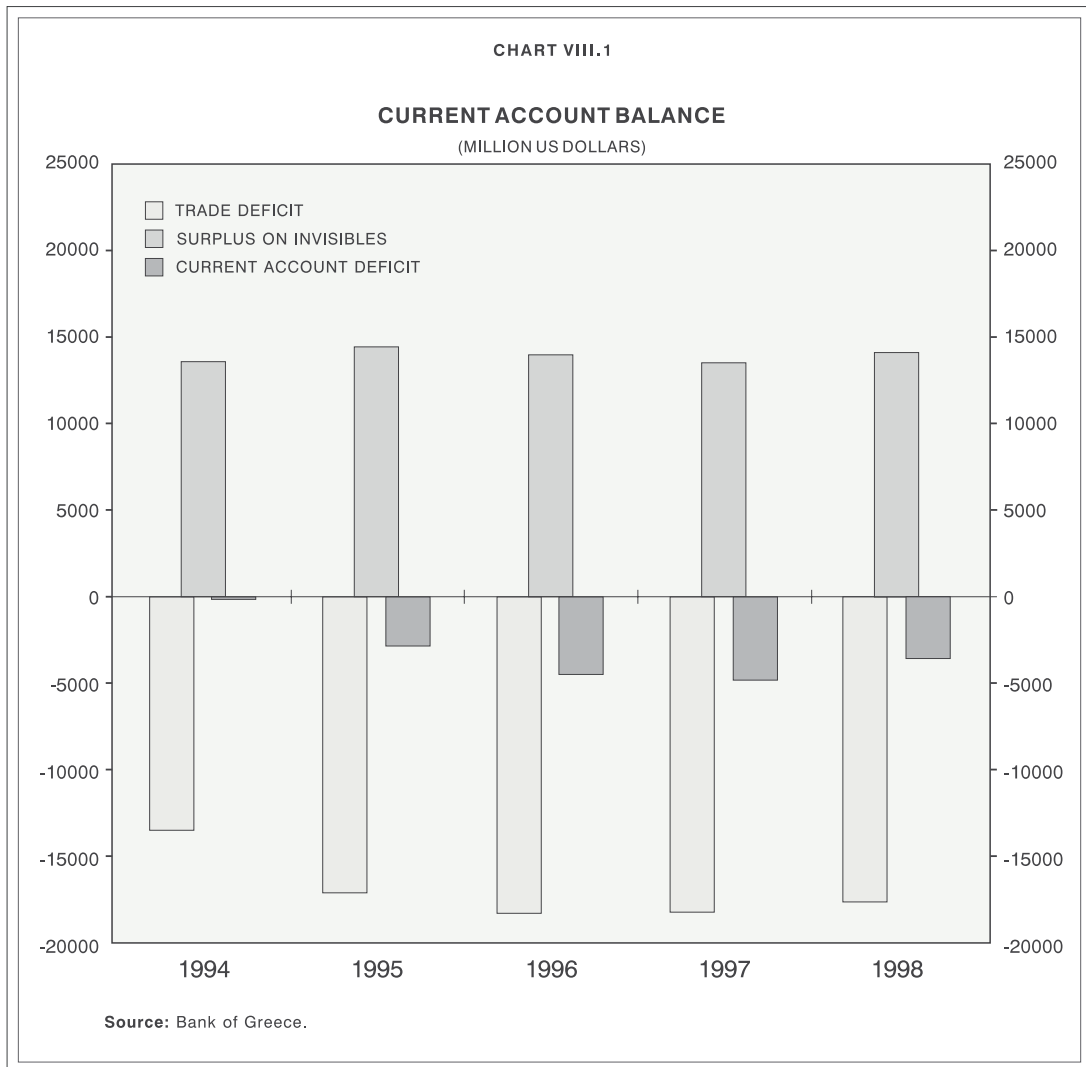
rent account deficit as a percentage of GDP declined from 4.0 per cent in 1997 to 3.0 per cent in 1998 (see Table VIII.1 and Chart VIII.1).

Current account developments were affected by several factors, some of which pertain to the international economic environment, such as the slower growth of world economic activity and world trade volume, as well as the reduction in the price of crude oil and many other raw materials. Besides, the climate of uncertainty which prevailed in money markets, as a result of the continuing turmoil in Eastern Asia and the economic crisis that hit Russia, temporarily affected the Greek economy as well. The Russian crisis had a par-

¹ This applies to the balance of payments expressed in US dollars. In drachma terms, the trade deficit increased slightly.

ticularly serious impact on Eastern European economies, to the markets of which a large share of Greek exports is directed.

Moreover, balance-of-payments developments in 1998 have also been influenced by factors related to the domestic economic environment, such as the continuing high growth of the Greek economy, especially of investment activity, the effect of which on the balance of payments, however, seems to be offset in the medium term by the increase in productiv-



ity. The drachma's entry into the ERM in March 1998, accompanied by an adjustment in its exchange rate (see Box VIII.3) also played a positive role. At the same time, the speeding up of some structural reforms restored market confidence in the economy's prospects immediately after the drachma joined the ERM, a fact reflected in the course of capital flows after the first quarter of 1998. Owing to the situation in the foreign exchange market, the drachma gradually appreciated after March and offset a large part of its devaluation.

The recording of balance-of-payments items after the first quarter of 1998 has been significantly affected by the application of a new compilation method based on the distinction between residents and non-residents (see Box VIII.1). In particular, under the new system, some of the items, such as export and travel receipts, reflect the respective activities more accurately, while the importance of items such as “withdrawals from convertible

BOX VIII.1

The new system of balance of payments compilation

Aggregated external transactions statistics in 1998 are published retaining the structure and breakdown of transactions already employed, including, however, statistical information based both on the previous and the new method for compiling the balance of payments. More specifically, as from the second quarter of 1998, statistical data submitted by banks on the basis of the new method began to be used. In the third and fourth quarter, the share of data collected by the “new method” gradually increased and it is estimated that the transition to the new statistical information regime for external transactions will be completed soon.

The previous method of balance of payments compilation was based on the institutional framework of restrictions and rules on foreign currency and was aimed at recording transactions in foreign currency settled through credit institutions located in Greece. Thus, only those transactions which involved conversion of foreign currency in drachmas or vice versa were recorded, irrespective of the counterparts’ residence. The new method, however, is based on the conceptual framework adopted by the International Monetary Fund, as defined in the Fifth Edition of the Balance of Payments Manual (1993). The aim is to record all transactions between residents of Greece and residents of other countries (non-residents), irrespective of the currency in which the transaction takes place. The new definition of “resident”, which is related to the existence of an economic interest in a country, gives a different dimension to the method of balance of payments compilation. In particular, in the case of Greece’s balance of payments, concepts such as the compulsorily surrenderable or free foreign exchange do not exist anymore, a fact which affects the depicting of many balance-of-payments items, such as export receipts regarding goods, travel and transport.

The presentation of total, aggregated items of the balance of payments still follows the old method, during this transitional period, because it is conceptually impossible to adapt data compiled by the old method to the structure of the new method. For the transitional period, then, the system of reverse adaptation (i.e. adaptation of the new method to the previous one) was adopted, in view of the data collection by all banks on the basis of the new method.

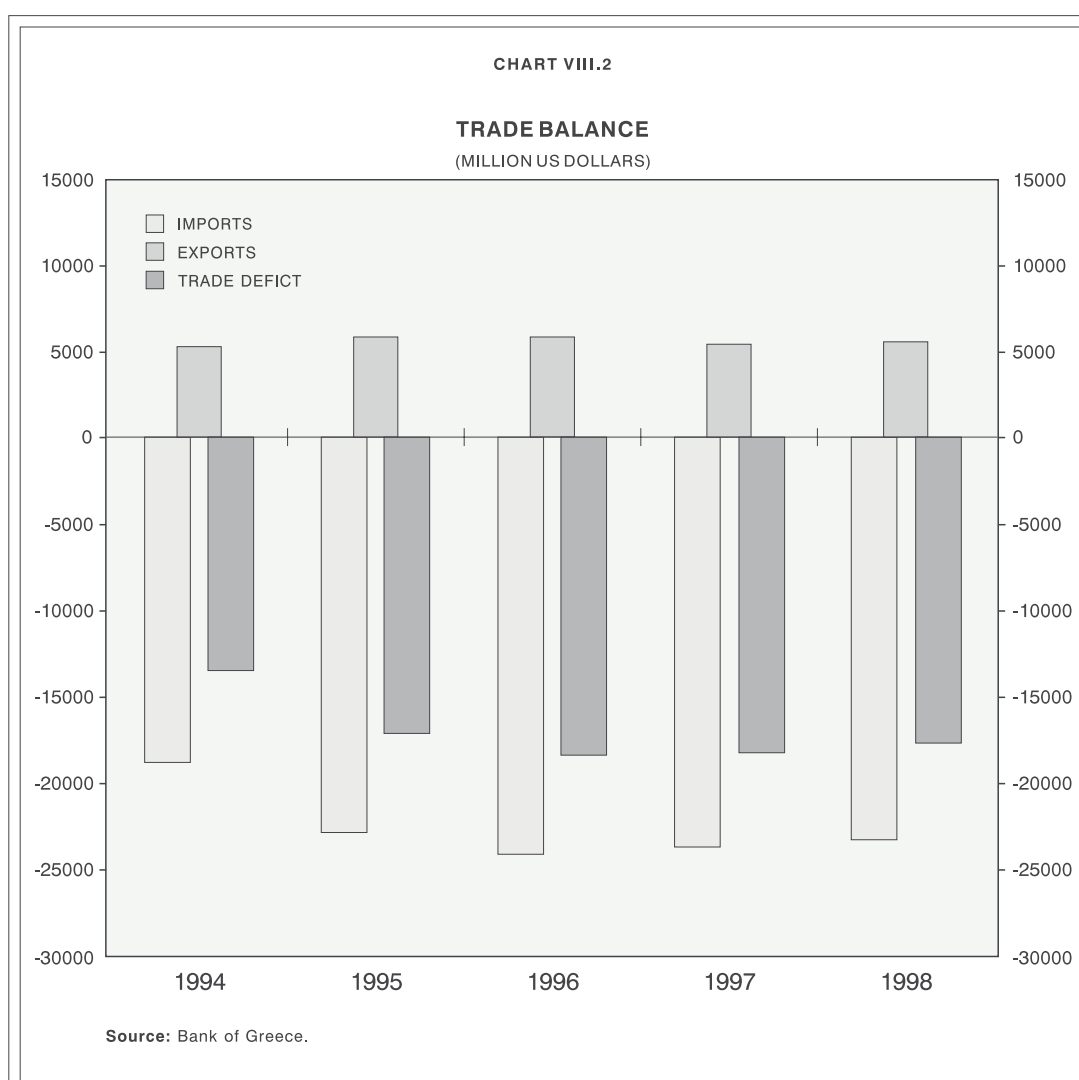
From the above it follows that, in conceptual terms, the data collected on the basis of the new method are not fully comparable with those based on the previous one, especially concerning items such as exports of goods, transport receipts and tourist services. However, the problem is reduced when one makes comparisons among large, grouped categories of transactions, e.g. those concerning the current account.

drachma accounts” and “other invisible receipts” is diminishing. Also, the new methodology has affected the breakdown of items under the current account and capital movement.

2. TRADE BALANCE

2.1 Introduction

On the basis of provisional data on payments for 1998, the trade deficit was reduced by \$590 million, compared with 1997, and corresponded to 14.6 per cent of GDP



(15.2 per cent in 1997). This improvement resulted not only from the cut in the import bill but also from the increase in export receipts (see Chart VIII.2). More specifically, the

TABLE VIII.2
NON-OIL TRADE BALANCE

	1997	1998*	1997 Q1	1997 Q2	1997 Q3	1997 Q4	1998* Q1	1998* Q2	1998* Q3	1998* Q4
Settlements statistics										
Imports (million US dollars) (percentage change)	20,839.2 -2.0	21,222.6 1.8	5,134.6 -0.7	5,324.3 -2.2	4,971.0 -3.9	5,409.3 -1.1	4,853.9 -5.5	5,341.3 0.3	5,206.8 4.7	5,820.6 7.6
Exports (million US dollars) (percentage change)	4,772.0 -6.8	4,839.4 1.4	1,157.3 -14.5	1,095.4 -12.6	958.0 -19.7	1,561.3 18.5	984.2 -15.0	1,129.8 3.1	1,186.7 23.9	1,538.7 -1.5
Trade balance (million US dollars) (percentage change) (million US dollars, on a cumulative basis)	-16,067.2 -0.4	-16,383.2 2.0	-3,977.3 4.3	-4,228.9 0.9	-4,013.0 0.8	-3,848.0 -7.4	-3,869.7 -2.7	-4,211.5 -0.4	-4,020.1 0.2	-4,281.9 11.3
Imports (billion drachmas) (percentage change)	5,703.8 11.1	6,283.8 10.2	1,340.2 7.1	1,451.3 9.8	1,413.3 14.4	1,499.1 13.3	1,428.3 6.6	1,659.1 14.3	1,552.8 9.9	1,643.6 9.6
Exports (billion drachmas) (percentage change)	1,297.4 5.6	1,420.6 9.5	299.8 -8.0	296.7 -2.0	270.7 -4.4	430.2 35.7	288.2 -3.9	348.3 17.4	352.2 30.1	431.9 0.4
Trade balance (billion drachmas) (percentage change) (billion drachmas, on a cumulative basis)	-4,406.4 12.9	-4,863.2 10.4	-1,040.4 12.4	-1,154.6 13.2	-1,142.6 20.0	-1,068.9 6.2	-1,140.1 9.6	-1,310.8 13.5	-1,200.6 5.1	-1,211.7 13.4
Customs statistics										
Imports (billion drachmas) (percentage change)	6,809.3 9.8	7,425.8 9.1	1,536.6 2.3	1,780.0 11.7	1,647.5 12.0	1,845.2 12.7	1,681.3 9.4	1,904.6 7.0	2,081.0 26.3	1,758.9 -4.7
Exports (billion drachmas) (percentage change)	2,786.7 6.6	2,867.1 2.9	678.6 1.7	733.4 14.8	643.2 2.2	731.5 7.9	682.0 0.5	765.0 4.3	741.4 15.3	678.7 -7.2
Trade balance (billion drachmas) (percentage change) (billion drachmas, on a cumulative basis)	-4,022.6 12.0	-4,558.7 13.3	-858.0 2.8	-1,046.6 9.6	-1,004.3 19.4	-1,113.7 16.1	-999.3 16.5	-1,139.6 8.9	-1,339.6 33.4	-1,080.2 -3.0
			-858.0	-1,904.6	-2,908.9	-4,022.6	-999.3	-2,138.9	-3,478.5	-4,558.7

* Provisional data.

Source: Bank of Greece (settlements statistics) and NSSG (customs statistics).

reduction in the trade deficit was exclusively due to the lower net oil import bill, caused by the fall in crude oil world prices. The non-oil trade deficit increased compared with 1997. Moreover, the part of the import bill covered by export receipts grew to some extent, from 22.7 per cent in 1997 to 23.9 per cent in 1998. This development occurred in a period when Greece's GDP increased at a much faster rate than both its potential growth rate and the GDP growth rate in the country's trade partners. This implies an improved performance of the Greek economy and an export shift towards products with a higher value added. Finally, although exports rose at a rate almost twice as high as that of imports (11.8 per cent against 6.4 per cent), the total trade deficit, expressed in drachmas, increased slightly, owing to the considerable difference between export receipts and the import bill.

The trade balance data for 1998 reflect to a certain extent the increased accuracy in recording the country's external transactions. It should be borne in mind that the settlements statistics system used up to the first quarter of 1998 overestimated the trade deficit, especially in recent years. By the application of the new method for balance-of-payments compilation, this overestimation seems to have been reduced. Indicatively, a comparison of customs statistics (NSSG) with settlements statistics (Bank of Greece) reveals that in 1998 the trade deficit, based on payments data, was only 6.4 per cent (1997: 15.2 per cent) larger than the deficit on the basis of customs statistics. The latter deficit was 4,932 billion drachmas in 1998 (rise of 13.5 per cent over 1997) or 13.8 per cent of GDP.

Quarterly settlements statistics indicate that the trade deficit¹ in all quarters, except the fourth, was lower than in 1997, mainly because of the decline in net oil imports. The 2.7 per cent drop in the non-oil trade deficit in the first quarter was due to the reduction in the import bill, which more than offset the decrease in export receipts. In the second and third quarter of 1998, the deficit did not show any notable changes against 1997, while in the fourth quarter it rose, owing to the substantial growth of imports, which was largely attributable to the increase in passenger car imports, after the cut in the relevant special consumption tax (see Table VIII.2).

