



THE EXCHANGE RATE AND ITS ROLE IN THE EMU ACCESSION PROCESS

INSTITUTIONAL ASPECTS OF CONVERGENCE CRITERIA OF THE EXCHANGE RATE IN THE FRAMEWORK OF EMU*

Rastislav Čársky, Martina Klačanská, Andrea Tvarošková

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Greece's participation in the ERM and ERM II exchange-rate mechanisms in the period prior to entering the EMU

Greece is the only country which participated in the ERM II prior to accession to the EMU. Greece entered the ERM¹ on 16th March 1998. Upon its accession to the ERM the central parity of the drachma against the ECU was set approximately 14% below than the average exchange rate of the drachma in the 10 preceding days, at the level of 357 GRD/ECU, i.e. within the $\pm 15\%$ fluctuation band.

The devaluation made at setting central parity of the drachma was a consequence of the strong drachma policy applied by the central bank, as well as the fiscal policy carried out by Greek authorities. The strong drachma policy was introduced in 1995 and was based on a nominal depreciation of the drachma exchange rate against the ECU lower than the inflation differential between Greece and the EU average. Over the course of 1995 to 1997 the application of this policy essentially meant a fixed exchange rate regime vis-à-vis the ECU. The reasons which led the Bank of Greece to adopt a strong drachma policy include the failure in money supply targeting, financial liberalisation (through the effect of which the long-term stability of the demand for money function was threatened), as well as the intention to enter the EMU. The main aim of the strong drachma policy was to reduce inflation by means of reducing prices of imported goods for final consumption, domestic goods produced from imported raw materials and intermediate goods, the reduction of prices of products in the tradable sector (firms were exposed to international competition and couldn't rely on the crawling

peg system, which would have maintained their competitiveness) and through the effect of the drachma exchange rate as a nominal anchor in the economy, through which inflationary expectations would have been reduced (with a subsequent impact on wage contracts, as well as in firms' pricing policies).

The implementation of the strong drachma policy was manifested positively in increased confidence in the domestic currency, which was not threatened by speculative attacks aimed at depreciating the exchange rate, in the case of which the central bank was not forced to devalue the drachma. At the same time, the central bank gradually reduced the level of adjustment of the currency (crawling peg). A further positive factor was the reduction of inflation from 11% (1994) to 6% in 1997.

The strong drachma policy however also had negative consequences, which were reflected in the need to devalue the exchange rate of the drachma. This was caused by the lack of a strict fiscal and incomes policy, which together with growing problems of competitiveness contributed to an increase in the current account deficit in the balance of payments. The insufficient adjustment of the exchange rate in comparison with the development of the inflation differential in consequence of the implementation of the policy adopted however led to the reduction of inflation, but on the other hand meant a loss of competitiveness. The development of the current account of the balance of payments indicated that the loss of competitiveness raised pressure on the external sector of the economy and the strong drachma policy had driven the drachma off its long-term equilibrium. The real effective exchange rate over the course of 1995 to 1997 appreciated by 7%.

A further negative factor in applying the strong drachma policy were growing problems with liquidity, caused by higher domestic interest rates than those abroad, which concurrently exceeded the expected rate of appreciation of the drachma. This difference reflected the risk premium, which investors required for investing in assets denominated in drachma. Concurrently the high interest rate differential caused a significant inflow of short-term and medium-term capital, which resulted

* Opinions stated in this article are those of the authors and do not necessarily reflect the opinion of the NBS.

¹ Up to the time of adopting the euro in 1998 the European Commission evaluated the drachma's exchange rate stability against the median of currencies participating in the ERM. The median of a currency in the framework of the ERM is defined as the exchanges rate of the currency that is closest to its central parity vis-à-vis the ECU on a given day.



in a significant growth in money supply and threatened the anti-inflationary monetary policy. The central bank sterilised the capital inflow by interventions in the money market. On the one hand a decline in interest rates with the aim of limiting the inflow of speculative capital was desirable, but on the other hand a too fast fall in interest rates could have created pressures on exchange-rate development.

Despite the fact that the strong drachma policy helped to reduce inflation, its disadvantages together with insufficient fiscal consolidation, as well as the absence of structural reforms undermined its sustainability and credibility. Upon the entry of Greece to the ERM, the extent of the central parity of the drachma's devaluation against its current exchange rate reflected both the inflation differential between Greece and other EU countries, as well as the policy of overvaluing the currency, which, in the case of the non-realisation of reforms, was not sustainable from a long-term point of view.

