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THE LIBERALISATION OF CAPITAL MOVEMENTS IN THE COMMUNITY AND ITS IMPLICATIONS FOR GREECE

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PREFACE

This study analyses the liberalisation of capital movements in Europe from the perspective of both the European Community in general and Greece in particular.

Part I presents the prevailing situation in the Community and the current Commission proposals for the full liberalisation of capital movements. Both the benefits and risks of the liberalisation are assessed. It is stressed that the abolition of exchange controls needs to be accompanied by additional harmonization and coordinating measures in the fields of financial supervision, taxation, and monetary policy. Otherwise, the major Community objective of creating a totally integrated European financial area may not be attained. It is also pointed out that the liberalisation process entails risks for the less prosperous Member States. These risks would have to be tackled if the social and economic cohesion of the Community is to be safeguarded and indeed strengthened.

Part II starts with an account of the economic problems and performance of Greece, which apart from providing the necessary background information to those not familiar with the Greek economy, also highlights the economic weaknesses of the country which might create serious obstacles to the relaxation of existing controls on capital movements. It then focuses on the possible effects of the liberalisation on the Greek economy and its implications for economic policy. The study concludes with certain economic policy recommendations, which - if implemented - are expected to help the Greek economy not only to comply with Community rules in this field, but also to correct existing macroeconomic imbalances which create uncertainty, discourage productive investment, and hamper economic growth.

The study has been prepared by Christina Mitsouli, a Robert Schuman Scholar, under the auspices of the Directorate General for Research of the European Parliament and further to a request made by Mr G. ROMEOS, Vice-President of the European Parliament.

Any opinions and recommendations contained in this study are those of the author. They are not necessarily those of this Directorate General, or of the European Parliament or any of its organs or Members.

David Millar
Director

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PART I :

THE LIBERALISATION OF CAPITAL MOVEMENTS AND THE CREATION OF AN INTEGRATED FINANCIAL AREA IN THE COMMUNITY

1 <u>The international context</u>

The recent increase in the value assigned to the liberalisation of capital movements within the Community and to the creation of an integrated European financial area is closely related to the structural changes occurring in the international financial system. International developments have forced EEC Member States to recognize that exchange controls are losing their effectiveness, and prompted them to search for new ways to strengthen the position of European capital markets in the world financial system. It follows that for a better understanding of the various issues involved in European financial integration, it is necessary to be aware of the international context within which integration is taking place. Therefore, it would be useful to start with a brief assessment of changes in the international financial system, their causes and their implications for the Member States of the Community[1].

During the last fifteen years, the economic significance and institutional framework of international financial operations have undergone profound change.

The role of international financial operations in financing trade, investment, government expenditure and balance of payments deficits has become very important. This is shown by the growth of international banking activities as well as by the expansion of securities and equities markets. During the last ten years, activity in the major financial markets expanded at a more rapid rate than real output in the major industrial countries.

The internationalization and integration of financial markets has increased considerably. This has been reflected in the faster growth of offshore financial markets and in the greater foreign participation in domestic financial markets. National financial credits, loans and deposits have become more sensitive to terms and conditions set in international markets. Moreover, a 24-hour global market in securities has emerged with strong linkages between major financial centres.

More recently, there has been unprecedented innovation in financial instruments, services, and trading techniques, altering the structure of intermediation and bringing about new forms of competition between financial institutions. New, more flexible financial instruments have appeared, such as negotiable certificates of deposit, money market mutual funds, various interest-bearing checking accounts, bonds with variable interest rates and inflation guarantees. Securities markets have grown significantly and there has been a shift from bank credit towards negotiable instruments, a phenomenon referred to as securitization (see Table 1). Moreover, the traditional distinction between commercial banks and savings institutions has tended to break down. In the face of stiff competition from non-bank financial institutions, banks have been forced to circumvent regulations and expand the range of their activities. As a consequence, the asset as well as the liability side of different financial institutions have become increasingly similar.

TABLE 1

International financial market activity by market sectors

	1981	1982	1983	1984	1985	1986
International bond issues	44.0	71.6	72.0	107.9	163.7	220.3
Euro-note[1] facilities	1.0	2.3	3.3	18.8	49.5	69.5
Total securities markets	45.0	73.9	75.3	126.7	213.2	289.8
Syndicated[2] bank loans	96.5[3]	99.4[4]	51.8[4]	36.6[4]	21.1[4]	37.8[4]

1 Covers all Euro-note facilities including underwritten facilities (NIFs, RUFs and multi-component facilities with a note issuance option) and non-underwritten or uncommitted facilities/Euro-commercial paper (ECP) programmes.
2 Excludes existing loans newly negotiated where only spreads are changed.
3 Excludes $35 billion of US takeover-related standbys.
4 Includes the following amounts of non-spontaneous bank lending: $11.2 billion in 1982, $13.7 billion in 1983, $6.5 billion in 1984, $2.3 billion in 1985 and $8 billion in 1986.

Source : Bank of England

These quantitative and qualitative changes have been the result of the interaction of a wide range of factors :

- The breakdown of the Bretton Woods system and the introduction of flexible exchange rates in 1973, have led to an increase in interest and exchange rate variability. The resulting rise in uncertainty and risk created the need to shift quickly and cheaply between financial instruments, stimulated the development of new techniques for risk-management, such as futures, options, interest rate and currency swaps, and consequently increased the economic significance of the financial sector.

- After the economic shocks of the 1970s, many countries had to raise substantial amounts of foreign funds to finance balance of payments deficits. This development stimulated the growth of international financial markets. The present large international trade and current account imbalances between major industrial countries have similar consequences. Moreover, rising government deficits (especially the sizeable US budget deficit) have led to an increase in the volume of government bonds issued, and contributed to a deepening of existing bond and other money markets[2].

- The growth of multinational business in general has helped to promote the diversity and volume of international financial transactions.

- The development of offshore financial markets induced national authorities to liberalise regulations governing financial activities, in order to avoid adverse competitive effects on domestic financial institutions by limiting excessively their international operations. Deregulation was also prompted by the expected domestic benefits from the development of a more efficient financial services industry. This liberal, market-oriented approach has encouraged the growth of international financial operations.

- Finally, the advance in information and communications technology has reduced the cost and increased the speed and efficiency of financial transactions, thus creating an incentive for financial institutions to furnish a wider and more competitive range of instruments. It has also made possible the development and expansion of global markets.

The aforementioned significant changes in international financial operations, that is in operations covered by exchange controls, have important implications for the economies of the Member States of the Community and for the attitude of their authorities towards the liberalisation of capital movements.

The growing interdependence of national financial markets and the flexibility of new financial instruments have increased the interest and exchange rate sensitivity of capital flows and therefore have imposed additional constraints on the policy options of monetary authorities. Given the increasing size, number and sophistication of international financial operations in recent years, "it has become increasingly difficult to isolate domestic financial markets, especially the most developed ones, from external events. The period of time in which it is possible to take advantage of the supposed benefits of controls - smoothing and delaying the internal adjustments to outside pressures - may be shortened as a consequence, while the operational costs involved in stemming given financial flows may increase."[3]. Moreover, exchange controls have considerable negative effects on the competitiveness of national financial institutions and can produce unfortunate distortions in the national financial systems. Those Member States which want to play an active role in the rapidly expanding international financial market have no choice but to participate in the process of internationalization, deregulation and modernization. Many countries have realized this and have made efforts to liberalise their financial markets.

It is clearly in the economic interest of all Member States that this move towards financial liberalisation acquires a European dimension. This would render European capital markets much more attractive and would increase their capacity of providing risk capital and of financing short-term investments in the new financial world of advanced technology. Moreover, it would give Europe a greater say on issues concerning the operation of the international financial and monetary system. But for this to happen, European financial integration needs to go beyond the simple accrued participation of EEC Member States and their financial institutions in the process of globalization of capital markets. The liberalisation of capital movements, which is a form of 'negative integration', should be accompanied by positive measures which would strengthen the financial and monetary identity of the Community. The necessity and desirability of such positive measures will become obvious later in our analysis.

2 **Measures for the free movement of capital in the Community**

Progress in the field of the liberalisation of capital movements has been particularly slow. This is in great contrast with the results obtained in other fields of the Community and with the growing significance of financial operations in the world economy. An assessment of the progress made so far and of the factors that have tended to retard the liberalisation and financial integration will follow. Beforehand, however, it would be useful to define a number of basic concepts that are central to the analysis of the process of capital movement liberalisation.

2.1 Basic concepts

By movement of capital we generally mean: the settlement or transfer of tangible or intangible assets by residents of a Member State in the territory of another Member State; and the financial operations which result in a change in the level or composition of debt between two parties that are residents of different Member States[4]. The sum of these transactions make up the capital account of a country's balance of payments. Capital movements can be either short-term or long-term. However, the distinction between the two is not always clear. In general, short-term capital movements primarily reflect international differences in interest rates and speculators' expectations about exchange rate changes. Capital tends to leave countries with low interest rates and/or weak currencies in danger of devaluation. In contrast, long-term capital movements are much less speculative, reflecting government or private investment in other countries guided by long-term considerations.

For the purpose of our analysis, we can distinguish three different categories of financial operations which also correspond to three different degrees in the liberalisation of capital movements[5]:

a) Capital Operations. These operations are directly linked to the effective exercise of the other fundamental freedoms of the common market, i.e. the freedom of establishment, the freedom of trade in goods and services and the free movement of persons. They include import and export credits, direct investments and various personal capital movements.

b) Operations in financial market securities. This category includes the acquisition by investors and the issue and placing by enterprises of bonds, shares and other securities of a participating nature on the capital market. The liberalisation of these operations places Member States' financial markets in direct competition and therefore can give rise to significant capital flows. Its impact on the balance of payments is usually greater immediately after the removal of exchange restrictions, because financial operators are suddenly offered the right - which they did not have before - to restructure their portfolios by purchasing foreign securities. In the long-term, the volatility of such capital flows is expected to be much more limited. It should be noted, however, that financial innovation tends to increase the liquidity and mobility of this type of placement.

The liberalisation of operations in securities is a necessary precondition for the interconnection of Member States' financial markets and for the creation of a single European market in securities.

c) Operations involving financial credits and operations relating to money market instruments. These operations include the opening of and placing of funds on current or deposit accounts, the granting and repayment of short-term credits and short-term investments in treasury bills and other securities dealt in on the money market. Their liberalisation has an impact on the organization and functioning of national banking and financial systems. It also affects the conduct of monetary policy by making ineffective certain national anti-inflationary measures, such as domestic credit controls. Monetary authorities are forced to rely mainly on interest rate management and open market operations. Finally, the liberalisation of these operations, which are extremely sensitive to expectations about exchange rate changes, increases the risks of speculation against the national currency when tensions arise in foreign exchange markets, and can seriously aggravate balance of payments difficulties. On the other hand, however, experience shows that the effectiveness of controls on short-term monetary operations is increasingly being eroded.

The liberalisation of short-term monetary operations is a necessary precondition for the establishment of a unified financial system in the Community.

2.2 The Treaty of Rome and the Directives of 1960 and 1962

The Treaty establishing the European Economic Community sets the objective of the free movement of capital between Member States, but limits its scope by providing that the removal of restrictions to the free movement of capital must take place progressively and only "to the extent necessary to ensure the proper functioning of the common market" (Article 67). It imposes no calendar for the removal of exchange restrictions and leaves to the Council the task of issuing the necessary Directives for the progressive liberalisation of capital movements (Article 69).

The limited ambition of the Treaty of Rome regarding the liberalisation of capital movements, can be partly explained by the economic situation in Europe at the time of the establishment of the EEC. International financial operations were much more limited than nowadays and most Member States had just re-established the external convertibility of their currencies. National authorities at that time were particularly concerned with a perceived insufficiency of domestic investment and savings. Moreover, they were anxious to preserve their monetary policy autonomy and recognized that under a system of free commercial exchanges and fixed exchange rates, the liberalisation of capital movements would have made such an autonomy impossible.

The cautious approach to the liberalisation of capital movements was probably also an expression of political realism. Agreement between Member States, even on the principles of the liberalisation of commercial exchanges, had been obtained with great difficulty; any attempt to commit them to a parallel liberalisation of capital movements might have destroyed the consensus that had been attained.

Due to the above situation, the implementation of article 67 was limited to two Directives adopted in 1960 and 1962[6]. These Directives liberalised the first category of financial operations (i.e. the capital operations which are directly linked to the effective exercise of the other fundamental freedoms of the common market) as well as the acquisition of securities dealt in on the stock exchange of a Member State. Liberalisation of these operations was unconditional and could only be suspended by invoking the safeguard clauses of the Treaty. The liberalisation of other forms of capital movements, such as the introduction of securities of a national enterprise into the market of another Member State, operations in securities not dealt in on the stock exchange, medium- and long-term financial credits, was conditional. Member States were allowed to maintain or reintroduce restrictions, which were operative on the date of entry into force of the Directive or on the date of accession to the Community, where their elimination might form an obstacle to the achievement of national economic policy objectives. For the remaining financial operations, concerning monetary transactions of a short-term nature, Member States were free to impose restrictions or not.

2.3 The 1970s: the reinforcement of exchange controls

Despite the limited ambitions of the 1960 and 1962 Directives, Member States did not comply with them in practice. Developments in the field of the liberalisation of capital movements during the 1970s were particularly disappointing. Exchange controls were reinforced[7]. Most Member States invoked the safeguard clause of article 108 to maintain and even reintroduce restrictions on capital movements that were supposed to be liberalised. These derogations tended to become permanent. By the end of the decade, only the FRG and the Benelux contries complied with Community obligations[8].

The above situation was mainly due to:

- the pronounced instability in international monetary relations, which prevailed after the breakdown of the Bretton Woods system, and the general deterioration in the international economic environment. The effect of global inflation and recession on the European economies proved to be decisive;
- the existence of significant divergences in Member States' economic performance and of great differences in their relative ability to adjust[9];
- the lack of political consensus at the Community level about what form adjustment policies should take, and the unwillingness of some Member States (like the UK, France and Italy) to accept constraints on their monetary policy autonomy.

The establishment of the European Monetary System (EMS) in 1979, meant that the Member States which participate in the exchange rate mechanism (ERM) have had to accept additional constraints in the conduct of their monetary policy in exchange for the benefits deriving from the creation of "a zone of monetary stability in Europe". But four out of the eight Member States participating in the ERM (Denmark, France, Italy, Ireland) continued to use controls on capital movements as an instrument to stabilize their exchange rate. The UK, on the other hand, refused to participate in the ERM of the EMS, but decided to remove all barriers to capital movements.

2.4 The revival of interest in the liberalisation of capital movements

The secondary role attributed by the Treaty of Rome to the liberalisation of capital movements could not last for long, if European integration was to proceed further. The revival of interest in the economic and monetary integration of the Community gave a new impetus to discussions concerning the liberalisation of capital movements between the Member States. The start was made in 1983 by a communication of the Commission to the Council for the creation of an integrated financial area in the Community[10]. Then, in May 1986, the Commission proposed a comprehensive programme for the full liberalisation of capital movements in two phases[11].

A. The first phase:

The objective of the first phase is to achieve the unconditional and effective liberalisation throughout the Community of capital operations most directly necessary for the proper functioning of the common market and for the linkage of national financial securities' markets.

For the attainment of this objective, a Directive was adopted by the Council in November 1986 which extended the obligation of unconditional liberalisation to the following financial operations[12]: long-term commercial credits; the acquisition of financial market securities, whether or not they are dealt in on a stock exchange; and the admission of securities (shares and bonds) of an enterprise of a Member State to the capital market of another Member State, under condition that these securities are dealt in on, or are in the process of introduction to, a stock exchange in a Member State.

In order to reinforce these new regulations, the Commission has also engaged in a much more rigorous management of the derogations accorded to some Member States (see Section 2.5 below).

B. The second phase:

In the second phase, decisive steps will have to be taken towards the creation of a European financial market without frontiers by abolishing all restricitons to capital movements. For this purpose, the Commission has already made specific proposals to the Council for[13]:

a) A Directive based on article 67 of the Treaty, aiming at extending liberalisation to all capital movements. This extention will mainly cover the following operations: investments in short-term securities dealt in on the money market, current and deposit account operations, and financial loans and credits. Moreover, Member States will be able to maintain or introduce a dual exchange market only under a safeguard clause.

   The new Directive will also contain a specific safeguard clause which will permit the reintroduction of controls on short-term capital movements for a limited period of time, if these movements are seriously endangering the monetary or exchange rate stability of a Member State. It should be noted, however, that the effectiveness of this safeguard clause may be low, since the achievement of financial integration in the Community will further reduce the already limited effectiveness of controls on short-term capital movements. The only lasting way to limit destabilizing capital flows between Member States is through long-term measures to increase the financial stability of the Community and to reinforce the EMS (see also Section 4.3). The safeguard clause can only be a short-term emergency measure.

b) The amendment of the 1972 Directive on regulating international capital flows[14], so as to:
   - include a declaration of intent by Member States that they will endeavour to attain a degree of liberalisation of capital movements to and from third countries equivalent to that within the Community;
   - give a Community dimension in measures taken vis-à-vis third countries;

- provide for the symmetrical use of regulatory instruments (which now cover mainly inflows of capital). This will enable the Community to protect itself from short-term capital movements of great magnitude to and from third countries, which could lead to serious disturbances in the monetary and exchange rate policies of the Member States and could threaten the stability of the EMS.

However, doubts have been expressed about whether the amendments proposed by the Commission will be sufficient to protect the Community from monetary disturbances originating abroad.

c) A Regulation combining the existing Community loan and medium-term financial assistance mechanisms into a single financial support instrument, and extending the conditions under which medium-term assistance can be granted, to cover needs associated with the liberalisation of capital movements. This extension is mainly aiming at dissuading destabilizing speculation and at increasing the ability of the authorities to cope with it.

The implications of the second phase will be considerable. From a quantitative point of view, the amount of short-term capital in international markets is at least equal to that of medium- and long-term capital. From a qualitative point of view, the liberalisation of short-term monetary operations will open the way for intensified speculation against national currencies under pressure and will completely deprive national authorities of their already limited monetary policy autonomy.

2.5 Exchange controls in the Member States

The aim of this section is to give a general idea of the present state of exchange controls in the different EEC Member States[15]. This will suffice to show that great differences exist between them in the degree of capital movement liberalisation already implemented and that substantial progress is still needed in order to establish a truly integrated European financial area, comprising all twelve Member States.

Several Member States have liberalised capital movements beyond their Community obligations.

