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The European Monetary Union, the Prospects of Convergence and Greek Economic Integration

97-11

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I.   Introduction

The institution of the Single European Market (SEM) in the end of 1992 and the achievement of monetary union by the end of the century will together create a powerful new entity within the word economy. The European Community (EC) will become an integrated economy of just under 350 million people producing approximately one third of all output by members of the Organization for Economic Co-operation and Development (OECD) and today accounting for over 26 per cent of world exports. This extraordinary economic transformation will inevitably have a considerable impact on the performance of both the EC economy and the world economy more generally.

To the extent that macroeconomic effects may be meaningfully separated from microeconomic effects, the macroeconomic impact on non-member States will be shaped by a combination of two sets influences. First, the macroeconomic performance of an area representing one third of the OECD economy will necessarily be a significant determinant of the performance of the other two thirds. So the rate of growth, the rate of price inflation, and the conduct of monetary policy within the EC will all be important components of the macroeconomic environment in which the rest of the world operates. Second, the creation of a single currency in Europe will necessarily mean changes in the organization of international trade and finance and in the operation of the international monetary system.

The scale and content of these effects are not, of course, independent of one another. The impact and the role of the ecu within the international monetary system is dependent on the macroeconomic performance of the EC, and vise versa. However, at the current stage of the European monetary evolution, in which the institutional relationships of economic and monetary union (EMU) have already been designed (even though occasionally revised), it is useful to consider them separately, as will be done in the sections following the discussion on the exchange rate mechanism (ERM) and on European introversion. In both cases it will be argued that there are important design flaws in the current proposals that are likely to result in macroeconomic inefficiency[1] both within the EC and in the international economy as a whole. Then, a provisional assessment is sketched of Greece's overall comparative performance and of the prospects for the country's overall successful participation

II.   The ERM as the Precursor of Monetary Union

Since 1987 there have been no realignments of parities within the ERM,[2] and members States clearly intend to avoid realignments if possible. The absence of realignments, together with the closer

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[1] By «macroeconomic inefficiency» is meant the persistence of a trend rate of growth below that which, with current resources and technological expertise, is potentially sustainable.

[2] Other than the Italian quasi-realignment in January 1990. The lira had fluctuated within the bands of 6 per cent around the central parity. In reducing fluctuations to the more typical bands of 2.25 per cent

2

monetary cooperation established in the Basle-Nyborg Agreements of 1987 and the removal of controls on capital movements, have led to the characterization of the post-1987 ERM as a «new» European Monetary System (EMS). This new EMS comprises a system of fixed exchange rates and integrated financial markets, in contrast to the «old», pre-1987 EMS, which has essentially a crawling peg buttressed by barriers to the movement of capital.[3]

In an era of free capital movements, the disruptive potential of speculative capital flows induced by even the possibility of exchange rate changes has greatly increased the importance of maintaining currency credibility. A credible commitment to a given parity will, it is hoped, discourage speculation. Lack of credibility must be paid for in interest rate premia. In increasingly integrated capital markets, such penalties may be imposed not only on currencies that are perceived as weak, but on the system as a whole. The creation of a single currency will remove this upward bias in interest rates by removing the need for these credibility premia.

The new EMS has arisen from attempts by members of the ERM to emulate a single currency by convincing the markets of their commitment to maintaining parity, most notably with the deutsche mark whatever might be the implications of the commitment for the conduct of domestic policy. This has produced some paradoxical results. Since credibility plays a vital part in the determination of capital flows, the attainment of a credible commitment to the new EMS has resulted in the overfunding of current account deficits in high-inflation, high-interest rate members such as Italy, Spain, Portugal and Greece, pushing their exchange rates to the top of the permitted trading band. The credibility of the fixed rate means that the high normal rate of interest in Greece translates into a very high real rate when compared to, say, the German rate of inflation. However, some lack of credibility over Greece's ability to commit to its entry parity, notably in light of the co-existence of large and persistent current account deficits with domestic recession, will most likely result in its future entry's being accompanied by a persistent weak drachma.

In some ways, therefore, the new EMS imitates the operation of a monetary union in which States surrender control of their monetary policy to a central body. Although today monetary policy is, of course, still the responsibility of the authorities of the member States, it is becoming increasingly clear that not all member States have actual control over this policy. Indeed, fixed exchange rates, free capital movement and autonomous monetary policies are incompatible. Under the new EMS the role of setting monetary policy has been devolved to the Deutsche Bundesbank. But in these circumstances the

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the Bank of Italy took the opportunity to retain the lower limit of fluctuation and move its central reference parity down to 3.7 per cent.

[3] In this, Giavazzi and Spaventa (1990, p. 74) write that "financial liberalization has been accompanied by a 'regime change'. It is as if the authorities had realized that once the exchange controls are gone, realignments become virtually impossible, since the mere possibility of a realignment

3

conduct of monetary policy is quite different from that which would prevail in a proper monetary union. In current circumstances. monetary policy is essentially asymmetric. German monetary policy is determined primarily (though, perhaps not absolutely) by German domestic concerns. The monetary policy of other ERM members are determined by the need to maintain the parities of their currencies with the deutsche mark. The factors that establish the position and role of Germany within the EMS are the former's industrial dominance within the EC, which translates into persistent German current account surpluses, and the low inflation rate anchor of the deutsche mark (Portes, 1989). Of course, the pressures on the German economy arising from unification may alter this pattern of monetary relationships. Whether this does happen and what the consequences will be, depend on the medium- to long-term impact of reunification on the competitive strength of the German economy.

The degree to which the conduct of European monetary policy will be changed with the establishment of EMU, and the transfer of monetary policy from the Deutsche Bundesbank to the Eurofed (the European central bank which will manage the single currency) can only, at present, be a matter of speculation. The draft constitution for Eurofed is virtually identical to the Bundesbank's, requiring the European bank as its primary responsibility to pursue monetary policies that strengthen price stability.[4] None the less, the current asymmetry in monetary policy will formally disappear with EMU, as monetary policy will be determined on a European scale.

III.   The Introversion of the EC

A further aspect of the EC's performance over the past decade that bears on the likely effects of EMU is the growing introversion of Community trade. The balance between intra- and extra-EC trade has swung steadily in favor of the former since the foundation of the EC (see table 1). This growing introversion has also resulted in national trade balances being determined predominantly by intra-EC trade.

