

# Greece and the Euro

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I am honored to be here this evening to accept the Fred Heldring Award from the Global Interdependence Center. I applaud the work of the Center in promoting events and communication about international economic and financial interdependence.

Because tonight's festivities celebrate Greece, I thought that I might say a few words about the remarkable turnaround of Greece's economic performance, a success that is closely linked to entry into the European Monetary Union at the start of 2001.

As usual, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments. Christopher J. Neely, assistant vice president in the Research Division, provided special assistance. I retain full responsibility for errors.

I know that this event is not the occasion for a formal lecture, but once you give a lawyer's son and former professor turned central banker a soapbox, you have accepted a certain risk. I promise not to present a lecture, but cannot resist a few remarks. And what is on my mind is how very well the creation of the euro has worked out, for Greece and the other member countries.

Consider the Greek economic situation in the 1980s and early 1990s, prior to the decision to attempt to join the euro zone. During this period, Greek monetary and fiscal policy left

much to be desired: Inflation and interest rates both topped 20 percent. High inflation typically damages economic growth. Greece was no exception. Its real GDP growth averaged 0.7 percent annual rate between 1980 and 1994.

High interest rates compounded the government's fiscal problems by raising borrowing costs on its very substantial debt. Annual government budget deficits often exceeded 10 percent of output. Annual peacetime budget deficits in excess of 10 percent of GDP are large for any country. As a result of many years of these large deficits, the Greek gross public sector debt stood at about 88 percent of GDP by 1995. In 1995, the GDP-weighted average ratio of debt to GDP in the European Union was 73 percent; other countries with high ratios were Belgium at 135 percent, Italy at 122 percent and the Netherlands at 90 percent.<sup>1</sup>

In 1992, the Maastricht Treaty set forth the mechanisms by which member states would transition to a single European currency, the euro. Specifically, the treaty laid down so-called convergence criteria to which all countries had to conform before joining the European Monetary Union, the EMU. The criteria required that every member state have inflation and interest rates similar to those of the best performing members, sound public finances, a period of exchange rate stability and appropriate legislation with respect to its central bank.

<sup>1</sup> The following countries were members of the EU in 1995: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom. The paragraph cites debt-to-GDP data from the OECD. Eurostat, however, reports a much higher estimate of Greece's 1995 debt-to-GDP ratio, 109 percent. The OECD number is much lower because the OECD reports large upward revisions to Greek GDP that Eurostat has not yet accepted.

While Greece expressed interest in monetary union even before the Maastricht Treaty was signed, the country was plainly unable to meet the convergence criteria in the early 1990s. As already noted, inflation and interest rates exceeded 20 percent and public finances were in terrible shape. Some observers even suggested that by the early 1990s Greece had the largest imbalances of any industrial country (Hochreiter and Tavlas, 2004).

In the mid-1990s, there was no guarantee that Greece would succeed in meeting the convergence criteria, despite a general desire to integrate more closely with Europe and to achieve better economic performance.

Although Greece had begun reducing inflation in the early 1990s, in 1995 the governor of the Bank of Greece, Lucas Papademos, took a serious step toward economic reform by introducing the “Hard Drachma Policy.” This monetary policy program, which entailed annual targets for inflation and exchange rates, made rapid progress against inflation, reducing it from over 10 percent in 1995 to less than 5 percent by the start of 1998.

Yet, despite the fact that Greece could not immediately meet the convergence criteria, Greece’s socialist prime minister, Costas Simitas, made complying with them a political priority. Joining the monetary union would help integrate Greece’s economy with those of the other members. It would lower the costs of international trade for consumers and businesses, facilitate international price comparisons, and raise living standards. The policy package included a number of complementary structural reforms to Greek energy and telecommunications markets.

The Greek public largely supported these government reforms. As one might expect, support was strongest among the business community, but moderate socialists also supported the plan. Farmers and left-wing activists constituted the main opponents, fearing job losses from increased competition and capital mobility.

Some observers, including many economists, also expressed the traditional concern about monetary unions: that they require a “one size fits all” monetary policy among the members. This concern seemed especially pressing for a

small country, like Greece, trying to join a monetary union of larger and wealthier countries.

Fiscal policy—government taxes and spending—is often considered another tool of macroeconomic management. The EMU, however, adopted the “Stability and Growth Pact,” a 1997 treaty that was designed to ensure that governments would continue to behave in ways consistent with the stability of the euro. The pact effectively limits government deficits to 3 percent of GDP, which restricts countercyclical fiscal policy. Thus, euro skeptics were concerned that the EMU would handcuff both monetary and fiscal policy, fostering unstable economic conditions.

Even Governor Papademos (*Wall Street Journal Europe*, February 12, 2001) admitted to some concern on this point: “I’m a little bit concerned that in the course of the year that if there’s a severe shock or an unanticipated domestic development, it may not be possible for fiscal policy to be implemented with the required degree of prudence.” The requirement of restrictive fiscal and monetary policies to join the monetary union drew the most direct criticism. Labor unions, in particular, fought the new policies with strikes and political rallies.

The national airline, Olympic Airways, became a focal point of the struggle as the government sought to cut costs and turn it into a profit-making enterprise. Employees at the firm responded with frequent work stoppages. In 1998, Greece’s foreign minister, Theodoros Pangalos, even joked that “no logical person” would ride Olympic Airways, given the poor service (*Laredo Morning Times*, May 1, 1998).

Criticism of Greece’s entry to the monetary union came from outside the country as well. Early in 2000, the German Chambers of Industry and Commerce urged the German government to block Greece’s entry to EMU, citing Greece’s extremely large public debt. These groups were concerned that Greece’s large public debt might create pressure to inflate the euro.

The economic reforms of the 1990s were ultimately successful in bringing Greece into compliance with the convergence criteria. On January 1, 2001, Greece officially became a mem-

ber of the euro zone. As with previous members, the drachma-denominated notes and the euro notes circulated side by side for two months, until the euro became the sole currency on March 1, 2001.

The Greek economy has flourished since it entered the euro zone in 2001. Inflation has averaged 3.3 percent, compared with the 1990-2000 average of 10.4 percent. GDP growth has averaged 4.4 percent, compared with 2.2 percent in the prior period. Unemployment has fallen from its 1999 peak of 12.3 percent to 8.6 percent by the end of 2006. While this jobless figure is higher than anyone wants, it is likely to decline further in the environment of price stability that the European Central Bank fosters.

In September 2004, the Greek government released revised national accounts that showed that Greece had actually entered the euro zone with a budget deficit that exceeded the limit of 3 percent of GDP set forth by the Stability and Growth Pact guidelines. These revisions have caused some consternation among the member states. Still, it cannot be argued that entry into the EMU was a mistake. The Greek economy is not performing just marginally better, but enormously better.

European countries continue to see benefits from adopting the euro. The 10 countries that entered the European Union in 2004 have all

expressed their intention to join the full monetary union within ten years. Slovenia, which joined the euro zone on January 1 of this year, was the first of these new members.

I was fortunate to study under Milton Friedman, and I remember well one of his favorite sayings: The proof of the pudding is in the eating. For Greece, the EMU pudding has been very tasty indeed.

## REFERENCES

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