3 Economic Policy in Theory and Greek Practice

GEORGE E. DRAKOS

The objective of this chapter is to explain the contrasts in the performance of the Greek economy between the 1970s and the 1980s and to enquire what role policy changes played in these developments. Between 1950 and 1979 the performance of the Greek economy has been remarkable by any standards, combining very high rates of growth with price stability. Even after the first oil crisis of 1973, the Greek economy showed considerable resilience, continuing to grow at relatively (for the period) high rates while the rest of the industrialized world was passing through an unusually prolonged recession. After the second oil crisis of 1979, the Greek economy suffered a serious setback entering into a period of stagnation, accelerated inflation and early de-industrialisation. It is the purpose of this paper to enquire into the causes of this reversal of Greece’s economic fortunes and to underline the chain of events that brought the country into a vicious circle from which it has not yet extracted itself.

SOME PRELIMINARY REMARKS

Let us start by reminding ourselves that Greece is a small country. Greece is small by any criterion one cares to choose. For instance, Greece occupies less than 0.1 per cent of the total surface of the earth, has less than 0.22 per cent of the world population and produces about 0.35 per cent of the world GNP. Greece is also a small EEC partner, especially with regard to the economic meaning of ‘smallness’. Indeed, Greece occupies only 8 per cent of the EEC territory, has only 3.5 per
cent of the EEC population and produces about 1.5 per cent of the Community's GDP. Second, Greece is an open economy – no matter how one cares to measure 'openness'. For instance, if one measures openness by the ratio of imports to GDP or GNP this ratio is approximately 30 per cent for Greece in 1982. If one adds exports in the numerator the previous ratio becomes 40 per cent. And given the importance of invisible transactions for Greece, if one chooses to add in the numerator invisible payments and receipts, then about 66 per cent of either GDP or GNP 'cross the border'.

Of course, Greece is less open than other small EEC and non-EEC countries in the world. However, one should also take into consideration the stage of development of Greece and the fact that openness gets larger through time as development proceeds. Indeed, these same ratios have increased by approximately 100 per cent in the past twenty years.

Despite the openness of the Greek economy it still remains to a large extent an 'insular economy' in McKinnon's sense. Indeed, currency convertibility is limited and financial arbitrage with the outside world is not really allowed. Therefore the 'old' elasticities and expenditure approach to adjusting the exchange rate for balance-of-payments equilibrium still applies for Greece. In other words, the modern 'extreme' monetary approaches to exchange rate determination are not really appropriate for the Greek 'insular' economy, where capital mobility is far from perfect, and interest rates administratively determined.

Finally, no Greek product enjoys a truly monopolistic status in the world markets. Similarly, Greece is no monopsonist in any major product at the world markets and has to import many goods for which there are poor or no local substitutes. These facts, together with the two points raised above imply that Greece (as most small open economies) is a price-taker in world markets.

In essence therefore we may use the 'law of one price', following the purchasing power parity theory, according to which:

\[ p = ep' \]

where \( p \) and \( p' \) are the domestic and foreign price levels and \( e \) the exchange rate (number of units of the home currency per unit of foreign currency). Now this 'law of one price' can only hold if all commodities are traded and 'flexprice' in the Hicksian sense; or it may hold if future exchange rates are fully anticipated. Although this usual theoretical approach is going to be followed here, it is well known that for various reasons price levels across countries are not the same. In fact, any small open economy is in general a policy-taker in an interdependent world.