2.2 Exports

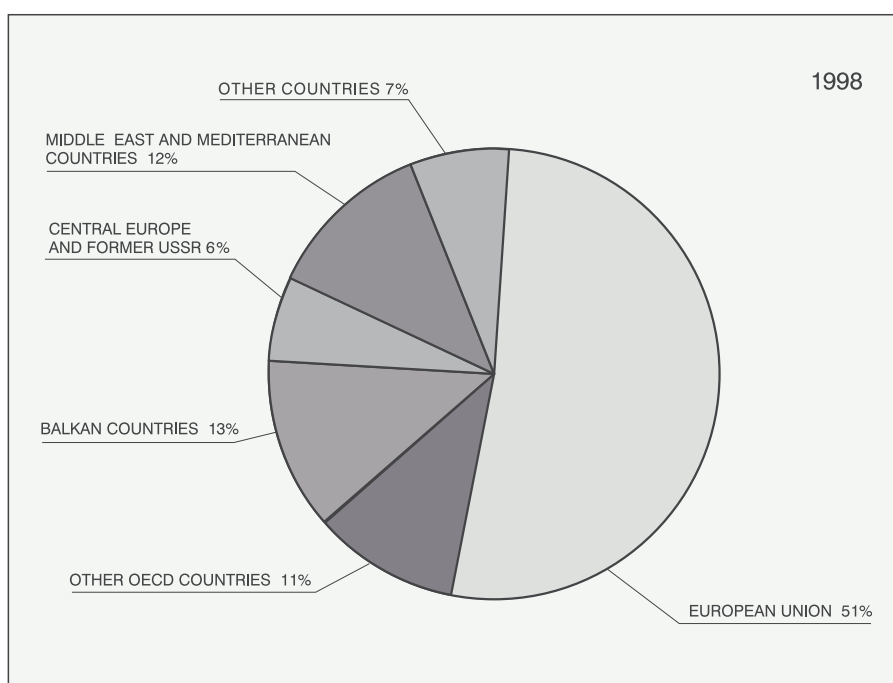
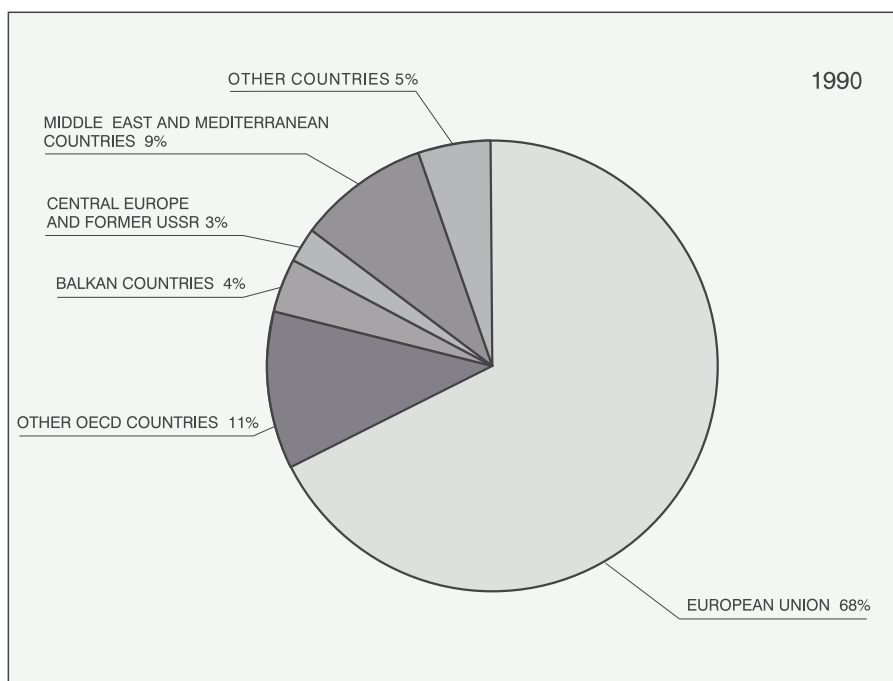
In 1998, non-oil export receipts rose, both in dollar and in drachma terms, according to provisional settlements statistics. Given the developments in export prices, on the basis of the relevant NSSG wholesale price sub-index, it seems that export volume increased much more than in 1997 (see Table VIII.3a).² Export

1 These findings refer to balance-of-payments data expressed in US dollars. The trade deficit, expressed in drachmas, rose, but at a clearly declining rate.

2 By contrast, according to provisional NSSG customs statistics, in 1998 export volume decreased slightly. The difference of about 6 percentage points between the data from the two sources is attributable, on the one hand, to the improved recording of data on a settlements basis and, on the other hand, to the provisional nature of customs statistics, which leads to an underestimation of transactions.

CHART VIII.3

GREEK EXPORTS BY DESTINATION



Source: NSSG.

prices, according to the wholesale price index, grew slightly faster, compared with the previous year. This can be attributed to exporters' efforts to increase their profit margins.

As regards foreign demand, import volume of OECD countries, to which the bulk of Greece's exports is directed, is estimated to have risen in 1998, albeit at a slower pace (6.9 per cent, compared with 9.9 per cent in 1997). OECD countries, especially those which are members of the European Union, remain the traditional destination for more than 60 per cent of Greek exports. It should be noted that Greek exports to EU markets face strong competition from products coming from low-cost countries.

In the last few years, however, a shift is observed in the geographical breakdown of Greek exports, with an increasing share going to the Balkans, Central Europe and the former Soviet Union, where demand for Greek products seems to be growing faster (see Chart VIII.3). This trend continued in 1998, since, according to NSSG data, export

BOX VIII.2

Trade with Balkan countries

Greece's trade with Balkan countries has grown considerably in recent years. Trade with these countries was regulated in the past through clearing agreements. Since the early 1990s, the share of exports towards the Balkan countries is steadily increasing; these exports mostly include

TRADE BALANCE BETWEEN GREECE AND THE BALKAN COUNTRIES
(Million drachmas)

	1990	1991	1992	1993	1994	1995	1996	1997	1998*
Romania	-2,016	-1,338	8,215	8,196	60	10,946	7,276	-7,619	7,873
Bulgaria	-8,739	-7,426	1,176	24,238	28,376	-8,434	-14,152	-26,622	16,388
Albania	878	61	4,420	25,420	43,162	51,816	69,324	58,667	46,016
Other countries**	-14,633	-11,718	1,533	25,418	-2,411	14,557	66,169	81,850	88,293
Total	-24,510	-20,421	15,344	83,272	69,187	68,884	128,617	106,276	158,570

* Provisional data.

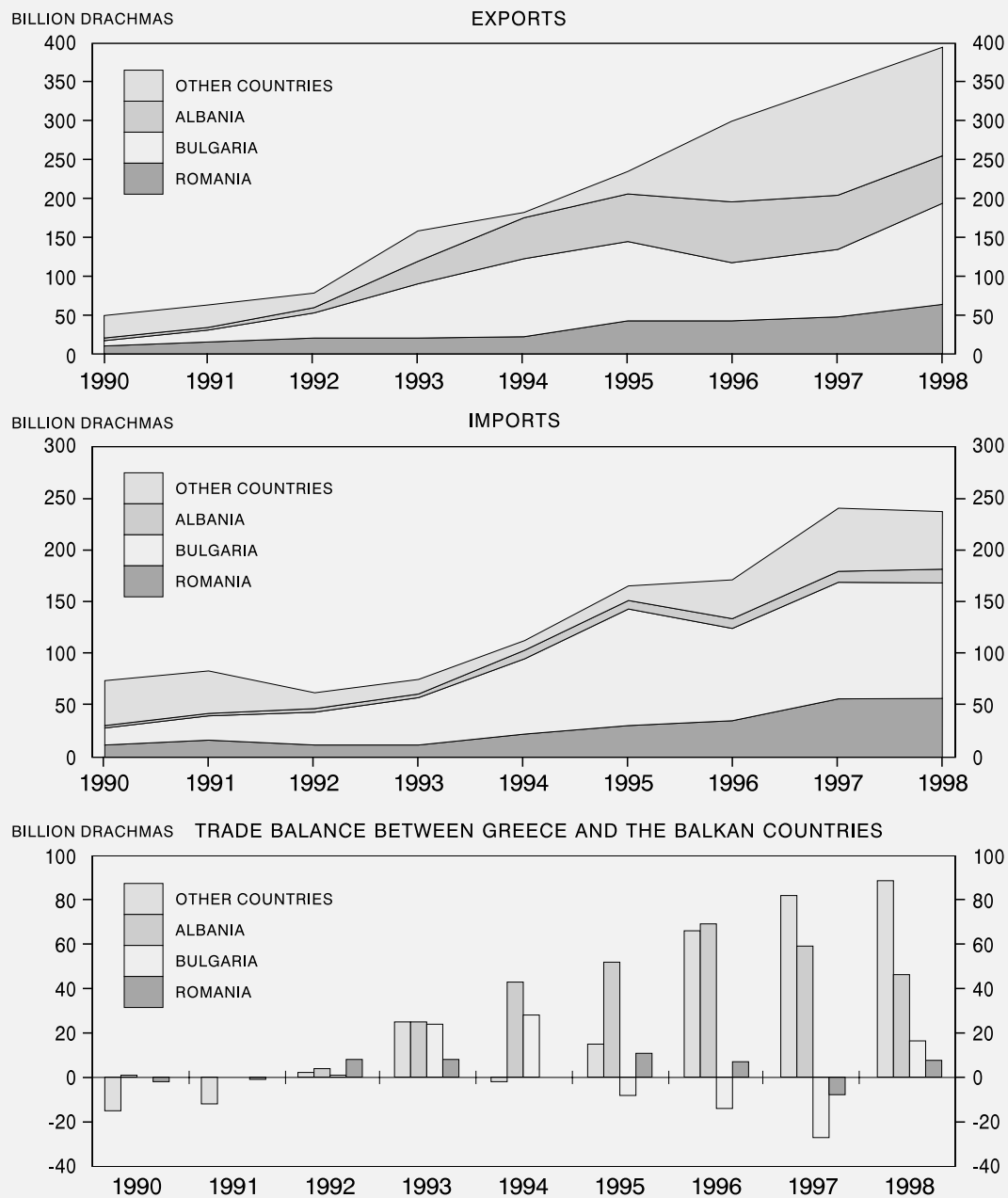
** Including countries of the former Yugoslavia.

Source: NSSG.

traditional Greek products, such as food, tobacco, textiles and clothing. Export shares to Albania and Bulgaria show a significant rise. Exports towards the republics of the former Yugoslavia fell sharply, owing to political instability. After 1996, the situation gradually →

→ returned to normal, until the recent crisis. Greece's trade balance with the total of Balkan countries shows an increasing surplus. Since the early 1990s, the share of Greek exports to the group of these countries has tripled and the relevant trade balance is positive since 1993. Greece's imports from the Balkan countries have not changed significantly since 1990, while, among these countries, Bulgaria is the top exporter to Greece (see table and chart in the Box).

TRADE BETWEEN GREECE AND THE BALKAN COUNTRIES



Source: NSSG.

volume to traditional destinations (OECD countries)¹ fell by 3 per cent, while export volume to new markets increased by 1.4 per cent. Thus, export receipts from most Balkan and Central European countries grew, while exports to Russia and other countries of the former Soviet Union decreased. However, the great uncertainty about economic and political developments in these countries and the recent events in the Balkans affect demand for Greek exports.

According to detailed NSSG data, export receipts from several product categories fell considerably. The most significant drop was observed in cereals, vegetable oils and fats, footwear and clothing. In the case of cereals, the drop in export receipts was partly due to the smaller production of durum wheat, which as a rule is intended for export. The

TABLE VIII.3a
NON-OIL EXPORT PRICES AND VOLUME
(Percentage change)

Non-oil export receipts	1996	1997	1998**
Value (billion drachmas)			
Settlements statistics	0.5	5.6	9.5
Customs statistics	10.1	6.6	2.9
Export prices*	4.5	5.0	5.8
Volume			
Settlements statistics	-3.8	0.6	3.5
Customs statistics	5.4	1.6	-2.7

* Calculated on the basis of the export sub-index of the WPI compiled by the NSSG.

** Provisional data.

Source: Bank of Greece (settlements statistics) and NSSG (customs statistics).

significant reduction in olive-oil prices, due to increased production in many EU countries, led to a decline in export receipts from these countries in the categories of vegetable oils and fats. By contrast, exports of these items to third (i.e. non-EU) countries increased significantly. A similar shift in export activity from the EU to third countries was observed for clothing and tobacco products. Greek tobacco products represent 2 per cent of world production and 5 per cent of world exports. The fall in tobacco exports and the shift of export activity to third countries is attributed, to a great extent, to the anti-smoking campaign in EU countries. By contrast, export receipts from fruit and vegetables increased significantly; a large part of this increase stemmed from the rise in the output and exports of peaches.

¹ Including the 24 countries which were already OECD members before 1994.

2.3 Imports

The non-oil import bill, in US dollars, increased slightly, compared with 1997, while in drachma terms it rose considerably, even though at a lower rate than in 1997. If account is taken of the evolution of import prices, according to the relevant NSSG wholesale price sub-index, import volume appears to have increased, albeit at a much slower pace than in 1997 (see Table VIII.3b).¹

The rise in imports was not uniform for all product categories. According to detailed NSSG data, the import volume of capital goods increased at a rate double that in 1997, a fact related to the fast rise in investment in equipment, which continued in 1998. In contrast, the volume of industrial consumer-goods imports remained unchanged (+0.2 per cent), while in 1997 it had increased by 8.7 per cent. Finally, food import volume decreased by 3 per cent (compared with a 5 per cent rise in 1997). Developments in the last two import categories were mostly due to the decline in the growth rate of private con-

TABLE VIII.3b
NON-OIL IMPORT PRICES AND VOLUME
(Percentage change)

Non-oil import bill	1996	1997	1998**
Value (billion drachmas)			
Settlements statistics	6.8	11.1	10.2
Customs statistics	13.3	9.8	9.1
Import prices*	1.6	1.8	6.0
Volume			
Settlements statistics	5.1	9.2	4.0
Customs statistics	11.6	7.8	2.9

* Calculated on the basis of the import sub-index of the WPI compiled by the NSSG.

** Provisional data.

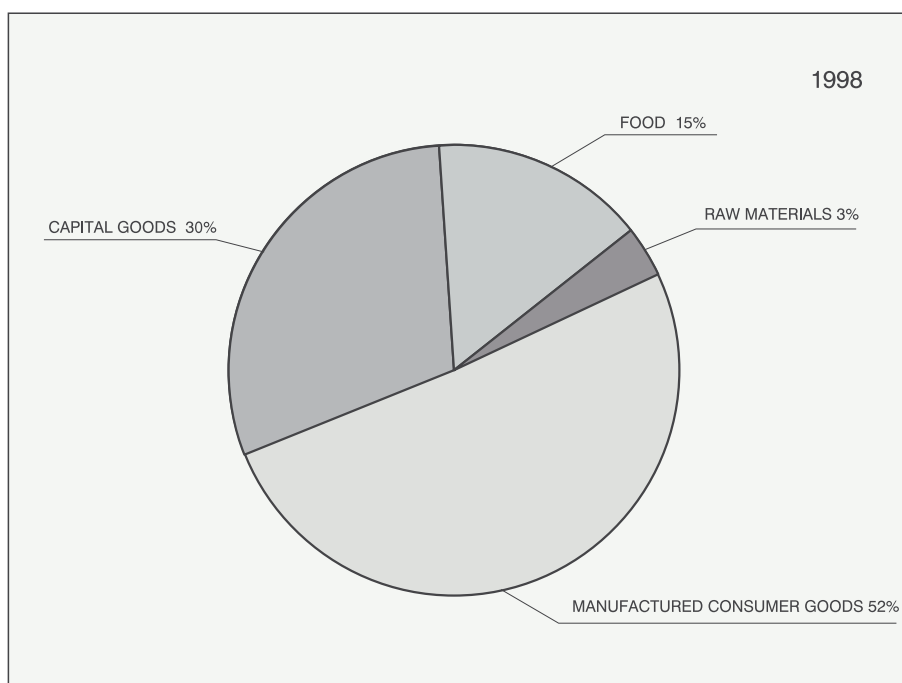
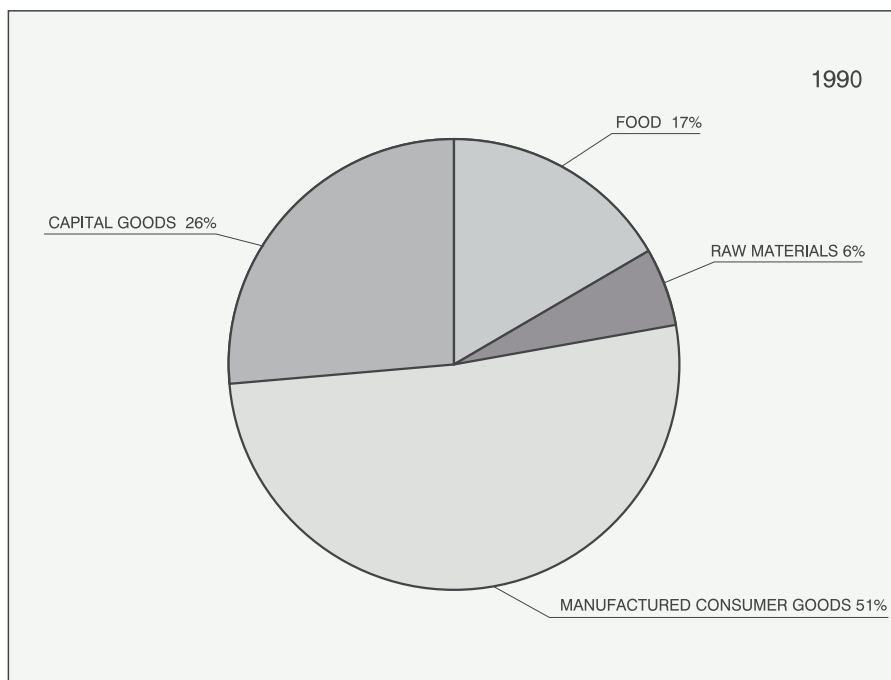
Source: Bank of Greece ((settlements statistics) and NSSG (customs statistics).

sumption, caused by the slower increase in real disposable income, but also to the adjustment of the exchange rate of the drachma, which caused Greek product prices to rise at a slower pace than import prices. In particular, the NSSG wholesale price index for domestic products rose by 5.1 per cent, while the index for imports by 6 per cent. The fact that food imports declined, while imports of industrial consumer goods remained stagnant must be attributed to the different degree of substitution by domestic products. Chart VIII.4 shows the change in the composition of Greek imports by product category in the 1990s.