In the FRG the law (Aussenwirtschaftsgesetz) authorizes the imposition of restrictions on capital movements in certain cases, especially restrictions concerning capital imports. At present, however, no restrictions exist in this country either for residents or for non-residents and capital movements are virtually free.

In Belgium and Luxembourg, capital movements are liberalised. The only exception is the existence of a dual exchange market, which is regarded by many as a major imperfection.

In the UK, all restrictions to capital movements to and from third countries were abolished in October 1979.

Since the beginning of the 1980s, important steps towards liberalisation of capital movements have also been taken by Member States which previously applied strict exchange controls.

In the Netherlands, a new law was introduced in 1980, making capital movements to and from third countries free and abolishing the requirement for prior authorization. However, like in the FRG, the law permits the imposition of restrictions on capital movements in certain periods. Until July 1983, a number of capital imports were subjected to such restrictions. But since then capital movements have been completely liberalised. Only the issue of foreign securities in the Netherlands requires prior authorization of the central bank[16].

Denmark was initially authorized to retain restrictions on capital movements liberalised at the Community level. However, during the first half of the 1980s it proceeded to a rapid abolition of the restrictions. In May 1983, the Danish authorities liberalised completely the purchase by residents of exchange-listed bonds and lifted the ban on the sale abroad of Danish government bonds. Then in January 1984, residents gained access to the purchase of exchange-listed shares. These measures allowed Denmark to terminate its derogation in December 1984. In June 1985, Denmark adopted additional liberalising measures in the field of financial loans[17].

In France, severe restrictions on capital movements have been applied in the past under the safeguard clause of the Treaty. However, in May 1986, the French authorities announced that they would no longer invoke the derogation and adopted important measures for the relaxation of exchange controls. For instance, direct investments abroad were liberalised, exporters and importers were permitted to buy foreign currencies in advance for hedging, ceilings in bank transfers of individuals to non-residents were abolished. Nevertheless, important restrictions still exist in the field of short-term capital movements[18].

In Italy, while capital transactions by non-residents have been relatively free, exports of capital by residents have been subjected to severe restrictions. In 1974, Italy was authorized to invoke article 108 of the Treaty. Italian residents who purchased real estate abroad or acquired foreign securities, were required to make a non-interest-bearing bank deposit equal to 40% of the value of the acquired foreign assets. For securities issued by EEC institutions the deposit obligation was 30%, and for securities retained for less than one year 50%. Collective investment undertakings were exempted from the deposit requirement up to an amount equivalent to 10% of the value of their portfolios. During recent years, steps were taken to limit the deposit obligation. Finally, in May 1987 the Italian authorities announced the termination of the protective clauses from which Italy previously benefited[19]. However, the move towards relaxation of exchange controls proved to be rather limited and uncertain. In mid-September 1987, as part of a policy tightening to protect the lira, the Italian authorities reintroduced a number of controls on the external transactions of enterprises[20].

In the remaining EEC Member States, which possess the least advanced economies within the Community and relatively undeveloped capital markets, many exchange controls are still in force. For these Member States the road towards the liberalisation of capital movements is full of obstacles and risks (see Section 4.4 below).

In Ireland, the central bank practices a rigorous control on capital movements. For example, residents are not free to buy foreign securities - except when these are issued by Community institutions; loans in favour of non-residents are normally not permitted; direct investments are subject to prior authorization[21]. A Commission decision, as amended and renewed in

December 1987, authorizes Ireland to maintain restrictions on the acquisition by residents of foreign securities dealt in on a stock exchange[22].

In Greece, inward capital movements (e.g. for direct investment or for making deposits in foreign exchange) have been free and have been encouraged through various forms of incentives, while outward capital movements have been subjected to strict restrictions. The Accession Treaty authorized Greece to defer until the end of 1985 the liberalisation of certain capital movements that had already been liberalised at the Community level. In view of the difficulties facing the Greek economy, a Commission decision in November 1985, as amended in February 1987, authorized Greece to maintain the restrictions until the end of 1988[23].

Nevertheless, during 1986 and 1987 important steps were made towards liberalising a large number of outward capital movements by non-residents.

Foreigners who are not residents of the EEC and have made direct investments in Greece, are now permitted to repatriate the related interest and dividend income, and also, after a three-year period, the imported capital and capital gains. Capital exports by foreigners related to investment in real estate in Greece are normally not permitted, while capital exports related to investment in Greek securities are free.

Capital movements between Greece and the other EEC Member States are now covered by the provisions of Presidential Decree 207/87. The existing regulatory framework can be described as follows.

The repatriation of the capital imported to Greece by EEC residents for the purpose of direct investment, as well as of profits, dividends and capital gains is free. Personal capital movements and capital exports related to investment in real estate by EEC residents are also free. Approval of capital exports of the above categories is no longer based on the criterion of "economic need". Only the authenticity of the transactions is examined. For Greek residents liberalisation of the above capital movements has been postponed until 22 November 1988. Until then they are subject to prior approval.

The repatriation of the proceeds from the liquidation of Greek securities purchased by EEC residents is also free. The same holds true for investment in treasury bills and government bonds. Greek residents are not allowed to invest in foreign securities, except where they have legally obtained foreign exchange. The liberalisation of these financial operations has also been postponed until 22 November 1988. However, investment funds are allowed to invest 20% of their capital in foregn securities. Moreover, Greek residents are free to acquire securities issued by EEC institutions and by the EIB.

For the rest of capital movements strict restrictions and controls are still applied and prior authorization is required.

In Spain and Portugal, controls are applied on both inward and outward capital movements. In Portugal all private capital transactions are subject to prior authorization by the Bank of Portugal. In Spain, however, restrictions are less strict and during recent years there has been a move towards relaxation of a number of controls. For instance, in May 1985, regulations governing foreign direct and portfolio investments were substantially liberalised[24].

Spain and Portugal are authorized by the Accession Treaty to maintain a number of restrictions on capital flows[25]. Spain may continue to apply restrictions on:

- the acquisition of foreign securities by residents and direct investments by residents in foreign unit trusts until 31 December 1988;
- real estate investments by residents and direct investments by residents in foreign undertakings having as their object immovable property until 31 December 1990.

Portugal may continue to apply restrictions on:

- direct investments by non-residents until 31 December 1989;
- the purchase of immovable property and the transfer of proceeds of liquidation of real estate investments by non-residents, personal capital movements and the acquisition of foreign securities by residents, until 31 December 1990;
- direct investments abroad by residents until 31 December 1992.

3 Arguments for the liberalisation of capital movements

The arguments usually put forward in favour of the liberalisation of capital movements throughout the Community are mainly based on the following considerations[26]:

A. The completion of the internal market

The White Paper and the Single Act set the objective of completing by 1992 the internal market, in which goods, services (including financial services), and persons will be able to circulate freely[27]. The attainment of this objective is highly desirable for both economic (economies of scale, more efficient resource allocation, stimulation of investment, etc.) and political reasons, and is expected to strenghten integration. The realization of a large internal market without frontiers will not be possible without the prior liberalisation of capital movements. More specifically, the free movement of capital is a necessary precondition for:

- the unimpeded conduct of commercial exchanges, and therefore the further expansion of intra-EEC trade;
- the effective exercise of the freedom of establishment. For instance, restrictions on direct investment constitute an obstacle to the establishment of national enterprises abroad;
- the free supply of financial services and the creation of an integrated European financial market. Indeed, it would be pointless to harmonize national regulations concerning financial activities and to give financial institutions the right to supply their services in other Member States, if - because of the existence of capital movement controls - residents in one Member State were not allowed to execute financial operations in another Member State;
- the establishment of a healthy economic environment, in which all European enterprises will have access to the most advanced and efficient ways of financing and will compete on a fair basis;
- the creation of the Europe of citizens, in which European nationals will circulate freely, will be given the right to open an account in foreign currency and to use eurocheques and other payment instruments, and will be able to conclude transactions with residents of other Member States without being subjected to complex controls and formalities.

B. The reinforcement of the EMS and the creation of a monetary union

There is a strong link between the liberalisation of capital movements and the strengthening of the EMS. On the one hand, the exchange rate stability and monetary policy convergence already achieved, largely due to the successful operation of the EMS, make easier the gradual removal of barriers to the free movement of capital. On the other hand, the liberalisation of capital movements will require a reinforcement of the EMS in terms of closer and more disciplined coordination of monetary and economic policies of EEC Member States[28]. Closer coordination will increase the dynamism of Member States' economic policies and will have a favourable impact on confidence and investment throughout the Community. Furthermore, it will contribute to an expansion of the use of the Ecu both inside and outside the Community, and will constitute a step forward towards the creation of a European monetary union. Consequently, Europe will be better equipped to protect itself from external economic disturbances and will become able to play a more active role in the management of international monetary relations.

C. The improvement of the international competitiveness of European capital markets and the creation of an integrated European financial area

The liberalisation of capital movements will create pressure on European financial institutions to increase their efficiency, and therefore will improve their ability to face up to the competition from their counterparts in the US and Japan. Restrictions on capital movements can seriously harm the competitiveness of European financial markets, at a time when the financial sector is acquiring an increasing importance in the world economy (see Chapter 1). Furthermore, the liberalisation, if combined with appropriate harmonization measures, will lay the foundations of a totally integrated financial area. A European financial identity will thus be created.

D. The stimulation of economic activity in the Community

The liberalisation of capital movements and the creation of a unified European financial market will expose national financial institutions to a much more competitive environment. Stiffer competition will tend to lower the costs and increase the efficiency of intermediation. The development of new, more efficient ways of placement and financing will improve the allocation of resources, will inject new economic dynamism to Community enterprises, and will stimulate savings and investment, thus contributing to the creation of employment. In particular, small- and medium-sized enterprises, which currently have no access to the international capital market, will be able to benefit from more flexible terms of credit, loans in foreign currencies and a better financing of their own funds, and therefore will be encouraged to expand their activities. As investment opportunities inside the Community become more attractive and more easily exploited, it is possible that the amount of capital leaving the EEC for the US will be reduced.

In conclusion, according to the above arguments, the liberalisation of capital movements can create considerable opportunities for the future growth of the economies of the EEC Member States. However, the liberalisation process is not free of obstacles and risks. First of all, there is the general danger of an overexpansion of the financial sector and of financial activity to the detriment of productive investment and of real economic activity. This danger should be understood and avoided, mainly through intergovernmental monetary and economic cooperation to create a climate of stability favourable to productive investment. Otherwise, the aforementioned growth and employment benefits of creating an integrated financial area will not be realized. But other more specific obstacles and risks exist as well. An analysis of the most important among them will follow[29].

4 Difficulties and risks in the liberalisation of capital movements

4.1 Obstacles in the field of financial services

The liberalisation of capital movements may not be sufficient to ensure the attainment of the major objective of creating a stable integrated European financial area, if it is not accompanied by additional measures of 'positive integration'. As the recent stock market crisis of October 1987 has made obvious, uncontrolled dereguration entails risks for the stability of the financial system[30]. Furthermore, differing prudential regulations and controls of a technical nature as well as dissimilar legal and administrative systems, can continue to create artificial barriers to the conslusion of transactions between residents of different Member States and to the free supply of financial services throughout the Community. As a result, the European capital market may remain fragmented.

If the above risks are to be avoided, parallel progress must be made towards a common market in financial services. The Commission's method of approach in this matter is based on a number of innovative principles, which - if implemented - will have considerable impact on the evolution of financial systems in Europe. It comprises three main elements:

a) the mutual recognition of financial techniques in different Member States;

b) the harmonization of the essential elements of rules and standards concerning the protection of users of financial services and the supervision of suppliers. Such a harmonization is necessary, since mutual recognition is only feasible if there is sufficient institutional common ground;

c) the principle of 'home country control', according to which all activities of financial institutions throughout the Community will be supervised by the authorities in the country of origin. This principle actually means that each Member State will have to recognize on its territory the validity of regulations which are in force in other Member States and to trust the surveillance of foreign financial institutions to the competing authorities of the country of origin.

Progress in the field of financial services has been particularly slow. Nevertheless, a number of Directives have been adopted since the beginning of the 1970s, which have laid the foundations of a coordinated system. Moreover, in recent years there has been a revival of interest. For example, in the field of banking services the Commission has undertaken serious efforts to ensure the freedom of establishment and the coordination of regulatory systems. This was made necessary in view of the fact that - despite the adopted Directives - there is still not complete freedom for banks to establish in other Member States, and in some Member States foreign banks are still required to have their own endowment capital. The proposals put forward by the Commission concern: the reorganization and winding up of credit institutions; the harmonization of the concept of own funds for supervisory purposes; the approximation of solvency ratios; the establishment of deposit protection schemes; the control of large exposures of credit institutions; and the elimination of remaining barriers to the free provision of mortgage credit throughout the Community.

Special mention should be made to the proposal, recently presented by the Commission, for a Second Banking Directive, according to which all credit institutions duly authorized in the home country, will be able to establish or supply services throughout the Community without further authorization[31]. The implementation of this Directive is likely to hasten the process of deregulation already evident in many Member States. The Directive will allow a universal bank to offer all its services in countries where there may be a distinction between investment and commercial banking, thus leading to an erosion of such distinctions. Countries will be obliged to admit competing financial techniques used in other Member States, even if their own institutions are currently prohibited from offering them. Competition between national regulatory systems will be encouraged and this may lead to alignment at the level of the most liberal. Moreover, new financial instruments will be introduced and there will be pressure on domestic banks to provide them and on governments to allow their use[32].

From the above it becomes obvious that the principle of mutual recognition has far-reaching implications for the operation of national financial systems. Therefore, the necessary action in the field of financial services will inevitably face serious obstacles due to existing differences in the characteristics of national financial markets and in the levels of protection deemed necessary by different Member States. The ultimate question is whether the political commitment required to overcome these obstacles will exist.

4.2 Fiscal issues

In a Community where capital movements will be completely free, interest rates will tend to converge towards a common level. Therefore, investment decisions, concerning direct investments by companies as well as portfolio investments by individual investors, will be significantly influenced by differences in taxation between Member States. The result may be a highly undesirable misallocation of resources within the Community. In addition, the existence of tax incentives for the purchase of domestic securities, recently introduced by several Member States, may also lead to a misallocation of capital funds in the field of portfolio investment.

In order to avoid such developments, there should be a closer approximation of the tax systems, the taxable base and tax rates in the different Member States and an elimination of all relevant distortions.

Moreover, there is a risk that the full liberalisation of capital movements may lead to an increase in tax evasion. Investors holding bank accounts in other Member States may be tempted not to declare the interest income paid into these accounts. This practice could result in a reduction in government tax revenues and impair fiscal equity.

The Commission is at the moment considering various solutions for the purpose of minimizing the risks of tax evasion, such as an obligation on all banks to declare interest income, or a generalized witholding tax on interest payments. No simple and straightforward solution to this problem exists. On the contrary, various complexities are involved. On the one hand, the obligatory reporting of interest income by banks would be complex and would involve serious administrative costs. On the other hand, an EEC-wide withholding tax would face two main hurdles: firstly, it would be particularly difficult to reach agreement on an acceptable rate, and secondly, even if agreement on a common rate was reached, Member States would risk driving capital away from the Community to third countries with lower tax burdens. It follows that a fully effective solution could only be achieved through agreement at the international level. However, it is well-known that the attainment of international agreement on such thorny issues is particularly difficult.

4.3 Risks for the stability of the EMS

The full liberalisation of capital movements will have serious implications for Member States' monetary policies. The Member States which have already abolished all restrictions on capital movements will have to learn to live in a much more volatile and uncertain monetary environment. The increase in short-term monetary transactions by both residents and non-residents will render their monetary aggregates more sensitive and less easily controlled. However, it is the Member States which still apply exchange controls that are going to face the greatest challenge. Speculation against their currencies in periods of economic difficulties will be intensified. Capital flows will respond quickly to interest and inflation rate differentials and to expectations about exchange rate changes. Monetary authorities will have to resort increasingly to interest rate management through open market operations, while quantitative controls on domestic credit will become completely ineffective. Interest rates will actually be subordinated to maintaining the stability of the exchange rate, which signifies a virtually complete loss of monetary policy autonomy[33].

It follows that without controls on capital movements, the adoption of uncoordinated monetary policy measures can cause great losses of foreign exchange reserves in order to maintain parity within fluctuation margins. Only a strengthened EMS can reconcile the objective of a single financial market with exchange rate stability. Progress to be achieved in this direction does not necessarily entail immediate monetary union but rather a more organic monetary and economic cooperation among Member States as well as a more efficient and flexible method of short-term exchange rate management during periods of tension[34].

As far as the latter is concerned, an important development has been the adoption of a package on the strengthening of the EMS by the Finance Ministers at an informal Council meeting held at Nyborg on 12 September 1987. It was agreed that central banks would attempt to achieve a more flexible use of intra-marginal intervention to maintain exchange rate parities (i.e. of intervention that is conducted before a Community currency reaches the limits of its margins of fluctuation). There is a presumption that very short-term financing will be available on certain conditions for intra-marginal intervention. This, together with a number of other more technical reforms, is expected to make the exchange rate mechanism of the EMS much more operative[35]. However, the fact remains that the reforms of the September 1987 package are limited in scope and are not sufficient to guarantee exchange rate stability, in case of tensions, arising from the liberalisation of capital movements.

Furthermore, without a reinforcement of economic policy convergence, the strengthening of the external constraint resulting from capital movement liberalisation, could give rise to pressures for an enlargement of margins of fluctuation and for more frequent realignments of central rates. This would carry the Community away from its ultimate objective of monetary union[36].

The necessity of monetary policy convergence raises the problem of what form this convergence will take. The choice lies between: a) an alignment of Member States' monetary policy with that of the most powerful - in economic terms - Member State, or b) a symmetrical convergence based on common monetary policy choices.

Until now convergence has taken the first form. Priority was given to the fight against inflation. The FRG, having the strongest economy and the best inflation performance, played a pivotal role in the system, determining the level of real interest rates and the exchange rate relationships with third currencies, especially the dollar[37]. The other Member States, faced considerable monetary policy constraints, but were also able to reduce the cost of deflation because of the credibility they acquired by aligning their monetary policy to that of the FRG.

In the future, however, as monetary stability attains a more durable and credible form, policy convergence should acquire a much more cooperative character. A cooperation procedure should be established to define and jointly manage monetary policy objectives. This will aim at achieving price stability with the least possible sacrifice in terms of economic growth. It will require the use of a set of macroeconomic indicators as a reference framework for cooperation among Member States and the adoption of common policy objectives. The crucial question here is: can the Member States agree on the basic objectives of macroeconomic policy and on the means through which these objectives should be achieved? A lot will depend on whether such an agreement will be feasible.