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would stir up an unsustainable speculative attack. The committment to fixed exchange rates then becomes the only alternative to abandoning the EMS and letting exchange rates float freely."

[4]   The *Communication of the EC Commission* of 21 August 1990, declares the first fundamental principle of Eurofed to be the "objective: price stability. Subject to this objective. Eurofed should support the general economic policy set at the Community level by the competent authorities" (p. 37). It is not at all clear over a wide range of economic policy who the commission believes are "the competent authorities".

Table 1. SHARES OF INTRA-EC TRADE IN EC TOTAL TRADE, 1958-1992
(Percentage)

		1958	1992
Greece	Exports	50.9	64.2
	Imports	53.7	62.7
France	Exports	30.9	63.0
	Imports	28.3	65.6
Germany	Exports	37.9	54.1
	Imports	36.3	54.7
United Kingdom	Exports	21.7	55.5
	Imports	21.8	50.7
All members	Exports	37.2	61.3
	Imports	35.2	59.3

Source: European Economy, No. 58, 1994, p. 155.

Whereas in the 1960s, 37.9 per cent of exports and 36.3 per cent of imports of the then Federal Republic of Germany were absorbed by intra-EC trade in 1992, the numbers increased to 54.1 per cent and 54.7 per cent respectively, showing an almost 50 per cent increase in Germany's trade surplus. Similarly, whereas in the 1950s, 50.9 per cent of exports and 53.7 per cent of imports of Greece were absorbed by intra-EC trade, in 1992 the numbers increased to 64.2 per cent and 62.7 per cent respectively, without however indicating a significant change in the share of intra-EC trade deficit. The introversion of EC trade seems to have been brought about (at least outside agriculture) by trade creation rather than trade diversion (see table 2).

Table 2. INTRA-EC TRADE AND EXTRA-EC TRADE OF GOODS
(percentage of EC GDP at current prices)

	Extra-EC exports	Intra-EC exports and imports	Extra-EC imports
1960	8.7	6.4	9.9
1965	7.1	7.6	8.8
1970	7.8	9.2	8.9
1975	9.4	10.5	10.3
1980	9.7	12.2	12.4
1985	11.4	14.0	12.2
1990	8.7	14.4	9.7
1994	9.1	14.4	8.9

Source: European Economy, No. 58, 1994, pp. 148-53.

Table 3. EC BALANCE ON CURRENT TRANSACTIONS WITH THE REST OF THE WORLD, 1961-1994. (Percentage of GDP at market prices.)

	EC	United States	Japan
1961-1973	0.4	0.5	0.6
1974-1985	-0.2	-0.4	0.9
1986-1990	0.3	-2.5	2.8
1991	-0.6	0.2	2.5
1992	-0.3	-0.9	3.3
1993	0.9	-1.7	3.1
1994	1.3	-1.7	2.9

Source: European Economy, No. 58, 1994, p. 25.

In addition EC trade has tended to show its overall balance of payments to be near equilibrium. That this was so in the 1960s, and even the 1970s, when national current account balances were seldom very large as a proportion of national product, is unsurprising. But it is more notable as a characteristic of the 1980s and the 1990s, when very large national imbalances appeared and, indeed, persisted (see table 3). Thus even though individual countries have non-zero balances in their extra-EC trade, the EC as a whole does not. The counterpart to the German surplus has been a deficit in the rest of the EC, which must have been financed ultimately by capital flows from Germany. Net capital flows into the Community have been correspondingly small.

IV. Macroeconomic Performance of the EC

Monetary Union, defined as the establishment of a single currency,[5] will mean the establishment throughout the EC of a single monetary policy. There will be EC-wide rates of expansion of money and credit, a single structure of interest rates and a single external exchange rate. Each of the member states, including Germany,[6] will have lost control over all tools of monetary

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[5] There has been some debate as to whether monetary union is achieved once exchange rates are irrevocably fixed or once a single unit of account is established throughout the participating States. The key issue is the degree of market expectation that the fixed rate of exchange might change or, equivalently, the monetary union be broken up. The debate is rather academic, since either could, in certain circumstances, be the more probable. Compare, for example, the break-up of the single currency union between the UK and the Republic of Ireland, and the longevity of the de facto dual currency union between the Federal Republic of Germany and the Netherlands.

[6] The former president of the Bundesbank has commented that "Monetary policy decisions can only be taken by a single entity. Even under a federative system, monetary policy must remain indivisible... In the [ECBS], therefore, it will not be possible for the national central banks to have autonomous

policy. These will now be the responsibility of an independent Eurofed.[7] Evaluation of the likely effects of EMU amounts to assessment of the scale and implications of this national loss.

With monetary policy determined by the Eurofed, the weight of national economic management will fall on fiscal policy. European monetary union will not be accompanied by fiscal union. On the contrary, fiscal policy will remain the predominant responsibility of the member states, with the central budget of the EC remaining comparatively small (at present equal to 1 per cent of the GDP of the Community).

Of course the fiscal stance taken by one member State is not independent of those taken by others. An expansionary policy pursued in one country will spill over into others, raising savings and tax revenues. The interdependence of fiscal policy is recognized by the Commission in its call for greater fiscal coordination through the Council of Economics and Finance Ministers. Still, this amounts only to coordination, not the formulation of a common fiscal policy.

The achievement of EMU within the EC will, therefore, create an economic environment that is historically unique. The EC will become an economic zone with a single currency and open markets, including open capital markets, linking increasing interdependent economies, yet it will remain divided into nation States that are virtually autonomous in fiscal terms. Despite the inclusion of the term "economic" in the title of EMU, very little overall fiscal management and virtually no fiscal integration is planned.

Compare this with the Bretton Woods system, which established a fixed exchange rate system between autonomous sovereign units, punctuated only rarely by parity realignments. Indeed, Bretton Woods was so stable that those currencies that are long-term members of the narrow-band ERM[8] had experienced even less variation in their relative parities from 1961 to 1969 than has typically been the case since within the ERM (see Table 4). However, under the Bretton Woods system, unlike the ERM, national monetary and fiscal policies were shielded behind an elaborate structure of capital controls and a variety of trade restrictions and subsidies. The open markets condition did not apply.

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monetary powers of their own: they will only be the operational arm of the European Central Bank" (Pöhl, 1990, p. 9).

[7] "Independent" in the sense that, within the terms of its statutes, Eurofed will determine EC monetary policy. The board of Eurofed will be appointed for fixed terms and will not be subject to political recall. Its formal position will, therefore, be similar to that of the Deutsche Bundesbank in Germany.