¹ NSSG data also show a similar deceleration in the growth of import volume..

CHART VIII.4

GREEK IMPORTS BY PRODUCT CATEGORY



Source: NSSG.

2.4 Oil balance

The net oil import bill decreased significantly in 1998, thus leading to an improvement in the trade balance. The reduction in the value of net oil imports was due to both the rise in export receipts and the drop in the import bill caused by a fall in world market

TABLE VIII.4
OIL IMPORTS AND EXPORTS

	1995	1996	1997	1998*
Imports				
(million US dollars)	2,229.5	2,879.7	2,804.9	2,024.3
(percentage change)		29.2	-2.6	-27.8
Exports				
(million US dollars)	490.6	651.8	601.3	726.7
(percentage change)		32.9	-7.7	20.9
Oil trade balance				
(million US dollars)	-1,738.9	-2,227.9	-2,203.6	-1,297.6
(percentage change)		28.1	-1.1	-41.1
Crude oil price				
(US dollars per barrel)	17.0	20.7	19.1	12.7
(percentage change)		21.2	-7.6	-33.3
Import volume				
(million barrels)	130.8	139.4	146.9	158.9
(percentage change)		6.5	5.4	8.2

* Provisional data.

Source: Bank of Greece.

prices. Crude oil prices, in US dollars, fell by 33.3 per cent, compared with 1997. Conversely, the volume of oil imports¹ rose by 8.2 per cent, a development related to the significant growth of GDP and industrial production, as well as oil exports (see Table VIII.4).

¹ Assuming, for the sake of simplification, that the entire oil import bill concerns crude oil. This is not accurate, but it does not affect the conclusion about the change in oil volume, given that the prices of the remaining oil products are determined proportionately to the price of crude oil.

BOX VIII.3**Exchange rate and competitiveness**

The indices of the real exchange rate of the drachma measure the degree of competitiveness of Greek goods and services relative to those of competitors. The price indices usually used to calculate the real exchange rate are unit labour costs as well as the consumer and wholesale price indices.

The interpretation of these indices, however, requires particular caution and knowledge regarding the advantages and disadvantages of each. Being just indicators of relative prices or costs, these indices refer to developments either in the whole economy or in a specific sector (e.g. manufacturing), but not in individual branches. They thus give a general picture of cost or price competitiveness, but they ignore the effect of other, equally important determinants, such as quality, consistency in trading, the brand name etc.

It should be also borne in mind that each of the indices used has certain disadvantages. For example, unit labour costs do not include other production cost components, such as the financial costs, and thus give only a partial picture of developments. The wholesale price index does not include services and, therefore, provides no information for the interpretation of relevant developments in an economy like Greece's, where a large part of GDP regards services. Finally, the consumer price index includes indirect taxes and thus provides a false picture of price competitiveness of exported products and services.

The various indices of the real exchange rate of the drachma show a reduction in the price competitiveness of Greek products between 1994 and 1997. This was caused by the relatively limited depreciation of the drachma, combined with a rise in prices and labour costs at a much faster rate than in competitor countries. The extent of the estimated loss of competitiveness owing to this reason varies according to the index used; it is smaller if the index is calculated using consumer or wholesale relative prices and bigger if it is calculated on the basis of relative labour costs.

The deceleration of inflation in 1997 led to a slowdown in the loss of competitiveness. In 1998, after the devaluation of the drachma in March, and despite its appreciation in international markets from May onwards, competitiveness improved by 2 to 4 per cent, depending on the index used.

It should be recalled, however, that, because of their size, most Greek export firms are price takers – that is, they cannot determine or even affect prices in international markets. Therefore, any short-term fluctuations in their production costs affect their profit margins rather than the prices of their exported products.

3. INVISIBLE TRADE**3.1 Introduction**

The surplus on invisibles rose by 4.5 per cent (or by \$610 million) in 1998, compared with 1997,¹ and covered 79.4 per cent of the trade deficit (1997: 73.5 per cent).

¹ Excluding net transfers from the EU, the surplus rose to \$9,171 million, i.e. it rose by 4.2 per cent (1997: 0.4 per cent).

This improvement was related to the continued rise in real incomes in EU countries, despite the impact from the turmoil in world markets, the devaluation of the drachma and the containment of the external public debt, which, combined with the drop in the average interest rate on public debt servicing, resulted in just a small increase in interest payments.

It should be noted that the picture of some invisible trade items, which cannot be easily explained by the evolution of underlying economic aggregates, is attributable

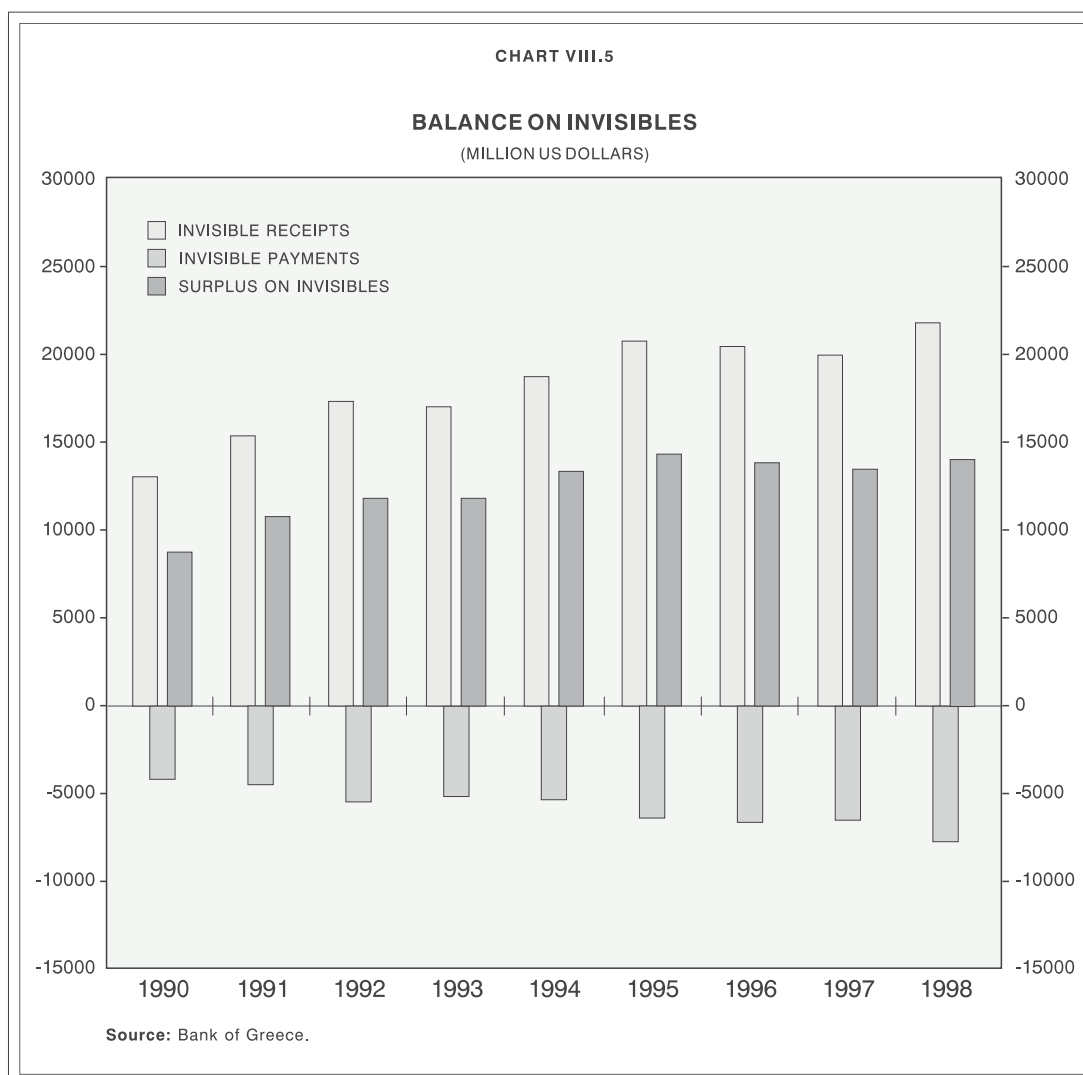
TABLE VIII.5
BALANCE ON INVISIBLES
(Million US dollars)

	1995	1996	1997	1998*	Percentage changes	
					1997/96	1998/97
<u>Invisible receipts</u>						
1. Travel	4,135.8	3,723.1	3,772.2	5,186.1	1.3	37.5
2. Transportation	2,189.8	2,263.5	2,111.3	2,280.6	-6.7	8.0
3. Emigrants' remittances	3,070.7	2,996.0	2,916.2	3,027.6	-2.7	3.8
4. Interest-dividends-profits	1,008.9	971.4	961.8	1,193.8	-1.0	24.1
5. Withdrawals out of non residents' convertible drachma accounts	2,810.0	3,005.7	3,060.0	2,827.0	1.8	-7.6
6. Other	2,587.2	2,427.4	2,524.0	2,413.0	4.0	-4.4
7. Net EU transfers	4,968.0	5,057.0	4,622.0	4,865.3	-8.6	5.3
T o t a l	20,770.4	20,444.1	19,967.5	21,793.5	-2.3	9.1
<u>Invisible payments</u>						
1. Travel	1,322.9	1,210.1	1,326.8	1,755.7	9.6	32.3
2. Government services	365.1	407.9	454.2	432.2	11.4	-4.8
3. Interest-dividends-profits	2,682.7	3,003.2	2,481.5	2,716.3	-17.4	9.5
4. Transportation	421.6	431.2	393.7	531.6	-8.7	35.0
5. Other	1,682.7	1,565.3	1,884.1	2,320.9	-20.4	23.2
T o t a l	6,475.0	6,617.7	6,540.3	7,756.8	-1.2	18.6
Balance on invisibles	14,295.4	13,826.4	13,427.2	14,036.7	-2.9	4.5

* Provisional data.

Source: Bank of Greece.

to the better recording of transactions, which is being gradually achieved through the new method of balance-of-payments compilation. As stated in previous Reports, part of some transactions (travel, transportation) was either not recorded by the previous system or was recorded under other items of invisible trade (non-residents' deposit withdrawals, other invisible receipts). Under the new system, the problems of transaction recording are being gradually eliminated. Consequently, the various items of the balance on invisibles depict transactions ever more accurately (see Table VIII.5 and Chart VIII.5)



3.2 Invisible receipts

Travel services

The particularly large rise in travel receipts (37.5 per cent in 1998, compared with 1.3 per cent in 1997) should be mostly attributed to the improved recording under the new system, given that the increase in tourist volume, as measured by foreigners' overnight stays, was about 8 per cent and, combined with the small rise in drachma prices (2-3 per cent), cannot account for such a large rise in receipts. Indeed, most of the increase in travel receipts was recorded in the third quarter of 1998 (56 per cent, compared with 3.5 per cent in 1997), while, at the same time, deposit withdrawals by non-residents decreased considerably (-42 per cent, as against +0.6 per cent in 1997). These changes were to a great

degree expected, since the number of data-reporting banks under the new system expanded mainly during the third but also in the fourth quarter. However, the evolution of the purely economic factors affecting tourism to Greece was also favourable. As mentioned above, the direct effects of the Asian crisis on the European economies were not significant in 1998; as a result, the negative impact on the income of these countries was limited. Thus, private consumption in EU countries, where most of the tourists come from, rose by 2.8 per cent (1997: 2 per cent).¹ At the same time, the policy of restraining Greek tourist service prices continued in 1998 and it is estimated that the average rise in drachma prices did not exceed 3 per cent. This improved the competitiveness of tourist services and increased Greece's market share, according to available data on overnight stays in Greece's main competitor countries. By contrast, data on tourist arrivals show that the rate of increase for Greece almost tallied with that for other countries.

Because the adjustment of the exchange rate of the drachma occurred at a time when the pricing of tourist services had been almost completed (March 1998), its positive effects were limited to independent travellers and to those who made their reservations after the devaluation. In 1999, if tourist service prices do not rise exorbitantly, the number of tourists is expected to increase even further, provided that the recent crisis in the Balkans does not have a serious impact. It should be pointed out that, after Greece joins EMU, it will no longer be possible to use exchange rate policy to influence the international prices of tourist services. Thus, competition between different European host countries will focus mainly on the quality of services and the variety of tourist products supplied.

Transportation

Transportation receipts increased by 8 per cent in 1998 (compared with a 6.7 per cent decrease in 1997), despite the unfavourable conditions in the international freight market for the most part of the year. Indicatively, in 1998 the dry cargo freight index (BFI) was far lower than in the previous two years. The index reached a minimum in mid-August, a level to which it returned by year-end, after a temporary recovery.

The effects of the Asian crisis on the economies of developing countries, which hold an increasing share of the world sea trade, and a greater than expected rise in capacity supplied seem to have largely contributed to the creation of unfavourable conditions in world freight markets.

Given the international developments, the continuing shrinking of the merchant fleet flying the Greek flag, the devaluation of the drachma against the US dollar and the further drop of domestic inflation, factors that usually affect the inflow of foreign exchange for the financing of shipping enterprises' domestic outlays, the rise in transport receipts must be merely due to the improvement in the data compilation system. It should

¹ European Commission, Economic Trends, Supplement A, No. 4, April 1999.

be noted, however, that the unfavourable conditions for sea transport seem to persist, something which is expected to pose considerable problems for those shipping companies which bear a substantial financial burden. Finally, the negative impact of the shrinking of the merchant fleet under the Greek flag on the inflow of transport receipts could be mitigated to the extent that new entries in the Greek shipping register concern newly built ships, which meet modern requirements and are, therefore, more competitive.

Emigrants' remittances

The devaluation of the drachma, combined with the rise in disposable income in countries where Greek emigrants live and work, affected emigrants' remittances (increase of 3.8 per cent in 1998, compared with a 2.7 per cent decrease in 1997). Specifically, in the USA and Germany, where most of the remittances come from, average disposable income, expressed in US dollars, rose by 2.5 per cent.

Net transfers from the EU

In 1998, net transfers from the EU increased by 5.3 per cent to \$4,865.3 million, from \$4,622.0 million in 1997. Expressed in drachmas, they grew by 13.0 per cent and in ECU by 6.3 per cent. Inflows from the Guarantees Section of the European Agricultural Guidance and Guarantees Fund remained almost unchanged, while the inflow of funds from the Structural Funds accelerated (see Box VIII.4). Greek contributions to the Community Budget grew by 21.3 per cent in 1998, mainly because of a rise in contributions based on each member's GDP.

BOX VIII.4

Development and prospects of community fund flows to Greece

Since the first year of its entry into the EU, Greece shows a "net" fiscal benefit from the Community Budget (CB), i.e. receipts exceed payments. "Net" inflows represent a considerable proportion of national income and the balance of payments. Over the last few years, they represent 25-32 per cent of the trade deficit and account for 3.9-4.4 per cent of GDP (see the first table of the Box). About 50 per cent of the inflows comes from the Guarantees Section of the European Agricultural Guidance and Guarantees Fund, according to the arrangements of the Common Agricultural Policy (CAP), and most of the rest comes from the Structural Funds (European Regional Development Fund, European Social Fund, European Agricultural Guidance and Guarantees Fund/Guidance Section) and the Cohesion Fund, in the context of the Delors II package, which covers the seven-year period 1993-1999. →

→ From 1988 onwards, inflows from the Structural Funds were incorporated into the Community Support Frameworks (CSFs). The second Community Support Framework (1994-1999) provided Greece with about 11 per cent of total sources granted by the Structural Funds. The other “Cohesion” countries got: Spain 23 per cent, Portugal 11 per cent and Ireland 4.4 per

NET INFLOWS* FROM THE COMMUNITY BUDGET AS A PERCENTAGE OF GDP
AND OF BALANCE OF PAYMENTS AGGREGATES

Year	Net inflows (million US dollars)	Percentage of GDP	Percentage of the trade deficit	Percentage of invisible receipts
1990	2,901	3.5	23.5	22.3
1991	4,034	4.5	32.8	26.3
1992	4,058	4.1	29.2	23.5
1993	4,085	4.4	32.5	24.0
1994	4,307	4.4	31.9	23.0
1995	4,968	4.3	29.0	23.9
1996	5,057	4.1	27.5	24.7
1997	4,622	3.9	25.3	23.2
1998**	4,865	4.0	27.5	22.3

* Receipts less payments.