4.4 Risks for the less prosperous Member States

Great disparities exist in the level of economic development and living standards between the less advanced Member States and the Community average (see table 2). The liberalisation of capital movements within the EEC could result in a concentration of investment capital in the most prosperous regions of the Community where more attrative financial investment opportunities may exist. Moreover, the relatively small-sized unsophisticated financial institutions of the less advanced Member States may face great difficulties in adjusting in a highly competitive environment dominated by the big transnational companies of the major financial centres. This would tend to aggravate economic and social disparities, and therefore would threaten the cohesion of the Community. However, according to article 130(b) of the Single Act, the implementation of common policies and of the internal market must take into account the objectives of cohesion. This implies that specific measures should be taken in order to protect the less advanced Member States from the risks arising from the liberalisation of capital movements and to preserve (or even strengthen) economic and social cohesion in the Community.

The Commission's position on this problem has been that a more gradual process of liberalisation should be adopted in the less prosperous Member States, allowing them to extend their period of adjustment. Furthermore, as we have already said, it has been proposed that all financial instruments within the Commission's powers be used not only if a Member State is faced with a major crisis, but also to help Member States with difficulties in getting ahead on the road towards the free movement of capital.

Resource transfers from the structural funds can also contribute in neutralizing the risks of disequilibrium deriving from a reinforcement of free competition within the Community. Until now, both the resources committed and the results obtained in this field have been small. But the adoption of the "Delors package" in the summit of February 1988 in Brussels creates hopes for a quantitative and qualitative improvement in structural economic aid to the Community's poorer regions.

TABLE 2

Real convergence - per capita GDP[1] and its divergence in the Community

	1960	1970	1975	1980	1985	1986	1987[2]
B	96,1	99,5	103,0	104,4	101,7	101,8	101,2
DK	119,8	116,7	111,3	109,5	116,7	117,8	115,1
D	118,2	113,6	109,6	114,2	116,0	116,2	115,6
GR	38,7	51,7	57,1	58,4	56,1	55,3	53,7
E	58,3	72,3	80,1	73,8	72,3	72,7	73,9
F	101,4	106,1	110,4	111,6	109,0	108,2	106,8
IRL	61,9	61,4	63,0	64,7	63,8	62,3	62,7
I	91,4	100,6	97,7	102,0	103,2	103,5	104,4
L	141,3	125,3	122,7	120,5	127,5	127,5	127,4
NL	120,0	117,3	116,3	112,4	107,3	106,7	105,9
P	38,2	47,4	50,3	54,3	52,6	53,2	53,8
UK	128,3	108,0	105,7	100,7	103,9	104,2	105,3
EUR 12	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Ratio of 4 poorest to 4 richest countries	41,0	56,3	63,4	60,0	58,6	58,9	59,9

[1] GDP per capita at current prices and purchasing power standards as a percentage of the Community average.

[2] Economic forecast, September 1987.

Source: European Economy, No 34, November 1987

The aforementioned measures will certainly help the less prosperous Member States to adapt in a highly competitive European financial environment. But are they sufficient? And if not, what are the risks threatening these Member States in view of the full liberalisation of capital movements throughout the Community? What economic policy measures should they adopt in order to minimize these risks, achieve a gradual adjustment of their economic structures, and reduce the gap dividing them from the other Community Member States?

No general answer to these difficult questions exists. A case by case analysis is much more appropriate, since the less prosperous Member States possess different economic characteristics and face specific structural problems.

In Part II of this study, we will attempt to provide an analysis of the possible effects of the liberalisation of capital movements on the Greek economy and to give general economic policy guidelines which - if adopted - will permit a gradual relaxation of controls without any major destabilizing consequences.

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<u>PART II</u> :

<u>THE LIBERALISATION OF CAPITAL MOVEMENTS AND GREECE</u>

1 The Greek economy

Before proceeding to our attempt to analyse the implications for Greece of the liberalisation of capital movements in the Community, it would be useful to assess the and the general economic performance of the country, the character of the macroeconomic policy pursued, with special reference to exchange rate policy, and, most importantly, the situation and problems of the financial sector. All these are elements which will influence decisively the effects of capital movement liberalisation on the Greek economy and their assessment will highlight the economic policy measures necessary in order to proceed to the relaxation of existing controls.

1.1 General macroeconomic policy and performance

A. The 1960s and early 1970s

During this period Greece experienced high rates of economic growth associated with considerable migration abroad and falling unemployment. Between 1960 and 1973, real GDP grew at an average annual rate of 7.7%, a rate much higher than the Community average. Public sector investment, mainly in infrastructure, was the main factor behind rapid growth. However, despite large increases in public expenditure, the public sector borrowing requirement (PSBR) as a percentage of GDP remained at relatively low levels until the early 1970s, as rapid increases in income led to rising government revenues. The lack of any serious inflationary pressures was characteristic of the period. Although the money supply grew rapidly, the inflation rate was kept at levels lower than the Community average. This was mainly due to the absence of any pressures in the labour market. External economic factors, such as high levels of international economic activity, the relative stability of prices of primary products and raw materials, and the existence of a fixed exchange rate regime, also contributed to the achievement of monetary stability[38]. Trade account deficits were large during the whole period. But thanks to considerable net invisible receipts and autonomous capital inflows, the external debt did not increase much. On the other hand, however, these high invisible receipts and autonomous capital inflows led to overvaluation of the exchange rate, which, in turn, discouraged the development of exports[39].

B. From 1973 to the end of the decade

Between 1973 and 1980, a period of marked deterioration in the international economic environment, the average annual rate of GDP growth fell to 3.4%. Despite this slowdown, the growth rates of the Greek economy continued to be higher than the Community average.

Economic policy was based on the Keynesian model of aggregate final demand, according to which an increase in any of the components of final demand leads to corresponding increases in the supply of goods and services in the economy and reduces unemployment. The authorities used expansionary monetary and fiscal policy as the main instrument for keeping economic activity at a satisfactory level[40]. However, private investment activity did not respond and remained at remarkably low levels. Moreover, the rapid rise in public expenditure was not accompanied by a corresponding expansion of the tax and revenue-generating base of the economy, thus bringing about a substantial increase in the PSBR. The inability of government to finance rising expenditures through savings led to substantial increases in the supply of money.

Large public deficits, expansionary monetary policy and wage increases in excess of productivity growth gave rise to an inflationary wage-price spiral. This wage-price spiral was further fuelled by: exogenous increases of the price of oil and of imported goods and raw materials; rises in the price of imports caused by exchange rate depreciation; deliberate increases by the government of agricultural product prices; strong inflationary expectations on the part of households and firms; certain structural imbalances (e.g. monopoly elements and a large black economy); and rigidities in the supply side of the economy (e.g. overexpansion of the construction sector), which made impossible the satisfactory response of the various sectors to increased demand for their products[41]. The average rate of inflation in Greece during 1973-80 was 16% compared to 12.3% for the Community average. High inflation led to distortions in the allocation of production factors and hampered structural change.

A large number of manufacturing firms, being unable to adjust to rapid and substantial increases in unit labour costs, incurred significant losses. The net profit rate (i.e. profits after depreciation and financial charges in relation to equity capital) which averaged 15% between 1970 and 1973, fell to

8% by 1979, with nearly 40% of firms reporting losses. Firms had to rely increasingly on external finance and were soon faced with rapidly rising financial charges[42].

C. The first half of the 1980s

The performance of the Greek economy during the first half of the 1980s was characterised by sluggish growth of output (slightly more than 1% on average), high rates of inflation, substantial external account imbalances, rising unemployment, particularly among women and young people, and alarmingly low levels of productive investment.

In contrast to the fiscal retrenchment in most OECD countries at the beginning of the 1980s, fiscal policy in Greece remained on the whole expansionary until mid-1985. Government expenditure increased rapidly to reach 48.1% of GDP in 1985. This was mainly the result of considerable increases in government consumption, largely due to rapid growth of the wage and salary bill, and of the rise in social security payments, due to a policy pursued since the beginning of the 1980s, which increased substantially pensions and disconnected social security benefits from contributions. Furthermore, the combined operating deficit of public corporations and enterprises rose markedly from 2% of GDP in 1979 to 5.5% in 1985, 2.8% of which was financed by government transfers. On the other hand, government revenues lagged considerably behind the growth of expenditures. They increased from a low 29% of GDP at the end of the 1970s to only 34.5% in 1985. As result, net public sector debt rose from almost 40% of GDP in 1981 to 81.5% in 1985 and the PSBR from 8.4% of GDP in 1980 to 17.6% in 1985. Public sector deficits were financed partly through new money creation and partly through bank borrowing, with credit being administratively directed to the public sector. As public sector claims on financial resources rose rapidly, crowding-out mechanisms may have become stronger. Moreover, rapid growth of the money supply had serious adverse effects on inflation[43].

During the first half of the 1980s, the rate of inflation accelerated to over 20% on average. The socialist government, which came to power in October 1981, first tried to curb inflation through price controls, but this was counteracted by a redistributive wage policy. Introduced in 1982, the policy aimed at improving the incomes of the lower paid, in the hope of encouraging consumption and stimulating production. A programme of automatic indexation was also introduced for public sector wages, which soon became the accepted benchmark in the private sector too[44].

Declining productivity, rapidly rising unit labour costs and widespread controls on prices had adverse effects on the profits of enterprises. After 1982 the average net profit rate turned negative. In response, firms increased their bank borrowing to unsustainable levels, as evidenced by the sharp rise in the overall ratio of debt to equity to 6.9 in 1985 from 2.5 at the end of the 1970s[45].

As a result of the deterioration in the competitiveness of Greek products, export performance worsened during the first half of the 1980s, despite greater export subsidies and severe cuts in profit margins. On the other hand, import penetration, particularly in light consumer goods, increased markedly. These developments together with increased payments for oil imports, brought about a deterioration in the trade balance[46]. Moreover, between 1980 and 1985 invisible receipts decreased by $ 1.6 bn to $ 5.2 bn. Community transfers grew substantially, but this was insufficient to counteract the decline in other items (shipping, tourism, remittances). The inflow of private short-term capital slowed down too. As a result, following the second oil crisis, the current account deficit doubled and remained around $ 2 bn until 1984. Then, in 1985, it soared to $ 3.3 bn, nearly 10% of GDP. To finance these deficits foreign borrowing increased considerably. The external debt rose from around 13% of GDP in 1979 to 47% in 1985.

Economic developments during the first half of the 1980s made obvious that, for a small open economy like Greece, unilateral expansion affects mainly the inflation rate, creates pressures for devaluation and has limited and temporary effects on output and employment. The authorities have been forced to recognize that expansionary monetary and fiscal policy cannot constitute a feasible long-term solution to the economic problems of the country[47].

D. The two-year stabilization programme

October 1985 marked a major change in economic policy attitudes. A comprehensive two-year stabilization programme was introduced[48]. The main objectives were a slowdown in the year-on-year rise of consumer prices to 10%

by the end of 1987 and a reduction of the current account deficit to around $ 1.25 bn, in order to stabilize the level of external debt from 1988 onwards. These objectives were to be achieved through a reduction in domestic demand and expenditure and an increase in export competitiveness. All components of macroeconomic policy were geared to these ends. More specifically, the measures comprised[49]:

a) curbs on tax evasion and government expenditure, aiming at bringing the PSBR down to 9.5% of GDP by 1987;
b) a tightening of monetary policy through reduction in the growth of domestic credit expansion and through the gradual establishment of positive real interest rates for all borrowers;
c) a restrictive incomes policy, based on the modification of the automatic indexation scheme. Wages were adjusted on the basis of projected instead of past inflation after excluding the effect from import prices;
d) a 15% devaluation of the drachma, followed by a gradual slide of the effective exchange rate to maintain competitiveness, and a temporary six-month non-interest bearing deposit equivalent to 40% or 80% of the value of selected imported goods[50].

Despite the achievement of progress towards the right direction, there has been some slippage in the attainment of the aforementioned objectives[51]. The PSBR fell from 17.6% of GDP in 1985 to 13.7% in 1986, mainly due to increased taxation of petroleum products, as the benefit of lower imported oil prices was not passed on to final users. However, there were significant shortfalls in revenues from direct taxes and social security contributions and excesses in expenditures, especially on social benefits and subsidies. Moreover, the borrowing requirements of public enterprises were significantly higher than projected. In 1987 the PSBR remained at around 13.3% of GDP, a level much higher than the objective set in the stabilization programme, reflecting difficulties in the collection of VAT and expenditure overruns by public corporations and entities, notably the social security funds.

Domestic credit expansion decelerated considerably in comparison to previous years. However, as a result of the overrun of the PSBR and of a sales volume of treasury bills and medium-term paper to the non-bank public substantially below the initially projected level, the rate of growth of total domestic credit was above target in both 1986 and 1987[52]. Nevertheless, the rate of growth of bank lending to the private sector was largely within target.

The firm implementation of the restrictive incomes policy produced a 10% reduction in real wages and a 7% fall in real personal disposable income in the period 1986-87. However, due to initial doubts about the durability of the austerity programme, to speculative behaviour, and to the fact that the black economy escaped the restrictive effects of the government's incomes policy, private consumption contracted much less than expected, bringing about a considerable decline in the personal savings ratio.

During 1986 the rise in the consumer price index was 16.9% compared to 25% in 1985, but remained at 15.7% for 1987, a rate considerably higher than the 10% target[53]. This disappointing performance can be partly attributed to the introduction of VAT, to some relaxation of price controls and to the increase in agricultural prices as a result of unfavourable weather conditions.

The stabilization programme and in particular the moderation of labour costs during the last two years, together with some liberalisation of price controls, boosted profits of enterprises and led to a considerable improvement in the business climate, evidenced by a recovery of private productive investment after years of continuous decline.

The current account deficit fell to $ 1.7 bn in 1986 and to $ 1.3 bn in 1987. The 1986 decline was mainly due to the reduction in imported oil prices, to the recovery in receipts from tourism and remittances and to a 60.2% increase in EEC transfers over the previous year. The volume of exports grew, spurred by the gain in competitiveness secured by the October 1985 devaluation, but the improvement in export value was not significant because of the J-curve effect. The further decline of the current account deficit in 1987 was basically the result of a 24.4% rise in export value and a 30% increase in total invisible receipts. Non-oil imports, however, in both 1986 and 1987, instead of declining, rose, due to the maintenance of a higher than projected level of demand for consumption, to inelasticity of industrial demand for imports of semi-finished goods and equipment and to continuing weaknesses and rigidities in supply.

Finally, a particularly remarkable development during 1987 was the reversal of the unrecorded capital flight of previous years. Net private capital inflows increased by 66.6% to $ 1.4 bn, making stabilization of the external debt possible. Private capital inflows were stimulated by the rise in real interest rates, by changes in expectations about an impeding exchange rate crisis and by the emergence of a favourable business climate, following the consistent implementation of the stabilization programme.

1.2 Exchange rate policy

The exchange rate is a very important economic variable. At the individual level, it affects patterns of tourism and consumer purchases. At the corporate level, exchange rate changes often make the difference between profit and loss and have an important impact on investment decisions and therefore on the allocation of resources in the domestic economy. Most significantly, the degree of confidence in the home currency can greatly influence international capital flows, with potentially destabilizing consequences for the balance of payments (see Chapter 2 below).

The authorities in Greece operate a managed float for the drachma. Official exchange rates for the dollar and other currencies are determined during the daily fixing session, in which the central bank and the authorized commercial banks participate. Since Greece's accession to the EEC, the drachma has become negotiable in the Paris exchange market. However, the quantities traded there are small and do not change in practice the way in which exchange rates are set by the central bank.

In March 1975, after more than twenty years of a fixed par value vis-à-vis the dollar, the Greek authorities decided to float the drachma. The drachma was allowed to depreciate steadily against the dollar and the EEC currencies. The pace of depreciation accelerated during the 1980s (see table 3). The objective of the exchange rate policy of sustained depreciation was to restore competitiveness, as the inflation rate in Greece remained at substantially higher levels in comparison to that of its main trading partners. However, depreciation lagged behind and did not always fully compensate for the loss in competitiveness[54]. Moreover, it has failed to provide a remedy for balance of payments problems.

TABLE 3

Exchange rate developments in Greece (1970-1987)

Year	drachma/dollar	Percentage change	drachma/ECU	Percentage change
1970	30.00		30.67	
1971	30.00	0.0	31.43	-2.4
1972	30.00	0.0	33.65	-6.4
1973	29.63	+1.2	36.95	-8.9
1974	30.00	-1.2	35.78	+3.3
1975	32.05	-6.4	39.99	-10.5
1976	36.52	-12.2	40.88	-2.2
1977	36.84	-0.9	42.04	-2.8
1978	36.73	+0.3	46.78	-10.1
1979	37.04	-0.8	50.77	-7.9
1980	42.64	-13.1	59.32	-14.4
1981	55.41	-23.0	61.62	-3.7
1982	66.80	-17.1	65.34	-5.7
1983	88.06	-24.1	78.09	-16.3
1984	112.72	-21.9	88.34	-11.6
1985	138.12	-18.4	105.74	-16.5
1986	139.98	-1.3	137.42	-23.1
1987	135.43	+3.4	156.09	-12.0

Source: Bank of Greece; European Economy, No. 34, November 1987; and author calculations.

Economic theory helps explain the limited effectiveness of exchange rate changes in correcting external imbalances. Devaluation is an expenditure-switching policy which operates through relative price changes. To be effective, devaluation must lead to a fall in the real exchange rate and consequently to a reduction in real domestic wages[55]. This is what usually happens immediately after an unexpected change in the nominal exchange rate. However, the implied change in domestic real wages has little effect upon trade flows in the short run, due to low import demand elasticities and long time lags[56]. Most importantly, the real income effect of devaluation quickly becomes obvious to the inhabitants (absence of money illusion), who attempt to achieve an equivalent rise in their nominal wages. This is particularly true for small open economies, like Greece, in which the proportion of imports to consumption is high. In the long run therefore the initial effect upon real wages is offset, due to resistance to real wage cuts. Furthermore, as the economy becomes more open and trade interpenetration increases, the benefits of devaluation in enhancing the competitiveness of exports are also eroded by the upward impetus given to import prices which eventually filters through to prices of all goods[57].