[8] Belgium, Denmark, France, Germany, Ireland, Luxemburg and the Netherlands.

Table 4.   INSTABILITY OF THE EXCHANGE RATES OF THE MEMBERS OF THE NARROW-BAND ERM

	Nominal effective exchange rate relative to member countries[a]	Percentage change in Nominal effective exchange rate relative to 19 industrial countries[b]
1961-1969	0.9	-0.3
1970-1971	2.5	1.1
1972	1.6	2.0
1973	4.9	2.7
1974	4.0	-1.8
1975	4.0	1.4
1976-1978	4.4	-3.3
1979-1980	1.8	4.1
1981	2.0	-16.1
1982-1985	2.9	-6.7
1986	3.2	9.8
1987	2.9	6.9
1988	1.0	-1.6
1989	0.3	-3.0
1990	2.0	11.5
1991	2.1	-3.3
1992	2.9	2.3
1993	2.4	-9.0
1994	1.9	-3.4

Source: European Economy, No. 46, 1990, p. 144; No 58, 1994, p. 166.

[a]   Unweighted average of the absolute annual percentage change of the currencies originally participating in the narrow-band of the ERM

[b]   Average of the absolute annual percentage change of the twelve EC member currencies.

Or compare the ERM with mature monetary unions, such as Canada, the Federal Republic of Germany or the United States, within which there is a single currency and free capital movements. All these monetary unions deploy relatively large central budgets, which are a means of maintaining the economy's overall fiscal balance and of integrating fiscal policy within the union. Consequently, these monetary unions have the means of mitigating differences in incomes and productive potential existing in different parts of the union, as well as the means of offsetting regional socks. No such integrated fiscal system is planned for the EC.

Whether the novel structure planned for EMU will prove to be macroeconomically efficient depends on two features. First, it is a function of whether the mixture of policy instruments allows member States to sustain satisfactory rates of growth (that is, to maintain levels of employment) without suffering growing international indebtedness, including indebtedness within the EC. Second, it depends on whether the fiscal policy instruments of the member States are sufficient to deal with their differing policy needs within the monetary union. Would, for example, Greek fiscal policy be sufficient

8

to deal with the differential impact on German industry of a change in the common external exchange rate of the ecu against the dollar?

Recognition of the potential inefficiencies that could arise from differences in policy stances among the economies of member States has led to an emphasis being placed on the need for convergence of national economies in their movements towards monetary union. However, these discussions show little clarity about the exact meaning of convergence and about the relationship between particular indicators of convergence and the attainment of common responses to policy measures. For example, monetary stability would require only convergence of inflations and interest rates. But convergence in rates of inflation might be attained when, for example, one economy is growing relatively rapidly and another is in recession, hardly a desirable policy outcome. Moreover, as will be demonstrated below, even if the underlying structures of national economies have converged towards a potentially sustainable pattern, the segmentation of responsibility for operating economic policy instruments may still create differences in economic performance.

Yet convergence in the rates of price inflation is the fundamental characteristic of convergence as far as the EC is concerned [9] (differences in nominal wage inflation should be associated only with differences in productivity growth, including the productivity gains of catching up). In these terms, there has been significant convergence between the members of the ERM. Although the fall in the rate of inflation in the 1980s has been shared by both members of the ERM and non-members (indeed the proportionate fall in the rate of inflation has been greater for non-members), there has clearly been a significant narrowing in the inflation differentials between members of the ERM, particularly among the founders of the narrow-band ERM (see table 5).

Table 5. GDP DEFLATORS, 1986-1994, MEMBERS OF THE NARROW BAND ERM AND THE EC AS A WHOLE.

	Narrow-band countries: Averages [a]	Narrow-band countries: dispersion [b]	Community: Average [a]	Community: Dispersion [b]
1986	3.8	1.6	5.5	4.3
1987	2.3	1.2	4.2	3.1
1988	2.3	0.9	4.5	3.0
1989	3.0	1.2	5.1	2.7
1990	3.5	0.4	5.7	3.9
1991	4.0	0.8	5.4	2.5
1992	3.8	1.4	4.3	3.1
1993	2.9	2.3	3.5	3.9
1994	2.6	1.1	2.9	2.8

Source: European Economy, No.46, 1990, p. 153; No 58, 1994, p. 134.

[a] Weighted average.

[b] Unweighted arithmetic mean of each country's absolute deviation from the weighted average.

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[9] The Commission's evaluation of the impact of EMU is presented in EC (1990b). The definitions of convergence are found in pages 37-39.

However, this convergence in inflation rates was accompanied by very low rates of economic growth in Belgium, France and the Netherlands, and a somewhat low rate of growth in ERM countries generally up to 1987. Indeed, the EC has been distinguished during the 1980s by its low rate of growth relative to Japan and the United States and its persistent high rate of unemployment. And the burst of growth seen since 1987 has slowed sharply since mid-1990. It is not yet clear whether the attained convergence in rates of price inflation is sustainable at reasonable levels of economic growth.

If convergence is to be associated with economic balance in the Community, then price convergence is not a sufficient monetary policy tool. Price convergence must also be accompanied by balance between the rate of growth of demand and the rate of growth of supply within each major region and each nation State. If that balance is not maintained, then the difference must be met by resource transfers. Moreover, if an imbalance persists over the medium term, there will be an accumulation of debt. In the long term, the continual accumulation of debt is unsustainable, and will necessitate painful remedial measures. If this outcome is to be avoided, the real economy measure of effective convergence prior to monetary union should be the ability of each country to sustain an appropriate balance on current account (appropriate in the light of the pattern of long term capital flows) at rates of growth that maintain high levels of employment.

This definition of convergence does not imply uniform productivity throughout the EMU. Indeed, even price inflation might not be uniform. What is necessary is that the variety of factors determining the growth of demand and supply (such as prices, productivity, real wages, investment and fiscal balance) should, taken together, ensure a long term balance of aggregate demand and supply.