** Provisional data.

Source: Bank of Greece.

cent. The total costs of projects under the 2nd CSF amount to about 30 billion ECU, at constant 1994 prices. Of these, national contribution accounts for 7 billion ECU, community contribution for 14 billion ECU (excluding 1.8 billion ECU from the Cohesion Fund and 1.5 billion ECU from Community Initiatives) and private expenditure for 9 billion ECU. Part of the national contribution comes from European Investment Bank loans. The European Regional Development Fund provides 68 per cent of the community contribution. The adjustment of the exchange rate of the drachma in March 1998 led to a rise in CSF funds, in drachma terms. However, the European Commission accepted the Greek government's request to increase from 66.3 per cent to 69.2 per cent the share of Structural Fund contribution in the total costs of projects, so as to avoid burdening the Greek government budget.

During 1998, the absorption rate of community funds increased much faster, owing mostly to institutional and administrative interventions aimed at improving the implementation mechanisms of the 2nd CSF. On the basis of payments out of the CB, in 1994-1998 Greece received 60 per cent of the Structural Funds allocation for the 2nd CSF and ranked fifth among EU Member-States, lagging, however, behind the other “Cohesion” countries (see the second table of the Box). On the basis of commitments, Greece's absorption rate for the above period came to 82 per cent of the Structural Funds' allocation.¹ →

1 For the coverage of projected expenditure, the CB makes the following distinction of appropriations:

- Payment appropriations, covering expenditure arising from commitments undertaken during the current or previous fiscal years and paid within the year.
- Commitment appropriations, covering, during the current year, commitments undertaken for actions whose realisation extends beyond one fiscal year.

→ It should be borne in mind that receipts from the 2nd CSF will continue until 2002. The decision that all the projects under the 2nd CSF which will not have been completed in time will be funded from the 3rd CSF is also important. Community fund inflows in Greece will continue after the end of the 2nd CSF, because the new package which was approved by the Berlin European Council (24-25 March 1999) will provide substantial funds for the less developed regions of the EU, for the period 2000-2006.

ABSORPTION OF SECOND CSF RESOURCES BY MEMBER STATES
IN 1994-1998* AS A PERCENTAGE OF TOTAL COMMUNITY CONTRIBUTION

Member States	Payments under the Community budget	Commitments under the Community budget
Greece	60.03	82.14
Spain	64.48	79.79
Portugal	71.07	95.29
Ireland	71.93	86.14
Belgium	46.69	70.05
Denmark	54.36	65.91
Germany	65.78	81.79
France	51.28	70.32
Italy	45.90	69.30
Luxemburg	57.16	91.12
Netherlands	44.50	58.67
Austria	54.78	68.53
Finland	49.93	68.75
Sweden	37.95	62.13
United Kingdom	49.41	70.62

* Including only inflows from the Structural Funds.

Source: EU services.

Inflows from the Structural Funds and the Cohesion Fund to Greece will be considerably higher than what they are now and will reach 25 billion euro. Especially important is the decision that the Cohesion Fund will continue to finance the "Cohesion" countries, irrespective of their participation in the Third Stage of EMU, while this Fund will continue to operate beyond 2006. In parallel with Structural Fund inflows, European Agricultural Guidance and Guarantees Fund (Guarantees Section) inflows will continue. The Berlin Council ratified, in principle, the agreement of the Ministers of Agriculture of March 1999. On the basis of this agreement, it is estimated that, in the context of the new revision of CAP, Greece's fiscal benefit for the period 2000-2006 will be marginally higher than that during the current period.

Finally, concerning contributions to the CB, it was proposed, among other things, to gradually replace VAT-based contributions with GDP-based ones, a method considered more fair.

3.3 Invisible payments

Travel services

Payments for travel services increased impressively (32.3 per cent in 1998, compared with 9.6 per cent in 1997). This development, however, must be interpreted with caution, since these outlays include spending on education and medical care abroad; at the same time, data for 1998 have been affected by the application of the new method of transaction recording.

Interest-dividends-profits

Payments for interest, dividends and profits rose by 9.5 per cent (against a 17.4 per cent decrease in 1997). The rise was due to the increase in private interest payments, since, under the new system, this category includes interest on non-residents' deposits with domestic banks. However, the largest part (about 80 per cent) of the increase in interest payments came from the public sector (rise of 6.7 per cent), while private interest payments increased by about 12 per cent. Payments for dividends and profits also grew; however, these items account for a small percentage of total invisible payments.

4. CAPITAL MOVEMENT

4.1 Introduction

Total net capital movement in 1998 showed an inflow many times as high as in 1997. During 1998, capital flows recorded large fluctuations as a result of important events, both in the global environment and in domestic economic activity, as mentioned above (see Table VIII.6). The devaluation of the drachma upon entry into the ERM in mid-March was the most important development, which, in connection with the prospects of the Greek economy for convergence and for joining EMU, resulted in capital inflows and, thus, a rise in foreign exchange reserves. There has been a considerable inflow of funds for the purchase of shares and government bonds by foreign investors,¹ while the state's foreign borrowing also increased, because of low interest rates. On the other hand, the turmoil in international money markets, which was rekindled in August 1998 because of the Russian crisis, had a temporary effect on the Greek market as well, leading to capital outflows at the end of August. Indicative of the great sensitivity of capital flows is the fact that major items, such as credit institutions' redeposits with the central bank, other capital, and the state's long-term net borrowing (which includes non-residents' investments in government paper), fluctuated considerably, especially from March through August 1998 (see Table VIII.7), resulting in significant changes (increase or decrease) in

¹ Part of these purchases was financed by loans from domestic banks.

foreign exchange reserves. In early September the situation returned to normal, while the unrest in Brazil had a minimal effect on capital movement.

In any case, data on capital flows, like all the other balance-of-payments items, have been affected from April 1998 onwards by the gradual adoption of the new compilation method and, thus, any comparison with the corresponding 1997 data requires careful consideration.

4.2 Private sector

In 1998, private capital recorded a net outflow of \$1,451.4 million, compared with \$4,370.5 million in 1997. More specifically, only "other capital" showed an outflow in 1998. The positive development of all the other items except "other capital" was related to the

TABLE VIII.6
CAPITAL FLOWS

	Million US dollars			Billion drachmas		
	1996	1997	1998*	1996	1997	1998*
Private sector	7,216.2	-4,370.5	-1,451.4	1,716.9	-1,307.5	-472.6
Entrepreneurial capital**	4,844.4	2,619.6	2,806.0	1,154.7	676.1	832.7
Real estate investment	1,043.9	966.6	903.3	250.4	263.2	265.3
Commercial banks**	5.5	-4.6	456.9	1.2	-1.5	129.4
Credit institutions' deposits***	-602.6	-3,343.5	587.6	-149.2	-936.1	169.6
Suppliers' credit	259.1	469.8	365.9	62.0	126.5	109.1
Other capital	1,665.9	-5,078.4	-6,571.1	397.8	-1,435.7	-1,978.7
Public sector	1,441.2	4,482.3	9,979.1	311.2	1,222.2	2,955.5
Long-term borrowing**	4,431.0	3,257.8	10,954.5	1,036.7	891.0	3,259.9
Central government	9,760.2	9,516.4	16,932.1	2,335.1	2,683.2	5,036.6
Public enterprises and entities	866.9	307.8	747.3	208.9	82.7	226.1
Suppliers' credit	-0.2	-0.1	-0.7	0.0	0.0	-0.2
Amortisation	-6,195.9	-6,566.3	-6,724.2	-1,507.3	-1,874.9	-2,002.6
Short-term borrowing (net)	-2,989.8	1,224.5	-975.4	-725.5	331.2	-304.4
Total capital flows (net)	8,657.4	111.8	8,527.7	2,028.1	-85.3	2,482.9

* Provisional data.

** Net flows.

*** Redeposits with the Bank of Greece.

Source: Bank of Greece.

favourable course of the Greek economy and the prospects of Greece joining EMU, while the substantial outflow of "other capital" was mostly due to external factors.

In greater detail, entrepreneurial capital recorded a net inflow (i.e. less amortisation payments) of \$2,806 million, i.e. it rose by about \$200 million, compared with 1997.

It is known that, according to the previous compilation method, foreign currency borrowing by Greek firms from the domestic banking system was included in entrepreneurial capital, while, under the new method, these transactions are not included in the balance of payments, as they are carried out among residents. Therefore, to the extent that the balance of payments still includes bank data collected on the basis of the previous method, the level of foreign direct investment in Greece cannot be estimated accurately. It is possible, however, by observing the change in the outstanding balance of net borrowing in foreign currency from domestic banks, to estimate, to some degree, the share of foreign direct investment and private sector's foreign borrowing in "entrepreneurial capital". In 1998, the net outstanding balance of domestic borrowing in foreign currency rose by 358 billion drachmas or about \$1.2 billion. Therefore, in the same period, the sum of direct foreign investment and firms' foreign borrowing must have been at least \$1.6 billion, a significant part of which is estimated to represent investments. This estimate is also corroborated by sample survey findings, based on a large number of domestic enterprises, which suggest a significant rise in direct foreign investment. The improvement in Greece's macroeconomic aggregates, especially the fast growth of investment activity over recent years, has had a favourable effect on attracting foreign direct investment. Indeed, according to data from banks/depositories and brokerage firms, net foreign capital inflows for the purchase of shares grew quite impressively.¹ However, in order to estimate the net investment position of the private sector, we should include Greek funds invested abroad, either as direct investment — especially in the Balkan countries — or in the form of placements in bonds, shares and deposits. These placements, a large part of which concerns portfolio investment and is included under "other capital", have grown significantly in recent years, owing to the full liberalisation of capital movement and the prospects of Greece joining EMU. Thus, according to data supplied by commercial banks, brokerage firms and mutual fund companies, the net increase in 1998 of the amount invested in securities was about \$1 billion.

Foreign currency redeposits of credit institutions with the Bank of Greece rose by \$588 million in 1998, compared with a significant decrease of \$3,343 million in 1997.² As mentioned above, this item fluctuated considerably during the year, depending on positive or negative changes in foreign currency deposits. By contrast, capital inflows for the purchase of real estate were relatively stable at \$903 million during the year, albeit slightly lower than the 1997 figure.

The category of private capital which recorded particularly strong fluctuations in 1998 was "other capital", part of which concerns short-term transactions, mainly of a spec-

1 Although this capital ought to be included under "entrepreneurial capital", it is possible that part of it appears under "other capital".

2 The reduction in deposits in 1997 was to a great extent caused by the decision of the Bank of Greece to abolish the redeposit requirement on 70 per cent of residents' deposits.

ulative nature. This item recorded large positive and negative changes (see Table VIII.7) in several cases, as in March (after the devaluation of the drachma and its entry in ERM), at the end of April (because of expectations of a further devaluation of the drachma in

TABLE VIII.7
MONTHLY EVOLUTION OF BASIC CAPITAL FLOW AGGREGATES IN 1998*
(Million US dollars)

	Jan.	Feb.	March	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Credit institutions' deposits**	217.0	704.3	21.3	-217.0	705.0	-85.0	-298.0	-53.0	-15.0	-229.0	-245.0	82.0
Other capital	-88.0	48.4	1,902.6	-2,668.0	-975.3	441.5	-251.6	-3,085.1	864.0	-255.0	-1,350.5	-1,154.1
Net long-term borrowing (public sector)	393.5	912.4	3,666.6	1,630.0	1,276.0	-256.0	584.0	-52.0	499.0	550.4	1,023.4	727.2
Change in foreign exchange reserves	568.9	1,174.1	5,330.0	-2,102.0	700.0	373.7	24.8	-2,623.5	911.1	582.6	-714.6	630.1

* Provisional data.

** Redeposits with the Bank of Greece.

Source: Bank of Greece.

view of the European Union Summit that would select the countries qualifying for joining the euro area) and in August (owing to the crisis in Russia). In 1998, "other capital" recorded a total net outflow of \$6,571 million, up from \$5,078 million in 1997.

4.3 Public sector

In 1998, net long-term borrowing by the public sector rose to \$10,954 million, from \$3,258 million in 1997. Relevant balance-of-payments data do not reflect actual foreign borrowing, as many banks still record transactions on the basis of foreign currency conversion into drachmas rather than on the basis of the "resident/non-resident" distinction. Thus, an important proportion of bond purchases by residents — mostly domestic banks and mutual funds — against foreign currency is recorded as foreign borrowing. Banks, in particular, after the reduction in the redeposit requirement with the Bank of Greece, used the released funds in foreign currency to buy bonds. Also, substantial purchases of drachma bonds by non-residents, which are included in long-term borrowing, were funded by loans extended by domestic credit institutions to foreign investors. Therefore, the increase in the country's external liabilities is, in fact, much smaller. Some of the borrowing in foreign currency took place during the first quarter, aimed in part at supporting exchange rate policy, and was facilitated by the drop in interest rates in world money markets. Substantial purchases of

drachma-denominated bonds by foreign, mainly institutional, investors occurred after the entry of the drachma into the ERM in March and were related to the enhanced prospects of Greece joining EMU and to expectations of considerable capital gains. In the same period, the public sector's net short-term borrowing was negative (\$975 million).

5. EXTERNAL DEBT AND SERVICING COSTS

The general government's external debt in foreign currency,¹ according to provisional data, was \$32 billion at the end of 1998, about \$2.8 billion higher than in 1997. This development was the result both of the rise in external borrowing and the drop in the exchange rate of the US dollar against the Deutschemark, the yen and the ECU between end-1997 and end-1998.

TABLE VIII.8
EXTERNAL DEBT IN FOREIGN CURRENCY, AND GENERAL GOVERNMENT'S INTEREST AND
AMORTISATION PAYMENTS
(Million US dollars)

	1996	1997	1998**
External debt	28,265.0	29,167.1	32,000.0
External debt as a percentage of GDP	22.9	24.3	26.6
Interest and amortisation payments	5,648.6	7,123.5	7,600.0
Interest payments	1,938.4	1,887.2	2,000.0
Amortisation payments*	3,710.2	5,236.3	5,600.0
Ratio of interest and amortisation payments of general government to current account receipts (per cent)	21.5	28.1	27.8

* Including prepayments of loans.

** Estimates.

Source: Bank of Greece.

External debt, as a percentage of GDP, stood at 26.6 per cent at the end of 1998, rising slightly from 1997 (24.3 per cent).

General government's interest and amortisation payments rose by \$477 million to \$7,600 million. This amount consisted of \$5,600 million for amortisation payments on long-term loans and \$2,000 million for interest payments. An amount of \$1,100 million concerned loan prepayments.

The ratio of interest and amortisation payments to current account receipts fell slightly, from 28.1 per cent in 1997 to 27.8 per cent in 1998, owing to the increase in current account receipts (see Table VIII.8).

¹ This amount does not include drachma-denominated bonds held by foreigners; the outstanding amount of these bonds changes, owing to transactions in the secondary market.

6. FOREIGN EXCHANGE RESERVES

The country's foreign exchange reserves rose by \$4.9 billion during 1998 to \$18.2 billion at year-end. Therefore, coverage of the import bill expanded to $9\frac{1}{2}$ months, from $6\frac{3}{4}$ months in 1997. As mentioned before, the monthly change in foreign exchange reserves fluctuated considerably. The most important changes were observed in March (+\$5.3 billion), April (-\$2.1 billion) and August (-\$2.6 billion), for the reasons already mentioned.

IX. THE BANKING SYSTEM AND ITS SUPERVISION

1. INSTITUTIONAL ADAPTATION OF THE GREEK BANKING SYSTEM AND INTERNATIONAL TRENDS

The Greek banking system now operates in a deregulated environment, radically different from the one in existence up to the mid-1980s, whose dominant feature was the numerous restrictions and administrative regulations that were responsible for banks' low degree of competition and poor competitiveness. In response to substantial developments in financial sectors worldwide, along with Greece's obligation to transpose EU regulations into its banking legislation, and to the essential need for improved efficiency and competitiveness as well as for restructuring, a number of measures were taken, aimed at modernising the Greek banking system and adapting it to the new conditions. With a view to ensuring a smooth transition to the new regime, gradual steps were taken towards the abolition of administrative regulations, the liberalisation of interest rates and the lifting of foreign exchange controls on current transactions and capital movements. At the same time, major reforms and new institutions were introduced, that expanded credit institutions' field of activity and strengthened competition. The bond market was modernised, measures were taken to upgrade the Athens Stock Exchange, a more modern and efficient payments system was established, while the supervision of credit institutions was significantly strengthened and harmonised with the EU supervisory standards. Moreover, in order to familiarise Greek credit institutions with EMU requirements and procedures, the monetary policy framework was further harmonised to a great extent with the respective framework used by the European Central Bank (ECB) for the single monetary policy.

