

# **The Drachma's Adhesion to the European Monetary System**

## **Possible Effects\***

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The present paper examines the possible effects of a previously floating currency of a small open economy joining a currency area with predominantly fixed exchange rates, taking Greece as an example.

Monetary policy in Greece is implemented in the form of a credit policy through a complex system of secondary reserves for different credit lines, aimed towards the availability of credit for purposes of economic development<sup>1</sup>.

For the time being, the drachma's exchange rate, vis-à-vis various foreign currencies, is set by a "governmental decision" by the Bank of Greece, according to a basket of currencies. The weight of each currency in the basket is given by the relative importance of each country as a commercial partner of Greece. Since Greece's adhesion to the EC, the drachma has been introduced to the Paris exchange market but the quantities handled there are small and do not really influence the exchange rates set up by the Bank of Greece.

Inflation in Greece has an external and an internal component, the external being due to price increases of imports, either absolute (as the two oil shocks) or to an increase in the equivalent in drachma, due to a devaluation of its exchange rate. The internal component depends on factors such as the financing of the budget deficit, wage developments, money supply expansion and structural disequilibria. The structural element, that mirrors the disequilibria of the Greek economy, like monopoly elements, an important intermediate sector from production to consumption, a possible important "shadow" economy, speculative elements etc., has often been stressed as

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<sup>1</sup> *George Demopoulos* "Monetary Policy in the Open Economy of Greece" Centre of Planning and Economic Research, Athens, 1981.

accounting for an important part of the inflation, although empirical evidence as to the relative importance of each element for inflation is lacking<sup>2</sup>.

In the following sections, some economic policy options that could be raised against participation to the EMS, are examined and criticised. The main conclusion is that adhesion of the drachma to the EMS can be an element in a general stabilisation policy. Further, the possible cost of the adhesion is examined and some accompanying policy measures are discussed.

Adhesion to the EMS, with its fixed central rates means abandoning flexible exchange rates, entailing the loss of independence in the shaping of monetary policy and a constraint in economic policy in general. This would have negative influence on employment and competitiveness and related to this on the balance of payments. If a country follows an exchange rate target, as in the case of the EMS countries, then it would no longer be able to reduce unemployment through an expansionist monetary (and fiscal) policy. The validity of this argument, i.e. that an independent monetary policy can reduce unemployment, is based on the existence of a normal *Phillips* relation.

But empirical evidence, as well as theoretic considerations, point to the non-existence of a normal *Phillips* relation, which was based on a certain degree of money illusion and considerable lags in the adaptation of expectations to changes in money supply. Even if one does not accept the extreme case of rational expectations, expectations adapt now much faster than two decades ago, when the *Phillips* relation was normal. Nowadays in the long-term, an increase in inflation does not change employment. A short-term unexpected increase in inflation could reduce unemployment but only temporarily. But the social cost of this would be high, since the adaptation results in a waste of resources. Further, in order to have permanent effects, such a policy would lead to higher and higher inflation, since the relevant issue is not a high rate of inflation, but an increase in its rate. For the same reasons the exchange rate cannot be used to lower real wages, in order to increase competitiveness, if real wages are deemed to be too high. The existence of stagflation combined with high unemployment is an indication of the non-existence of a normal *Phillips* relation<sup>3</sup>.

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<sup>2</sup> According to some Commission estimates, the total (direct and indirect) effect of unit labour cost increases on price increases was 7.6% both in 1982 and (estimated) for 1984, while the exchange rate depreciations in 1980 and 1983 resulted each time in a 2% rise of inflation. See "European Economy" No 18, November 1983.

<sup>3</sup> For example papers by *P. Minford*, *W. Buiter* and *M. Miller*, and *M. F. G. Scott* in *W. A. Eltis* and *P. J. N. Sinclair* "The Money Supply and the Exchange Rate" Clarendon Press, Oxford 1981, *P. Korteweg* "Exchange Rate Policy, Monetary Policy and

It is also argued that under flexible exchange rates a country can choose with greater freedom its economic policy, choosing an expansionary path leading to higher growth. This would not have been possible under fixed exchange rates, since it would result in devaluations, i.e. abandoning the exchange rate target.