V. Convergence and National External Balances

Moreover, the EMU must aim for overall external balance. An excessive accumulation of net external debt caused by excess demand will necessitate an eventual slow-down in growth of domestic demand, possibly well below previous levels, if reduced indebtedness is to be achieved.[10] Reduction in demand may be attained either by a reduction in the level or growth rate of per capita income, by a steady increase in the level of unemployment, by out-migration, or by a combination of all three. In a monetary union the pressure exerted by debt accumulation will be manifest in the markets for public or

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[10] There are clearly some circumstances in which resource transfers will not be associated with accumulation of indebtedness (public and/or private) in recipient regions or States. Rentier regions and States, or regions and States that receive fiscal transfers, aid or long term investment flows, can sustain a long-run excess of demand over supply (expenditure over income). Even when resource transfers are associated with the accumulation of debt, they may prove in the long-run to be self-correcting, if the

private bonds (wherever indebtedness is accumulated) rather than in the foreign exchange markets. Although the immediate impact of growing indebtedness is confined to the debtor, rather than making all members suffer the impact of an external financial crisis, the consequences in terms of the required reduction in the aggregate real income to correct the imbalance are the same anyway.

The Commission of the EC appears to associate excessive regional or national external imbalances with public sectors imbalances (EC, 1990b, p. 209). The need for convergence towards a sustainable external equilibrium is less apparent since the external current account disequilibria that exist at present might be financed without difficulty once capital markets are completely integrated. Further convergence in external current accounts is desirable from a policy point of view only if the current disequilibria reflect excessive public dissavings. It is therefore not evident that further policy action would be necessary to correct current account imbalances once sound public finances have been achieved in all member countries.

But this is rather wrong. In fact, the accumulation of debt, either by the public sector or the private sector, must ultimate precipitate an external adjustment whether or not there is monetary union. In the absence of monetary union it occurs through the foreign exchange markets; in a monetary union it occurs through the bond markets. But in both cases, adjustment will take the form of a fall in the growth of domestic demand, with the associated downward adjustment in real income. The need for external balance is the same, inside or outside a monetary union, and whether the public sector accounts are in balance or not.

There has been no convergence as yet in the trade balances within the EC. Instead, trade balances have diverged, particularly those for intra-EC trade. National trade accounts within the EC have in the past few years been dominated not only by intra-EC trade, but specifically by trade with Germany, with all countries except Ireland experiencing growing bilateral deficits. Since variations in real exchange rates have been small, especially in recent years, these trends in trade imbalances suggest that a major determinant of a member State's trade performance is its rate of growth relative to Germany's.

Whether the trade balance with Germany is a constraint to growth throughout the EC depends on the ability of the deficit countries to finance these deficits and any accumulated indebtedness. In particular, if Germany were a significant exporter of long term capital (as was the United States in the 1940s and 1950s), then funding would not be based on short-term, potentially volatile funds and expansion could be sustained. However, this has not be the case. From 1990 to 1994, a period in which Germany's current account with its EC partners was in surplus, rising from DM 23.12 billion in

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absorption of resources results in a rate of growth in competitive productive capacity greater than the rate of interest payable of the debt.

1990 to DM 31.69 billion in 1994, long term capital outflow from Germany to the rest of the EC was non-existent except for the year 1995. (see table 6).

Table 6. GERMANY: CURRENT ACCOUNT BALANCE AND LONG TERM CAPITAL MOVEMENTS WITH REST OF EC, 1990-1996 (DM million).

	Current Account	Long-term Capital
1990	23.125	+ 954
1991	24.233	+ 1020
1992	25.298	+ 924
1993	27.286	+ 800
1994	31.698	+ 312
1995	29.773	- 862
1996	27.525	+2.820

Source: Deutsche Bundesbank: Monthly Report. February 1997, vol. 49, No 2.
- Net capital outflow
+Net capital inflow

The large scale of German surpluses, given the very large growth differential between Germany and other EC countries, indicates that that the real economy definition of convergence has not been met within the EC. Such lack of convergence imposes a further asymmetry on national economic policies, an asymmetry which was familiar on a wider scale during the Bretton Woods period. Essentially, deficit countries were forced to limit the growth of their deficits, where surplus countries needed to do nothing. The action for deficit countries would consist of a devaluation of their currency, a slow-down in growth relative to surplus countries or, more likely, a combination of both. In every case, a deficit country suffered a reduction in real income growth. Long term difficulties can arise if the asymmetry is self-perpetuating, as those countries forced to grow slowly tend to invest less and to suffer a cumulative decline in competitiveness. This real asymmetry will not be removed by EMU. Indeed, the lack of current account calculations may tend to obscure the extent of the imbalances, limiting the pressure for remedial action, and hence reinforcing the eventual deflationary impact.

The impact of a correction in unbalanced trade will not be confined to the deficit countries within the EC. It will impose a deflationary bias on the entire trading system as well, as deficit countries deflate, and as there is no incentive for surplus countries to expand. In deficit countries, policy is constrained by international priorities. In surplus countries, policy may be made with respect only to domestic concerns, with no overriding concern for international balances. But deflation is contagious, since the slow-down in deficit countries cuts back the exports of surplus countries. The more closely integrated the trading system, the more powerful the contagion will be. The EC, for instance, has clearly displayed those characteristics the past decade. And as the importance of intra-EC trade in relation to total trade grows, the deflationary bias will become even more severe.

An important, though probably temporary, qualification should be entered at this point. The absorption of the eastern regions within the Federal Republic of Germany is resulting in an acceleration in German growth, combined with a deterioration in the average competitiveness of the country as a whole. The acceleration of German growth rate will allow other countries to grow faster without running large trade imbalances with Germany. The special problems created by the need to absorb the low-productivity eastern part of the country will put great pressure on the German investment goods industries, with demand spilling over to other parts of the EC. This will tend to reduce, albeit perhaps only temporarily, the imbalance in EC trade patterns.

VI.   Policy Responses to Imbalances Within the Community

The problems of asymmetry in trade arise from differences in relative competitiveness between countries and regions. In the absence of sustained long-term transfers (such as long-term capital movements) from the more competitive to the less competitive, reasonable balance may alternatively be sustained by: changes in relative price levels, changes in levels and relative rates of growth of real income, changes in the foundations in competitiveness (such as quality of capacity, quality of labor force, rates of innovation, design and marketing); and labor migration. Especially, under both the new EMS and full monetary union, the real exchange rates between deficit countries and Germany can only be lowered by deficit countries' sustaining a lower rate of inflation than Germany.

Attainment of EMU might be expected to increase the possibilities for international and regional adjustment through a mixture of more flexible wages and larger long-term capital flows. However, the experience of large federal economies (such as the United States) suggests that neither mechanism will prove sufficient to significantly reduce inequalities in regional incomes and competitiveness.