Important though they may be, the above measures concern only the institutional adaptation of the Greek financial sector. They provide potential and incentives, but they do not automatically ensure the efficiency and competitiveness of Greek credit institutions – now open to the challenges posed by European integration and market globalisation. Banks, in particular, face increased competition because of the adoption of the euro, the cross-border provision of services, the entry of non-bank financial institutions into their field of activity, and disintermediation in the form of increased fund-raising directly from the capital market. In addition, they have to cope with the spectacular advances in the fields of information technology and communications, which, along with the deregulation of domestic markets, have led to a global market for financial products, have supported the development of portfolio management services and a drastic reduction in transport and data processing costs and have internationalised banking competition. The impact of these developments is not confined to international financial markets and wholesale banking but is also felt in local markets and retail banking.

Studies on the effects of EMU on EU banking systems¹ suggest that EMU is likely to reinforce the existing trends in the banking industry. In particular, EMU is estimated to strengthen competition, speed up the process of disintermediation, lead to increased internationalisation and geographical diversification, put additional pressure on banks' profitability, force banks to make a more rational use of resources by reducing excess capacity, in terms of staff or branches, and foster merger and acquisition activity, thus leading to the creation of powerful financial conglomerates. With regard to the various activities undertaken by banks, the most direct effect will be the reduction in foreign exchange operations. Instead, banks may take advantage of the opportunities offered by the creation of deeper and more liquid integrated money and capital markets and expand their operations in this area. This is the case in particular with private bond issues, which are expected to increase owing to lower issue costs and to the decline in the issuance of government paper, as a result of the reduction in the debt and the borrowing requirement of the general government due to EU-wide fiscal consolidation. Benefiting from the more favourable growth prospects generated by the introduction of the euro and macroeconomic stability, lending activities are also expected to increase, though not to a large degree, owing to the expected further disintermediation. A positive impact is expected on banks' off-balance-sheet business as a whole, although divergent developments will probably occur in individual financial instruments.

2. STRUCTURAL FEATURES AND PERFORMANCE OF GREEK BANKS

The performance of Greek banks has been satisfactory in recent years. Indeed, as suggested by an analysis of their income statements for the years 1988 to 1997 (see Table IX.1), the latest period for which data are available, Greek commercial banks, taking advantage of the opportunities offered by the deregulation, have expanded their business and improved their profitability. As a result, their pre-tax profits as a percentage of their total assets rose significantly to an average of 1.01 per cent in 1995-97, a period during which banks operated in an almost fully deregulated environment, from 0.58 per cent in 1988-90, when banking operations were still subject to numerous restrictions and regulations. It should be noted that bank profitability was even higher (1.28 per cent), in 1991-94, when the process of deregulation was sped up and almost completed, while competition among banks was still at relatively low levels. The profitability of Greek banks thus exhibited the same pattern as the one observed in other European countries following banking deregulation.

Both the gross income and the operating expenses of Greek banks, as a percentage of their total assets, exhibited an upward trend in the years 1988-97. It should be

¹ See e.g. European Central Bank (1999), "Possible effects of EMU on the EU banking system in the medium to long term".

noted, however, that the upward trend in gross income weakened slightly (1988-90: 3.22 per cent, 1991-94: 4.11 per cent and 1995-97: 4.30 per cent), while that in operating expenses became more pronounced (1988-90: 2.31 per cent, 1991-94: 2.40 per cent and 1995-97: 2.81 per cent). The trend in gross income reflected the evolution of revenue from non-lending operations, notably income from commissions, which, after a significant rise in 1991-94, stabilised at about 2.2 per cent of total assets in 1995-97, mainly as a result of increased competition. By contrast, net interest income, as a percentage of total assets, showed a significant upward trend throughout the period under review (1988-90: 1.26 per

TABLE IX.1
INCOME STATEMENTS OF GREEK COMMERCIAL BANKS
(Percentage of average total assets)

	1988 – 1990	1991 – 1994	1995 – 1997
1. Interest income	12.22	12.71	10.24
2. Interest expenses	10.96	11.03	8.13
3. Net interest income	1.26	1.68	2.11
4. Non-interest income (net)	1.96	2.43	2.19
5. Gross income (3+4)	3.22	4.11	4.30
6. Operating expenses	2.31	2.40	2.81
– Staff costs	1.78	1.72	1.91
– Depreciation	0.11	0.16	0.22
– Other	0.42	0.52	0.67
7. Net income (5–6)	0.91	1.72	1.50
8. Provisions	0.33	0.44	0.49
9. Profit before tax	0.58	1.28	1.01
10. Taxes	0.10	0.34	0.32
11. Profit after tax	0.48	0.94	0.69
12. Distributed profit	0.30	0.48	0.39
13. Retained profit	0.18	0.46	0.30

Source: Bank of Greece.

cent, 1991-94: 1.68 per cent and 1995-97: 2.11 per cent), although since the end of 1992 banks do not reckon interest on loans not performing for more than 12 months and although bank competition in the field of lending was far stronger in the period 1995-97 than during each of the two previous periods (1988-90 and 1991-94). This significant rise in net interest income is related to banks' credit portfolio shifts to more profitable financing operations with both the private and the public sectors, following the abolition, in 1994 and early 1995, of the remaining restrictions on bank lending. Indeed, in 1995-97 banks introduced several innovative products and expanded rapidly to new and more profitable areas, such as housing and consumer loans. Government borrowing from banks

on terms and at rates freely determined by market conditions has also played a role in this development.

The evolution of banks' operating expenses has been affected by the performance of staff expenses, which, after a slight decline to 1.72 per cent in 1991-94 from 1.78 per cent in 1988-90, rose to 1.91 per cent of total assets in 1995-97. Moreover, a strong upward trend was observed in depreciation (1988-90: 0.11 per cent, 1991-94: 0.16 per cent, 1995-97: 0.22 per cent) and in other operating expenses (1988-90: 0.42 per cent, 1991-94: 0.52 per cent, 1995-97: 0.67 per cent). Specifically, developments in depreciation largely reflect banks' efforts to expand their branch networks and to modernise and improve their operations through significant investments, mostly in information technology.

Improved profitability enabled banks to increase their savings (retained profits as a percentage of total assets, 1988-90: 0.18 per cent, 1991-94: 0.46 per cent, 1995-97: 0.30 per cent), which, combined with capital increases, helped them to significantly strengthen their capital base. At the end of 1997, Greek commercial banks' own funds¹ amounted to 5.1 per cent of their total assets, compared with just 3.1 per cent in 1989. As a result, Greek banks now face the keener competition and the emerging conditions from a considerably better position than a few years ago. It should be noted, however, that progress has not had the same pace across individual credit institutions. Some of them need to intensify their efforts for restructuring and strengthening their capital base. Also, despite the improvements, Greek credit institutions must keep up their modernisation efforts, given that, within an integrated EU-wide market, they will have to compete with banks of a significantly larger size, which have already been offering many new products and have adapted to international competition and, therefore, face from a more advantageous position the new conditions created by the introduction of the euro.

A comparison of the balance sheets and income statements of Greek banks with those of other EU banks highlights the specific structural features of the Greek banking sector. Although Greek banks enjoy a wider spread between lending and deposit rates than their EU counterparts, their net interest income as a percentage of total assets is not among the highest in the EU. As suggested by comparative data for 1996, Greek commercial banks² net interest income accounts for 2.15 per cent of their assets, compared with 2.20 per cent in the United Kingdom, 2.70 per cent in Denmark and 2.71 per cent in Italy (see Table IX.2). This is mainly due to the fact that the loans extended by Greek banks represent a relatively low percentage of their assets. Indeed, a comparison of the structure of commercial banks' balance sheets across EU Member States in 1996 (see Table IX.3) indicates that only in three countries (Belgium, France and Portugal) bank lending, as a percentage of total assets, is at levels comparable with those recorded in Greece. In all the other EU Member States, this percentage is much higher and in one case (the Netherlands) it is more than double (64 per cent, compared with 31.5 per cent

1 Defined as the sum total of share capital, reserves and results brought forward.

2 Excluding the Agricultural Bank of Greece.

TABLE IX.2
INCOME STATEMENTS OF COMMERCIAL BANKS IN 1996 AS A PERCENTAGE OF AVERAGE TOTAL ASSETS

	Austria ¹	Belgium ¹	Denmark ²	Finland	France	Germany	Italy ¹	Nether- lands ¹	Portugal	Spain	Sweden	United Kingdom	Greece ³
Interest income ⁴	5.50	8.19	6.11	4.63	5.43	5.74	8.01	6.47	7.75	8.11	6.38	5.82	10.48
Interest expenses	3.85	6.97	3.41	3.25	4.73	3.91	5.31	4.63	5.66	5.96	4.29	3.62	8.33
Net interest income	1.66	1.22	2.70	1.38	0.70	1.83	2.71	1.84	2.08	2.15	2.09	2.20	2.15
Non-interest income (net)	1.15	0.54	1.28	1.65	0.88	0.75	0.90	1.03	0.94	1.03	1.57	1.38	2.05
a) Fees and commissions receivable	0.62	0.27	0.79	–	0.50	0.68	0.43	–	0.36	0.72	0.87	1.29	1.23
b) Fees and commissions payable	0.13	0.14	0.08	–	0.13	0.09	0.10	–	0.06	0.14	0.13	0.16	0.07
c) Income on financial operations	0.15	0.35	0.65	–	0.39	0.09	0.05	0.23	0.40	0.44	0.56	0.25	0.74
d) Other income	0.51	0.07	–0.09	–	0.12	0.07	0.53	0.13	0.24	0.01	0.27	–	0.14
Gross income	2.81	1.76	3.98	3.03	1.58	2.58	3.60	2.88	3.03	3.18	3.66	3.58	4.20
Operating expenses	1.94	1.16	2.26	2.70	1.27	1.69	2.42	1.94	1.95	2.03	2.36	2.23	2.87
a) Staff costs	1.02	0.70	1.35	0.87	0.73	0.99	1.56	1.04	1.06	1.25	1.04	1.22	1.97
b) Depreciation	0.58	0.09	–	0.23	0.07	–	0.68	0.14	0.22	0.75	–	0.48	0.22
c) Other	0.34	0.37	–	1.60	0.47	0.70	0.17	0.75	0.67	0.03	–	0.54	0.67
Net income	0.87	0.60	1.72	0.33	0.31	0.89	1.19	0.94	1.08	1.15	1.31	1.35	1.33
Provisions	0.44	0.22	0.49	–0.05	0.28	0.39	0.69	0.18	0.39	0.42	0.01	0.20	0.55
Profit before tax	0.43	0.39	1.23	0.37	0.03	0.49	0.50	0.77	0.69	0.73	1.30	1.15	0.79
Tax	0.09	0.13	0.20	0.04	0.04	0.19	0.32	0.20	0.14	0.14	0.30	0.41	0.30
Profit after tax	0.34	0.26	1.03	0.33	–	0.31	0.18	0.56	0.55	0.59	1.00	0.74	0.49

1 All banks.

2 Including savings banks.

3 Commercial banks authorised in Greece.

4 Including income from shares and participations.

Source: OECD (1998), Bank Profitability.

for Greece). The relatively low size of Greek banks' lending is related to several factors, such as their substantial holdings of Greek government securities, the restrictions that applied until recently on some types of credit and the high interest rates that dampened demand for loans. It is clear, however, that with the reduction in the public deficit, the expansion of banks' lending activities to new areas and the gradual decline in interest rates in the run-up to Greece's entry into the euro area, all the above factors will lose their importance. Therefore, Greek banks' loans can be reasonably expected to grow as a percentage of their assets, despite the increasing disintermediation and firms' direct recourse to capital markets to raise funds. However, an increase in lending does not imply a com-

TABLE IX.3
COMMERCIAL BANKS' LOANS AND ADVANCES IN 1996
(Percentage of total assets)

Country	Percentage
Austria*	50.9
Belgium*	31.9
Finland	49.0
France	32.0
Germany	56.3
Germany*	53.5
Italy*	40.2
Japan	66.1
Netherlands*	64.0
Portugal	32.7
Spain	42.3
Sweden	37.6
Switzerland*	53.5
United Kingdom	55.3
Greece	31.5

* All banks.

Source: OECD (1998), Bank Profitability.

mensurate rise in banks' income, since intensifying competition puts downward pressure on the interest rate spread, hence on banks' interest income. In addition, any shift on the part of banks to lending rather than to credit-risk-free government securities will require increased provisioning for possible doubtful loans, with a negative impact on banks' profits. The increase in risk, however, affects not only Greek banks but also all EU banks, which under competitive pressure might shift to more risky business.

Greek banks' non-interest income is the highest in the EU (2.05 per cent of average total assets in 1996, compared with 1.65 per cent in Finland, 1.57 per cent in Sweden and 1.38 per cent in the United Kingdom). This is due to the relatively high income from

commissions and financial operations. As mentioned above, however, in recent years banks' income from commissions has grown at a very low rate and its share in total assets is steadily declining. In any case, only banks in the United Kingdom have income from commissions higher than that of Greek banks, probably reflecting the strength of the London financial market.

Banks' high income from financial operations stems to a large extent from sales of securities, as would be expected in an environment of falling interest rates and heavy activity in capital markets. However, the consolidation of an environment of low inflation and interest rates will not only induce savers to seek higher-yield investments alternative to deposits, but it will also put an end to banks' high capital gains on the bond market. Finally, non-interest income is likely to be adversely affected, as the adoption of the euro will probably lead to a reduction in foreign exchange operations and foreign exchange risk hedging operations involving derivatives. The above developments make it imperative for Greek banks — as well as foreign banks — to look for alternative sources of income and to expand their business by taking advantage of stronger demand for financial services and products as a result of the single European market, as well as of opportunities in non-EU markets. However, insofar as the effort to replace lost income would lead to greater involvement in some non-EU markets, country risks are likely to rise, which is something not to be overlooked.

Regarding Greek banks' operating expenses, it should be pointed out that their share in average total assets is significantly higher than in other EU countries. This is mostly due to staff expenses, which are even double than in other EU countries (for 1996, Greece: 1.97 per cent, Spain: 1.25 per cent, Portugal: 1.06 per cent, Germany: 0.99 per cent, France: 0.73 per cent of total assets). Despite the efforts made in recent years by Greek banks to reduce these costs, it is obvious that the Greek credit system is overstaffed. This is evidenced by the fact that comparative staff numbers per branch in banks of other EU countries correspond to more than double average total assets and deposits and to even higher loans per branch. Another factor which must be taken into account is depreciation. Although, as already mentioned, Greek banks' depreciation has increased in recent years, its share in total assets remains low, at least compared with some other EU countries (for 1996, Greece: 0.22 per cent, Portugal: 0.22 per cent, Finland: 0.23 per cent, but United Kingdom: 0.48 per cent, Italy: 0.68 per cent, Spain: 0.75 per cent). In any case, given the need to upgrade credit institutions' IT systems and the investment required for the various technical adaptations and for modernising and expanding their distribution network, the Greek banks' depreciation should rise significantly, with a negative impact on their profits.

It would be interesting to examine the evolution of some indicative aggregates of Greek and EU credit institutions relative to GDP since 1990. Specifically, in the 1990-1997 period (end-of-year data), both deposits and loans of EU credit institutions increased as a percentage of GDP (see Table IX.4), although they remained virtually unchanged over the period 1990-1995. Deposits rose from 99 per cent of GDP in 1990 to 102 per cent in

1997 and loans from 117 per cent to 124 per cent of GDP. Total assets grew even more strongly, from 207 per cent of GDP in 1990 to 244 per cent in 1997. The corresponding Greek figures are mixed. On the one hand, in the period 1990-1995, reflecting both the conversion of government-guaranteed loans to bonds and increased bank holdings of government paper, loans declined as a percentage of GDP, which affected negatively the entire period 1990-1997 in spite of a recovery in 1996-1997. On the other hand, deposits increased from 81 per cent of GDP in 1990 to 86 per cent in 1997 (rising by 6 per cent, almost double the rate recorded in the EU as a whole), while total assets grew from 113 per cent of GDP in 1990 to 122 per cent in 1997, recording an increase of 7.9 per cent, i.e. well below the EU average. Nonetheless, Greek banks increased their share capital by 425 billion drachmas in 1998, compared with increases of 297 billion drachmas in 1997 and 169 billion in 1996; this confirms their intense and systematic effort in the past few years to

TABLE IX.4
BANKING AGGREGATES IN GREECE AND THE EUROPEAN UNION
(End-of-year figures as a percentage of GDP)

	1990	1995	1997
Lending			
Greece	45.1	37.3	39.2
European Union	116.7	116.9	123.9
Deposits			
Greece	81.1	77.9	86.0
European Union ¹	98.9	98.8	102.0
Total assets			
Greece	113.1	118.5	122.0
European Union ¹	206.9	221.6	244.2

1 Weighted average.

Source: Bank of Greece, and ECB (1999), "Possible effects of EMU on the EU banking systems in the medium to long term".

strengthen their capital base and expand their business. This effort is expected to be kept up in 1999, as suggested by the massive capital increases announced by some credit institutions for this year.