Following the country's entry into the ERM, the government announced the adoption of fiscal and structural measures aimed at consolidating public finances. The drachma's entry into the ERM system, where the central parity (supported by the realisation of the measures) was perceived by international institutions and financial markets as adequate and sustainable, meant a fundamental change in the policy regime, indicating an intensification of the efforts to realise policies aimed at achieving accession to EMU on 1st January 2001. The financial markets also reacted positively to the drachma's entry to the ERM, and the exchange rate following an initial depreciation (which meant an adaptation to the set central parity), began to appreciate, interest rates fell and equity markets experienced an upturn.

From 1998 to 2000 the central parity was revalued twice, whilst the fluctuation band remained unchanged. Since 1st January 1999, following the introduction of the euro, the drachma participated in the ERM II and, for technical reasons, a new central parity was set (353.109 GRD/EUR), which was slightly different from that previously set against the ECU (357 GRD/ECU). This difference was caused by setting the central parities of currencies (participating in the ERM II) against the euro through a recalculation via the conversion rate.

With regard to the fact that the exchange rate moved constantly in the appreciation part of the fluctuation band, on 17th January 2000 the central parity of the drachma was changed, being revalued by 3.5% to 340.75 GRD/EUR (from 353.109 GRD/EUR)². The

decision to revalue the central parity was made after the application of Greece was accepted with the approval of the economy and finance ministers and governors of central banks participating in the ERM II and the ECB. This enabled the realisation of an anti-inflationary monetary policy since pressure on prices was less than it would otherwise have been in the case of a weak drachma. Despite the setting of a new central parity, the exchange rate of the drachma against the euro moved in the appreciation band. The appreciation of the central parity had a favourable effect on inflationary expectations and contributed to a moderation of wage growth in collective bargaining.

On the basis of the ECOFIN Council decision (on 19th June 2000) the central parity at a level of 340.75 GRD/EUR was set as the irreversible conversion ratio of the drachma to the euro with effect from the date of entry of Greece to the euro area, i.e. 1st January 2001.

Development of the drachma exchange rate in relation to the ECU, EUR

Through the entire period of its participation in the ERM and the ERM II (March 1998 – December 2000), the exchange rate of the drachma remained in the appreciation part of the fluctuation band. Deviation of the exchange rate from the central parity at the end of 1999 stood at 6.5% and, following the revaluation in mid-January 2000, reached 2.9%. The relative appreciation of the drachma over the course of the year gradually fell, so that by mid-December 2000, this deviation had been eliminated and the exchange rate had converged by the end of December 2000 to central parity. Over the period of the drachma's membership in the ERM (from 16 March to the end of 1998) the appreciation of the exchange rate vis-à-vis the central parity moved in the range 2.2% to 8.5%. In 1999 drachma deviation from the central parity moved in the range 6.5% to 9%.

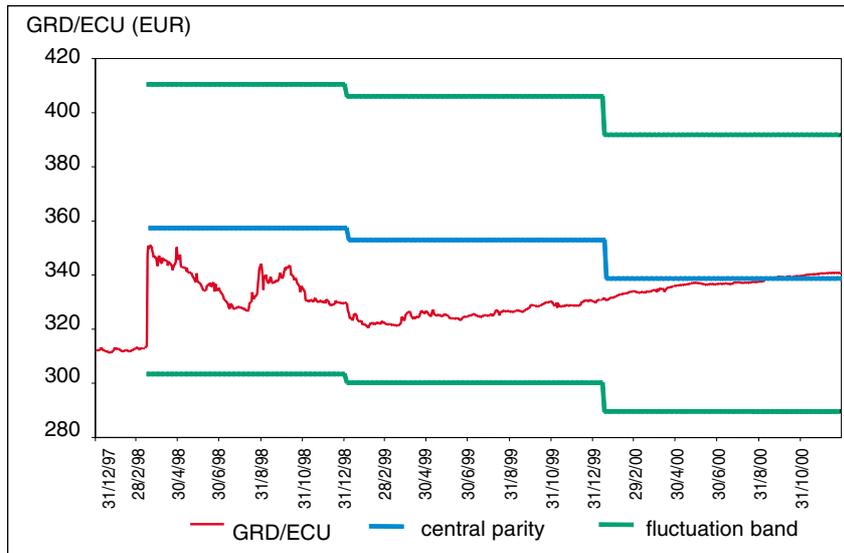
The development of the drachma exchange rate during participation in the ERM / ERM II, may be divided into two periods. In the period from the drachma's entry into the ERM up to the end of February 1999 the exchange rate was characterised by a trend of appreciation, to which contributed the high differential between interest rates in the EU / EMU and Greece, resulting from the restrictive monetary policy aimed at reducing inflation³. In the period from February 1999 to the end of 2000, the drachma gradually depreciated towards central parity, helped by the reduction in the interest rate differential vis-à-vis the euro area.