The completion of the EMS and the attainment of monetary union will need to be in place for a number of years before the EC attains the unified financial characteristics of the United States. Yet differences in per capita GDP among the Canadian provinces are greater than those between the member States of the EC (EC, 1977, ch.7; 1990b, p. 230). However, at lower levels of aggregation, income differentials are greater within the EC. The segmentation of the European labor market provides greater scope for enlarged wage differentials than may exist in linguistically homogeneous States. Significant wage differentials in the United States have not led to long-term convergence in regional economic performance; but even so, they have induced labor migration on a scale that is politically unacceptable and that would be economically inefficient within the EC.

13

Such long-term regional problems require a long term solution. Overcoming an uncompetitive position and securing the scale and composition of investment to establish competitiveness is a difficult, often painful, process. Diversion of resources towards investment will typically place a severe limit on consumption growth in an economy in which growth is already constrained by lack of competitiveness. Imports of capital and technology may speed improvements in competitiveness and increased competitive pressure, as in the completion of the internal market, will in itself encourage restructuring. However, the comparative advantage of the more competitive countries and regions will exert powerful centripetal forces on the EC economy and further impoverish the more uncompetitive regions. Regional imbalances will result in a tendency for the EC as a whole to underperform as it has done for much of the past decade

In the circumstances of the 1990s, both political cohesion and economic efficiency in the EC will require a method of recycling persistent surpluses and alleviating persistent regional and national deficits. Significant divergence's in competitiveness must be offset by long-term transfers or they will result in persistent differences in rates of growth which tend ultimately to exacerbate the imbalance. Even relatively loose international arrangements such as the Bretton Woods system could not survive without long-term capital transfers from the more competitive to the less competitive.

There are three alternative methods of redistribution within mature monetary unions, such as Germany or the United States. First, it can be achieved through personal income tax, public expenditure programs and social security benefits. So long as a country has a progressive fiscal and benefits system, and public expenditure provides roughly equal per capita benefits, then income is transferred automatically from relatively prosperous to relatively poor regions, limiting the growth of indebtedness and the relative decline in the standard of living in the poorer regions. This will not be the case with the EC.

Second, redistribution can be attained through intergovernmental grants or tax-sharing arrangements, which redistribute income according to specific criteria, such as per capita income or fiscal capacity. Australia, Canada and the United States (that is until revenue-sharing was abolished by President Reagan) have major federal grant systems. In Germany transfers are made directly among the various States. In the United Kingdom there are substantial grants from the central Government to the local authorities. But such large-scale fiscal transfers between the member States of the Community are explicitly ruled out in the Delors Report.

Finally, specific purpose grants could be considered. The United States makes the greatest use of such specific transfers, notably by means of good stamps and urban renewal programs. The regional and social funds of the EC also fall into this category of transfer program, as, in a distinctly perverse fashion (redistributing income from poor to rich), does the CAP.

14

Reliance on specific-purpose grants alone is unlikely to provide an adequate scale of recycled savings within the monetary union. Yet, under the Community's current political circumstances, there will neither be an integrated tax and benefit system, however limited in scope, nor a system of direct fiscal transfers.

Furthermore, the peculiar macroeconomic design of EMU is likely to prove inefficient, even if real economic convergence is broadly attained. The fact that EMU throws all the weight of national economic management onto autonomous national fiscal policies will severely limit the capacity and effectiveness of this fiscal management, and will tent to reinforce the impact of differential shocks that might otherwise be satisfactory managed. An increase in spending intended to offset a downward shock to a national economy must, given the EMU structures against monetization of debt, be financed by borrowing. This borrowing will tend to create a fiscal obligation in the future. Higher taxes will then tend to induce entrepreneurs to seek investment opportunities in areas in the Community where taxes are lower. The cases of various regions within a country are familiar where attempts by the authorities to offset a drop in activity through greater spending results eventually in greater taxation, out-migration of industry, further increases in tax rates on a falling tax base, further out-migration and so on. This same phenomenon will now be reproduced on a national scale. As a consequence, either the use of fiscal policy is discouraged or its positive effects severely limited in the EC. Both negative growth effects are greater if there are large external spillovers from changes in national fiscal stances.

These limitations on the effectiveness of national fiscal policy could be overcome if at least part of this were organized at the Community level. The externalities associated with national fiscal policy would be internalized. But, more important, spending within one nation or region would not result in localized increases in taxation. Instead, it would be funded within the Community as a whole with the more prosperous regions contributing proportionately greater sums. In effect, a Community-wide fiscal policy would be a regional stabilizer, offsetting, at least in part, localized shocks.

This analysis suggests that in the absence of a significant redesigning of Community institutions, the low rate of growth and high levels of unemployment that have characterized the past decade will become endemic. They will probably be accompanied by relatively low rates of inflation as well. Certainly, inflation rates are likely to be relatively low in those member States, such as Greece, that have experienced inflation rates substantially in excess of German rates. Although interest rates may be somewhat lower than they are within the new EMS, the inefficient fiscal design of the Community suggests that low growth and low inflation will still be accompanied by high real interest rates, as monetary policy is used as the principal means by which an independent Eurofed manages effective demand within a deregulated financial system. Without a significant change in the formulation and execution of fiscal policy, therefore, the post-EMU Community is unlikely to have an expansionary impact on the world economy; rather the reverse is likely.

VII. Greece and the EMU

The participation of Greece in the transition process towards monetary union, if it is to prove macroeconomically efficient and socially acceptable, must be associated with a serious attention by policy makers to the considerable problems arising, given the structures of EMU, from the process of transition. The focus must rest on a decisive co-operation between economic and political agents in bringing macroeconomic imbalances and structural inefficiencies more in line with their EC average counterparts and in mobilizing and implementing efficient structural policies with a long-term view within the institutional arrangements historically and socially established in the nation.

The existing differences in performance between Greece and other member states of the EC are significant and the distance to be, therefore, covered is quite substantial (see table 7).

Table 7. PERFORMANCE OF EC MEMBER STATES IN RELATION TO CONVERGENCE IN 1994-1996

	Consumer price index	Govern. Deficit / GDP ratio	Govern. Debt / GDP ratio	Long term interest rate	GDP growth (percent change)	Real unit labor cost (percent change)	Productivity growth (percent change)
FR	1.6	4.5	57.8	6.8	2.0	-0.8	1.5
FRG	1.9	3.2	62.4	6.1	1.8	-1.1	2.2
UK	2.4	5.2	56.2	7.4	2.9	-1.2	2.2
GR	8.8	9.1	111.4	16.4	2.0	1.5	0.7
EC	2.7	4.6	74.3	7.1	2.3	-1.3	2.0

Source: European Economy, Supplement A, June 1996.

