

**ON THE VERGE OF ENTRY INTO THE EMU: GREECE, THE  
CHALLENGE OF CONVERGENCE AND A NEW BEGINNING**

**Kenneth Matziorinis, Ph.D.**

*Founder of Hellas Capital*

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# HELLAS CAPITAL

## Introduction

My presentation tonight will outline 1) the conjunctural context in which Greece has found itself in recent years and the challenges posed by the Treaty of Maastricht ; 2) the current economic performance of the Greek economy and its recent policy achievements which are now positioning Greece to enter the EMU by January 1, 2001 and 3) the implications of Greece=s entry into the EMU on its economy and the equity market in particular.

## Situation Analysis

Almost 50 years ago in April, 1951 six of Europe=s war-torn countries decided to form the European Coal and Steel Community in an attempt to establish the conditions for economic cooperation, friendship and peace on the European continent. Jean Monnet=s dream was to forge a new united Europe that would spring from the ashes of the old destroyed continent. Two imperatives drove the need to forge a United Europe. The first, to avoid a future war with all its destructive consequences. The second, to regain Europe=s lost competitive economic and political advantage which had been lost to the USA. In a world of continental-sized economies and economies of large scale production, Europe had to unite economically and if possible politically if it were to provide a counterweight to and compete effectively against the USA.

Based on the early success of the Coal and Steel Community, European countries went on to establish in 1956 the European Common Market (ECM) and in 1981 the European Union (EU). These steps, although significant, were still not enough to restore Europe=s competitiveness because countries still imposed their own internal barriers to trade, employment and movements of capital and even worse, each country continued to use its own currency. This acted as the single, most significant barrier to free trade and investment within the community. Thus European countries decided to eliminate all internal non-tariff barriers to trade and to harmonize their trade, commercial and financial policies and open their borders to all internal competition in both goods and services, such as trade, transportation, communications, insurance and banking. With this challenge accomplished by 1992, Europe=s leaders turned to the final, boldest, the most significant step in the process of economic union, that of monetary integration. In 1992, in the Dutch city of Maastricht they decided to form a monetary union, the EMU by 1999; to give up their currencies and replace them by one continental-wide currency, the Euro; to create a single pan-European central bank, the ECB which would take over the responsibility for the monetary and exchange rate policy of the Union.

To establish a monetary union demanded that certain preconditions be achieved by all member nations. The entry criteria, as laid out in the Maastricht Treaty were: 1) to bring budgetary deficits under 3% of GDP; 2) to achieve a debt-to-GDP ratio under 60% of GDP; 3) to achieve rates of inflation under 3%; 4) to achieve convergence in short-term and long-term interest rates and achieve currency stability for a period of twelve months prior to entry into the EMU. A country would not be eligible for membership unless it had met the above conditions.

Greece joined the EEC as an associate member in 1961 and as a full member in 1981. In the early years, from 1951 to 1973 Greece achieved the highest rate of growth in GDP of all OECD countries. Greece surpassed both Germany and Japan in the rate of growth but no one spoke of a Greek Economic Miracle  $\cong$ . As with the East Asian Tigers in the 1970s and 1980s, this growth had been achieved at the expense of social justice and democracy. With the collapse of the junta in 1974, Greece embarked into an era of democratization which saw the reigns of power transferred from the right wing establishment to the left. Redressing the social and political injustices of the past became the priority and Greece entered an era of fiscal laxness, where economic objectives were subordinated to those of social justice, political pluralism and consolidation of democratic institutions. By 1994, twenty years later Greece emerges as a pluralistic society with solid and tested democratic foundations and institutions-a necessary precondition to further growth and development. But the price for this social and political achievement was that Greece had fallen to the bottom of economic rankings in Europe and the OECD, with huge budget deficits, high inflation, a depreciating currency and high interest rates.

When in May, 1998 the European Council met to decide which countries were eligible for membership into the EMU, Greece was not one of them. Although government authorities had embarked on an ambitious program to restore fiscal and monetary discipline and restructure the economy the progress had not been sufficient to meet all the conditions for entry. Greece was on probation, it had to demonstrate that it is capable of meeting the stringent standards that other European nations had met and which were necessary for monetary integration.

### **Current Economic Performance and Policy Achievements**

Over the past six years the Greek economy has undergone a radical transformation. Momentous steps and measures were taken to bring down budgetary deficits, to halt the growth in public debt, to stop the slide in the currency, to bring down inflation, to lower interest rates, to deregulate markets and the financial and banking sectors, to liberalize the international movement of capital, to give the central bank independence, to stop printing money, all the while a massive infrastructure and public works project, the biggest investment boom seen in Greece this century has gotten under way with the support of EU structural funds amounting to almost 3% of GDP.