But, also under flexible exchange, it is by no means certain that expansionary measures have the desired effect on real variables. Expanding aggregate demand spills over into the foreign sector, putting immediate downward pressure on the exchange rate. Since the foreign exchange market is the archetypal “flex-price” market, such pressure will immediately be converted into a depreciating exchange rate, raising import prices and hence raising money wages and inflation. Thus the price for expanding domestic demand and employment, if at all successful, is unacceptably high in terms of inflation. Also, recent experience, as in France in 1981, indicate the unfeasibility of unilateral expansion. Unilateral expansionary economic policy measures are even less feasible for a small open economy like Greece. The autonomy of economic policy is constrained by the size and openness of the economy, independently of fixed or flexible exchange rates.

In the late 1960s, flexible exchange rates had been advocated as a system that would contribute to national economic sovereignty by removing the balance of payments constraints. But for the 1970s they did not operate that way, because, while they allowed for vast differences in inflation rates, the external constraint, especially for weaker countries, actually increased. The floating exchange rates, while not solving the balance of payments constraint, transmitted fully the shock of external disturbances (like the oil shocks) to domestic inflation. Given the already existing major difficulties of inflation control, the possibility of a fall in the exchange rate was a more frightening prospect than a balance of payments deficit under fixed exchange rates. So, the idea that inflation control required at least the avoidance of permanent exchange rate falls, gained increasing ground. It was widely believed that Germany and Switzerland, but also Austria and the Netherlands, had actually gained from an appreciating exchange rate prompting a “virtuous” circle after the first oil crisis. This idea also made weaker countries, such as Italy and Ireland, join the EMS. Their entry to the

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Real Exchange Rate Variability” Essays in International Finance, Princeton University, No 140 December 1980, *Pentti Kouri* “Macroeconomics of Stagflation under Flexible Exchange Rates” American Economic Review, 1982. Empirical studies for Greece point to the existence of a vertical *Phillips* relation for the period after 1971. *D. Panayotopoulos* “The Phillips Curve and the Greek Experience”, SPOUDAI, Athens 1981.



EMS, entailing to a certain degree the acceptance of the lead of Germany in the field of monetary policy, was seen as a commitment to inflation control in these countries. The EMS has contributed to nominal exchange rate stability within the Community during a period of turbulence and has also promoted progressively convergence on low rates of inflation. During 1983 it also achieved a better coordination of economic policies for the Member States fully participating in it<sup>4</sup>.

Another argument in favour of flexible exchange rates and not joining the EMS is that under relatively fixed exchange rates competitiveness would suffer and the balance of payments deteriorate. Tighter monetary policy in order to safeguard the exchange rate target inside the EMS would mean higher real exchange rates and so a fall in competitiveness. With exchange rate targets it is no longer possible to follow an accommodating monetary policy and a continuous devaluation of the exchange rate to influence domestic industry, stimulate exports and reduce the balance of payments deficits.

This view is open to serious criticism. First, it is *ex ante* not certain that a devaluation will have the desired effect on the balance of payments, since this depends on the relevant elasticities and absorption. Second, the important element for competitiveness is the real and not the nominal exchange rate, but this depends, in the long-run, on real variables, like the differences in the supply characteristics of aggregate production at home and abroad, which result in different rates of productivity growth in the respective traded goods sector. Third, the existing empirical evidence supports the view that devaluation does not usually have the desired effect on the balance of payments. Current account positions seem to react disappointingly low, if at all, to exchange rate changes, even when these were large and went consistently in one direction. This can be explained in part by the fact that the price, which is effected by the exchange rate is only one element of competitiveness, nonprice elements such as quality, punctual delivery and after sales services, having great importance, in particular for high technology products<sup>5</sup>. The Greek experience also seems to support this view, because the steady devaluation of the drachma (from 32.02 to an ECU in 1961 to 64.73 in 1982) did not ameliorate in the long-run the current account of the balance of payments situation that underwent fluctuations but remained

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<sup>4</sup> J. van Ypersele, "LE SME" in 'Perspectives européennes', Commission des CE, 1983.

<sup>5</sup> J. Llewellyn and S. Potter "Competitiveness and the Current Account" in A. Boltho "The European Economy's Growth and Crisis", Oxford UP 1982.

always negative (from  $-2.2\%$  of GDP in 1961 to  $-2.4\%$  in 1982, reaching a maximum of  $-5.8\%$  in 1965 and a minimum of  $-0.9\%$  in 1980).

Fourth, the above mentioned argument does not take into account the influence of inflation and the connected devaluation expectation on capital movements. Capital flows depend on changes in the uncovered interest rate differential and changes in the expected rate of exchange rate change. Inflation differences coupled with expectations and interest rates differences result in capital outflow from the weaker currencies, which influences negatively the capital account and also the short-run exchange rate, which is determined primarily by the capital account situation. At the same time, domestic investment is reduced, resulting in negative effects on growth.