During the period 1994-6, inflation in Greece, as measured by the consumer price index, was 8.8 percent, more than three times higher compared with the EC average of 2.7 percent. In the same year, net borrowing requirements and the accumulated public debt were 9.1 percent and 111.4 percent of GDP respectively. The corresponding EC averages were 4.6 percent and 74.3 percent. Long term interest rates were 16.4 percent, more than twice the EC average of 7.1 percent. Economic growth was 2.0 percent which is 15 percent lower than the EC average. During 1994-6, real unit labor cost in Greece has increased by 1.5 percent, whilst the EC average has fallen by 1.3 percent. Finally, productivity growth was at an anemic 0.7 percent, almost a third compared with the EC average.

A better understanding of the relative state of the Greek economy and the country's level of development emerges from a carefule consideration of the country's overall international trade performance (see table 8):

16

Table 8.   TRADE AND CURRENT BALANCES AND EXPORT PERFORMANCE [a]

COUNTRY	Trade Balance ($ billion)	Current Balance ($ billion)	Current Balance (percentage of GDP/GNP)	Export Market Share (percentage)	Export Market Share (growth rate, 1985-92)
Greece					0.1
1980				0.4	
1992	-11.6	-2.1	-2.8	0.3	
1993	-10.6	-0.7	-1.0		
1994	-11.5	-1.0	-1.3		
Germany					1.3
1980				16.8	
1992	32.0	-22.0	-1.1	17.3	
1993	42.1	-21.3	-1.1		
1994	59.2	-13.0	-0.7		
France					1.7
1980				9.4	
1992	2.9	4.3	0.3	8.9	
1993	9.3	10.9	0.9		
1994	16.1	18.4	1.4		
UK					0.2
1980				8.8	
1992	-23.5	-15.1	-1.4	7.2	
1993	-20.5	-16.4	-1.7		
1994	-25.2	-21.3	-2.1		
Italy					0.4
1980				7.0	
1992	2.5	-26.6	-2.2	6.7	
1993	34.1	12.4	1.3		
1994	43.8	20.0	2.0		

Source: OECD Annual Review 1994 - Industrial Policy, pp. 129, 136, 138.
[a] manufacturing exports of a given country in total OECD exports

During the 1992-4 period, Greece experienced constant trade deficits which remained approximately at the same level, whilst the other European countries, with the exception of the UK, experienced trade surpluses which, moreover, improved. In the same period, the country's current balance, though significantly improved as a result of substantial inflows of capital, was negative too. Thus, the international competitiveness of Greek manufacturing was maintained at low levels and its ability to capture foreign market share has been diminished. The shifts in the market share of the country's manufacturing exports show that whatever growth in foreign market penetration was achieved during the 1970s was followed by a stagnation during the 1980s. Of course, these downward trends in foreign market penetration were experienced by the other European countries too. However, these countries succeeded in eventually overcoming their constraints and gradually improving their export performance by substantially more than Greece managed to do (compare the very low 0.1

17

percent of Greece's foreign market share average growth rate for the period 1985-92 with that of the other European countries).

The shifts in export market shares discussed above are due to a number of factors shaping international competitiveness. Broadly speaking, these can be classified into price and non-price/structural factors. The identification of the relative significance of some of those factors can be conducted by constant market share analysis[11] (see tables 9a, 9b). Table 9a shows the calculations for the composition and destination of domestic exports by selected OECD countries in absolute terms, i.e. the difference in decomposition between 1980 and 1992 of a country's exports as a percentage of total OECD exports. This permits the analysis to capture shifts in the structure of the overall trend and thus visualise the losses and gains of foreign market shares by each country. Thus, during 1980-92, Greece has experienced a fall, in absolute terms, in its share of OECD exports. Even though most large European countries seem to have lost foreign market share as well, Greece stands in sharp contrast to all smaller EC countries, except Belgium, who saw their foreign market share of OECD exports to rise instead. Greek export industry has proven unable to penetrate foreign markets and capture any significant portion of the lost markets by the larger European economies. Moreover, it has proven unable to adjust the composition of its exports adequately so that to catch up with the faster growth and diversification of world trade. As a result, Greek export products exhibited very low ability relative to the other small European countries to adapt to the world changes characterizing the market composition of commodities.

On the other hand, table 9b shows, for the same period, the calculations for the composition and destination of exports in relative terms, i.e. as a percentage change and decomposition of a country's exports as a percentage of total OECD exports. This allows for a comparison of the evolution of export performance of smaller countries: regardless of the size of their initial shares, all countries that doubled their export market shares, are taken to have expanded at the same speed and thus performed equally well. The same conclusions about overall Greek export performance can be drawn here as well. Greece has been unable to follow the strengthened ability of the largest European economies, with the exception of France, to adapt to the changing commodity and geographical structure of trade, much less was it able to achieve the spectacular performance by the smaller countries, such as Portugal, Spain and Ireland. The relative importance of Greece's traditional exports and that of its trading partners has declined in contrast to what is evident in most European countries.

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[11] Constant market share analysis is a methodology aiming at the identification of the underlying determining factors of international competitiveness by looking behind the evolution of market shares. This is achieved by decomposing the changes that have occurred in export markets into five different effects each reflecting changes in the composition of products and the destination of exports as well as the capacity of the trading countries to adapt to them (Fagerberg and Sollie, 1987).

18

Table 9a.   CONSTANT MARKET SHARE ANALYSIS OF EXPORTS (percentages)*

	Market share (percent)	Difference 1980-92	Market share effect[1]	Commodity composition effect[2]	Commodity adaptation effect[3]	Market composition effect[4]	Market adaptation effect[5]
Greece		-0.08	0.07	-0.05	-0.01	-0.04	0.02
1980	0.38						
1992	0.30						
Germany		0.48	0.70	0.67	-0.33	-0.57	0.07
1980	16.02						
1992	16.50						
France		-0.23	0.32	0.09	-0.23	-0.45	0.09
1980	9.23						
1992	9.00						
UK		-1.62	-1.46	0.13	0.23	-0.54	0.08
1980	8.62						
1992	7.00						
Italy		0.19	0.80	0.28	-0.41	-0.27	-0.21
1980	6.41						
1992	6.60						
Spain		0.77	0.92	-0.08	-0.02	-0.10	0.05
1980	1.73						
1992	2.50						
Ireland		0.39	0.33	0.00	0.03	0.02	0.01
1980	0.73						
1992	1.10						
Belgium		-0.39	-0.16	-0.19	-0.01	0.10	-0.12
1980	5.09						
1992	4.70						
Portugal		0.32	0.35	-0.01	-0.01	0.00	0.00
1980	0.38						
1992	0.70						

Source: OECD Annual Review - Industrial Policy. pp. 138, 140.