This is what has largely happened in Greece. Empirical evidence supports the view that the depreciation of the drachma, accompanied by expansionary monetary policy, has fuelled inflation through import price increases and offsetting nominal wage changes[58]. The country has consequently been caught in an inflation-depreciation spiral, which threatens economic growth by hampering the creation of a stable business climate favourable to productive investment. Continuous downward exchange rate adjustments have also reduced competitive pressures on enterprises to lower their operational costs and to adjust their production to changing patterns of international trade and demand. Finally, exchange rate developments in Greece have adversely affected confidence in the domestic currency, thus giving rise to considerable illegal capital flight.

Finally, it should be mentioned that pricing is only one factor influencing the competitiveness of Greek products. Other factors, such as the degree of product diversification, the ability of exporters to penetrate markets by upgrading their sales methods, on-time delivery, high quality and reliability, are equally important. The performance of Greek exports in the past has not been satisfactory in these respects.

The above arguments are now widely recognized by the Greek authorities. In the words of the Governor of the Bank of Greece, "exchange rate policy can improve international competitiveness only in the short run and can in no way be a substitute for policies aiming at attacking the primary causes of low competitiveness of domestic products"[59].

1.3 <u>The financial sector</u>

A. Main characteristics and problems

The underdevelopment and inefficiency of the financial sector in Greece has been a central reason behind the structural economic problems of the country. Moreover, as we shall argue later, it forms a major obstacle in liberalising capital movements and in strengthening the economy in general. A discussion of the main characteristics of the Greek credit policy and financial system will follow[60].

A strict regulatory framework has governed the volume and allocation of credit in Greece. Monetary policy has therefore been conducted in the form of a credit policy. Its principal means have been the administrative determination of interest rates on deposits and loans and the imposition of specific regulations and direct credit controls.

Until recently, an extremely complicated multiple interest rate system existed, with differentials among the various lending rate categories. The authorities have used interest rates to promote the development of certain sectors of the economy and to discourage what they regarded as undesirable economic activities. Underlying economic forces have not been taken into account; interest rates have been designed to serve the government incentive and subsidy policies. Despite the acceleration of inflation during the 1970s and first half of the 1980s, nominal interest rates were kept at low levels. The result was negative real interest rates for most of the period.

TABLE 4

Long-term interest rates in Greece

Nominal long-term interest rates

1970/77	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987[1]
9,8	10,0	11,2	17,1	17,6	15,4	18,2	18,5	15,8	15,8	17,4

Long-term interest rates adjusted by actual inflation[2]

1970/77	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987[1]
-1,5	-2,6	-6,2	-0,5	-2,0	-7,6	-0,8	-1,3	-1,5	-2,7	0,6

1 Average of first seven months
2 GDP deflator
Source : European Economy, No 34, November 1987

The activities of banks and specialised credit institutions have been closely regulated and controlled. Apart from the ordinary reserve requirement on their deposits, banks have also been obliged to invest a predetermined percentage of their deposits in treasury bills and loans to public enterprises, in medium- to long-term loans for productive investment, and in loans to industry and handicrafts. In addition, a second much more complex reserve-rebate system on different credit lines exists, which aims at diminishing the differences in the rate of return on different lending categories, which result from the fact that interest rates are administratively set. The credit expansion of the specialised credit institutions is earmarked by the central bank. A system of special credit controls also exists, aiming at restricting the provision of credit for consumption and imports.

The financial system has been dominated by the banking sector, especially by the commercial banks[61]. On the supply side, more than 90% of savings which go through the financial sector take the form of bank deposits, the majority being deposits with commercial banks. On the demand side, private enterprises as well as the public sector have depended excessively on bank lending for financing their needs.

The capital market, on the other hand, has remained undeveloped. This is in contrast to the situation prevailing in developed economies where the capital market constitutes the principal mechanism for the supply and allocation of funds for long-term investment. The Greek primary capital market is limited to bank bonds and treasury bills, while there are no medium- to long-term government bonds and bonds issued by private enterprises. This largely determines the size of the secondary market in which securities change hands.

The Athens Stock Exchange (ASE), the only stock exchange in Greece for trading in officially listed securities, is small. This is evidenced by the relatively few companies listed in the market, by the low daily volume of transactions and by the small total market capitalization of securites traded. The limited width and depth of the market can, in turn, create serious problems for the normal formation of prices. Moreover, the market suffers from organizational and functional shortcomings[62].

The main reason behind the underdevelopment of the Greek capital market has been the lack of a regular and adequate supply of securites for investors. Firms have financed the majority of their investment through bank borrowing rather than through the issue of securities. This situation has primarily been the result of the following factors[63]:

- The monetary and credit policy pursued by the authorities secured easy access to bank finance at low or even negative real interest rates. This combined with the existence of close ties between banks and enterprises - especially big enterprises, which in theory have both the potential and the need to make extensive use of the capital market - has made financing through the issue of securities less attractive.
- Due to the family character of both large and small firms, there has been no distinction between management and ownership. The diffusion in the ownership of shares, which would result from financing through the stock market, was considered undesirable; in such a case the big shareholders would be judged and controlled by the market for their management decisions and would therefore be less free to use the resources of the firm for personal purposes.
- The introduction of the securities of a company in the stock exchange creates obligations for the disclosure of information on its financial position. The majority of Greek companies have been unwilling to provide such information.
- Finally, the inadequacy of supply of new share issues was exacerbated by the deterioration of the international and domestic economic environment after 1973, which led to a sharp reduction in business investment. Moreover, inflation and inflationary expectations increased the attractiveness of bank financing, by lowering its anticipated cost.

The public sector has also not used the securities market for financing its needs. As a result of low interest rates, it has been less costly to borrow from banks. Access to bank borrowing was facilitated by the fact that the monetary authorities yielded without difficulty to pressures to finance large public sector deficits by relaxing their initial monetary target for the credit expansion of the economy.

The situation of the Greek financial sector described above resulted in low operational (in terms of costs) and allocative efficiency of financing mechanisms, with serious adverse consequences on the development of the real sector of the economy. The most important among the consequences will be mentioned briefly[64].

a) The high degree of dependence on bank borrowing by enterprises increased their vulnerability in periods of economic difficulties. The existence of close ties between banks and enterprises has led to continuation of financing even when this was not warranted by pure economic criteria. The risk was therefore transferred to the banks, which were subsequently obliged to carry the burden of problematic firms.

b) The lack of an efficient money and capital market has enabled banks to attract peoples' savings without difficulty and has created inertia in the system. Banks have not been subjected to competitive pressures to provide new, more efficient methods for the mobilization of savings, to extend their activities in new sectors and make use of new financial instruments, to upgrade the quality of their services and to increase their productivity. The absence of such pressures has resulted in inflexible management and a certain degree of backwardness in the banking sector.

c) The administrative determination of interest rates and the various direct credit controls have increased the operational costs of banks and, consequently, have affected their rate of return. Monetary authorities have thus assumed the responsibility of supporting the financial position of banks and specialised credit institutions. This has further reduced competitive pressures on financial institutions for the improvement of their profitability.

d) Credit controls, apart from being costly, have also been of limited effectiveness. For instance, the fact that many enterprises are involved in both industrial and commercial activities has made possible an indirect flow of capital from industry to commerce.

e) Extensive state intervention in the credit mechanisms of the economy has led to important distortions in the allocation of resources. Normally, when state interference with market forces is kept at a minimum, the unimpeded interaction of supply and demand in money and capital markets results in interest rates which represent the real cost of capital and leads to an efficient allocation of resources by directing capital to the most productive uses[65]. These forces have not been allowed to operate in Greece. As a result, resources have ended up financing the government deficit and have flowed to capital-intensive projects with rates of return lower than the real cost of capital.

f) The underdevelopment of the capital market has deprived investors of the possibility of diversifying their portfolios and of achieving the desired risk/return combinations. The lack of alternatives for the placement of savings has induced investors to place a big part of their assets in real estate rather than in securities, in order to preserve the value of their savings or for speculation. This, in turn, had adverse effects on the production structure of the economy.

g) The lack of an efficient securities market and the administrative fixing of interest rates have imposed important constraints on the conduct of monetary policy. The central bank has not been able to use open-market operations or the discount rate as its main monetary policy instruments. As a result, the efficiency of monetary policy in controlling the liquidity of the economy has been considerably reduced.

Furthermore, the absence of a variety of opportunities for the placement of savings apart from bank deposits, has resulted in an upward trend of the liquidity ratio of the economy, further complicating the conduct of monetary policy. Private savings deposits form an important component of M3. Although these deposits can be withdrawn without any cost, in practice a large part of them constitutes a long-term placement of savings. As a result, the effects of changes in M3 on inflation and the balance of payments are limited in comparison to what happens in countries with developed money and capital markets. In addition, in periods of changes in the behaviour and expectations of savers, the existence of a high liquidity ratio constitutes a potential source of monetary instability.

Constraints on the implementation of monetary policy are also imposed by the inability of the public sector to finance its deficits through means other than new money creation or bank borrowing. High PSBRs have in many cases necessitated the adoption of measures which render the achievement of monetary targets impossible.

h) Finally, negative real interest rates have strengthened consumption trends to the detriment of savings and investment, with serious adverse effects on inflation, on the balance of payments and on economic growth.

B. Recent developments

(i) The credit system

During recent years it has been officially recognized that the credit system suffers from important structural weaknesses. Efforts have therefore been initiated to bring about certain changes. The whole attempt to reform the credit system has acquired new impetus since the end of 1985. Significant progress has been achieved towards narrowing the differentials between the various interest rate categories and towards increasing the cost of bank lending. For example, in November 1985 a minimum interest rate of 16% was imposed on short-term bank credit. Then, in June 1986 a minimum rate of 15% was imposed on medium- and long-term bank loans. At the same time, adjustments were made in interest rates of other categories of credit (e.g. rates on short-term loans to handicraft enterprises were raised). Measures were also taken to relax a number of credit regulations and to liberalise certain activities[66]. The pace of reform accelerated during 1987.

The most important among the measures introduced will be mentioned briefly[67]:

- Banks and other credit institutions were allowed to accept time deposits for a period of seven days to three months with freely negotiable interest rates. Later in the year the rates offered on all types of time deposits were liberalised.
- A minimum interest rate of 21% was imposed on loans which previously carried maximum rates of 20% and above, with banks free to charge whatever rate they wished.

- Interest rates on favoured short-term loans, including agricultural working capital, were raised from 16% to 17% and rates on medium- and long-term loans from 15% to 16%.
- The compulsory allocation of 15% of bank deposits for financing investment in industry, which had resulted in the concentration of huge amounts of unused funds in the banks, was abolished.
- Commercial banks and designated specialised credit institutions were permitted to issue negotiable certificates of deposit with maturities of three, six, twelve and eighteen months and freely determined interest rates.
- Credit institutions were allowed to determine freely the rates they charge on loans for plant.

In January 1988 a number of further measures were announced, reaffirming the government's determination to liberalise the credit system, such as[68]:
- The aforementioned minimum interest rate of 21% on commercial bank credit for working capital and on certain loan categories of the Agricultural Bank of Greece was abolished.
- The percentage of obligatory deposits on high-rate loans with the Bank of Greece was reduced from 20% to 18%.
- The discount rate was reduced from 20.5% to 19%.
- The interest rates paid by the Bank of Greece on obligatory deposits of commercial banks were unified at the level of 12.5%.

Despite the progress made so far, large public sector deficits, high rates of inflation and the absence of a developed money and capital market, force the Bank of Greece to maintain extensive direct credit controls, which have important shortcomings. Moreover, the failure of attempts to limit the public sector needs for bank credit has in certain cases led to the introduction of contradictory measures, such as the increase in the compulsory allocation of bank deposits for the financing of public entities and enterprises, which have adversely affected the reform effort. Finally, certain deficiencies and problems in the structure of the banking sector, such as the absence of an active inter-bank market in securities, have not allowed banks to take full advantage of reforms[69].

(ii) The capital market

After ten years of almost continuous decline, the ASE showed a hesitant recovery during 1984-85, with the General Share Price Index (GSPI) up by 40% in two years. The recovery acquired a more rapid pace in 1986 (the GSPI rose by 69%) and accelerated significantly in 1987. More specifically, during the first ten-and-a-half months of 1987 the GSPI rose by 434%.

These developments were the result of a considerable increase in demand for shares from local individual and institutional investors as well as from EEC investors (particularly British mutual funds). The rise in demand was, in turn, stimulated by marked increases in profits of enterprises and by the introduction and firm implementation of the two-year stabilization programme, which brought about a favourable business climate and increased confidence in the economy.

However, at the end of October 1987, the international stock market crisis, combined with the lack of an adequate institutional framework which made speculation possible, led to a sharp fall in prices. Prices fell further towards the end of November 1987 due to certain unfavourable domestic politico-economic developments generating uncertainty, and have fluctuated since then.

Nevertheless, the revival of investor interest for the stock exchange remains a fact. This probably justifies some optimism for the future. Some companies have already started to issue new shares successfully, and there are signs that more firms are thinking of participating in the ASE. Furthermore, the new draft law concerning the modernization of the ASE, which is currently under discussion and will soon be submitted to the Parliament, is expected to strengthen the role of the market in the provision and allocation of investment funds. This law aims at upgrading the organizational and operational framework of the ASE, at securing more transparency in transactions and at improving the supervision of the market. However, despite these favourable developments, it should be recognized that the limited supply of securities remains a major weakness of the Greek financial system, with potentially destabilizing consequences.

2 The Greek economy in the light of the liberalisation of capital movements in the Community

The analyst attempting to evaluate the implications of the liberalisation for the Greek economy is inevitably confronted with certain questions:

- what have been the reasons leading to the imposition of pervasive controls on outward capital movements?
- how far have these controls been effective?
- what conclusions can be drawn about their efficiency?

Tentative answers to these questions will be given below.

2.1 The arguments for the imposition of controls on capital outflows

Exchange controls in Greece have been permanent and pervasive and have been dictated by long-term considerations. Their main purpose has been to restrict as far as possible outward capital movements.

The concern of the authorities was that capital outflows would lead to a considerable reduction in available resources to finance domestic investment, adversely affecting the rate of capital formation and therefore the country's growth rate. More specifically, the reasoning behind the imposition of controls has been the following: for growth to occur investment is needed. But savings may be insufficient to finance the required level of investment, thus creating a savings gap. This gap can widen further by an outflow of savings abroad. Furthermore, development plans may be frustrated by the fact that export receipts are not sufficent to finance certain imports which are vital for development. That is, a foreign exchange gap may exist as well. Unless this gap is closed, the targeted growth rate becomes unattainable. To prevent the lack of foreign exchange from constraining growth, pervasive restrictions were imposed on the export of capital, while generous incentives were offered to stimulate the import of capital[70].

Moreover, there was concern that capital outflows would reduce the ability of the government to tax all the income of its residents, because of existing difficulties in taxing wealth held abroad as well as income generated from that wealth. Low government revenues would increase the country's need to borrow from abroad, thereby increasing the foreign debt burden.

Short-term considerations also formed part of the argument for exchange restrictions. In times of economic difficulties capital outflows would tend to further aggravate problems. The currency would depreciate at a fast rate, generating additional destabilizing pressures in the economy. If the authorities intervened to defend the exchange rate, foreign exchange reserves would be depleted. This would create a need for more external borrowing. Sooner or later the country would be obliged to initiate balance of payments adjustment, which - irrespective of whether it takes place through expenditure-switching or expenditure-reducing measures - is painful and harmful to economic growth.

Finally, it was feared that capital outflows would limit the effectiveness of monetary and fiscal policy in stimulating investment and reducing unemployment.

2.2 The effectiveness and efficiency of controls on capital outflows

The effectiveness of controls can be assessed: (i) in terms of their ability to stem or prevent capital outflows, and (ii) in terms of their contribution to the relevant economic policy objectives (e.g. high rates of growth, increased domestic investment, low levels of external debt). These two aspects of effectiveness are closely related and can hardly be distinguished from one another. For analytical reasons, however, we will attempt to assess them separately.

Assessment of the effectiveness of controls in the first narrow and technical sense requires an estimate of whether there has been capital flight and a measurement of its size. Unfortunately there are tremendous difficulties in arriving at such estimates. Firstly, the definition of capital flight is not easy. In general, the term comprises short-term outflows for speculative purposes and outflows resulting from economic or political uncertainties in the home country. It is money 'fleeing from the country' rather than long-term investment guided by economic considerations. In a wider sense, the term includes the earnings of residents' foreign assets which remain outside the country, do not contribute to financing investment or servicing the country's debt, and therefore represent a loss of resources to the domestic economy[71]. Secondly, and most importantly, obtaining accurate information on the size of capital flight is almost impossible, as the statistics are often collected by the authorities themselves through their agents who carry out authorized operations.

However, it is widely acceptable that circumvention of capital movement controls in Greece has taken place and has been quite extensive. This may have been done by means of both legal substitution and illegal evasion. The former includes shifts in non-resident holdings of domestic assets and 'leads and lags', i.e. a situation where - due to lack of confidence in the domestic currency - purchases are delayed and payments are accelerated. The latter includes methods of channelling capital abroad such as: outright smuggling of currencies, the transfer abroad of funds obtained from the black market for foreign currencies, commissions and agents fees paid by foreign contractors directly into foreign bank accounts of residents, keeping part of foreign borrowing abroad, and most notably over-invoicing imports and under-invoicing exports. On this last point, there are studies on transfer pricing by multinationals in Greece showing that many foreign companies have in the past been able to circumvent restrictions and repatriate their profits by over-invoicing their exports and under-invoicing their imports[72]. Moreover, studies by the OECD have shown that in periods of strong speculative pressures, capital movement controls have been largely ineffective in preventing reserve changes or exchange rate adjustments both in countries using temporary controls and in countries using permanent controls[73]. This holds true for Greece too. For instance, the Governor of the central bank in his Report for 1986, recognizes that the strengthening of inflationary expectations and of expectations for a new devaluation of the drachma during the last months of 1985 and the first months of 1986 increased capital flight abroad[74]. In normal times, however, controls are likely to have been more effective in stemming capital outflows, partly because their circumvention involves significant costs and risks which sometimes offset the expected benefits.

The assessment of the effects of exchange controls on economic growth, investment, the exchange rate, the balance of payments, etc., is equally complicated. It is extremely difficult to distinguish the effects of controls from those of other economic policy measures. An accurate and objective analysis would actually require a counterfactual exercise. Ideally the comparison should be made between the economic performance of Greece during the last thirty years and its performance during the same period had the controls not existed. Differing economic performance could then be attributed to differences in the system of capital movement controls. Unfortunately in the real world such comparisons are impossible.