Greece has achieved enormous progress on all fronts, namely:

- X The public sector budgetary deficit has declined from 13.8% of GDP in 1993 to 1.9% of GDP in 1998.
- X The debt-to-GDP ratio has declined from 111.6% of GDP in 1993 to 105% in 1998, and is expected to fall below 100% in 2000.
- X The rate of inflation as measured by the CPI has been falling steadily from 20.4% in 1990 to 4.2% in 1998. In February, 1999 consumer inflation is running at a year-over-year rate of 3.7%, which is now expected to fall to 3.3% in March and 2.5% in April. By June, Greece's inflation will be running below 1.9% and is expected to fall to 1.5% by December, 1999.
- X Interest rates, as measured by the one year government treasury-bill have fallen from 24% in 1990 to 9.2% in February, 1999. Long 10-year government GRD bond yields are currently running at 6.06%.
- X The yield curve, remains strongly inverted with a gap of 382 basis points between 15-year long GRD bonds and 3-month GRD treasury bill yields. The slope of the yield curve demonstrates the tightness of the monetary conditions imposed by the Bank of Greece while at the same time demonstrating the phenomenal drop in inflation expectations which have pushed long bond yields to 6% levels.
- X Although interest rates have fallen substantially, they have yet to match the more substantial drop in inflation. The real 1-year treasury-bill rate is currently around 5.5%. Assuming that in 1999 the Bank of Greece maintains monetary conditions tight and therefore maintains the same spread between interest rates and inflation, the nominal 1-year interest rate should fall below 8% by June, 1999 and below 7% by December, 1999. Next year, the year before Greece's expected entry into the Euro we should witness a significant drop in real interest rates as well, which should bring nominal rates down to 5% by June 2000 and 3.75% by December, 2000.
- X Greek interest rates have also remained high relative to German rates as well. The differential between Greek and German 3-month treasury bill rates has narrowed from almost 13% in 1994, the year capital flows were liberalized to just above 8% in 1998. In 1999, the differential should average 6 percentage points (600 basis points) and in 2000 it should fall below 300 points. In 2001, once Greece enters the EMU, the differential should drop to under 50 basis points. The near disappearance of the differential is explained by the elimination of the currency and country risk. The only risk that will differentiate Greek from German bonds will be the credit risk, which due to Greece's higher debt-to-GDP ratio will remain higher for Greek Bonds. The differential between 10-year GRD bonds and 10-year German Euro bunds has narrowed to 200 basis points, (6.06%-4.07%) in early March, and provides further indication that international financial markets are confident in Greece's success in entering the EMU by 2001.

- X As a result of the success of Greece's convergence plan, the key indicators of the country's macroeconomic performance have started to respond. The growth in real GDP has picked up since 1994 and since 1996 is running at rates higher than its European partners. In 1998, the latest release of numbers shows that Greek GDP rose in 1998 by 3.8%, that is the highest rate of growth achieved in Greece since 1989. While for 2000 the Greek Ministry of National Economy projects it will rise to 4.5%, the highest rate since the early 1970s.
- X Most of the growth in Greece's GDP is driven by growth in fixed capital investment. From negative rates in the early 1990s, investment has rebounded and is now running at annual rates in excess of 10% per year.
- X The only weakness in Greece's report card remains current account balance, which since 1996 is stuck at a rate of -4% of GDP. Two factors underpin Greece's under-performance in this area: 1) GDP and consumption is growing faster than that in Europe and most of the world which is sucking in imports faster than exports and 2) Greece's investment boom which is heavily dependent of machinery and equipment most of which are imported. As we will see later, however, Greece's current account deficit will cease being a major issue once Greece enters the EMU and Greece adopts the Euro as its national currency.
- X Greek foreign exchange reserves have risen substantially in recent years and in January, 1999 stood at USD \$20.7 billion (vs. \$23.3 billion in Canada). Gold reserves have been also rising and now exceed the gold reserves of Canada (4.5 million ounces vs. 2.5 million for Canada).
- X The Greek Drachma has performed very well. The Chart shows that the rate of depreciation relative to the ECU and the German mark (DM) has slowed considerably. Moreover, the Greek Drachma did not suffer any damage when the international monetary turbulence broke out in 1997 and again in 1998 despite the persistence of rumors that the Drachma would suffer a devaluation. Greece's entry into the European Exchange Mechanism (ERM) last March in fact turned a challenge into a victory. Despite the fact that Greece was not admitted into the EMU, the fact that it entered the ERM has shown the confidence its European partners have bestowed on its efforts to achieve convergence and in itself has contributed to the GRD's stability in 1998. Relative to Canada, the chronic depreciation that marked the period 1974-1989 has now come to an end. In the 1990s, the Greek Drachma has shown remarkable stability relative to the Canadian dollar.