However, despite the growth of banking aggregates relative to GDP, financial disintermediation is an indisputable fact, both in Greece and in the EU. For example, the increase in mutual funds' assets, as a percentage of GDP, is a multiple of the respective increase in credit institutions' assets in all EU countries (see Table IX.5). Especially in Greece, the growth rate of mutual funds' assets is clearly higher than in most other EU countries. Thus, the assets of Greek mutual funds as a percentage of GDP are rapidly approaching the levels of countries whose mutual fund market is far more mature than the respective Greek market. Specifically, the assets of Greek mutual funds rose from 1.1 per cent of GDP in 1990 to 22.4 per cent in 1997, compared with 18.9 per cent in Italy,

24.7 per cent in Germany and 34.9 per cent in Spain over the same year. Responding to the shift to this type of investment as an alternative to deposits, banks have begun to offer this product themselves, by setting up subsidiaries specialising in mutual fund management. It is indicative that in 1997, in all EU countries with the exception of the Netherlands, mutual funds under bank management accounted for over 80 per cent of total domestic mutual funds' assets and in two cases (Austria and Portugal) this share even approached 100 per cent.

Branches of foreign banks operating in Greece, although they have strengthened their presence over the 1990s, both in absolute and in relative terms, do not seem to be major competition for domestic credit institutions. With the exception of 4-5 banks which have expanded their network in order to enter the retail banking market, foreign credit

TABLE IX.5
ASSETS OF MUTUAL FUNDS
(End-of-year figures as a percentage of GDP)

	1990	1995	1997
Austria	8.4	14.3	22.6
Belgium	12.2	23.6	32.4
Denmark	3.0	5.0	8.0
Germany	9.9	16.3	24.7
Italy	3.7	7.2	18.9
Ireland	5.5	36.8	69.9
Netherlands	12.0	16.0	19.0
Portugal	5.0	17.0	26.0
Spain	3.1	18.0	34.9
Sweden	8.3	11.0	20.8
Greece	1.1	9.1	22.4

Source: Bank of Greece, and ECB (1999), "Possible effects of EMU on the EU banking systems in the medium to long term".

institutions confine their operations to specific market niches and some of them (e.g. Chase Manhattan) have sold their Greek network in the context of a broader strategy of concentration on big financial centres. The market share of foreign banks in traditional banking operations, such as deposits and loans, is rather small, about 9 per cent. However, their assets, as a percentage of the total assets of all credit institutions, are much higher, about 15 per cent. Data on the total foreign presence in the banking sector (subsidiaries and branches of foreign banks) as at the end of 1997 show that the asset share of foreign banks operating in Greece was 17.5 per cent, compared with 99.9 per cent in Luxembourg, 53.6 per cent in Ireland, 52.1 per cent in the United Kingdom, 36.3 per cent in Belgium, 11.7 per cent in Spain, and below 10 per cent in each of the remaining EU countries.

The sector of cooperative credit has grown strongly in the past few years. At the end of 1998, there were 12 cooperative banks in Greece, compared with 7 in 1996 and 4 in 1994, the first year of their effective operation. Despite the local or regional character of these banks, their branch network has also expanded (to 31 in 1998 from 10 in 1996), while one of them has been authorised to operate nationwide. Yet, the market share of cooperative banks remains very low. In 1998, they accounted for just 0.2 per cent of private deposits and for 0.7 per cent of total lending. On its part, the Bank of Greece has allowed cooperative banks to carry out some operations of an intermediary nature with non-members as well and has raised the upper limit of their total exposure to the same member or group of associated customers from 5 per cent to 15 per cent of their own funds, so that it can converge to the limit applicable to other credit institutions.

3. THE NEW CONDITIONS AND GREEK BANKS' STRATEGIES

Against this background, Greek banks have to respond and formulate far-reaching strategies, pondering their capabilities and defining their goals. As suggested by relevant studies, the type of bank which can effectively operate at an EU-wide level must have: (i) adequate size so as to take advantage of any economies of scale, (ii) ability to offer a broad range of services, (iii) presence in international financial centres, and (iv) an extensive and efficient distribution network. The efficiency of the distribution network is largely determined by the possibilities opened up by modern technology, which diminish the importance and change the operation of bank branches, by drastically reducing their size and by spreading the use of alternative (mostly electronic) distribution channels. In terms of organisation, it seems that the model that tends to prevail internationally is that of a financial conglomerate, with specialised subsidiaries providing the entire spectrum of financial services efficiently and flexibly, also taking advantage of the various synergies.

Credit institutions are called to decide whether they will move towards the above model or instead they will retain a purely local character and specialise in certain segments of the market, especially in retail banking, a sector which will be more sheltered from competition in the single European area. Indeed, retail banking, lending in particular, is characterised by information asymmetry between banks and their customers, given that the former have access to privileged and non-tradeable information. Moreover, demand for deposits and other retail services is still determined by how close to customers a bank branch is located. Therefore, personal advice-intensive commercial banks may enjoy an information advantage, which would make it hard for other banks to enter domestic markets.

Those credit institutions which will opt to expand their activities in Europe must secure a size that will enable them to take advantage of economies of scale and to make the necessary investment in infrastructure upgrades; this, however, will entail heavy costs that cannot be easily afforded by small banks. Moreover, wholesale banking, a sector in

which competition has increased very much, requires a pan-European network and presence in international financial centres, since the boundaries of local and regional markets have been abolished in practice. Nevertheless, the strengthening of credit institutions at the local level is common practice in the European area and is a first step towards dealing with the conditions that have emerged in the single European market.

The actions of Greek banks so far do not seem that much different from those of credit institution in other EU countries, with their efforts focusing primarily on strengthening their position in the domestic market, although there are also efforts for a broader expansion, especially to the Balkans.

1998 was a year of important restructuring in the Greek banking industry. In the previous two years (1996-1997) some relatively small steps had been taken towards mergers and acquisitions, most notably the acquisition of Interbank by Eurobank and the merger of the two housing banks (National Mortgage Bank and National Housing Bank) of the National Bank Group. By contrast, a number of important mergers and acquisitions took place in 1998, such as the takeover of Macedonia-Thrace Bank by Piraeus Bank, that of the Bank of Crete by the Eurobank Group and the merger of the National Bank of Greece with its subsidiary National Mortgage Bank, which resulted in the creation of a large bank, by Greek standards, with over 600 branches and total assets exceeding 12 trillion drachmas at the end of 1998. Another major step in the context of banking industry restructuring was the recent (March 1999) acquisition of Ionian Bank by Alpha Credit Bank.

Of great significance are also the initiatives of some credit institutions aimed at building up a presence in international financial centres, such as London and New York, setting up offshore units and penetrating the market of the Balkans via acquisitions or by establishing branches or joint ventures. Finally, some Greek banks have entered into remarkable strategic alliances with foreign banks and other financial institutions; this will allow them to import know-how and to take advantage of an international network with a strong presence in major financial centres abroad.

4. DEVELOPMENTS IN THE INSTITUTIONAL FRAMEWORK OF BANKING SUPERVISION IN GREECE AND INTERNATIONALLY

The deregulation and internationalisation of the Greek banking system and increased competition among banks have led banks to assume additional risks, because of their expansion into new activities. Against this background, banks need to upgrade their risk management and internal control systems if they are to ensure their soundness and effective operation. To this end and in the context of strengthening prudential banking supervision, the Bank of Greece decided to establish, by Governor's Act 2438/6 August 1998, general criteria and principles with which banks' internal control systems must comply in order to ensure effectiveness, and instructed credit institutions to take the necessary measures in this direction, e.g. by setting up an Auditing Committee and an independent Risk Management Unit.

Furthermore, to improve the quality and speed up the restructuring of banks' lending portfolios – an objective to which banks themselves attach great importance and which they have been pursuing over a number of years – the Bank of Greece, by Governor's Act 2442/29 January 1999, specified a general framework of minimum quantitative criteria for assessing the adequacy of banks' provisions for bad debts and established the requirement for more frequent and systematic reporting on banks' lending portfolios.

At the international level, the main developments concerning the institutional framework of banking supervision were the following:

The Basle Committee on Banking Supervision initiated the revision of the institutional framework governing the capital adequacy of banks. This revision was deemed necessary given that the latest banking developments and techniques have gradually aggravated the inherent weaknesses of the existing framework, in particular of the 1988 Accord on the calculation of banks' solvency ratio which laid down the capital requirements against credit risk. The revision process, which is also under way at the EU level through the Banking Advisory Committee, concerns the regulatory framework of capital adequacy, the procedure for prudential assessment and the enhancement of disclosure of banks' financial situation.

The regulatory framework of banking supervision at the EU level was amended and supplemented during 1998 with three Directives (98/31/EC, 98/32/EC and 98/33/EC) of the European Parliament and the Ecofin Council; these must be transposed into Greek law within two years. The Directives determine, *inter alia*, the capital requirements for position risk on commodities, supplement the table of risk weights regarding positions in certain over-the-counter derivatives, determine the risk weights of mortgage loans and state that banks may use, on an optional basis and under certain conditions, their own risk-management systems (internal models) for the purpose of calculating capital requirements against market risks.

Also, the competent working group of the Council of Ministers, in which representatives of the Bank of Greece participate, discussed in 1998 a draft Directive on electronic money. This Directive aims to establish a minimum supervisory framework, similar to the one governing credit institutions but far less strict. Such a framework would regulate the setting up and operation of issuers of electronic money which are not credit institutions and therefore do not fall into the scope of the existing Banking Directives.

5. THE EVOLUTION OF KEY INDICATORS OF CAPITAL ADEQUACY FOR COMMERCIAL AND COOPERATIVE BANKS

According to the prudential data reported by banks to the Bank of Greece, the Greek commercial banks' prudential own funds rose by 47 per cent in the period from 31 December 1996 to 31 December 1998, reaching 1,531.2 billion drachmas. The main components of own funds (share capital, reserves, results brought forward) exceed 90 per cent

of the Greek commercial banks' prudential own funds. On the other hand, risk-weighted total assets and off-balance-sheet items, including the notional amounts corresponding to capital requirements to cover market risks, rose by 27 per cent in the same period, and stood at 13,638 billion drachmas on 30 June 1998. Thus, the total capital adequacy ratio of Greek banks rose steadily, from 9.7 per cent at end-1996 to 10.3 per cent at end-1997 and to 11.2 per cent on 30 June 1998. The upward trend of this ratio is expected to keep momentum, given that, from 1 July 1998 to 31 March 1999 commercial banks raised additional capital totalling 495 billion drachmas, which amounts to 32 per cent of the outstanding balance of their prudential own funds on 30 June 1998 and is estimated to more than offset the rise in risk-weighted assets over the same period, without taking account of retained profits of the financial year 1998.

The capital adequacy ratio of cooperative banks as a whole has declined from 48.1 per cent on 31 December 1996 to 41.6 per cent on 31 December 1997 and to 36.5 per cent on 30 June 1998, but remains high. This decline is due to the fact that, after the end of the relatively recent, for most of these banks, period following the start of their operation, when their assets were almost fully financed from own funds, their subsequent large rise in assets was mostly financed from deposits.

6. OTHER SUPERVISORY ASPECTS

A) Co-operation of the Bank of Greece with other supervisory authorities

The need for close cooperation among EU banking supervisors has become even more urgent since early 1993, when the single market for banking services was established and the responsibility for the supervision of each bank was assigned to the supervisory authority of its home country. In this context, the Bank of Greece, during 1993-1997, entered into cooperation agreements with banking supervisory authorities in France, Germany, the Netherlands, the United Kingdom and Italy, given that banks based in these countries have branches in Greece, and Greek banks operate branches and subsidiaries in most of these countries.

More recently, in December 1998, the Bank of Greece signed a Cooperation Protocol with the Greek Capital Market Committee, as provided for in Article 5 paragraph 2 of Law 2396/96, on the exchange of supervisory information and mutual assistance in the performance of their supervisory tasks. Also, in January 1999, the Bank of Greece signed a Cooperation Agreement with the Central Bank of Albania. Besides banking supervision, this agreement covers monetary policy, statistics and payment issues. With particular regard to banking supervision, the agreement is expected to facilitate a more effective supervision by the Bank of Greece on Greek banks operating in Albania.

B) The "Year 2000 problem"

Addressing the year 2000 problem by banks is a major concern of the Bank of Greece, as the supervisory authority. The Bank of Greece pointed out the problem by its Administration's Circular 14/9 September 1997 and set a timetable for dealing with it in distinct phases. Subsequently, through questionnaires and guidelines of its Banking Supervision Department — drawn up in the light of international experience — the Bank of Greece aimed to further raise awareness of the need for a timely solution of the problem and to investigate the state of year-2000 compliance of individual banks. Also, since early November 1998, Bank of Greece supervisors have been conducting continuous on-site inspections and assessments regarding the preparedness of banks' information systems.

Based on the findings of the on-site inspections and other available information, the Bank of Greece considers that, in general, marked progress has been made in dealing with the year 2000 problem and the relevant work proceeds on schedule. It points however to some delays and weaknesses, which must be remedied in time. Specifically:

- There are delays in completing the final testing phase and migration to production of some critical applications.
- In the case of banking groups, the coordination and control of the work done in foreign subsidiaries and branches is inadequate.
- The majority of banks have not established contingency procedures.
- Interbank testing with the DIAS S.A. payment system and the book-entry securities settlement system needs to be conducted as soon as possible.
- Moreover, the timely and efficient completion of the year 2000 compliance project is also affected by the fact that at the same time some banks are carrying out significant projects aimed at upgrading or replacing their existing IT systems or at meeting the IT needs of the groups that have resulted from mergers and acquisitions.

C) Prevention and suppression of money laundering

In the context of its competence under Law 2331/95 re: "Prevention and suppression of money laundering", the Bank of Greece has issued a series of circulars, documents and guidelines addressed to banks and other financial institutions under its supervision.

Specifically, it has issued a circular that incorporates into a single text all the obligations of credit and financial institutions under Law 2331/95 and the recommendations of the OECD inter-governmental body (Financial Action Task Force), it has communicated an indicative list of transactions that are likely to involve money laundering and has established certain objective criteria for detecting transactions which must be carefully examined by every credit institution and financial organisation.

It should be noted that under Law 2331/95, the detection and reporting of any suspicious transactions is required on credit institutions and other financial corpora-

tions, which must take all necessary measures to prevent use of these transactions for the purpose of money laundering. The Bank of Greece attaches particular importance to the implementation of Law 2331/95 and since 1998 it has included in its on-site inspection scheme the monitoring of compliance with the provisions on the prevention and suppression of money laundering.

X. PREPARATION BY THE BANK OF GREECE FOR THE CHANGEOVER TO THE SINGLE CURRENCY

1. MONETARY POLICY INSTRUMENTS

The framework for the conduct of the single monetary policy by the European System of Central Banks (ESCB) was finalised after the European Central Bank (ECB) was established in June 1998. The basic features of the ESCB and the allocation of responsibilities between the national central banks (NCBs) and the ECB are described in the “General documentation on ESCB monetary policy instruments and procedures”, published by the ECB in September 1998, and in various subsequent regulations and other provisions.

The Bank of Greece has almost completed the adjustment of its monetary policy framework to the ESCB model, which was designed to increase efficiency in: (a) influencing total liquidity and, in particular, short-term interest rates; (b) reducing excessive interest rate fluctuations; and (c) unambiguously signalling the monetary policy stance.

This adjustment has allowed the Bank of Greece to participate successfully in most of the overall testing procedure carried out by the ESCB in the second half of 1998 and involving a large number of Greek credit institutions. These tests were aimed at checking the operational efficiency of procedures and interlinked systems and, thus, at ensuring the smooth adjustment of the systems and procedures used by the Bank of Greece and credit institutions to those that it is envisaged to be applied once Greece joins EMU.

The adjustment of some of the minor characteristics and features of monetary policy instruments is also at an advanced stage and their degree of harmonisation with equivalent ECB instruments is determined by the conditions under which monetary policy is conducted. The nature and pace of these necessary minor adjustments are not expected to affect the Greek banks’ familiarisation with and, ultimately, smooth adjustment to, European standards.

The following section presents the three types of monetary policy instruments used by the Bank of Greece, namely (a) open market operations, (b) standing deposit and marginal lending facilities, and (c) required reserves – as well as their current and anticipated adjustment to instruments used by the ECB.

1.1 Open market operations

Regular weekly liquidity-absorbing/providing 14-day tenders are the main instrument of this type. Given the conditions of excess liquidity prevailing in the Greek money market, regular tenders, in the form of fixed-rate deposits with the central bank, are normally used as a liquidity-absorbing mechanism.

A tender intended to absorb part of the structural liquidity surplus over a period of 3 months, i.e. a longer-term operation, has been recently conducted for the first time by multiple rate auction.

Other tenders in the form of fine-tuning operations were also carried out in 1998, for the most part before the end of September, to counteract sudden variations in autonomous liquidity factors and thus contain sharp short-term interest rate movements. These interventions comprised reverse repos, liquidity-providing foreign exchange swaps and tenders for the acceptance of deposits with maturities that ranged from overnight to four months and reflected the duration of their anticipated impact on monetary conditions.