In more general terms, however, it can be said that the imposition of strict restrictions on capital outflows has not succeeded in promoting investment and fostering economic growth. As we have already said, although economic growth was buoyant during the 1960s, internal structural economic imbalances were building up, which became apparent later, when the external economic environment deteriorated sharply. Exchange restrictions - to the extent that they succeeded in stemming capital outflows - have not been able to reverse the downward trend of private investment activity and to protect the country from severe balance of payments problems. Savings obstracted from leaving the country have not been transformed to productive investment. And, despite the marked depreciation of the drachma, current account deficits remained large and the external debt rose to 47% of GNP by 1985.

Most significantly, the imposition of comprehensive and permanent exchange controls proved to be a highly inefficient economic policy instrument which led to considerable distortions in the economy. Controls have in practice operated as a subsitute for a strategy designed to correct the underlying disequilibria in the economy. By suppressing market forces, they have sheltered governments from the repercussions of their actions. They have allowed the pursuit of unsound overexpansionary monetary and fiscal policies, and made possible the prevalence of low nominal and negative real interest rates for many years (see Section 1.3 of Part II). The disastrous consequences of these developments on growth, investment, savings, monetary stability, resource allocation, the balance of payments and the structure of the financial sector have already been analysed and discussed.

The distortions created by the imposition of extensive restrictions on the outflow of capital make relaxation of controls particularly difficult and risky, thus creating great obstacles to Greece's compliance with EEC rules in the field of the liberalisation of capital movements. Despite the existence of considerable difficulties, during recent years an effort has been initiated to open the Greek economy to two-way capital flows. Nevertheless, considerable uncertainty remains over the possible effects of the liberalisation. This uncertainty is justified if we take into account the economic problems of the country as well as the fact that capital movements are often the result of intangible factors. The analysis that follows is aimed at highlighting some of the factors which might influence outward capital movements from Greece after a relaxation of restrictions, and at providing a stimulus for further and more detailed research in this issue.

2.3 The liberalisation of outward capital movements: possible effects and implications for economic policy

It is extremely difficult to predict - and even more so quantify - the effects of the liberalisation on the Greek economy. Exchange controls have been permanent and pervassive, and until 1986 there had been no efforts for their relaxation. Therefore, we have no past experience of an attempt to liberalise capital movements on which we could base our analysis. Furthermore, the factors influencing capital flows are particularly complex and may be only indirectly related to pure economic considerations. Especially for short-term capital movements, confidence and expectations play an important role. Economic theory has not managed yet to provide any universally accepted method for describing or modelling the formation of expectations and their impact on capital flows[75]. A considerable amount of conceptual and empirical research is still required in this field.

Firstly, a distinction must be made between the capital operations which have already been liberalised at the Community level by the Directives of 1960, 1962 and 1986 (although there are Member States which still apply restrictions), and the rest of capital operations, the liberalisation of which forms the object of the recent Commission proposal for a new Directive (see again Chapter 2 of Part I).

A. Capital operations already liberalised at the Community level

In Greece these capital operations are subject to different restrictions, according to whether the transaction is made by Greek residents or by non-residents. As far as outward capital movements by non-residents are concerned, as we have already said, important measures were introduced in 1986 and 1987 liberalising the repatriation of capital (as well as profits, dividends and capital gains) imported to Greece for the purpose of direct investment or for investment in real estate and securities. It is, however, very early to draw any concrete conclusions on the results of this liberalisation[76].

The first signs have been positive. The announcement of the liberalisation measures has been followed by a significant inflow of non-resident capital. The inflow of venture capital, which had fallen by 7.7% during the first half of 1986, rose by 13.8% during the second half of the year, bringing about an overall annual increase of 3.8% in relation to 1985. This favourable trend was reaffirmed during 1987 when venture capital inflows increased by 30.7% in relation to 1986. To this contributed significantly the substantial inflow of capital for the purchase of Greek securities, as the revival of activity in the ASE attracted the interest of foreign investors[77].

The inflow of capital for the purchase of real estate followed a similar - and even more remarkable - path. While it had fallen by 9.1% during 1985 in relation to the previous year and by 13.8% during the first three months of 1986, it subsequently experienced an accelerating rate of increase, leading to an overall annual rise of 7.4% for 1986. During 1987 the inflow of capital for the purchase of real estate reached astonishingly high levels, increasing by 45.7% over 1986.

It is almost impossible, however, to disentangle the impact of the liberalisation measures on the aforementioned capital inflows from the impact of other favourable economic developments which took place during 1986 and 1987. The firm implementation of the stabilization programme brought about a general improvement in the business climate, by indicating that Greece is moving towards more sound policies for the solution of its economic problems. The increase in the profits of enterprises had a favourable impact on

TABLE 5

Financing of the current account deficit

Million US dollars

	1980	1981	1982	1983	1984	1985	1986	1987[1]
BALANCE ON CURRENT ACCOUNT	-2,216.1	-2,420.8	-1,885.1	-1,875.9	-2,130.1	-3,275.7	-1,772.1	-1,291.0
Private capital	**1,546.7**	**1,208.6**	**675.5**	**918.7**	**869.3**	**808.7**	**838.6**	**1,397.0**
Venture capital	502.4	409.9	304.4	313.4	246.2	289.7	300.6	393.0
For the purchase of real estate	599.0	487.8	398.9	422.9	473.8	430.9	462.7	674.0
Commercial banks	77.7	136.2	64.4	64.6	-46.4	186.3	-47.4	-63.0
Deposits with credit institutions	84.5	246.3	122.7	275.1	338.2	76.8	286.4	380.0
(Deposits by Greeks living abroad)	(97.4)	(177.3)	(157.2)	(262.9)	(294.8)	(85.2)	(301.9)	(346.0)
Suppliers' credit (net change)	328.1	17.0	-101.1	-29.1	21.1	-40.8	-33.8	151.0
Other	47.5	49.2	22.4	45.3	25.6	-32.2	-23.9	-22.0
Amortisation	-92.5	-137.8	-136.2	-173.5	-189.2	-102.0	-106.0	-116.0
Errors and Omissions	**14.8**	**364.3**	**-40.1**	**-357.2**	**-312.3**	**22.4**	**-80.9**	**389.0**
Difference from readjustment of the value of gold	—	—	—	—	—	**705.2**	**350.0**	**558.0**
BALANCE OF PAYMENTS BEFORE CENTRAL BANK AND PUBLIC SECTOR BORROWING	-654.6	-847.9	-1,249.7	-1,314.4	-1,573.1	-1,739.4	-664.4	1,053.0
Central Bank and Public Sector Borrowing	**723.8**	**692.4**	**1,103.4**	**1,384.7**	**1,607.9**	**2,339.9**	**1,257.3**	**322.0**
Central Bank	748.6	697.0	1,017.5	576.6	1,015.0	1.970.1	749.2	869.0
Government	44.4	95.6	118.7	204.8	124.1	167.9	910.4	1,017.0
Public enterprises and entities	354.4	438.2	567.7	1,114.3	1,076.5	916.4	557.8	405.0
Suppliers' credit (net change)	-17.1	-23.0	-26.3	14.5	-10.7	47.4	-2.4	-15.0
Amortisation	-406.5	-515.4	-574.2	-525.5	-597.0	-761.9	-957.7	-1,954.0
Allocation of SDRs	**25.5**	—	—	—	—	**-2.1**	—	—
BALANCE OF EXTERNAL TRANSACTIONS	94.7	-155.5	-146.3	70.3	34.8	598.4	592.9	1,375.0
IMF	109.1	74.2	12.1	28.0	---	---	---	---
Change in foreign exchange reserves	-1.4	-328.4	-177.4	30.5	61.4	631.0	625.8	1,378.1
Change in clearing accounts	-13.0	98.7	19.0	11.8	-26.6	-32.6	-32.9	-3.1

[1] Provisional Data

Source: Bank of Greece

investment prospects. Moreover, it led to a rise in the value of their shares. This together with a deceleration in the depreciation rate of the drachma, increased the expected rate of return on Greek securities. Consequently, their purchase appeared as a promising investment opportunity to foreign investors trying to diversify their portfolios. The government's recognition that devaluation does not constitute a feasible and desirable long-term solution also had a favourable impact on investor confidence.

Nevertheless, the contribution of the liberalisation measures to the increased inflow of investment capital is beyond doubt. Foreign individuals and enterprises investing in Greece, apart from pure economic factors, are also particularly concerned about their ability to repatriate their profits and capital at some point in the future, if they decide it is in their interest to do so. Restrictions on the repatriation of profits and capital can therefore operate as a disincentive and discourage capital inflows, while abolition of such restrictions usually brings about the opposite result. The adopted liberalisation measures were perceived as a sign of changing government attitudes towards more liberal, market-oriented policies and increased investor confidence over the safety and flexibility of their capital when investing in Greece.

However, it should be recognized that the abolition of restrictions on non-resident outward capital movements renders the balance of payments more vulnerable to changes in domestic and external economic factors. This is particularly true for investment by non-residents in Greek securities, which is a rather liquid and flexible form of investment. As the participation of foreign investors in the Greek capital market increases, so does the sensitivity of the capital account balance with respect to changes in differentials in the perceived risk-adjusted rate of return on Member States' securities. A deterioration in the rate of return on Greek securities, a rise in long-term interest rates abroad, or expectations about a devaluation of the drachma, could all lead to capital outflows, as investors try to maximize their profits and preserve the value of their assets. This, as we shall see later in our analysis, has important implications for the future conduct of Greek economic policy.

Outward capital movements by Greek residents falling within this category of capital operations are still subject to important restrictions. According to the Commission Decision 87/152/EEC, Greece must abolish these restrictions by 22 November 1988. Even if the decision is renewed and a further extension is obtained, at some point in the future Greece will have to abolish the existing restrictions. Here an attempt will be made to analyse the factors which will determine the effects of such an abolition.

- Direct investment:

This type of investment is mainly influenced by long-term considerations and is less affected by short-term factors and currency unrest. It is made and liquidated according to the investor's assessment of production conditions. While production conditions in other EEC Member States have a number of advantages in terms of infrastructure, natural resources, transport costs, know-how, etc., the disturbance from capital exports by residents for direct investment abroad is not expected to be great, especially if we take into account the relatively low competitiveness and small size of Greek enterprises in most sectors of the economy. Greek enterprises with a comparative advantage over European ones are usually found in labour intensive sectors. These enterprises are not likely to increase their competitiveness by investing in other Member States, where labour costs are higher[78]. Furthermore, investment abroad may entail higher costs for the acquisition of adequate information and for market research, and may involve greater uncertainty and risk. However, residents' interest in investing abroad may increase as Greek firms and entrepreneurs modernize and adapt to stiff competition within the EEC resulting from the completion of the internal market. The reaction of investors will depend, among other things, on the prevailing domestic economic situation. A lack of investment opportunities at home may induce investors to search for alternatives in other Member States. On the contrary, a favourable investment climate, like the present one, would tend to keep domestic investment resources at home and to attract foreign investment funds from abroad. Finally, it should also be noted that direct investment abroad by residents may in certain cases generate inflows of funds too, as investors repatriate part of their profits and capital gains.

- Investment in real estate and personal capital movements:

Investment in real estate can take place for the purpose of personal use, for securing a steady flow of income and/or for speculative reasons (i.e. expectation of capital gains from future appreciation of the value of the asset). Investors interested in owning property abroad for personal use are usually wealthy individuals and most of them may have already been able to export capital abroad for this purpose either legally (e.g. in the case of shipowners) or illegally. Those interested in purchasing real estate abroad for securing a steady flow of income, may decide to do so if the perceived net rate of return is higher compared to that on alternative equally riskless types of investment at home or abroad. However, due to the variety and specificity of factors influencing such decisions and to the important role played by personal preferences, it is particularly difficult to forestall even the approximate size of capital outflows for this purpose. As far as speculation is concerned, if we take into account the greater difficulty and higher cost of obtaining information about real estate price trends abroad, and the greater risk and uncertainty involved, it is hard to imagine that there will be many people in Greece interested in this form of speculative investment. Nevertheless, even in the case where large capital outflows for the purchase of real estate abroad created balance of payments problems, it would be relatively easy for the government to restrict and control them, trying to distribute them more equally over time.

The liberalisation of personal capital movements (gifts and endowments, inheritances, transfers of capital belonging to residents who emigrate, etc.) is not expected to affect greatly the balance of payments. The amounts of money involved in these transactions are usually not large. Furthermore, there have already been attempts to liberalise these transactions through international agreements.

- Operations in securities:

The liberalisation of operations in securities will provide savers with new opportunities for diversifying their portfolios and for increasing the rate of return on their investments. The crux of the matter is how investors are going to react. Firstly, a distinction must be made between institutional and individual investors.

Institutional investors consist of social funds, investment funds, insurance companies, some specialised credit institutions, such as the Postal Savings Bank, etc. The participation of these investors in the domestic capital market has been very limited until nowadays. The opening of new opportunities for investing in foreign low-risk fixed-income securites will offer them the chance to improve the rate of return on their investments. However, the fact that the majority of these institutions are controlled by the state may put limits on their freedom to take full advantage of new opportunities. Consequently, their reaction to the liberalisation will take into account the general macroeconomic objective of stability and will not create problems for the balance of payments. The rest of the institutional investors who are not controlled by the state will base their investment decisions on pure economic criteria; the comparison will be made between the rate of return on low-risk investments in securities at home and abroad.

Individual investors belong in different economic classes. The size of their wealth influences their reaction to the liberalisation of the purchase of foreign securites. For the top economic class consisting of shipowners and large industrialists nothing will actually change. The former have never been subjected to restrictions and could always move their capital outside Greece[79]. The latter, even when subjected to restrictions, have been able to circumvent controls and export much of their capital abroad. Approximately the same holds true for these individuals which, while not belonging in the top class, are nevertheless quite wealthy. However, the decisions of these individuals will not be unaffected by the liberalisation. The flexibility of investing their capital abroad will be increased, while the cost of doing so will be reduced (i.e. the cost of the commission charged to obtain foreign exchange and to transfer it illegally abroad will be eliminated), and there will be no more risks associated with the illegal export of capital. The change will be considerably greater for the individuals belonging to the lower economic classes. Each of them possesses a relatively small amount of investment capital, but the total of their savings is considerable. Until nowadays these individuals have mainly placed their savings in bank accounts and in real estate, and have stayed away from the capital market. The main reason behind this has been the small size and underdevelopment of the Greek capital market. After the liberalisation, these individuals will be free to invest in more sophisticated financial instruments in other Member States' capital markets. A lot will depend on their reaction.

At first sight, one could say that, in the absence of an economic crisis which would tend to increase investors' concerns about preserving the value of their capital, small investors will not take full advantage from the opportunity of investing in foreign securities. This is due to a variety of reasons. As far as shares are concerned, the risk of large losses frightens Greek investors, who have a remarkable lack of experience with investing in the stock market. Moreover, there are difficulties in obtaining information about the financial position of foreign enterprises. As far as low-risk securities are concerned, the possibly limited knowledge about existing opportunities abroad, the existence of higher transactions costs and the general perception that investment abroad is more risky and uncertain may tend to discourage residents from participating in other Member States' capital markets.

However, things are not static and the behaviour of small investors may change as they become better acquainted with the opportunities of investing in the stock exchange. The government's present policy to reform the banking system and to promote the development of the capital market may contribute to this. Furthermore, as progress is made towards the realization of a unified European market in financial services, long-established foreign brokerage firms with large groups of highly competent analysts and with experience in the field of portfolio management, may enter the Greek market. These firms may differ in the type of clientele they will try to build up. For instance, some may mainly deal with investors of modest means who are primarily interested in preserving their capital and securing a steady flow of income, while others may seek wealthier customers who are more interested in making large profits by investing a proportion of their savings in relatively high-risk securities. These firms may end up managing a large part of investors' savings. But such a change in investment attitudes of Greek investors, particularly small ones, may take a long time to occur.

Nevertheless, assuming that Greek investors will become more familiar with investing in the capital market, subsequent capital outflows for the purchase of foreign securities will depend on perceived differences in the rate of return between Greek securities and foreign ones. Since Greek residents are usually interested in the rate of return in domestic currency terms, the comparison will be made between the nominal rate of return on domestic securities (r_d) and the total rate of return on foreign securities in domestic currency. This latter comprises the nominal rate of return on foreign securities in foreign currency (r_f) and the expected change in the exchange rate of the drachma vis-à-vis the currency in which the security is denominated (e*), over a time-period equal to the term of the security[80]. An outflow of capital will result as long as [81]: $r_d < r_f + e^*$.

In normal periods, when no great changes in the exchange rate are expected, capital outflows will mainly be a function of differentials in the rate of return between domestic and foreign securities. Even if moderate depreciation of the drachma is expected, a higher nominal interest rate on Greek securities may compensate investors and persuade them to hold domestic assets instead of foreign ones. Moreover, as long as substitutability between domestic and foreign assets is not perfect - due to difficulties in information and/or to differences in investors' preferences associated with investing abroad - some negative difference may continue to exist between r_d and (r_f + e*), even after the liberalisation[82]. Therefore, if interest rates on Greek securities are set at competitive levels, the abolition of controls on portfolio operations in EEC securities need not create problems for the balance of payments.

On the other hand, however, the paucity of opportunities for investing in the ASE, due to its limited width and depth, may induce investors to turn to other Member States' capital markets for placing their savings. Indeed, the underdevelopment of the domestic capital market is one of the main factors making the liberalisation of operations in foreign securities particularly difficult. Studies by the OECD have shown that the countries imposing relatively strict restrictions on international portfolio operations "are in most cases precisely those where there have been relatively underdeveloped capital markets with a very narrow range of financial investments available to domestic investors"[83].

Futhermore, it should be noted that, immediately after the liberalisation of operations in EEC securities, capital outflows could occur for diversification purposes. International diversification can be an important instrument for reducing risk[84]. While the return of a portfolio is the weighted average of the returns of the individual stocks, the risk of a portfolio is not simply the sum of the component risks of the securites comprising it. This arises from the fact that the returns of individual securities may move together or interact to a certain degree, i.e. they may have a certain degree of covariance. By investing in foreign securities, this covariance is potentially reduced, since securities' prices in different EEC markets do not move together in a highly synchronized fashion. National economies are subject to different socioeconomic and political domestic forces and are affected in differing degrees by external economic disturbances. Since the returns on securities in different markets do not move in an identical manner, the opportunity exists to reduce the uncertainty of portfolio returns by diversifying accross EEC markets[85]. But the fact that Greek investors have little experience with investing in the stock exchange, implies that the immediate one-off diversification effect on the Greek balance of payments will probably be moderate. Diversification may take place more gradually, as Greek investors begin to make use of more sophisticated portfolio management techniques.