### **Implications for EMU, the Greek Economy and the Equities Market**

The implications of the recent economic achievements for Greece are profound. The foremost implication is that by early May, 1999, when the April inflation figures are released, Greek inflation will fall below the important 3% level to probably 2.5% and then inch downwards for the rest of the year to under 2%. With the rate of inflation falling under 2% Greece will have effectively met all but one of the conditions for entry into the EMU. The only

hurdle that will have been missed is the debt-to-GDP ratio. But since Italy and Belgium were exempted of this criterion it is a certainty that Greece will be exempted as well. Thus it is a near certainty that when the European Council meets by April of next year do decide on Greece=s membership, the answer will be a yes. Greece=s membership into the EMU is now almost a reality.

The implications of joining the EMU are far reaching for Greece. Some of the implications are the following:

- X Greece will adopt a new currency, the Euro by January 1, 2001. What this means for investors is that there will no longer be a Greek Drachma risk when investing in Greece. The currency risk for Canadian investors will then shift to the more stronger Euro, the currency of the European block, a currency which by all accounts has become the second most important currency in the world, next to the United States dollar. All political uncertainty arising from domestic issues, relations with Turkey and other Balkan states will no longer impact the Greek Drachma or Greek Drachma denominated assets. If there is an impact it will be on the Euro and up to the ECB to resolve.
- X Interest rates will plunge over the next 18 months to levels never seen before in Greece. One of the implications of this is that the Greek state should save 1.2-1.5 trillion Drachmas a year in interest costs, equivalent to almost 4% of GDP. With the cost of servicing its public debt plunging, budget deficits will turn to budget surpluses as early as 2002, while a lot of room will open for increased public expenditures on services and lower taxes.
- X Another implication is that Greek Drachma fixed-rate bonds should continue to outperform comparable European instruments until 2001.
- X The borrowing costs of Greek corporations, especially those in the capital intensive manufacturing sector will fall significantly. There will be a permanent strong impact on the earnings of these corporations that will raise their profitability and raise their valuations. All companies listed on the ASE will see the value of their shares soar just as a result of this factor alone. The high cost of capital has been a chronic problem for the Greek economy. With the cost of capital driven to near European levels, a major handicap that has dogged the Greek economy will have been eliminated and become a thing of the past. With low cost of capital in Greece, the elimination of public borrowing and capital inflows, Greek companies will be in a position to raise big sums of capital to finance their export growth and direct investment into the Balkan and Black Sea regions.
- X One of the biggest beneficiaries of this transformation will be the Greek equities

market. In anticipation of these developments, the value of shares traded in the Athens market has recorded 21 consecutive highs so far this year alone and has broken above the 3,700 level. The potential exists in the Greek market for stocks to appreciate substantially above current values to perhaps even the 5,000 point a year from now. The market capitalization of the Greek market reached USD \$110 billion in March, which represents 82% of Greek GDP, clearly a milestone.

- X As a recent article in the Globe & Mail reported, the number of retail stock investors in Greece has reached 1,000,000, yet it is estimated that still less than 20% of households own shares, a proportion which is sure to rise over the next few years. Since January 1998, over 300,000 individuals have opened accounts in Greek brokerage houses. Despite of this spectacular number, however, in terms of money invested Greek investors are still way under-invested compared to other equity markets in Europe. One fact alone will underline the extent of under-investment in this market. Of the 10 trillion GRDs invested in Greek mutual funds last December, only 4.5% are invested in stocks and 8% in balanced funds. In other words, less than 10% of the money invested in mutual funds has found its way into the stock market. You can imagine what will happen as interest rates continue to fall. Fund investors will switch to equity funds from money market funds and that will provide a further push to stock prices.

Ladies and Gentlemen, there is much more that I could say, but time does not allow me to go on. What I have said should be enough to convey you both the opportunity and the urgency of the situation.

**THE GREEK STOCK MARKET: SOME CHARTS, SAMPLES OF OUR  
WORK AND TRACK RECORD**

**Emmanuel I. Varsos, Ph.D.**  
*Chief Executive Officer*  
*Investment Analysis, A.E.*

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