² The method for setting the new central parity was approved by common procedure, with the participation of the economic and finance ministers of the euro area member countries, the ECB, the finance and economy ministers of Denmark, Greece as countries in the ERM II, the European Commission and the Monetary Committee.

³ The average 3-month interbank rate in Greece in 1998 was 13.9% (10.3% in 1999); while in the euro area it stood at 3.9% in 1998 and 3.0% in 1999.



Development of the drachma exchange rate during participation in the ERM and ERM II



Exchange-rate policy of the central bank of Greece

The intervention of the central bank of Greece on the foreign exchange market was a basic factor contributing to the smooth convergence of the drachma's exchange rate to the conversion rate vis-à-vis the euro. At the same time, activities on the foreign exchange market were aimed at limiting the significant volatility of the exchange rate caused by exogenous factors. In 1998 and 1999 interventions on foreign exchange market were realised in the form of purchases of foreign currencies, and in 2000 in the form of their sale. Following the drachma's accession to the ERM in March 1998, at a time of high interest rates, the drachma exchange rate began to appreciate considerably, as a result of significant inflow of capital, influenced also by a growth in confidence of the financial markets in consequence of the stabilisation policies adopted.

By mid-August 1998 the appreciation of the exchange rate vis-à-vis the central parity reached 8.1%, but had fallen back to 4% by the end of August due to crisis in Russia⁴. From the beginning of September capital began to flow to the country again, and the inflow intensified during the last two months of 1998, and the central bank of Greece was obliged to intervene markedly on the foreign exchange market in order to restrain the appreciation trend of the drachma.

⁴ Interbank rates recorded a significant growth of 5 – 6 percentage points (e.g. the spread of 3-month interbank rates between Germany and Greece reached 15 percentage points at the end of August 1998).

During the first five months of the year 2000, the central bank of Greece intervened occasionally on the foreign exchange market by sale of foreign currency, aimed at mitigating the excessive volatility of the exchange rate, caused by unsubstantiated information concerning Greece's fulfilment of the Maastricht criteria. ECOFIN's decision on the conversion ratio of the drachma had a decisive influence on foreign exchange market expectations with regard to the further development of the drachma's exchange rate (up to the end of 2000).

Monetary Policy over the years 1998 – 2000

Following the drachma's entry to the ERM in March 1998, the drachma exchange rate to the ECU continued to be the main intermediary monetary policy objective. The drachma's entry to the ERM with a standard fluctuation band of $\pm 15\%$, in comparison with the original band of $\pm 2.25\%$, allowed greater flexibility in the conduct of monetary policy.

The basic pillar of monetary policy during 1998 to 2002, was the gradual reduction of key interest rates together with an appropriate intervention policy on money and foreign exchange markets aimed at limiting external inflationary pressures so that the drachma could converge smoothly to the set conversion ratio. The Bank of Greece also intervened on the money market to absorb excess liquidity.

The interest rate differential during 1998 reached high figures, the development of long-term interest rates was, however, characterised by declining trend converging towards levels common in the EU. The factors behind this development included a reduction in the inflation differential and in the risk premium in the financial instruments denominated in drachma.

In 1999, the primary objective of the Greek central bank was price stability (defined as a growth in consumer prices of less than 2%) and its intermediary goal was exchange-rate stability, where the development of the drachma exchange rate was to move in the narrow band of $\pm 2.25\%$. Due to the conflict of aims – disinflation and exchange rate stability – the inflation aim became the central bank's priority.

In mid-April 1999, a temporary measure was adopted for limiting credit expansion, aimed not only at minimising the risk of inflation ensuing from a marked growth



in loans (in particular consumer) and from growing competition in the banking sector⁵.

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⁵ In this period of competitive pressure, as well as expectation of a further decline in key interest rates, commercial banks reduced interest rates on credit to a greater extent than the central bank. On

the basis of the central bank's measure, commercial banks, whose rate of growth in loans to the private sector and public enterprises exceeded 12%, were obliged to hold six months' surplus volume in a non-interest bearing account at the central bank.