* calculations exclude oil and gas.

[1] total change in the exporting country's share in the imports of each partner country, weighted by the initial commodity composition of each partner country's imports and by each partner country's share in total OECD imports.

[2] total change in the shares of the partner countries in total OECD imports (market distribution of exports)

[3] change in commodity shares in OECD imports (commodity composition of exports)

[4] degree of success of the exporting country in adapting the market composition of its exports   to the total change in the market composition of OECD imports (geographical distribution of exports)

[5] degree of success of the exporting country in adapting the commodity composition of its exports to the overall change in the commodity composition of total OECD imports

Table 9b.   CONSTANT MARKET SHARE ANALYSIS OF EXPORTS (percentage change)*

	Market share (percentage change)	Relative Difference 1980-92	Market share effect	Commodity composition effect	Commodity adaptation effect	Market composition effect	Market adaptation effect
Greece		-2.6	18.4	-13.2	-2.6	-10.5	5.3
1980	0.40						
1992	0.30						
Germany		3.2	4.4	4.2	-2.1	-3.7	0.4
1980	16.00						
1992	16.50						
France		-2.0	3.5	1.0	-2.5	-4.9	1.0
1980	9.20						
1992	9.00						
UK		-18.1	-16.9	1.5	2.7	-6.3	0.9
1980	8.60						
1992	7.00						
Italy		3.1	12.5	4.4	-6.4	-4.2	-3.3
1980	6.40						
1992	6.60						
Spain		44.5	53.2	-4.6	-1.2	-5.8	2.9
1980	1.70						
1992	2.50						
Ireland		53.4	45.2	0.0	4.1	2.7	1.4
1980	0.73						
1992	1.10						
Belgium		-7.50	-3.1	-3.7	-0.2	2.0	-2.4
1980	5.09						
1992	4.70						
Portugal		89.5	92.1	-2.6	-2.6	0.00	0.00
1980	0.38						
1992	0.70						

Source: OECD Annual Review (Industrial policy), pp. 138, 140.
    * calculations exclude oil and gas.

Indeed, these results shouldn't be surprising. The country's structural transformation required by international competition has not been adequate. Net export performance of Greek agriculture and services shifted from a surplus position during the 1970s and mid-1980s to a deficit position since then (Giannitsis, 1993). During the same time, industrial export performance, particularly of the technologically advanced capital good sectors, has been showing a steady deterioration. Following the opening up of trade, the loss of competitiveness in Greek industry has been associated with an increase in domestic market penetration by foreign imports resulting in a reduction of the share of industry by 5 per cent on average. Even though export performance in manufacturing increased in volume, import penetration increased comparatively more. As a result, the balance of trade has been constantly negative, starting from 16.6 per cent of GNP in 1980, then increasing to 18.9 per cent in 1985, then falling to 13.8 per cent in 1994 and finally rising again with sign of further deterioration (Bank of

20

Greece: Report of the President, 1996, p. 15). The continuous erosion of Greek industrial competitiveness both domestically and abroad was associated with a shrinking of its 'natural' industrial base which further compounded the loss of competitive edge. The reduction in market share and the associated decline in exports created a vicious circle of reduced sales, which caused a productivity slow-down and this, in turn, further reduced exports.

It is, therefore, evident that any aspirations for faster economic growth in Greece cannot be readily warranted on the basis of foreign trade performance. The existence of growing trade deficits is a serious problem in the economy for they may turn out to be unsustainable if they lead inexorably to a rising ratio of debt to GNP. At some stage, the rising burden of servicing the debt will require the economy to generate large trade surpluses so that a net transfer of resources will pay for the interest on accumulated borrowing. Alternatively, the Greek economy may be trapped in a syndrome of slow growth and unemployment which will rise from one business cycle to the next. As foreign borrowing increases to balance the resulting current account deficit, the cost of borrowing will rise too but there is no automatic mechanism of self-adjustment. The attachment of risk premia on capital flows may not work in a gradual and smooth manner. Indeed, as the ratio of foreign debt to GNP rises, financial markets will become increasingly nervous about a collapse in the exchange rate of the drachma and the consequent capital losses. If the exchange rate is allowed to fall (which, of course, will depend on several factors, domestic and foreign), speculative actions are likely to be further destabilizing, leading to a rapid fall in the value of the domestic currency. The required use of higher interest rates to defend the currency and thus balance the current account through capital inflows will push the Greek economy, through adverse effects on investment, into recession with the consequent slowdown in efficiency growth and further loss of competitiveness. A higher rate of net inflow of interest, profits and dividends as well as other forms of funds (such as those by the EC), compared to the economy's low growth rate may not reverse this tendency if the Greek economy falls into a "wealth trap", that is uses all that revenues to absorb more manufacturing imports or consume rather than invest in manufacturing.

The loss of competitiveness may, in turn, be seen as the cause and result of insufficient investment opportunities and inefficient use of funds. The degradation of the national industrial base is reflected on the structure of investment expenditures in the last half of the 1980s (see table 10).[12]

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[12] Unfortunately, our effort to get more updated cross-country data on the structure of investment proved futile.

Table 10. STRUCTURE OF INDUSTRIAL INVESTMENT IN EC, 1986-1989. (percentages)

	Replacement				Extension				Rationalization			
	'86	'87	'88	'89	'86	'87	'88	'89	'86	'87	'88	'89
Greece	15	36	37	42	39	30	30	36	46	34	33	22
Germany	25	25	25	24	26	26	25	27	50	49	51	49
France	29	29	29	26	21	28	32	35	40	43	39	39
Italy	-	29	26	22	-	21	30	33	-	50	44	45
Spain	-	18	14	15	-	32	34	30	-	51	52	55
Ireland	-	28	22	19	-	25	26	35	-	48	52	46
EC	-	27	27	24	-	28	30	32	-	45	43	44

Source: *European Economy*, Supplement B, March 1989.