In periods of economic crisis, however, the emergence of strong expectations for devaluation of the drachma will tend to increase considerably the difference between r_d and $(r_f + e^*)$. Investors, trying to preserve the value of their capital, will rush out of drachma denominated assets into assets denominated in other EEC currencies considered to be stronger. Expectations about nominal exchange rate changes therefore become particularly important in determining capital flows. Investors' expectations are generally influenced by developments in real and nominal economic variables, such as productivity trends, shifts in the current account balance, and changes in inflation rate differentials. By observing these developments, investors try to determine whether a currency is overvalued or undervalued. If the current exchange rate is viewed as overvalued, then it is likely that the currency will be devalued at some point in the future. In Greece expectations about the future domestic inflation rate play a very important role. Investors' past experience with Greek exchange rate policy has shown that the government is unwilling to permit an excessive erosion of export competitiveness caused by large inflation rate differentials, and finally resorts to currency devaluation as a way to restore competitiveness.

Besides the pure economic factors, investors' expectations are also influenced by political and human factors which affect confidence. Whether the economy is in a good or bad shape, it is the monetary and fiscal policies of the government which attract attention. It is believed that the best way to protect the domestic currency is not by intervening in the foreign exchange markets, but by pursuing sound economic policies. Indeed, investors are great believers in economic policy conservatism and will act accordingly. The Greek experience of the last two years supports that view. Domestic and foreign investors have reacted favourably to the change in government policy attitudes, as evidenced by the remarkable increase in private capital inflows[86].

Therefore, in periods of economic and political uncertainty, capital seeks safety to the exclusion of all other factors. Even a big difference between r_d and r_f may not be sufficient to stem resident and non-resident capital outflows and to attract capital from abroad[87]. In such circumstances the adverse effects of large capital outflows on the balance of payments could be significant. As investors moved out of drachma denominated assets, the domestic currency would come under great pressure and would inevitably depreciate. Depreciation by raising import prices and by inducing offsetting nominal wage increases would result in an acceleration in the rate of inflation, further increasing the inflation differential between Greece and the other EEC Member States. This, in turn, would strengthen expectations about future devaluation further stimulating capital outflows. Expectations would in this way become self-fulfilling. Exchange rate changes could become greatly exaggerated and feed on themselves. A vicious circle of capital outflows-depreciation-inflation might result, which would be particularly difficult to break.

If the authorities intervened to support the drachma, they would deplete their reserves. Community credit mechanisms could help finance part of the loss in reserves. But intervention to support a currency is a policy unsustainable in the long run. The effectiveness of such a policy in the short run depends on its success in restoring confidence in the currency. Experience shows that when investors believe that economic policy is partly responsible for the crisis, it becomes particularly difficult for the domestic authorites to influence their decisions. The government, being unable to reverse the outflow of capital, would be obliged to reintroduce capital movement controls. But the effectiveness of controls would probably be even more limited than before. Moreover, once reintroduced, it would be extremely difficult to proceed to a re-relaxation of controls in the future. As the credibility of the government would be seriously impaired, investors would probably hurry to move their capital out of the country as soon as controls were lifted.

The above analysis makes clear that the liberalisation of outward capital movements by residents, which would allow Greece to comply with Community rules, would have to take place in a relatively stable macroeconomic environment. Otherwise, the consequences on the balance of payments could be significant[88]. Some prior development and strengthening of the domestic capital market would also be required. Subsequently, macroeconomic policy would have to be geared to the objective of external stability. The government would have to pursue a more active interest rate policy so as to ensure internationally competitive yields on domestic assets. This implies that yield differentials would have to vary in response to changing market expectations about exchange rates. In the absence of a sufficiently stable drachma, high interest rate differentials might become a market necessity in order to dissuade investors from moving their capital outside the country. This would be costly for the Greek economy. To avoid this cost it would be necessary and advisable to pursue a firm exchange rate policy aiming at currency stability. This would require keeping inflation rate differentials at low levels. This, in turn, would have implications for the conduct of fiscal policy, since it would deprive the government of the prerogative of financing a large part of its deficit through the so-called "inflation tax". The fiscal deficit would therefore have to be reduced at sustainable levels. Finally, the government would have to keep a predictable and credible stance with a view to strengthening investors' confidence in the economy and securing a stable economic environment favourable to investment.

B. The full liberalisation of capital movements

A similar method to the one used in the case of international portfolio operations in securities dealt in on the Member States capital markets can also be used for analysing the effects of the full liberalisation of financial operations in the Community. Resident and non-resident investors trying to decide whether to place their funds in Greece will compare nominal domestic interest rates with foreign interest rates suitably adjusted to take account for the expected exchange rate change of the drachma. As with operations in capital market securities, a negative difference between these two rates would result in capital outflows.

There are, however, tremendous quantitative and qualitative differences with the previous case. As far as Greece is concerned, this is particularly true for investments in deposits with banks. This is so for the following reasons. Firstly, the proportion of deposits with banks in the portfolios of the majority of Greek residents is particularly large. Secondly, this type of investment is sufficiently liquid, so that the related funds can easily be transferred from one Member State to the other. Thirdly, Greek investors are particularly familiar with this type of investment, and therefore it will be easier for them to recognize the existence of differences in the rate of return. While there may still be additional information and transactions costs associated with investing abroad, these are not likely to be large and are expected to diminish over time, as the financial integration of the Community increases. Finally, placing savings with the banking system is a low-risk investment; investing abroad instead of at home is not perceived as carrying increased risks as in the case of investing in capital market securities. Consequently, the existence of even small negative exchange-risk adjusted interest rate differentials between Greece and the other EEC Member States would normally result in massive and overwhelming capital outflows.

As Greek investors become better acquainted with existing opportunities for investing in short-term money market financial instruments, capital flows associated with this type of investment, will also become more responsive to expected interest rate and exchange rate changes.

The implications of the full liberalisation of capital movements are obviously far-reaching. However, they should be viewed within a framework of close monetary integration in the Community. The task of fully liberalising capital movements appears to be extremely difficult not only for Greece, but also for other countries, like France and Italy, which continue to apply exchange restrictions[89]. Full liberalisation of capital movements means that Greece as well as all other EEC Member States would have to manage the whole range of their interest rates and conduct their monetary policy with a view to maintaining exchange rate stability (or, in this case, fixity).

Concern is often expressed that growing capital flows stimulated by deregulation and financial innovation would create strong speculative disturbances in national economies. Especially in small countries, like Greece, it might be particularly difficult for the authorities to defeat speculators by intervening in the foreign exchange markets. But this concern is not necessarily warranted. In the event of speculative pressures, a strengthened EMS and a more efficient use of its ERM instruments, especially credit facility financing, could succeed in stabilizing exchange rates. Coordinated intervention based on commonly agreed criteria would potentially achieve recycling net capital flows and would publicly prove the governments' determination to prevent artificial market pressures from threatening the stability of the system.

Another more relevant concern is that Greece, having removed all its exchange controls, would be obliged to keep interest rates at very high levels in order to secure the external stability of the balance of payments, with adverse effects on future growth. While it is true that Greece will lose completely its already limited monetary autonomy, this loss need not necessarily be costly for the domestic economy. It is now widely recognized that decisions on exchange rate and monetary policy should be taken collectively and be based on common choices and that governments should take into account the external consequences of their policies. Interest rate policy should be coordinated with a view to preserving exchange rate stability and to maintaining real interest rates within an acceptable range in individual countries and across the EEC as a whole. In such a context Greece would be able to bear the fruits of the advantages deriving from an integrated European financial area, already discussed in Part I.

Going one step further, one could say that the fact that firms and individuals will have access to funds in any Community currency and will be able to denominate their savings in any of these currencies, would stimulate currency competition within the EEC, and the use of weak currencies, like the drachma, would tend to be eliminated[90]. The DM might become the hegemonic currency. However, as the experience of the Bretton Woods shows, this would not be a desirable development. Parallel measures would have to be taken to create the conditions in which a common European currency would assume a central role in the system.

Yet the challenges for Greece arising from the creation of a real monetary union would be considerable. For Greece and for the other less prosperous Member States to be able to cope with the increased strain imposed on them by the process of European monetary intergration, a strengthened EEC-wide system of regional transfers would also have to be established. This would aim at eliminating existing structural weaknesses in these Member States and at safeguarding the social and economic cohesion of the Community.

However, it is unavoidable to recognize that the aforementioned over-ambitious objectives could only be achieved in the distant future, since they presuppose considerable further progress in the field of political integration. Nevertheless, the desire for closer monetary coordination and cooperation and for the creation of a unified financial market in the EEC is real. The inefficiency and limited effectiveness of exchange controls is increasingly recognized and many Member States are making rapid progress towards liberalising capital flows. Greece has not been indifferent to that. It has also made some small hesitant steps towards relaxing a number of capital movement controls. For Greece to be able to proceed further in this field, a considerable economic adjustment effort is needed. Economic policy will have to play a central role in this effort.

3 Preconditions for proceeding towards the futher liberalisation of capital movements

From the above analysis it becomes obvious that Greece will not be able to comply with the Community Directives on the liberalisation of capital movements unless it continues the stabilization effort initiated in October 1985.

A deceleration of the rate of depreciation of the drachma and its gradual stabilization presuppose a considerable reduction in the rate of inflation which remains high in relation to that of Greece's main competitors. However, a firm exchange rate policy not accompanied by additional anti-inflationary measures on all other fronts would be biased against the tradeable goods sector and would tend to accentuate distortions in the economy. To avoid such a development, all instruments of macroeconomic policy should be employed in the fight against inflation. Overall nominal wage increases should be moderate. However, the sharp reduction in real disposable income during 1986 and 1987 implies that incomes policy cannot continue to carry the brunt of adjustment. More attention has to be paid to financial policies. Monetary policy should remain restrictive. But if the burden of monetary restraint is not to fall again excessively on the private sector, public sector deficits will have to be reduced. This, in turn, requires a sustained structural improvement in public sector finances aiming at increasing revenues and limiting expenditures. On the revenue side, further reforms are needed towards widening the tax base, abolishing long-established privileges and curbing tax evasion[91]. On the expenditure side, fundamental reforms are required, particularly in the social security system so as to better link contributions to benefits, in public sector employment with a view to increasing productivity and reducing overmanning, and in subsidies which remain large and tend to create or perpetuate economic inefficiencies. Important changes are also needed in the management and structure of public corporations and enterprises. The reduction of public deficits appears to be of utmost importance, particularly if we take into account that government spending tends to stimulate imports and to influence exports negatively through crowding-out mechanisms.

However, a firm exchange rate policy can in itself provide a powerful instrument for the reduction of inflation. As inflationary pressures subside, the possibility of the drachma joining the EMS should be seriously considered. Other Member States' experience shows that participation in the ERM of the EMS can contribute significantly to the success of domestic anti-inflationary strategies, thus facilitating economic policy convergence in the EEC. Moreover, participation in the ERM could strengthen investor confidence in the drachma and lead to increased capital inflows by both residents and non-residents[92].

As far as interest rate policy is concerned, an improved management of interest rates and a more efficient implementation of monetary policy presuppose considerable further progress in reforming the financial system. The persistence of direct credit controls deprive the monetary authorities of the ability to pursue a flexible monetary policy, which would be absolutely necessary under a less restrictive exchange control system. Therefore, efforts to liberalise interest rates, to eliminate inefficient direct credit controls, to introduce new financial instruments and techniques, and to stimulate competition between financial institutions should be strengthened. Measures should also be taken to create a forward market for the drachma and to liberalise the foreign exchange operations of banks. Progress in this field is made all the more essential in view of the growing competitive pressures resulting from the process of liberalising the supply of financial services in the EEC.

A vital component of the policy to reform the financial sector is the adoption of measures for developing and strengthening the capital market by increasing the supply and demand of securities and by modernizing the organizational and institutional framework of the ASE[93]. These measures are expected to provide better financing instruments for enterprises, to encourage savings by developing new ways of placement, to reverse capital flight and to stimulate the inflow of foreign capital, thus increasing available resources for productive investment.

However, financial reform becomes particularly difficult to implement when the PSBR and the inflation rate remain at high levels[94]. The fight against inflation therefore becomes of utmost importance. Of course, the economic adjustment required to stabilize the economy is not painless and costless. To minimize the costs, long-term efforts should be undertaken for expanding the productive base of the economy. The supply responsiveness of the economy should be improved, so as to gradually reduce the inelasticity of imports and accommodate a sustained growth of exports. This latter is crucial for the simultaneous achievement of a moderate rate of GDP growth and a sustainable external balance. Again, however, we should stress that the increase in investment activity required for a growth in exports is unlikely to occur in an inflationary irrational environment.

Finally, the improvement in the business climate evidenced in 1986 and 1987 should be maintained and indeed strengthened by reducing existing rigidities in the labour and goods markets. Furthermore, the credibility and predictability of economic policy should be enhanced. This would have a favourable impact on investors' expectations and consequently on economic stability, and would facilitate the restructuring of the economy[95].

In conclusion, the measures required for proceeding towards the further relaxation of exchange controls are precisely those which are essential for the general economic progress of the country. The implementation of the aforementioned recommendations in the fields of exchange rate, monetary and fiscal policy will lay the foundations of a stable economic environment favourable to investment and of an economy adequately strengthened to cope with the challenge of European financial integration.

Notes and References

[1] See BIS, Fifty-Seventh Annual Report, Basle, June 1987; Dini L., "Towards a European integrated financial market", Banca Nazionale del Lavoro Quarterly Review, No 159, Rome, December 1986; Eurépargne, "L'explosion des marchés de capitaux", No 11-12, Luxembourg, août/septembre 1987; Plender J., "The dangers of deregulation", Deutsche Bundesbank, Auszeuge aus pressartikeln, No 35, Frankfurt, 9.5.1986; and White B. and Vittas D., "Barriers in International Banking", Lloyds Bank Review, No 161, London, July 1986.

[2] Most significant in this respect has been the considerable increase in US external financing requirements. In 1985 the US became a net debtor nation for the first time in the postwar period.

[3] OECD, Controls on International Capital Movements: The experience with controls on international financial credits, loans and deposits, Paris, 1982, p. 17. For an assessment of the effectiveness of exchange controls in different OECD countries, see also Finance - the journal of Ireland's money and capital markets, "Exchange Controls", Dublin, 1987; Hewson J. and Sakakibara E., "The impact of US controls on capital outflows on the US balance of payments", IMF Document, Washington, June 1974; Hewson J. and Sakakibara E., "The effectiveness of German controls on capital inflows", IMF Document, Washington, January 1975; OECD, Controls on International Capital Movements: Experience with controls on international portfolio operations in shares and bonds, Paris, 1980.

[4] Baché J., "La libération des mouvements de capitaux et l'intégration financière de la Communauté", Revue du marché commun, No 304, Paris, février 1987, pp. 80-81.

[5] See Europe/Documents, "Programme for the liberalisation of capital movements in the Community", No 1407, 13 June 1986.

[6] OJ No L 43 of 12.07.1960; and OJ No L 9 of 22.01.1963.

[7] Even the FRG, a country with a traditionally liberal attitude towards capital movements, had to introduce extensive controls during the period 1968-73 when large capital inflows created serious obstacles to the achievement of domestic monetary objectives. These controls, however, were lifted during later years. For an evaluation of the effectiveness of the German controls on capital inflows, see Hewson and Sakakibara (1975), op.cit.

[8] With the exception of a dual exchange market in Belgium and Luxembourg.

[9] Particularly impressive was the economic strength of the FRG and the emergence of the DM as the second most important international reserve currency. For more on that issue, see Ludlow P., The making of the European Monetary System, Butterworths European Studies, London, 1982.

[10] COM (83) 207.

[11] COM (86) 292 final.

[12] OJ No L 332 of 26.11.1986. Date of entry into force: 28.02.1987.

[13] COM (87) 550 final.

[14] OJ No L 91 of 18.04.1972.

[15] A detailed account of exchange restrictions in all EEC Member States is outside the scope of this study. A more extensive mention will only be made for the case of Greece as a necessary background to the second part of the study. For a detailed account of other Member States' exchange restrictions, see IMF, Annual Report on Exchange Arrangements and Exchange Restrictions, Washington, 1987.

[16] See Swings A.A.L., "Entraves aux mouvements de capitaux dans la Communauté européenne", Eurépargne, No 10, Luxembourg, Octobre 1984.

[17] See Carsten F.J. and Hald J., "Foreign-exchange liberalization and capital movements", Denmark's National Bank Monetary Review, Vol. 24, No 4, Copenhagen, February 1986.

[18] See Speich N., La France et la libre circulation des capitaux en Europe, Parlement Européen, Dossiers de Recherche et Documentation, Série économique No 11, 9/1987.

[19] See Kredietbank, "La libération des mouvements de capitaux dans la Communauté européenne", Bulletin hebdomadaire, No 34, Bruxelles, 25.9.1987.

[20] See OECD, Economic Outlook, No 42, Paris, December 1987.

[21] However, it has been argued that the present economic situation in Ireland allows a further relaxation of controls on capital movements which anyway have in many cases been ineffective. See Finance - the journal of Ireland's money and capital markets, op.cit.

[22] OJ No L 5 of 8.1.1988. According to this decision, a number of exchange control relaxations are to be made with effect from 1 January 1988.

[23] OJ No L 373 of 31.12.1985; and OJ No L 63 of 6.3.1987.

[24] See Situation, "Main legal developments concerning the foreign sector", No 8, Bilbao, November 1985.

[25] See Act of Accession, articles 61 to 66 for Spain and 222 to 232 for Portugal. See also article 2 of the Directive 86/566/EEC.

[26] See Baché, op.cit.; Europe/Documents, op.cit.; and European Economy, Annual Economic Report 1987-88, No 34, Brussels, November 1987.

[27] White Paper COM (85) 310 final; and Single European Act, Bulletin of the European Communities, Supplement II/1986.

[28] It should also be mentioned that the FRG has set the liberalisation of capital movements between Member States as a necessary precondition for proceeding to the further reinforcement of the EMS.

[29] The Commission recognizes the existence of serious problems in this field, but argues that their solution should not be regarded as a necessary precondition for the implementation of the programme for the full liberalisation of capital movements. In its opinion, a unified European financial area should be realized by creating a dynamic process towards integration and by accepting some disequilibrium at the beginning; the liberalisation of capital movements - the Commission argues - will itself provide the momentum for this dynamic process.

30 For a discussion of the advantages and costs of financial liberalisation and of the possible ways to protect the stability of the financial system by upgrading and coordinating regulation internationally, see BIS, op.cit., pp. 85-89.