At present, the free movement of capital does not apply to Greece and even after the end of the transition period its application will not be complete, since the freedom of capital movement in the Community underlies to many limitations and derogations. Still, although Greece applies actually relatively severe capital export controls, there has been a constant and often illegal outflow of capital for speculative reasons, which was accentuated whenever a sharp devaluation of the drachma was expected. If the Greek monetary authorities continue the policy of maintaining fixed interest rates on deposits at low levels along with an underdeveloped domestic capital market and the presence of high inflation, this will result in a further increase in capital outflow in future, after capital export controls have been eased due to the expiration of the transition period. On the other hand, the adhesion of the drachma to the EMS would favourably influence expectations, the exchange rate and inflation. This in turn would influence positively capital outflow from Greece and thus result in a further stabilisation of the exchange rate, reducing the external pressure on inflation. This again would reduce the need of intervention by the Central Bank in order to defend a certain exchange rate target. Adhesion to the EMS would further influence positively the inflow of capital to Greece due to the special provisions for loans to aid investment in the less prosperous Member States<sup>6</sup>.

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<sup>6</sup> Council regulation no 1736/49 provides that: "Loans granted from its own resources by the European Investment Bank ... and loans granted under Decision 78/870/EEC to aid investment in the less prosperous Member States may carry an interest subsidy (of 3% per year) financed by the budget of the EC, provided that these States effectively and fully participate in the mechanisms of the EMS", Official Journal of the EC No L 200 of 8.8.1979. Considering that investment and capital inflow depend on profit and that profit is in part a function of the interest rate, a decrease in the interest rate through the subsidy would increase capital inflow and investment. Italy and Ireland did exploit fully the possibilities given by this regulation.

Another explanation advanced to explain some governments' preference for expansionary monetary policy that leads to inflation and is opposed to relatively stable exchange rates is that inflation profits them due to the "inflation tax" and because it eases the bargaining process. The "inflation tax" arises because due to inflation nominal incomes "jump" to higher income brackets where the tax coefficient is higher, so that the government's revenue is increasing without any new tax imposition. Also, inflation favours net borrowers and the State is usually a net borrower<sup>7</sup>. But even if the State profited from the existence of the "inflation tax" this would be due to an abuse of the State's monetary monopoly. In a democracy this is not acceptable and a greater transparency of the State's revenue is desirable. If a deceleration of inflation reduces the State's revenue (without at the same time reducing even more the State's expenses which could be possible under certain conditions) then the hidden "inflation tax" should be replaced by an open increase of taxation, that should be transparent to the taxpayer.

Since no money illusion is valid any more, money wages are determined in a bargaining context that stresses after-tax real wages. This implies that tax increases are inflationary, while tax cuts may have the opposite effect. Thus governments concerned about the level of wage settlements could offer tax cuts in exchange for moderation in wage demands, thus ensuring that real aspirations are satisfied at a lower level of wage settlements than would otherwise have occurred. On the other hand, given the non-existence of a normal *Phillips* relation and no money illusion, monetary policy is not adequate to ease the bargaining process.

In the preceding paragraphs some arguments for choosing flexible exchange rates and against joining the EMS with its relative fixed exchange rates have been examined and criticised. Relative exchange rate stability offers important advantages to small open economies. A small economy tends to produce a less diversified range of output with a relatively large concentration of traded goods. External shocks have thus a larger impact on the small, undiversified economy than on a bigger country with an important internal market. Relative exchange rate stability facilitates trade by reducing the risk due to the fluctuation of exchange rates.

A small economy with its modest currency faces in general a higher probability that collusive behaviour among speculators could alter the value of its exchange rate. The financial mechanisms of the EMS offer some degree of guarantee against such pressures. Also, to the extent that changes in

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<sup>7</sup> D. Laidler "Difficulties with European Monetary Union" in M. Fratianni, T. Peeters "One Money for Europe", McMillan, London 1978.



world prices or in the exchange rate affect a large proportion of items in the domestic price index, price movements inside the country are heavily influenced by external disturbances. The smaller and more open the economy the higher is the percentage of “imported” inflation under flexible exchange rates. Further, the low degree of diversification of the country’s output tends to reduce the price elasticities of exports and imports, so that the changes in domestic activity necessary to correct external imbalances are necessarily large. Since the small open economy is a price taker in the international market, expenditure switching policies (i.e. altering the relative price of traded to non-traded goods) are not an effective means of correcting balance of trade deficits, which require instead changes in domestic absorption. It also implies that attempts from the part of the monetary authorities to raise the domestic money supply above the amount the individual and firms demand leads to a balance of payments deficit and a loss of reserves. In the case of Greece, joining the EMS would mean a stabilisation of the drachma’s exchange rate in the framework of a general stabilisation policy. This would influence favourably Greece’s terms of trade<sup>8</sup>.