The full adjustment of this type of instruments to ECB standards calls for the modification of certain, rather technical, parameters. These include technical infrastructure measures designed, in view of the short time limits, especially in the case of quick tenders, to speed up the submission of bids by credit institutions and to apply the day-count convention Actual/360 instead of Actual/365. The most important of the impending adjustments involves monitoring the risk posed by the securities recognised by the Bank of Greece as eligible collateral in reverse repo operations, in the context of the marginal lending facility, or for the purposes of the “HERMES” Payment System. Eligible Greek government securities are consistent with the ECB’s list of eligible assets for use in the TARGET system and appear on the Bank’s Web site. The launching of the Electronic Secondary Securities Market (HDAT) will enable securities valuation at market price and the determination of a required haircut in a manner which, in comparison with the current haircut (20 per cent of nominal value), will more accurately reflect the estimated risk. This will help increase the efficiency of the Greek government securities market and reduce the opportunity cost for the credit institutions that use this type of securities as collateral in liquidity-providing operations conducted by the Bank of Greece.

1.2 Standing facilities

Standing facilities set the upper and lower limits of the corridor within which inter-bank money market rates can fluctuate and, compared with the rates on open market operations, signal the longer-term monetary policy stance. The Bank of Greece has already adopted both of the standing facilities established by the ECB. More specifically:

a) Under the marginal lending (Lombard) facility, credit institutions wishing to cover temporary liquidity needs may, on their own initiative, apply for financing from the Bank of Greece against collateral in the form of Greek government securities.

b) Under the standing overnight deposit facility introduced in March 1997, the excess daily liquidity of banks can be deposited with the Bank of Greece in two tranches, each with a different rate of interest.

The standing lending facility once made available to banks by the Bank of Greece through the rediscounting of promissory notes and bills of exchange is not one of the

ECB's monetary policy instruments. This facility, which over the years had fallen into disuse, was abolished on 10 April 1998.

Current monetary policy instruments have in effect been harmonised with the corresponding ESCB instruments. The technical adjustments that remain to be completed will be carried out gradually, depending on prevailing monetary conditions and with a view to facilitating the smooth operation of the HERMES payment system. Such adjustments include merging the two tranches of the overnight deposit facility and abolishing the ceiling on the marginal lending facility so that the level of lending will be determined solely by available collateral and risk control measures.

The launching of the HERMES real-time payment system will automatically lead to an extension in the hours of access to the standing facilities (which must coincide with HERMES operating hours), while the introduction of automated end-of-day procedures will allow the conversion of intraday into overnight credit. In addition, the marginal lending facility, which is currently of an indefinite maturity, will be converted into overnight lending.

1.3 Required reserves

The required reserves held by credit institutions with the Bank of Greece currently amount to 12 per cent of their deposits and other liabilities in drachmas and foreign currency. Half of these holdings are remunerated (at a rate of 11 per cent), while the other half are not. This system contributes to a more efficient control of monetary aggregates, either by creating a liquidity deficit or reducing the structural liquidity surplus and by increasing the degree to which the banks' demand for liquid assets can respond to interest rate movements. The system incorporates averaging provisions, which enable banks to meet their obligations on average over the maintenance period of one month. This facilitates daily asset management by credit institutions and has a stabilising effect on short-term interest rates, in particular limiting their sudden movement.

Greece's required reserve system has already been adjusted to a great extent to the ECB Regulation 2818/98 of 1 December 1998, with which euro area member states are required to comply as from 1 January 1999. Apart from a considerably higher reserve ratio than the one applied by the ECB, the Greek system has certain other differences, which involve reserve base items and the maintenance period. The Bank of Greece will proceed to the necessary reserve ratio adjustment before Greece joins EMU.

Considering that the conduct of monetary policy in Stage Three of EMU will be as decentralised as possible, the brief reference made above is by no means an exhaustive account of the adjustment measures required. The arrangements and procedures for adjusting monetary policy instruments are inextricably linked to adjustments in the other fields of activity of the Bank of Greece, particularly in the areas of statistics and accounting standards. Such adjustments contribute to the more efficient assessment and manage-

ment of autonomous liquidity factors. They are also linked to legal adjustments, which lay down the securities, including debt instruments issued by the ECB, that can be pledged as collateral in monetary policy operations.

2. STATISTICAL DATA AND STANDARDS

The conduct of a single monetary policy by the ECB calls for reliable and timely information, based on harmonised statistical data across the euro area. In July 1996, the European Monetary Institute (EMI) specified the statistical requirements for Stage Three in its report known as the "Implementation package", which includes ESCB requirements both for money and banking statistics and for national data on transactions with non-euro area residents. The Implementation package also specifies the format and structure of the Monetary Financial Institutions (MFI) balance sheet data to be reported to euro area national central banks. Such data must be transmitted to the ECB within specific deadlines.

In order to meet ECB reporting requirements with regard to money and banking statistics, the Bank of Greece proceeded to an extensive revision of its own reporting system. In consultation with representatives of banks and of the Hellenic Banks' Association, it finalised the format of the financial statements that credit institutions will have to report to the Bank of Greece on a monthly and quarterly basis. Bank of Greece Governor's Act No. 2430/12 February 1998 established a new monthly financial statement with 8 annexes, which credit institutions are required to submit to the Economic Research Department of the Bank of Greece. Because of the importance that the monetary authorities attach to timely statistical information, the financial statement and four of these annexes, which contain monthly data, must be submitted within 10 working days from the date which the data refers to. The Bank of Greece Governor's Act also lays down the penalties to be imposed in the event of a failure to submit complete data before the specific deadline.

Furthermore, in order to meet the new demands arising from the conduct of monetary policy in the ESCB context, the Bank of Greece, by way of its Governor's Act No. 2441/29 January 1999, revised the regime for monitoring deposit and lending rates. More specifically, with regard to lending rates, the reporting scheme was expanded, so as to include more categories of lending, mainly consumer and housing credit. Deposit rates were also reclassified in line with the reporting requirements of the Bank of Greece and the ECB.

The necessary infrastructure for reporting money and banking statistics in conformity with new financial statement requirements is already in place. Some credit institutions nevertheless still need to make certain technical adjustments that will enable them to report the necessary information to the Bank of Greece. Once these adjustments are completed, the Bank of Greece will be able to compile a consolidated financial statement of the banking system in conformity with ECB standards.

The conduct of the single monetary policy also implies that euro area Member States must report to the ECB timely and accurate data on their cross-border transactions, as well as on their asset and liability positions vis-à-vis non-residents (i.e. their international investment positions). The "Implementation package" fully details the ECB's statistical requirements with regard to the balance of payments and the international investment position. It also states that the ESCB needs to compile comprehensive and reliable data, including the main aggregates that affect monetary conditions and foreign exchange markets in the euro area, considered as a single territory.

The compilation of reliable area-wide balance of payments and international investment position statistics is based on specific methods and definitions, which have, for the most part, been harmonised with the relevant conceptual framework of the International Monetary Fund (IMF Balance of Payments Manual, 5th edition, 1993).

In early 1997, the Bank of Greece provided credit institutions with a "Balance of Payments Compilation Manual", based on the conceptual framework of the IMF but also incorporating specific ECB and Eurostat requirements. In addition, questionnaires were sent to financial institutions which do not qualify as credit institutions, notably mutual funds, investment firms and securities firms. Most credit institutions have already adjusted their accounting systems to the new reporting requirements.

Data on the international investment position are collected not only from credit institutions but also from other financial agents, such as mutual funds, investment firms and securities firms. In addition, the newly established Register of Enterprises serves as an information base on direct investments in Greece by non-residents and by Greek residents abroad, as well as on the loans contracted with non-resident credit institutions.

3. PAYMENT SYSTEMS

3.1 The Euro-Hermes payment system

Payment systems, as a fundamental channel for money transfers, constitute a junction between transactions effected in the money, foreign exchange and securities markets. They are therefore inextricably linked with the conduct of monetary policy. Smoothly operating payment systems not only contribute to the monetary policy effectiveness but also enhance financial stability. Any problems faced in payment systems are likely to spread quickly to the markets, causing financial fragility and crisis, with negative repercussions on the real economy. Past shocks have prompted central banks worldwide to seek close co-operation, redefine their role in respect of payment systems and elaborate the general principles that should underlie the operation of such systems.

In the European Union, the role of central banks in payment systems is explicitly laid down in the Maastricht Treaty, which states that one of the basic tasks of the ESCB

is “to promote the smooth operation of payment systems”. Along this line, one of the main tasks of the Bank of Greece under Article 2 of Law 2548/97 is to promote and oversee the smooth operation of payment systems.

In 1998, the Bank of Greece performed a series of end-to-end testing in which Greek credit institutions were also involved, and completed the development of an automated system for the real-time settlement of cross-border and domestic payments in euro – i.e. the Euro-Hermes system –, which forms part of the Hellenic Real-Time Payment System (Hermes), soon to be completed.

As an integral part of TARGET, Euro-Hermes became operational on 4 January 1999, as did the other national payment systems in the EU. Euro-Hermes enables participating credit institutions to settle rapidly and safely their euro-denominated payments vis-a-vis any EU Member State, even though Greece has yet to adopt the single currency. In accordance with the Euro-Hermes Operating Regulations established in 1998, all credit institutions operating in Greece may, subject to certain eligibility criteria, become members of the system.

To facilitate the smooth operation of Euro-Hermes, the Bank of Greece offers participants interest-free intraday liquidity in euro, on collateral, considered by the ECB as eligible for this purpose. Thus, credit institutions can meet all liquidity needs arising from the time lag between incoming and outgoing payments.

As Greece has not yet entered monetary union and remains a Member State with a derogation, this intraday financing in euro to credit institutions is subject to a global ceiling, set by the ECB at €1 billion, and cannot be converted into overnight credit. Any effect on the conduct of monetary policy of euro-area Member States is therefore averted. To this end and for as long as the country remains with a derogation, all debit positions in credit institutions’ settlement accounts in euro that are not settled by the end of the working day are subject to penalty interest, at a rate determined by the ECB.

The price structure of Euro-Hermes payments was established by the Monetary Policy Council. The fees charged by the Bank of Greece for both domestic and cross-border payments handled by Euro-Hermes will be based on the number of transactions, according to the following digressive scale: €1.75 for each of the first 100 transactions per month; €1.00 for each of the next 900 transactions per month; and €0.80 for each subsequent transaction in excess of 1,000 per month.

The fees for cross-border payments were established by the ECB and are the same across the national RTGS systems comprising TARGET. It should be noted that the basic principle underlying the determination of the fee, for both cross-border and domestic payments, is that the system’s operating costs should be recouped in full. After the first full year of operation of the Euro-Hermes, the Bank of Greece will therefore re-examine the fees charged for domestic payments.

Currently, 33 credit institutions and the Bank of Greece itself are direct participants in the system. During its first three months of operation, the system processed a total number of 5,908 payment orders of a value of €78.7 billion. Of these, 79 per cent

were cross-border payments of a value of €76.7 billion and 21 per cent domestic payments worth €2.0 billion. The number of transactions handled tends to rise, but has yet to reach the anticipated level. Two factors, however, indicate that this trend is likely to continue: first, the system is likely to be more extensively used by credit institutions that have not yet completed the required changes in their internal systems in view of the launching of the Hermes system; second, it is expected that there will be an increase in familiarisation with the relatively new settlement procedures and the wide range of advantages offered by the system (speed, safety, payment finality, real-time settlement and extensive working hours).

BOX X.1

The TARGET System

TARGET, an acronym for Trans-European Automated Real-time Gross Settlement Express Transfer System, is a real-time gross settlement system for large-value payment orders in euro. Developed by the European Central Bank (ECB) and the National Central Banks (NCBs), TARGET comprises 15 national Real-Time Gross Settlement (RTGS) systems, the ECB Payment Mechanism and the Interlinking mechanism. Target constitutes a uniform platform for processing cross-border payments and provides finality on intraday payments. Liquidity is tied up only for as long as the real-time gross settlement procedures require and can therefore be reused several times within the same business day.

Target pursues three objectives:

- to serve the needs of the common monetary policy conducted by the European System of Central Banks (ESCB),
- to provide a sound and reliable mechanism for the settlement of cross-border payments on an RTGS basis,
- to increase the efficiency of intra-EU cross-border payments.

All credit institutions, including those established in Member States with a derogation, may use TARGET to settle bank-to-bank and customer payments. There is no minimum or maximum value limit for TARGET payments. All payments related to monetary policy operations or to various netting systems must be processed through TARGET. Large-value net settlement systems also have to settle their end-of-day balances in euro via TARGET.

TARGET provides credit institutions with liquidity management flexibility: it reduces their need to keep multiple positions, which the use of various non-interconnected systems would have implied, and thus enables the management of total intraday liquidity. Furthermore, it contributes to the elimination of settlement risk, as payments are settled in central bank money promptly, safely and with immediate finality. Its long operating hours (from 7 a.m. to 6 p.m., Central European Time), which overlap with those of the US Fedwire system and of the payment system of the Central Bank of Japan, help to reduce the settlement risk of payments in foreign exchange.

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→ *Special terms for Member States with a derogation*

The central banks of Member States with a derogation ("non-participating NCBs") may provide collateralised intraday credit to participants in their respective RTGS systems up to a maximum amount, which cannot deviate by more than 10 per cent from the amounts specified below by the ECB for each non-participating NCB:

- for the Bank of Greece: 1 billion euro,
- for Danmarks Nationalbank: 1 billion euro, and
- for the Bank of England: 3 billion euro.

- Non-participating NCBs cannot grant intraday credit in excess of the above amounts.
- Central banks may remunerate the credit balances of credit institutions that are members of their RTGS systems. In such an event, the rate applied shall at all times equal the rate of the ECB deposit facility.

- In the event that the extended intraday credit should not be reimbursed by the EURO-HERMES/TARGET closing time (7:00 p.m., local time), penalties shall be imposed, which only the ECB shall have the power to waive. These sanctions involve a progressive penalty rate depending on the frequency of violations. Recurrence can lead to the credit institution's exclusion from the system for a period of one week.

Parallel to the development of the EURO-HERMES system, further progress was made in 1998 towards the completion of the HERMES system, which will enable real-time settlement for domestic payments in drachmas. The operating regulations of this system were also adopted. The Bank of Greece pressed ahead with the automation of its internal payment procedures and the integration of its software systems into a comprehensive IT system, which is a prerequisite for the effective operation of a fully automated payment system.

HERMES will enable credit institutions to effect their interbank and customer drachma-denominated payments in real time without any settlement risk and is designed to provide them with information that will facilitate a more efficient management of reserves. Meanwhile, the Bank of Greece will be able to monitor credit institution positions, act in time to deal with any bottlenecks in the flow of payments and facilitate the smooth functioning of the system.

3.2. *Securities settlement systems*

The unhindered conduct of monetary policy by the Bank of Greece largely depends on the proper organisation and operation both of payment and securities settlement systems and of the market for Greek government securities.

Securities settlement systems are used for the conduct of monetary policy operations (Article 17 of the Statute of the ESCB/ECB) and have a direct impact on the smooth operation of payment systems overseen by the Bank of Greece (under Article 3 of its Statute and Article 2 para. 1 indent d of Law 2548/1997), given the interaction between the two types of systems. Payment systems are based on collateral in securities; hence their smooth operation hinges upon the proper functioning of securities settlement systems. And the other way round: the organisation of securities settlement systems relies on the soundness of payment systems and of the money market, since the cash component of transactions in securities settlement systems is cleared through payment systems.

Furthermore, the existence of an effective secondary market for government securities, where representative prices can be formulated, determines the attractiveness of such securities and is of vital importance for the smooth financing of the borrowing requirements of the government and for the efficient management of public debt.

The Book-Entry Securities Settlement System, used by the Bank of Greece, is of particular significance in view of Greece's participation in EMU, since book-entry government securities will be posted as collateral to ensure the smooth operation of payment systems and guarantee monetary policy operations. Especially once Greece joins EMU, it is expected that this system will be used by foreign banks as well.

The main objective of the Bank of Greece was not only to complete the necessary preparations in time for Stage Three of EMU, but also to establish a modern infrastructure whose institutional aspects and architecture would meet international standards. The creation of such an infrastructure has provided a sound basis for the development, automation and internationalisation of the primary and secondary markets for Greek government securities as well as of payment, clearing and securities settlement systems.

Specifically, after having systematically researched and studied systems already in place in other developed markets, the Bank of Greece decided to proceed with the design and development of the necessary systems and to submit a set of draft proposals to the government, so that the required legal framework could also be established. In this context, the efforts of the Bank of Greece focused on the following issues:

1. the automation of the Bank of Greece Securities Settlement System;
2. the development of an electronic trading system for securities, which will be supervised mainly by participating agents, as well as the electronic exchange of over-the-counter transactions in securities, which now account for more than 95 per cent of the total turnover in the secondary market for government securities;
3. the creation of a specialised unit within the Bank of Greece, which will be supported by the appropriate technical infrastructure, in particular by modern teletransmission systems, and will undertake to manage on behalf of third parties (notably the ECB, national central banks and credit institutions) the collateral on securities kept or held in custody in central securities depositories of EU Member States. This collateral will secure credit (cross-border or otherwise) extended by the above agents; and

4. the setting-up of a special depository for securities in physical form, mainly for the purpose of providing the entire range of custody services and enabling the pledging of such securities — irrespective of their type — as collateral.