Investment expenditures in Greece compared both with other member states and the EC as a whole were directed more towards the replacement of obsolete capital equipment rather than technological advance in products and processes (see also Lyberaki, 1993). Indeed, from 1986 to 1989 only the share of investment for replacement increased by almost three times whilst investment for rationalization, denoting product and process development, organizational innovations, changes in production set-ups was reduced in half. The average share of both components for the EC as a whole remained roughly the same during that period. The diffusion of new technologies with the associated spillovers due to forward and backward linkages that tended to characterize the incoming of a new technological paradigm in most of Europe during the 1980s does not seem to be a notable feature of Greece's economic adjustment. The introduction of incremental improvements in technology and the reorganization of existing production possibilities was not embedded in a more general, technology-related, strategy of industrial restructuring. The rate of innovation has not matched the EC average and the cumulative effects it is associated with were absent, or very anemic, from Greek manufacturing. This should not, however, surprise us. In mid-80s, the share of GDP in Greece devoted to research and development was only 0.33 per cent compared with 2.70 per cent in Germany and 1.5 per cent in EC as a whole in the same period (Vaitsos and Giannitsis, 1987).

The need for long term capital investment for the restoration of respectable income growth rates along with the necessary improvements in the quality of capacity and labor force and the rates of innovation that consolidate the efficacy of 'non-price' factors in international competitiveness seem to have been notably absent from Greek industrial considerations. Excessive reliance on monetary instruments to achieve nominal convergence for full EMU participation will not achieve the intended results. We are somewhat skeptical of the suggestion that, at the face of structural deficiencies in the Greek economy, exchange rate realignments and wage and price deflation will suffice to correct the

22

imbalances and gear the economy towards macroeconomically efficient growth.[13] A consistent short-term policy-mix pursued by socially respectable monetary and fiscal authorities does raise the chances for improvement but for a shift to a sustainable long term growth path only a long term sound industrial and trade policy, aiming at productivity increases, network development and social cooperation, can provide a firm basis.

A general slowdown in the expansion process of Greece could be avoided by enabling the weak, structurally-deficit sectors of the economy to grow at rates higher than their respective balance of payments equilibrium rates. This means effectively allowing those sectors to run continuous current account deficits. Current policies, on the contrary, usually aim at leaving the burden of adjustment to be borne by the weak sectors themselves by forcing them to live within their 'own means'. In such a case, a generalized contraction of domestic effective demand may not be avoided. But the slow down of the growth of effective demand in those weak sectors will spread from sector to sector through the foreign trade multiplier. The situation will get worse if world growth rates are relatively low. In this way a generalized deflationary process might set in with adverse effects on output and employment. As a long-run consequence, Greece's competitiveness will be steadily deteriorating, as is regulated by the free operation of the markets in a world economy, and performance differentials will be progressively increased. This will reinforce the tendency for retarded growth, structural decline and technological slow down. The overall effect will, of course, depend upon the structure of Greece's net exports position which, at any one time, reflects the process of development in terms of dynamic economies of scale, learning and technical change. At the same time, it determines the potential for market expansion and the opportunity for efficiency enhancement. It is in this respect that Greek policy makers should not rest their efforts on merely meeting the standards for participation in the next stage of EMU, for

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[13] This seems to be the main conclusion reached by Papademos (1993) and Alogoskoufis (1993). While they convincingly argue that a proper exchange-rate policy associated with financial markets deregulation will indeed enhance the monetary authorities' effectiveness in reducing inflation, they tend to over-emphasize the need for a consistent policy-mix, without a proper, to my view, account of the constraints, domestic and international, involved. In their view, since nominal convergence must be the main policy target, a consistent monetary policy associated with an accommodating fiscal policy will create the conditions for successful entry in the ERM. The latter's disciplinary power will then act as the catalyst for domestic rationalization. Papademos argues for a more gradual process of ERM participation for this would provide the necessary time for economic and social adjuastment (both short-term and long term) to the entry shock, whilst Alogoskoufis strikes through the heart by advocating a rather immediate entry for this, given his faith on the effectiveness of ERM's disciplinary power, will bring Greece faster to the horseback of nominal convergence. However, the extent to which exchange rate and interest rate flexibility will, in conditions of high inflation, can be relied on to reduce trade and fiscal deficits towards their equilibtium levels without being associated with great losses in output and employment is questionable both on theoretical and empirical grounds. This postulate is subject to the specific assumptions made about the functioning of the economy. For an alternative analytical presentation of the macroeoconomic impact of devaluation and deflation that emphasizes the constraining role of the structuralist characterisitics in an economy, see Taylor (1991).

such a policy may turn out to be associated with politically unacceptable levels of social cost in terms of high unemployment and social unrest. The very process of EMU, given the foundations on which it is designed, does not guarantee sustainable long term outcomes, if high employment, high growth, increased international competitiveness are sought for.

VIII.   Conclusion

The design of EMU is not a purely economic exercise. Rather, the division of responsibilities has been in large part dictated by political considerations within the EC. The peculiar character of the European debate at the moment means that although there is a large measure of agreement - though not unanimity - on the establishment of an independent Eurofed, there is no likelihood of agreement on developing a common EC fiscal policy, or to hand exchange rate policy over to the Eurofed. The contradiction arises not only from politics as such, but also from the lack of a coherent theory of economic policy for the monetary union, and hence the lack of an appropriately designed institutional framework to execute policy. The theoretical error appears to steam from a simplistic monetarism, which suggests that the monetary policy affects only nominal variables, and that the real economy is always at or near equilibrium. If this framework is abandoned for either theoretical or empirical reasons, then fiscal and monetary policies can no longer be assumed to be independent, and both have real consequences. Moreover, if fiscal policies and monetary policies are independent, then dividing responsibility for them is likely to be inefficient and counter-productive. Similar arguments apply to the relationship between monetary and exchange rate policy and other aspects of external economic relations. It is this inefficiency in the policy framework proposed for monetary union, not the monetary union itself, that poses negative macroeconomic consequences for both member States and non-member States. For that purpose, Greek economic policies should not take their fate as already given, but aim at providing a framework for development that secures the achievement and maintenance of competitive edge both domestically and abroad as a basic presupposition for effective growth.

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ΠΑΝΕΠΙΣΤΗΜΙΟ ΘΕΣΣΑΛΙΑΣ
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