31 COM (87) 715 final.
The mutual recognition of authorizations and supervisory systems is founded on the prior harmonization of a number of essential rules (e.g. the establishment of an adequate level of initial capital, supervision of the major shareholders of credit institutions, limitation of the size of equity participations of credit institutions in non-financial undertakings).

32 See BBL, "Vers une Europe des services financiers", Bulletin Financier, Bruxelles, 18.2.1987; Burani U., "Bilan de l'action Communautaire dans le secteur bancaire", Revue du marché commun, No 307, Paris, mai-juin 1987; Dini, op.cit.; Kredietbank, op.cit.; and Young J., "A Free Market for Banking", The Economist Intelligence Unit, European Trends No 4, London 1987.

33 See European Economy, op.cit.; Mingasson J. "Programme pour une libération des mouvements de capitaux dans la Communauté", Forex club, Luxembourg, 25 novembre 1986; and Problèmes économiques, "Libéralisation des mouvements de capitaux: Un test pour le SME", No. 2004, Paris, 24 décembre 1986.

34 Two other exssential measures for the further strengthening of the EMS, as well as for the expansion of the role of the Ecu, are: a) the adoption of a common exchange rate policy vis-à-vis the dollar, and b) the participation of the UK in the ERM.

35 Other more technical - but with far-reaching implications - changes in the mechanisms of the EMS are: the extension of the maximum duration of very short-term financing from two-and-a-half to three-and-a-half months, the doubling of the amount of financing eligible for automatic renewal and the changing from 50% to 100% of the accepted limit for repayment in official ECUs.
Furthermore, in the Nyborg meeting, it was decided that central bank governors of the member states should meet regularly in order to examine a set of economic indicators (e.g. real economic activity and nominal income levels, inflation rate, money supply growth rate). Although no such obligation exists, it is hoped that multilateral consultations will lead to more common attitudes in the field of economic policy.

36 On the other hand, of course, as we have already said in previous sections, capital movement liberalisation can itself stimulate greater monetary policy cooperation. This is what has already happened in the field of exchange rates: the constraints imposed by the EMS as well as its successful operation contributed significantly to convergence towards lower inflation rates.

37 For a detailed explanation and assessment of the pivotal role of the DM in determining the EMS-dollar policy see Kyriazis N., US-EC Monetary Relations, European Parliament, Research and Documentation Papers, Economic Series No. 8, 2nd revised edition, 11-1986.

38 See Economou G., The Price and Incomes Policy in Greece, KEPE, Athens 1981 (in Greek); and Tsoris N.D., The Financing of Greek Manufacture, KEPE, Studies No. 8, Athens 1984.

[39] The term "automonous" must be qualified. In fact capital inflows were attracted to Greece by a multitude of government incentives. See Maroulis D., Economic Development and the Structure of the Balance of Payments, KEPE, Studies No. 18, Athens 1986.

[40] Most OECD countries after 1975 began to implement anti-inflationary measures for the stabilization of their economies. In Greece such measures were not introduced until the second half of 1978 and even then their success was limited.

[41] See Economou, op.cit.; IOBE, Public Expenditure and Inflation, Athens 1979 (in Greek); Panayiotopoulos D., Monetary Policy in Greece, Athens 1984 (in Greek); and Tsoris, op.cit.

[42] See OECD, "Greece", Economic Surveys, Paris, July 1987.

[43] See OECD (July 1987), ibid; and Panayiotopoulos (1984), op.cit.

[44] An attempt was made in 1983 to pursue a more restrictive incomes policy, but was not accompanied by sufficient additional measures.

[45] See OECD (July 1987), ibid.
In 1983, to prevent over-indebted firms from going bankrupt, the socialist government created the Organization for the Reconstruction of Enterprises which took over the management of the so-called problematic firms. Despite the adoption of a number of welcome measures, these firms continue to incur sizeable losses, which remain a serious problem for the Greek economy.

[46] The persistent trade deficits in the Greek balance of payments are structural and reflect the relative underdevelopment of the tradeable goods industries and the inability of the manufacturing sector to adjust to stiff competition from low-cost producer countries and to changes in international trade and demand patterns. This inability has been exacerbated by the high level of protection enjoyed by Greek industry prior to accession to the EEC, by large government subsidies, by labour market rigidities and by a wide-ranging regulation of markets.

[47] The belief in expansionary economic policy was based on the existence of a trade-off between unemployment and the inflation rate, as expressed by the well-known Phillips curve. However, economic theory as well as empirical evidence point out that the Phillips relation has lost its validity since the beginning of the 1970s. The fact that nowadays expectations adapt much faster than in the past means that the Phillips curve is vertical in the long-run. This holds true for Greece too.
For empirical evidence on the Phillips curve in Greece, see Panayiotopoulos D., "The Phillips curve and the Greek experience", Spoudai, Vol. ΛΒ', No. 1, Athens 1982.

[48] The plan was supported by the Community authorities who granted a balance of payments loan of 1.75 bn Ecu phased in two tranches.

[49] For more details see OECD, "Greece", Economic Survey, Paris, January 1986.

[50] This import-deposit scheme was abolished in 1987.

[51] See Bank of Greece, Report of the Governor for the year 1986, Athens 1987 (in Greek); The Economist Intelligence Unit, "Greece", Country Report,

Analysis of Economic and Political Trends Every Quarter, No. 4, London 1987; European Economy (1987), op.cit.; OECD (July 1987), op.cit.; and OECD (December 1987), op.cit.

[52] In an attempt to facilitate the sales of treasury bills, interest rates have been raised to a range of 17.5-19.5%.

[53] The average level of the rise in the consumer price index was 19.3% in 1985, 23% in 1986 and 16.4% in 1987.

[54] See Maroulis D., "Exchange rate policy and competitiveness", Economicos Tachydromos, Athens, 17.10.1985 (in Greek).

[55] The nominal exchange rate (NER) does not tell us the rate at which real goods and services can be swapped between different countries. The real exchange rate (RER) endeavours to answer that question by modifying the NER to allow for differences in price levels. Thus we have: $RER = NER \frac{Pd}{Pf}$ where Pd is the domestic price level and Pf the foreign price level.

[56] Trade volumes are likely to respond slowly to exchange rate changes as plans are changed and contracts re-drawn.
Moreover, since traded manufactured goods are usually invoiced in the currency of the exporter, the domestic-currency prices of exports will remain unchanged (at least in the short run), while those of imports will rise. This will bring about a deterioration in the current account until export and import volumes have responded sufficiently to offset the unfavourable change in the terms of trade. This is the so-called J-curve effect.

[57] See Allsopp C., "Inflation", in A. Boltho, The European Economy: Growth and Crisis, Oxford 1982; Kyriazis N., The Drachma's adhesion to the EMS: possible effects, European Parliament, Research and Documentation Papers, Economic series No. 5, 5-1983; Parkin J.M., "Monetary union and stabilization policy in the European Community", Banca Nazionale del Lavoro Quarterly Review, Rome, September 1976.

[58] See Panayiotopoulos (1984), op.cit.

[59] Bank of Greece (1987), op.cit., p. 26.

[60] See Demopoulos G., Monetary Policy in the Open Economy of Greece, KEPE, Athens 1981; Papaioannou G.I., The development of direct financing in Greece, KEPE, Studies No. 27, Athens 1986 (in Greek); Panayiotopoulos (1984), op.cit.; and Report on the Reform and Modernization of the Banking System, Union of Greek Banks, Contemporary Issues No. 5, Athens 1987 (in Greek).

[61] For an assessment of the prerogatives enjoyed by commercial banks, see Halikias D.I., Possibilities and Problems of Credit Policy: The Greek experience, Bank of Greece, Archive of studies and speeches, Athens 1976 (in Greek).

[62] For more details on the operational framework of the ASE, see Kotitsas G.D., The Athens Stock Exchange: Organization-Operation-Investments, Athens 1979 (in Greek).

[63] See Niarchos N.A., "The Stock Market in Greece: An Emerging Market", World

Convention of Fast Growing Companies, Montreal, 11 September 1987; and Papaioannou, op.cit.

64 See Bank of Greece (1987), op.cit.; Kyriazis (1983), op.cit.; Papaioannou, op.cit.; Panayiotopoulos (1984), op.cit.; and Report on the Reform and Modernization of the Banking System, op.cit.

65 Of course, the allocation of resources which results from the free interaction of market forces may not be optimal from a social point of view. State intervention may therefore be needed to direct resources towards uses that are socially desirable. However, this should be done through simple transparent methods, such as direct transfers, the cost of which will appear in the budget, and not by interfering with the price mechanism. In the latter case, the distortions generated may incur an unacceptably high cost for the economy.

66 See Bank of Greece (1987), op.cit.

67 For a detailed account of the adopted measures, see Valamvanos V., "What has happened, what will happen in the banking system", Agora, Athens, 4.1.1988 (in Greek). An account of these measures will also be included in the Report of the Governor of the central bank expected to be published later this year.

68 See Nicolaou N., "Reserved optimism for 1988", Economicos Tachydromos, Athens, 14.1.1988 (in Greek).

69 See Bank of Credit, "Experience from the first steps of liberalism in the banking system", Economic Bulletin, No 36, Athens, November 1987 (in Greek).

70 The dual gap analysis has been widely criticised for its unrealistic assumptions and its theoretical deficiencies (see Maroulis (1986), op.cit.). Here, however, we will be concerned with how the policy options based on this analysis have worked in practice in the case of Greece.

71 See Khan M.S. and Ul Haque N., "Capital Flight from Developing Countries", Finance and Development, A Quarterly Publication of the IMF and the World Bank, Volume 24, No 1, Washington, March 1987; and Lessard D.R. and Williamson J., Capital Flight: The Problem and Policy Responses, IIE series on Policy Analyses in International Economics, No 23, Washington, 1987.

72 See Roumeliotis P., Multinational companies and overpricing-underpricing in Greece, Athens, 1978 (in Greek).

73 See OECD (1980) and OECD (1982), op.cit.

74 See Bank of Greece, op.cit., p. 33. See also p. 46 where it is admitted that in a country like Greece, for which invisibles and private capital inflows are the main sources of foreign exchange, the effectiveness of exchange restrictions is limited.

75 For a discussion of existing difficulties in this field, see OECD, Exchange Rate Management and the Conduct of Monetary Policy, Paris, 1985, Annexes II and III.

76 Among other things, it is also difficult to know whether the existence of

administrative complexities has so far delayed the export of profits, dividends, etc., of foreign enterprises. See Bernitsas P.M., "Some very recent developments in the field of capital movements", Economicos Tachydromos, Athens, 22.10.1987 (in Greek).

77 Data obtained from the Bank of Greece. Unfortunately in published statistics no distinction is made between capital inflows for direct investment and capital inflows for the purchase of securities. This lack of data creates additional difficulties for our analysis.

78 See Roumeliotis P., The economic crisis and Greece's accession to the EEC, Athens 1980 (in Greek).

79 See also Kyriazis N., Greece's accession to the European Community, European Parliament, Research and Documentation Papers, Economic series No. 4, 8-1982.

80 In our analysis we assume that the nominal rates of return r_d and r_f are adjusted to account for differences in transaction costs and in taxation. For an assessment of the various issues arising from differences in taxation between Member States see again Section 4.2 of Part I.
We also assume that the government will not create administrative and bureaucratic obstacles which will artificially raise the cost of acquiring foreign securities.

81 For convenience of exposition and for analytical reasons, we assume that a uniform rate of return on securities exists throughout the market. In reality, however, different rates of return exist for different types of securities. The comparison made by investors is between the rate of return on securities which are perceived as equivalent in terms of risk.

82 It should be noted, however, that as progress is made in the technological sophistication of the Greek financial sector, existing difficulties in obtaining information are likely to be eliminated.

83 OECD (1980), op.cit., p. 29.

84 See Fischer D.E. and Jordan R.J., Security Analysis and Portfolio Management, Fourth edition, Prentice Hall Inc., New Jersey, 1987.

85 Of course, as EEC capital markets become more closely integrated, prices will tend to follow an increasingly similar path.

86 It is also the experience of other countries that nowadays investors react promptly by shifting their assets when confidence in economic policy is undermined. See Carsten and Hald, op.cit.

87 In Denmark, for example, during periods of currency unrest, capital outflows occurred despite the existence of large interest rate differentials in favour of domestic securities. See Carsten and Hald, ibid.

88 However, the fact that it is particularly difficult to quantify the possible capital outflows imposes serious constraints on our ability to draw any concrete conclusions on the effects of the liberalisation of the aforementioned capital operations.

89 These countries have in the past used exchange controls to sever the link

between domestic and Eurocurrency interest rates. While the effectiveness of controls has been particularly limited in recent years, restrictions (especially those on non-resident borrowing in domestic markets) have played some role in limiting speculative pressures and in defending central rate parities in the EMS.

[90] On the other hand, of course, as monetary and economic policies converge and monetary stability is achieved in all Member States the distinction between strong and weak currencies would tend to blur.

[91] An important step to modernize the tax system has been taken by the introduction of the VAT in 1987. At the end of 1987 some welcome changes in direct taxation were also announced. But further reforms are still required.

[92] For a detailed assessment of the potential advantages of exchange rate stability for a small open economy, like Greece, see Kyriazis (1983), op.cit.

[93] For proposals concerning the development of the Greek capital market, see Papaioannou, op.cit., and Report on the Reform and Modernization of the Banking System, op.cit.

[94] See Edwards S., "Sequencing Economic Liberalisation in Developing Countries", Finance and Development, Vol. 24, No. 3, Washington, September 1987, and Report on the Reform and Modernization of the Banking System, ibid.

[95] Community credit and transfer mechanisms can certainly contribute to the restructuring of the Greek economy, but economic policy will still have to play the central role.

A N N E X

A_N_N_E_X

FIRST COUNCIL DIRECTIVE

of 11 May 1960

for the implementation of Article 67 of the Treaty[1]

THE COUNCIL OF THE EUROPEAN ECONOMIC COMMUNITY,

Having regard to the Treaty, and in particular Articles 5, 67 (1), 69, 105 (2) and 106 (2) thereof,

Having regard to the proposal from the Commission, which consulted the Monetary Committee for this purpose,

Having regard to the Decision of 11 May 1960 on the application to Algeria and to the French overseas departments of the provisions of the Treaty concerning capital movements,

Whereas the attainment of the objectives, of the Treaty establishing the European Economic Community requires the greatest possible freedom of movement of capital between Member States and therefore the widest and most speedy liberalization of capital movements,

HAS ADOPTED THIS DIRECTIVE,

Article 1

1. Member States shall grant all foreign exchange authorizations required for the conclusion or performance of transactions or for transfers between residents of Member States in respect of the capital movements set out in List A of Annex I to this Directive.

2. Member States shall enable such transfers of capital to be made on the basis of the exchange rate ruling for payments relating to current transactions.

Where such transfers are made on a foreign exchange market on which the fluctuation of exchange rates are not officially restricted, this obligation shall be taken to mean that the exchange rates applied must not show any appreciable and lasting differences from those ruling for payments relating to current transactions.

The Monetary Committee shall watch closely the trend of exchange rates applied to such transfers of capital, and shall report thereon to the Commission. If the Commission finds that these rates show appreciable and lasting differences from those ruling for payments relating to current transactions, it shall initiate the procedure provided for in Article 169 of the Treaty.

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(1) Text incorporating the amendments contained in the Second Council Directive of 18 December (63/21/EEC) and in Article 29 of the Act of Accession of 22 January 1972 and in the Council Directives 85/583/EEC of 20 December 1985 and 86/566/EEC of 17 November 1986.

This text is not an official document. It should also be noted that the new Commission proposal for the full liberalisation of capital movements implies that there will be no more need for different lists of capital operations. Moreover, according to this proposal a number of amendments should be made in the nomenclature.

Article 2

Deleted

Article 3

1. Subject to paragraph 2 of this Article, Member States shall grant all foreign exchange authorizations required for the conclusion or performance of transactions and for transfers between residents of Member States in respect of the capital movements set out in List B of Annex I to this Directive.

2. When such free movement of capital might form an obstacle to the achievement of the economic policy objective of a Member State, the latter may maintain or reintroduce the exchange restrictions on capital movement which were operative on the date of entry into force of this Directive (in the case of new Member States, the date of accession). It shall consult the Commission on the matter.

The Commission shall examine the measures, for coordinating the economic policies of Member States which will enable these difficulties to be overcome and, after consulting the Monetary Committee, shall recommend their adoption by the Member States.

3. The Commission may recommend that the State in question abolish the exchange restrictions which are maintained or reintroduced.

Article 4

The Monetary Committee shall examine at least once a year the restrictions which are applied to the capital movements set out in the lists contained in Annex I to this Directive; it shall report to the Commission regarding restrictions which could be abolished.

Article 5

1. The provisions of this Directive shall not restrict the right of Member States to verify the nature and genuineness of transactions or transfers, or to take all requisite measures to prevent infringements of their laws and regulations.

2. The Member States shall undertake not to render more difficult the autorization procedures required on the date of entry into force of this Directive. They shall simplify as far as possible the authorization and control formalities applicable to the conclusion and performance of transactions and transfers and shall where necessary consult one another with a view to such simplification.

3. The restrictions on capital movements under the rules for establishment in a Member State shall be abolished pursuant to this Directive only in so far as it is incumbent upon the Member States to grant freedom of establishment in implementation of Articles 52 to 58 of the Treaty.

Article 6

Member States shall endeavour not to introduce within the Community any new exchange restriction affecting the capital movements that were liberalized at the date of entry into force of this Directive (in the case of new Member States, the date of accession) nor to make existing provisions more restrictive.

Article 7

Member States shall make known to the Commission, not later than three months after the entry into force of this Directive (in the case of new Member States, three months after the date of accession):

(a) the provisions governing capital movements at the date of entry into force of this Directive which are laid down by law, regulation or administrative action;

(b) the provisions adopted in pursuance of the Directive;

(c) the procedures for implementing those provisions.

They shall also make known, not later than the time of entry into force thereof, any new measures going beyond the obligations of this Directive, and any amendment of the provisions governing the capital movements set out in List C of Annex I to this Directive.

Article 8

Deleted

Article 9

This Directive shall apply without prejudice to the provisions of Articles 67 (2), 68 (3) and 221 of the Treaty.

Article 10

Lists A, B and C contained in Annex I, together with the Nomenclature of Capital Movements and the Explantatory Notes in Annex II, form an integral part of this Directive.

Done at Luxembourg, 11 May 1960.