A small country’s adhesion to the EMS raises some specific questions, the first being the possible danger of a depletion of reserves of foreign exchange used in interventions by the Central Bank in order to keep the currency’s exchange rate within the margins of the EMS. This is reasonable in the case of a widely diverging inflation rate of the adhering country from the EMS average. But this fear is no longer valid in the context of a general stabilisation policy with the aim of reducing inflation. In this context the reduction of inflation and stable exchange rates within the EMS would be parallel and mutually supporting aims. Further, the financial support mechanisms of the EMS can be used in such an eventuality. Also, the drachma could benefit from a larger margin of fluctuation within the EMS, at least till the inflation rate is considerably reduced. Lastly, central parities can be realigned if necessary, although too frequent realignments would counteravail the advantages of relatively stable exchange rates.

Adhesion to the EMS would require some liberalisation of capital movements (that is foreseen independently of Greece’s adhesion to the EMS after the end of the transition period in 1985) and the existence of a real foreign exchange market for the drachma, where the daily bilateral exchange rates could be set. The drachma could join the EMS at a point where its inflation rate would have been reduced to acceptable levels.

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<sup>8</sup> H. Christie, M. Fratianni “European Monetary Union: Rehabilitation of a Case and Some Thoughts for Strategy”, in M. Fratianni and T. Peeters.

Throughout this paper adhesion to the EMS is seen as an element in a general stabilisation policy and the fight against inflation. An anti-inflationary policy may have some cost in terms of employment but this is only transitory compared to the permanent and increasing cost of inflation. The success of such a necessary stabilisation policy depends in great part on wage behaviour. Without an appropriate wage moderation during a certain period, an anti-inflationary policy would not be possible<sup>9</sup>. In order to achieve this, some form of accompanying incomes policy can be chosen, as for example an incomes policy as a common framework of assumptions and data on the economic situation on which the bargaining process is to be based, or even stricter forms of wage and incomes controls for limited periods.

A stabilisation policy is necessary in Greece due to the still very high inflation. In the framework of a general stabilisation policy, adhesion to the EMS at an appropriate moment will be an additional important positive element in safeguarding the external side of the economy and influencing favourably inflation, expectations and capital movements.

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<sup>9</sup> E. Malinvaud, "Wages and Unemployment", Economic Journal, March 1982.



## **Zusammenfassung**

### **Die Einbeziehung der Drachme in das EWS**

Im vorliegenden Artikel wird am Beispiel der griechischen Drachme untersucht, welche möglichen Wirkungen es für eine zuvor floatende Währung einer kleinen offenen Volkswirtschaft hat, wenn sie einem Währungsgebiet mit vorwiegend fixen Wechselkursen, wie dem Europäischen Währungssystem, beitrifft.

Wirtschaftspolitische Einwände, die gegen eine Teilnahme am EWS erhoben werden könnten, werden geprüft und kritisiert:

1. „Verlust der Unabhängigkeit der Wirtschaftspolitik bei Aufgabe flexibler Wechselkurse könnte negative Wirkungen auf die Wettbewerbsfähigkeit und die Beschäftigung haben.“ Die Stichhaltigkeit dieses Arguments beruht auf der Existenz einer normalen Phillipskurve, die in Wirklichkeit nicht gegeben ist. Expansive Geldpolitik ist kein adäquates Instrument um Arbeitslosigkeit abzubauen. Darüber hinaus wird die Autonomie der Wirtschaftspolitik davon bestimmt, wie groß und wie offen eine Volkswirtschaft ist, aber nicht von dem Wechselkursystem.
2. „Relativ fixe Wechselkurse könnten der Zahlungsbilanz eine Beschränkung auferlegen.“ Flexible Wechselkurse, die die Zahlungsbilanzbeschränkung nicht beseitigen können, übertragen den Schock externer Störungen vollständig auf die heimische Inflation. Außerdem muß eine Abwertung nicht zu einer Verbesserung der Zahlungsbilanz führen, denn die negative Wirkung auf die Inflationserwartungen induziert häufig einen Kapitalabfluß.
3. „Flexible Wechselkurse, die eine laxe Geldpolitik erlauben, werden von Regierungen wegen der Existenz einer ‚Inflationssteuer‘ vorgezogen.“ Dies bedeutet einen Mißbrauch des staatlichen Währungsmonopols und ist in einer Demokratie inakzeptabel.