The above objectives have largely been achieved and the projects planned in the context of the Bank's preparation for the participation of Greece in Stage Three are all expected to have been completed by the end of 1999. Specifically:

3.2.1 Bank of Greece Securities Settlement System

The Bank of Greece Securities Settlement System, which has been operational since May 1995, was adapted not only in order to cover issues of Greek government securities in euro, but also to deal successfully with any number of transactions in drachmas. Trading in securities grew rapidly in 1998 and now the system accepts at least 750 messages for processing per day. This figure does not include transactions carried out between participants in the system (i.e. credit institutions) and their customers; the number of these transactions is estimated to be much larger.

Although the present system would have been adequate to cover transaction requirements in Stage Three of EMU, the Bank of Greece, in line with the international organisational and operational standards, is already redesigning the application and the IT platform employed. The new system will operate in real time, in parallel to the system of electronic trading in government securities (HDAT), by using state-of-the-art machinery, which can operate without interruption.

3.2.2 Electronic Secondary Securities Market (HDAT)

The establishment and operation of HDAT has been completed, enabling the electronic trading in government securities and covering over-the-counter transactions in the secondary securities market.

The HDAT system is based on binding quotes entered by participants, especially the Primary Dealers, in the context of the obligations they have undertaken. Each participant, through the terminals and displays available to him, is linked to the central system installed in the premises of the Bank of Greece and is in a position to select from his display binding quotes by the other participants and carry out, in real time and in electronic form, transactions in securities.

Participants' binding quotes must comply with the operating rules of the electronic system, regarding the minimum amounts per bid, the minimum spread between bid and ask price, the obligation to submit repetitive quotes during the day, etc.

HDAT has created the necessary conditions so that the valuation of the portfolios of credit institutions, mutual funds, insurance companies and, in general, all business firms

required by law to value their portfolios can be effected at market prices. Meanwhile, HDAT has made it possible to estimate the current value of securities used as collateral in borrowing/lending operations.

3.2.3 Correspondent Central Banking Model

The organisation and the operating regulations of a specialised unit, in the context of the Correspondent Central Banking Model (CCBM), which operates via SWIFT, have been completed. This system ensures, for the European Central Bank and national central banks, as well as for commercial banks, a basic correspondent and reliable guarantor for pledging securities as necessary collateral in favour of lending agents. This is achieved by blocking the borrowing agents' securities, which are kept or held in custody at the Bank of Greece's depositories.

This system enables credit institutions/TARGET participants to use, on a cross-border-basis, as collateral, securities approved by the ECB as eligible assets, so as to receive interest-free intraday credit by the central bank of the country in the payment system of which they participate.

4. PRODUCTION OF EURO BANKNOTES AND COINS AND PREPARATION FOR THE REPLACEMENT OF DRACHMA BANKNOTES AND COINS

According to the Maastrich Treaty, the last phase of the process of monetary unification is the launch of the single currency, the euro, in physical form (banknotes and coins) on 1 January 2002. In the first half of 2002, the euro will circulate in parallel to national currencies, which will gradually be withdrawn. Therefore, by 31 December 2001, all Monetary Union participants must have produced the necessary quantities of banknotes and coins, in the various denominations already determined by the ECB, so as to achieve a smooth and unhindered replacement of national currencies by the euro.

The National Plan for Greece's Changeover to the euro (ESM), drawn up by the Ministry of National Economy and published in July 1998, taking into account the principles of equal treatment and facilitation adopted by the informal ECOFIN in Noordwijk in autumn 1997, provides for a one-year transitional period, running from the irrevocable fixing of the drachma's parity against the euro to the launch of euro banknotes and coins in physical form (while for the 11 euro area countries the transitional period is three years). Thus, the euro will be launched in physical form in Greece and the other Member States simultaneously, i.e. on 1 January 2002; therefore the production of the necessary quantities of euro banknotes and coins must be completed in time.

The final designs and the technical specifications for euro banknotes were approved by the EMI Council in February 1998 and the work then began for transforming these designs into the origination material.

The printing works of all EU national central banks, following ECB instructions, were entitled to participate in the banknote pilot-series production. The Bank of Greece Printing Works (IETA) was actively involved, printing the 20-euro denomination. The pilot series production was aimed at checking whether all printing works could achieve a uniform production of euro notes, and at ensuring strict compliance of the origination materials with production specifications, as well as the establishment of a preliminary basis for a quality management system.

It should be noted that euro banknotes, according to the specifications approved by the ECB, should meet high quality standards in terms both of printing results and of production materials and, at the same time, incorporate advanced security features. These features, on the one hand, protect banknotes from counterfeiting and, on the other hand, enable the sure detection of counterfeits.

The security features include:

- features which can be easily identified by the public, such as watermarks, security threads, intaglio printing with tactile properties;
- features which can be checked using simple devices, such as UV fluorescent features and microletters; and
- machine-readable features, which can be checked both in banknote-accepting machines and in banknote-sorting machines.

After the pilot-series printing was finished, the banknotes were subjected to quality control and assessment. The quality control of the pilot-series production was carried out at the laboratories of the Member States' central banks and concerned quantities of banknotes produced by other EU national central banks. On the basis of the assessment made by the competent group of the ECB, the quality control indicated that the euro banknotes printed at IETA fulfilled the quality standards set.

IETA, in order to meet the high requirements for the printing of euro notes, has already been supplied with modern production machinery and has put it into operation. The equipment now available can print the 5-, 10- and 20-euro notes. At the same time, the procedure for the procurement of a silk-screen printing system, which will enable IETA to print 50-, 100-, 200- and 500-euro banknotes as well, has been speeded up.

Concurrently, a modern unit for the destruction of old banknotes has been put in place and is now fully operational. In addition to being environmentally friendly (since it dispenses with incineration), it has enough capacity to accommodate any amount of Greek banknotes when these will be withdrawn from circulation to be destroyed.

As decided by the ECOFIN Council, euro coins will have a "common" side, bearing agreed designs, common for all EU Member States, and a "national" side, featuring a national theme to be chosen by individual Member States. This implies that each Member State must be able to produce the required stocks for all denominations in its own production plant.

The specifications of blanks and coins were established by the Working Group of EU Mint Directors. The 2-euro coin, however, will be subject to some changes, as request-

ed by the European Commission, to enable unmistakable and secure recognition by the visually impaired and by vending machines.

The themes that will appear on the national side of the euro coins in Greece were selected by a Theme Selection Committee, comprising representatives of: the Faculty of Philosophy of the University of Athens, the Museum of Numismatics, the Chamber of Fine Arts, the Ministry of Culture, the Ministry of Finance, as well as of the Bank of Greece Cash Department and Printing Works (IETA) Department.

After having assessed the work of the Committee, the Bank of Greece submitted the relevant proposals to the Ministry of Finance. The Minister of Finance has already approved the designs that will appear on the national side of all euro coin denominations.

The process of creating the relief models and the manufacturing of master dies (on the basis of which the working dies will be manufactured) are being completed at IETA. The production of a pilot series is envisaged for all coin denominations.

With a view to meeting high quality standards, an ECB Working Group is elaborating a common quality control plan for euro blanks and coins, to be implemented by all EU mints. In addition, an *ad hoc* committee has been set up, whose task will be to oversee and monitor compliance with the above-mentioned quality control plan.

IETA is in the position to produce euro coins. In order to meet the high standards required to manufacture the dies and rings, to carry out quality controls and produce finished euro coins, procurement procedures have already been initiated for the gradual replacement and upgrading of existing equipment.

The Bank of Greece has also made provision for the supply of euro coins to the public and the withdrawal of drachma notes and coins and is speeding up the preparation of the required logistical framework. It has also adopted the necessary measures for the repatriation of national banknotes of other euro-area countries by the year 2001, under Article 52 of the Statute of the ESCB.

5. RESTRUCTURING THE ACCOUNTING SYSTEMS

The accounting framework used by the ESCB is aimed at producing financial accounts that reflect transactions and produce financial statements for the euro area as a whole. Additionally, this framework meets the requirements for liquidity management in the euro area, as well as the need for adequate statistical information.

The aim of the Bank of Greece in this field is to restructure its accounting software and chart of accounts (inter alia in terms of Cost Accounting), so as to develop systems fully compatible with the ESCB's accounting standards. The Bank therefore decided to develop an Accounting Information System capable of responding fully and promptly both to internal information requirements and to the reporting requirements of the ECB.

The concerted action by all of the Bank of Greece's services involved in the task resulted in the implementation of several new projects in 1998, while existing applications were significantly improved.

More specifically, the necessary infrastructure for restructuring the Bank's accounting system (including Cost Accounting) and developing the Accounting Information System was set up. This project, once completed, is expected to meet the Bank's regular needs for an automated presentation of accounting data, while satisfying the information requirements of the Bank's Administration and the reporting requirements of the ECB: the compilation of daily financial statements, as well as of monthly and cumulative figures, either in aggregate form or analysed by type of activity of the Bank, will all be possible.

To forward the project's implementation, an *ad hoc* senior staff committee examined the current situation in the area of accounting infrastructure and drafted a chart of accounts. This chart meets the Bank's current needs, as it was specifically designed to incorporate both the principles of the Greek Uniform Chart of Accounts and those laid down in the relevant ECB Guideline addressed to the national central banks.

However, restructuring and implementing a new chart of accounts is only part of a wider series of changes, mainly in areas such as cost accounting, IT applications, new software procurement or development to support accounting procedures, setting out both the rules and the types of information required at various levels etc. The appointment of an external consultant, whose task would be to coordinate the entire project and closely monitor progress and compliance with respective timetables, was therefore deemed necessary. The consultant has already been selected, by decision of the General Council of the Bank of Greece, and has begun a series of studies, on the basis of which proposals will be submitted for the revision of the chart of accounts and the design of comprehensive cost accounting systems.

ANNUAL ACCOUNTS
OF THE BANK OF GREECE

BALANCE SHEET

AMOUNTS IN DRACHMAS

ASSETS	1998	1997
GOLD AND FOREIGN CURRENCIES*		
1. Bank's holdings	5,046,416,763,921	3,282,303,303,746
2. Reserve position in the IMF	75,753,782,285	43,447,353,337
3. Special Drawing Rights in the IMF	13,974,029,153	16,144,380,787
4. ECU holdings	—	403,796,773,821
5. Contribution to the EMI	—	3,860,775,623
6. Deposits with the ECB	4,082,066,407	—
	5,140,226,641,766	3,749,552,587,314
MISCELLANEOUS CLAIMS IN FOREIGN EXCHANGE	287,137,931,111	286,876,086,407
COIN	1,450,390,734	2,332,003,179
CLAIMS ON GOVERNMENT		
1. Treasury bills and government bonds	694,117,220,000	263,010,893,062
2. Long-term loans in drachmas	960,327,270,640	1,300,783,172,900
3. Loans for membership of the IMF	233,287,909,551	221,966,592,504
4. Long-term loans in foreign exchange	1,082,800,621,461	1,578,750,441,319
5. Long-term loans and securities with a foreign exchange clause	2,891,393,149,007	2,775,495,213,087
	5,861,926,170,659	6,140,006,312,872
CLAIMS ON BANKS		
1. Advances	60,369,358,014	65,040,854,758
2. Deposits	175,014,750	271,691,350,050
	60,544,372,764	336,732,204,808
PREMISES AND EQUIPMENT		
1. Land	13,159,232,685	13,158,831,485
2. Buildings and equipment	48,534,326,395	44,814,826,417
Less depreciation:		
Up to 1997 (inclusive)	36,886,314,140	
In 1998	2,145,124,240	
	39,031,438,380	
	9,502,888,015	
	22,662,120,700	
	37,663,867,301	
	7,150,959,116	
	20,309,790,601	
VALUE OF BANKNOTE PRINTING MATERIALS	14,513,704,268	12,778,950,909
Less depreciation	2,527,305,050	1,972,194,657
	11,986,399,218	10,806,756,252
OTHER ASSETS	79,269,642,382	82,602,125,938
INTERIM ACCOUNTS	198,673,836,574	130,795,458,586
T O T A L	11,663,877,505,908	10,760,013,325,957
OFF-BALANCE-SHEET ITEMS		
Investment in government securities on behalf of public entities**	1,403,485,632,359	1,396,742,837,445

* The Bank's holdings in gold and foreign currencies have been calculated on the basis of the drachma /US parity effective on 31st December 1998 (drs 282.570 per US dollar).

The value of gold in US dollars has been calculated on the basis of 65 per cent of the average purchase price of gold in December 1998, i.e. US dollars 189.43 per ounce.

** Including legal persons in public law and Insurance Funds in public and private law.

AT 31 DECEMBER 1998

SEVENTY FIRST YEAR

LIABILITIES	1998	1997
CAPITAL	16,686,504,800	13,905,421,600
RESERVES		
1. Regular reserve	16,686,504,800	13,905,421,600
2. Special reserve for foreign exchange valuation differences	102,029,853,427	83,977,679,999
PROVISIONS		
1. Provision according to Article 71 of the Statute	18,018,990,315	13,228,478,458
2. Other provisions	1,679,587,500	1,613,028,088
DIFFERENCE FROM REVALUATION (LAW 2065/92)	—	2,245,595,057
BANKNOTES IN CIRCULATION	2,469,767,153,900	2,404,011,947,950
LIABILITIES IN DRACHMAS		
1. Central government cash management account	289,373,470,244	399,312,934,881
2. Public entities' cash management accounts	70,770,359,839	22,865,684,273
3. Deposits by banks	3,146,568,565,951	1,760,425,159,143
4. Deposits by international institutions and foreign banks	158,706,627,059	180,131,382,979
5. Other deposits	63,103,566,259	49,320,071,681
6. Dividends for financial year	4,618,586,150	3,600,510,950
LIABILITIES IN FOREIGN EXCHANGE		
1. Central government deposits	300,398,690,572	84,948,812,374
2. Redeposits by banks	2,390,091,738,774	2,782,013,085,305
3. Other deposits	852,896,950,429	710,678,078,016
4. Long-term loans in foreign exchange on behalf of the Greek State	1,065,864,445,640	1,533,859,427,862
5. Other long-term liabilities in foreign exchange	246,499,271,504	274,538,188,985
6. Allocation of Special Drawing Rights in the IMF	40,964,688,308	39,574,061,149
7. Reserve position in the IMF	75,753,782,285	43,447,353,337
OTHER LIABILITIES	104,385,053,827	114,597,121,788
INTERIM ACCOUNT	229,013,114,325	227,813,880,482
T O T A L	11,663,877,505,908	10,760,013,325,957
OFF-BALANCE-SHEET ITEMS		
Public entities' funds management account**	1,403,485,632,359	1,396,742,837,445

PROFIT AND LOSS ACCOUNT

AMOUNTS IN DRACHMAS

<u>DEBIT</u>	<u>1998</u>		<u>1997</u>	
PERSONNEL REMUNERATION - PENSIONS				
Wages and salaries	27,855,294,907		26,078,355,174	
Principal and supplementary pensions	<u>11,467,237,907</u>	39,322,532,814	<u>11,196,917,622</u>	37,275,272,796
CONTRIBUTIONS TO PERSONNEL INSURANCE FUNDS				
Pension funds	6,634,325,995		6,243,946,268	
Supplementary Pension Fund	2,880,797,032		2,838,209,219	
Self-insurance Fund	407,117,454		468,799,459	
Health Insurance Fund	<u>2,193,354,290</u>	12,115,594,771	<u>2,068,091,937</u>	11,619,046,883
CONTRIBUTIONS TO OTHER SOCIAL SECURITY FUNDS AND ENTITIES		2,129,444,842		1,945,802,868
OTHER ADMINISTRATIVE EXPENSES		4,960,540,640		4,278,281,303
DEPRECIATION				
Banknote printing materials	2,527,305,050		1,972,194,657	
Buildings and equipment (other than office equipment)	881,907,490		758,608,972	
Office equipment	<u>1,263,216,750</u>	4,672,429,290	<u>851,556,541</u>	3,582,360,170
PROVISIONS				
Provision according to Article 71 of the Statute	5,326,000,000		5,286,000,000	
Sundry provisions	<u>78,000,000</u>	<u>5,404,000,000</u>	<u>78,000,000</u>	<u>5,364,000,000</u>
		68,604,542,357		64,064,764,020
NET PROFIT		101,195,638,253		100,433,102,413
		<u>169,800,180,610</u>		<u>164,497,866,433</u>

FOR THE YEAR 1998

71ST YEAR

CREDIT	1998	1997
Interest, commission and other earnings	169,800,180,610	164,497,866,433
	169,800,180,610	164,497,866,433

DISTRIBUTION OF NET PROFIT OF DRACHMAS 101,195,638,253

(Article 71 of the Statute)

	1998	1997
Dividend on capital, i.e. drs 672 per share, on 2,979,733 shares	2,002,380,576	1,668,650,592
For the ordinary reserve	2,781,083,200	—
Additional dividend of drs 878 per share, on 2,979,733 shares*	2,616,205,574	1,931,860,358
Tax payment (Law 2166/93 Article 18)	3,079,057,433	2,400,340,633
To the government	90,716,911,470	94,432,250,830
	<u>101,195,638,253</u>	<u>100,433,102,413</u>

* The additional dividend for 1997 was drs 778 per share, on 2,483,111 shares.

Athens, 18th March 1999

LUCAS D. PAPADEMOS
GOVERNOR

DIMITRIOS E. MATSIMANIS
DIRECTOR, ACCOUNTS DEPARTMENT