Relativ fixe Wechselkurse, die im Falle der Einbeziehung der Drachme in das EWS vorherrschen würden, werden als Element allgemeiner Stabilisierungspolitik und des Kampfes gegen Inflation betrachtet. Die Kosten einer solchen Stabilisierung sind nur transitorisch im Gegensatz zu der Alternative ständiger Inflationskosten. Der Erfolg einer solchen Politik hängt im wesentlichen vom Lohnverhalten ab, daher wäre eine ergänzende Einkommenspolitik, welcher Art auch immer, wünschenswert.

## **Summary**

### **The Drachma's Adhesion to the EMS**

The present paper examines the possible effects on a previously floating currency of a small open economy of joining a currency area with predominantly fixed exchange rates, such as the European Monetary System, taking the Greek drachma as an example.

Economic policy objections that could be raised against participation to the EMS are examined and criticised:

1. "Loss of independence in the shaping of economic policy when abandoning flexible exchange rates, which could have a negative influence on employment and competitiveness." The validity of this argument rests on the existence of a normal *Phillips* relation which actually does not exist. Expansionary monetary policy is not an adequate instrument to reduce unemployment. Furthermore, the autonomy of economic policy is constrained by the size and openness of the economy and is not dependent on the exchange rate system.
2. "Relatively fixed exchange rates could impose a constraint on the balance of payments." Flexible exchange rates, while not solving the balance of payments' constraint, fully transmit the shock of external disturbances to domestic inflation. Moreover, devaluation may not improve the balance of payments, since the negative effect on inflationary expectations often leads to an outflow of capital.
3. "Flexible exchange rates that permit lax monetary policies are preferred by governments due to the existence of an 'inflation tax'." This is an abuse of the State's monetary monopoly and is unacceptable in a democracy.

Relatively fixed exchange rates that would prevail in the case of the drachma's adhesion to the EMS are seen as one element in a general stabilisation policy and the fight against inflation. The cost of such stabilisation is only transitory compared to the alternative permanent inflation cost. The success of such a policy depends to a great extent on wage behaviour so that some sort of accompanying incomes policy would be desirable.

## Résumé

### L'adhésion de la drachme au SME

En prenant la drachme comme exemple, cet article examine les effets de l'adhésion d'une monnaie auparavant flottante d'une petite économie ouverte à une zone monétaire où prédominent les taux de change fixes, telle que le système monétaire européen.

Les objections politiques économiques qui pourraient être soulevées contre une participation au SME sont examinées et critiquées:

1. «Perte d'indépendance de la politique économique suite à l'abandon de taux de change flottants, ce qui pourrait influencer négativement l'emploi et la compétitivité.» Cet argument se base sur l'existence d'une relation normale de Phillips qui, en fait, n'existe pas. Une politique monétaire expansionniste n'est pas un instrument adéquat pour réduire le chômage. En outre, l'autonomie de la politique économique est contrainte par la grandeur et l'ouverture de l'économie et ne dépend pas du système des taux de change.
2. «Des taux de change relativement fixes pourraient imposer une contrainte sur la balance des paiements.» Des taux de change flottants transmettent entièrement le choc de perturbations extérieures sur l'inflation du pays, et ne résolvent pas la contrainte de la balance des paiements. En plus, une dévaluation n'améliore pas la balance des paiements parce que l'effet négatif sur des attentes inflationnistes entraîne souvent une évasion de capitaux.

3. «Les gouvernements préfèrent des taux de change flottants qui permettent des politiques monétaires relâchées à cause de l'existence d'une «taxe d'inflation». Ceci est un abus du monopole monétaire de l'Etat et est inacceptable dans une démocratie.

Si la drachme adhérerait au SME, les taux de change seraient relativement fixes, ce qui est considéré comme un élément dans une politique générale de stabilisation et de la lutte contre l'inflation. Le coût d'une telle stabilisation est seulement passager, à comparé au coût d'une inflation permanente alternative. Le succès d'une telle politique dépend en grande partie du comportement salarial, de telle sorte qu'une politique des revenus parallèle serait souhaitable.