For the Council

The Secretary-General CALMES

The President Eugène SCHAUS

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ANNEX I

LIST A

Capital movements referred to in Article 1 of the Directive

	Heading
Direct investments	I
excluding purely financial investments made with a view only to giving the persons providing the capital indirect access to the money or capital market of another country, through the creation of an undertaking or participation in an existing undertaking in that country	
Liquidation of direct investments	II
Admission of an undertaking's securities to the capital market	III A 1 and 2 III B 1 and 2
— Shares and other securities of a participating nature, dealt in on or in the process of introduction to a stock exchange in a Member State	
— Bonds dealt in on or in the process of introduction to a stock exchange in a Member State	
— Units of undertakings for collective investment in transferable securities covered by Directive 85/611/EEC [1], without prejudice to the provisions of that Directive relating to the marketing of UCITS units (Section VIII)	
Operations in securities	IV
— shares and other securities of a participating nature	
— bonds	
— units of collective investment undertakings	
— units of collective investment undertakings dealt in on a stock exchange	
— units not dealt in on a stock exchange	
— of undertakings for collective investment in transferable securities covered by Directive 85/611/EEC	
— of other collective investment undertakings the sole object of which is investment in transferable securities or other assets the acquisition of which has been liberalized	
Investments in real estate	V
Grant and repayment of credits in connection with commercial transactions or the provision of services in which a resident is participating	VII I A and B
Personal capital movements	
Gifts and endowments	X B
Dowries	X C
Inheritances	X D
Settlement of debts in their countries of origin by immigrants	X E
Transfers	X F
Transfers of capital belonging to emigrants returning to their countries of origin	X G
Transfers of workers' savings during their periods of stay	X H
Transfers by instalments of blocked funds belonging to non-residents by the holders of such funds in case of special hardship	X I
Annual transfers of blocked funds to another Member State by a non-resident account holder, up to an amount or proportion of the total assets, fixed uniformly by the Member States concerned for all applicants	X L
Transfers abroad of minor amounts	X M
Transfers in performance of insurance contracts	XI
as and when freedom of movement in respect of services is extended to those contracts in implementation of Articles 59 *et seq.* of the Treaty	

[1] Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). OJ No L 375, 31. 12. 1985, p. 3.

	Heading
Sureties, other guarantees and rights of pledge and transfers connected with them relating to	
credits in connection with commercial transactions or the provision of services in which a resident is participating	XII A and B in conjunction with VII 1 A and B
long-term loans with a view to establishing or maintaining lasting economic links	XII A and B in conjunction with I A 3 B 3
Other capital movements	
Death duties	XIV A
Damages (where these can be considered as capital)	XIV B
Refunds in cases of the cancellation of contracts and refunds of uncalled-for payments (where these can be considered as capital)	XIV C
Authors' royalties	
Patents, designs, trade marks and inventions (assignment and transfers arising out of such assignments)	XIV D
Transfers of the moneys required for the provision of services	XIV E

The use of the proceeds of the liquidation of assets abroad belonging to residents must be permitted at least within the limits of the obligations as regards liberalization accepted by Member States.

LIST B

Capital movements referred to in Article 3 of the Directive

	Heading
Admission of an undertaking's securities to the capital market	III A 1 and 2 III B 1 and 2
Shares and other securities of a participating nature, not dealt in on or in the process of introduction to a stock exchange in a Member State	
Bonds not dealt in on or in the process of introduction to a stock exchange in a Member State	
Units of collective investment undertakings not covered by Directive 85/611/EEC	
Operations in securities	
Units, not dealt in on a stock exchange, of collective investment undertakings not covered by Directive 85/611/EEC, the sole object of which is not investment in transferable securities or other assets the acquisition of which has been liberalized	IV
Grant and repayment of medium- and long-term credits in connection with commercial transactions or the provision of services in which no resident is participating	VII 2 A (ii) and (iii) B (ii) and (iii)
Grant and repayment of medium- and long-term loans and credits not in connection with commercial transactions or the provision of services	VIII A (ii) and (iii) B (ii) and (iii)
Sureties, other guarantees and rights of pledge and transfers connected with them and relating to:	
medium- and long-term credits in connection with commercial transactions or the provision of services in which no resident is participating	XII A and B in conjunction with VII 2 A (ii) and (iii) B (ii) and (iii)
medium- and long-term loans and credits not in connection with commercial transactions or the provision of services	XII A and B in conjunction with VIII A (ii) and (iii) B (ii) and (iii)

The use of the proceeds of the liquidation of assets abroad belonging to residents must be permitted at least within the limits of the obligations as regards liberalization accepted by Member States.

LIST C

Capital movements referred to in Article 4 of the Directive

	Heading
Short-term investments in treasury bills and other securities normally dealt in on the money market	VI
Opening and placing of funds on current or deposit accounts, repatriation or use of balances on current or deposit accounts with credit institutions	IX
Grant and repayment of short-term credits in connection with commercial transactions or the provision of services in which no resident is participating	VII 2 A (i) B (i)
Grant and repayment of short-term loans and credits not in connection with commercial transactions or the provision of services	VIII A (i) B (i)
Personal capital movements	
loans	XA
Sureties, other guarantees and rights of pledge and transfers connected with them relating to	
short-term credits in connection with commercial transactions or the provision of services in which no resident is participating	XII A and B in conjunction with VII 2 A (i) B (i)
short-term loans and credits not in connection with commercial transactions or the provision of services	XII A and B in conjunction with VIII A (i) B (i)
private loans	XII A and B in conjunction with XA
Physical import and export of financial assets	XIII
Other capital movements : Miscellaneous	XIV F'

ANNEX II

NOMENCLATURE OF CAPITAL MOVEMENTS

I. DIRECT INVESTMENTS[1]

A. *Direct investments on national territory by non-residents[1]*

1. Establishment and extension of branches of new undertakings belonging solely to the person providing the capital, and the acquisition in full of existing undertakings

2. Participation in new or existing undertakings with a view to establishing or maintaining lasting economic links

3. Long-term loans with a view to establishing or maintaining lasting economic links

4. Reinvestment of profits with a view to maintaining lasting economic links

B. *Direct investments abroad by residents[1]*

1. Establishment and extension of branches or new undertakings belonging solely to the person providing the capital, and the acquisition in full of existing undertakings

2. Participation in new or existing undertakings with a view to establishing or maintaining lasting economic links

3. Long-term loans with a view to establishing or maintaining lasting economic links

4. Reinvestment of profits with a view to maintaining lasting economic links

[1] See Explanatory Notes, pp. 98-99.

II. LIQUIDATION OF DIRECT INVESTMENTS

A. *Repatriation of the proceeds of the liquidation[1] of direct investments on national territory by non-residents*

1. Principal

2. Capital appreciation

B. *Use of the proceeds of liquidation of direct investments abroad by residents*

1. Principal

2. Capital appreciation

III. ADMISSION OF SECURITIES TO THE CAPITAL MARKET

A. *Admission of securities of a domestic undertaking to a foreign capital market*

1. Introduction[1] on a foreign stock exchange

(a) of shares and other securities of a participating nature

(b) of bonds

(i) denominated in national currency

(ii) denominated in foreign currency

(c) units of collective investment undertakings

2. Issue and placing[1] on a foreign capital market

(a) of shares and other securities of a participating nature

(b) of bonds

(i) denominated in national currency

(ii) denominated in foreign currency

B. *Admission of securities of a foreign undertaking to a domestic capital market*

1. Introduction on a domestic stock exchange

(a) of shares and other securities of a participating nature

(b) of bonds

(i) denominated in national currency

(ii) denominated in foreign currency

(c) units of collective investment undertakings

2. Issue and placing on a domestic capital market

(a) of shares and other securities of a participating nature

(b) of bonds

(i) denominated in national currency

(ii) denominated in foreign currency

(c) units of collective investment undertakings

C. *Admission of domestic securities of the public sector to a foreign capital market pursuant to Article 68 (3) of the Treaty*

1. Introduction of securities on a foreign stock exchange

(a) denominated in national currency

(b) denominated in foreign currency

2. Issue and placing of securities on a foreign capital market

(a) denominated in national currency

(b) denominated in foreign currency

D. *Admission of foreign securities of the public sector to a domestic capital market pursuant to Article 68 (3) of the Treaty*

1. Introduction of securities on a domestic stock exchange

(a) denominated in national currency

(b) denominated in foreign currency

2. Issue and placing of securities on a domestic capital market

(a) denominated in national currency

(b) denominated in foreign currency

IV. OPERATIONS IN SECURITIES[1] (not included under I, II and III)

A. *Acquisition by non-residents of domestic securities[1] dealt in on a stock exchange[1] and repatriation of the proceeds of liquidation thereof*

(a) quoted[1]

(b) unquoted[1]

1. Acquisition of shares[1] and other securities of a participating nature

2. Repatriation of the proceeds of liquidation of shares and other securities of a participating nature

3. Acquisition of bonds[1]

(i) denominated in national currency

(ii) denominated in foreign currency

4. Repatriation of the proceeds of liquidation of bonds.

5. Acquisition of units of collective investment undertakings

6. Repatriation of the proceeds of the liquidation of units of collective investment undertakings

B. Acquisition by residents of foreign secruities dealt in on a stock exchange, or of domestic securities issued on a foreign market but non dealt in on a stock exchange, and use of the proceeds of the liquidation thereof

(a) quoted

(b) unquoted

1. Acquisition of shares and other securities of a participating nature

2. Use of the proceeds of liquidation of shares and other securities of a participating nature

3. Acquisition of bonds

(i) denominated in national currency

(ii) denominated in foreign currency

4. Use of the proceeds of liquidation of bonds

5. Acquisition of units of collective investment undertakings

6. Use of the proceeds of the liquidation of units of collective investment undertakings

[1] See Explanatory Notes, pp. [illegible]

C. *Acquisition by non-residents of domestic securities not dealt in on a stock exchange and repatriation of the proceeds of liquidation thereof*

1. Acquisition of shares and other securities of a participating nature

2. Repatriation of the proceeds of liquidation of shares and other securities of a participating nature

3. Acquisition of bonds

(i) denominated in national currency

(ii) denominated in foreign currency

4. Repatriation of the proceeds of liquidation of bonds

5. Acquisition of units of collective investment undertakings

6. Repatriation of the proceeds of the liquidation of units of collective investment undertakings

D. Acquisition by residents of foreign securities not dealt in on a stock exchange, or of domestic securities issued on a foreign market but not dealt in on a stock exchange, and use of the proceeds of the liquidation thereof

1. Acquisition of shares and other securities of a participating nature

2. Use of the proceeds of liquidation of shares and other securities of a participating nature

3. Acquisition of bonds

(i) denominated in national currency

(ii) denominated in foreign currency

4. Use of the proceeds of liquidation of bonds

5. Acquisition of units of collective investment undertakings

6. Use of the proceeds of the liquidation of units of collective investment undertakings

E. *Physical movements of securities*

1. Belonging to non-residents

(a) import

(b) export

2. Belonging to residents

(a) import

(b) export

V. INVESTMENTS IN REAL ESTATE[1] (not included under I and II)

A. *Investments in real estate on national territory by non-residents and repatriation of the proceeds of liquidation thereof*

1. Acquisition of real estate

2. Repatriation of the proceeds of liquidation of real estate

B. *Investments in real estate abroad by residents and use of the proceeds of liquidation thereof*

1. Acquisition of real estate

2. Use of the proceeds of liquidation of real estate

[1] See Explanatory Notes, pp. 98-99.

VI. SHORT-TERM INVESTMENTS IN TREASURY BILLS AND OTHER SECURITIES NORMALLY DEALT IN ON THE MONEY MARKET

1. Denominated in national currency

2. Denominated in foreign currency

A. *Short-term investments by non-residents on a domestic money market and repatriation of the proceeds of liquidation thereof*

(a) by natural persons[1] } other than financial
(b) by legal persons[1] } institutions
(c) by financial institutions[1]

B. *Short-term investments by residents on a foreign money market and use of the proceeds of liquidation thereof*

(a) by natural persons[1] } other than financial
(b) by legal persons[1] } institutions
(c) by financial institutions[1]

VII. GRANTING AND REPAYMENT OF CREDITS RELATED TO COMMERCIAL TRANSACTIONS OR TO PROVISION OF SERVICES

1. In which a resident is participating

2. In which no resident is participating

A. *Credits granted by non-residents to residents:*
(i) short-term (less than one year)
(ii) medium-term (from one to five years)
(iii) long term (five years or more)
(a) by natural persons } other than financial
(b) by legal persons } institutions
(c) by financial institutions

B. *Credits granted by residents to non-residents:*
(i) short-term (less than one year)
(ii) medium-term (from one to five years)
(iii) long-term (five years or more)
(a) by natural persons } other than financial
(b) by legal persons } institutions
(c) by financial institutions

VIII. GRANTING AND REPAYMENT OF LOANS AND CREDITS NOT RELATED TO COMMERCIAL TRANSACTIONS OR TO PROVISIONS OF SERVICES (not included under I and X)

A. *Loans and credits granted by non-residents to residents:*
(i) short-term (less than one year)
(ii) medium-term (from one to five years)
(iii) long-term (five years or more)

[1] See Explanatory Notes, pp. 98-99.

(a) by natural persons } other than financial institutions
(b) by legal persons
(c) by financial institutions

B. *Loans and credits granted by residents to non-residents:*

(i) short-term (less than one year)
(ii) medium-term (from one to five years)
(iii) long-term (five years or more)
(a) by natural persons } other than financial institutions
(b) by legal persons
(c) by financial institutions

IX. OPENING AND PLACING OF FUNDS ON CURRENT AND DEPOSIT ACCOUNTS REPATRIATION OR USE OF BALANCES ON CURRENT OR DEPOSIT ACCOUNTS WITH CREDIT INSTITUTIONS[1]

A. *By non-residents with domestic credit institutions*

1. Accounts and balances in national currency
2. Accounts and balances in foreign currency
(a) by natural persons } other than financial institutions
(b) by legal persons
(c) by financial institutions

B. *By residents with foreign credit institutions*

1. Accounts and balances in national currency
2. Accounts and balances in foreign currency
(a) by natural persons } other than financial institutions
(b) by legal persons
(c) by financial institutions

X. PERSONAL CAPITAL MOVEMENTS (not covered by the other sections)

A. *Loans*

1. Loans granted by non-residents to residents
2. Loans granted by residents to non-residents

B. *Gifts and endowments*

C. *Dowries*

[1] *See Explanatory Notes, pp. 98-99.*

D. *Inheritances*

E. *Settlement of debts in their country of origin by immigrants*

F. *Transfers of capital belonging to residents who emigrate and are:*

1. Nationals of the country in question

2. Nationals of other countries

G. *Transfers of capital belonging to emigrants returning to their country of origin*

H. *Transfers of workers' savings during their period of stay*

I. *Transfers by instalment of blocked funds belonging to non-residents by the holders of such funds in case of special hardship*

L. *Annual transfers of blocked funds to another Member State by a non-resident account-holder, up to an amount or a percentage of the total assets, fixed uniformly by the Member State concerned for all applicants*

M. *Transfers of minor amounts abroad*

XI. TRANSFERS IN PERFORMANCE OF INSURANCE CONTRACTS

A. *Premiums and payments in respect of life assurance*

1. Contracts concluded between domestic life assurance companies and non-residents

2. Contracts concluded between foreign life assurance companies and residents

B. *Premiums and payments in respect of credit insurance*

1. Contracts concluded between domestic credit insurance companies and non-residents

2. Contracts concluded between foreign credit insurance companies and residents

C. *Other transfers of capital in respect of insurance contracts*

XII. SURETIES, OTHER GUARANTEES AND RIGHTS OF PLEDGE AND TRANSFERS RELATING TO THEM

A. *Granted by non-residents to residents*

B. *Granted by residents to non-residents*

XIII. IMPORT AND EXPORT OF FINANCIAL ASSETS

A. *Securities* (not included under IV) *and means of payment of every kind*

B. *Gold*

XIV. OTHER CAPITAL MOVEMENTS

A. *Death duties*

B. *Damages (where these can be considered as capital)*

C. *Refunds in the case of cancellation of contracts and refunds of uncalled-for payments (where these can be considered as capital)*

D. *Author's royalties*

Patents, designs, trade marks and inventions
(assignments and transfers arising out of such assignments)

E. *Transfers of the moneys required for the provisions of services (not included under IX)*

F. *Miscellaneous*

EXPLANATORY NOTES

For the purposes of this Nomenclature, the following expressions have the meanings assigned to them respectively:

Direct investments

Investments of all kinds by natural persons or commercial, industrial or financial undertakings, and which serve to establish or to maintain lasting and direct links between the person providing the capital and the entrepreneur to whom or the undertaking to which the capital is made available in order to carry on an economic activity. This concept must therefore be understood in its widest sense.

The undertakings mentioned under 1 include legally independent undertakings (wholly-owned subsidiaries) and branches.

As regards those undertakings mentioned under 2 which have the status of companies limited by shares, there is participation in the nature of direct investment where the block of shares held by a natural person or another undertaking or any other holder enables the shareholder, either pursuant to the provisions of national laws relating to companies limited by shares or otherwise, to participate effectively in the management of the company or in its control.

Long-term loans of a participating nature, mentioned under 3, mean loans for a period of more than five years which are made for the purpose of establishing or maintaining lasting economic links. The main examples which may be cited are loans granted by a company to its subsidiaries or to companies in which it has a share, and loans linked with a profit-sharing arrangement. Loans granted by financial institutions with a view to establishing or maintaining lasting economic links are also included under this heading.

Residents or non-residents

Natural and legal persons according to the definitions laid down in the exchange control regulations in force in each Member State.

Proceeds of liquidation (of investments, securities, etc.)

Proceeds of sale, amount of repayments, proceeds of execution of judgments, etc.

Introduction on a stock exchange

The admission of securities — in accordance with a specified procedure — to dealings on a stock exchange, whether controlled officially or unofficially, and their admission to public sale.

Securities dealt in on a stock exchange (quoted or unquoted)

Securities the dealings in which are controlled by regulations, the prices for which are regularly published, either by official stock exchanges (quoted securities) or by other bodies attached to a stock exchange — e.g. committees of banks (unquoted securities).

Placing of securities

The direct sale of securities by the issuer, or sale thereof by the consortium which the issuer has instructed to sell them.

Operations in securities

Any dealings in securities, including the initial sale of units by unit trusts.

Domestic or foreign securities

Securities according to the country in which the issuer has his principal place of business.

Shares

Include rights to subscribe for new issues of shares.

Bonds

Negotiable secutiries with a maturity of two years or more from issue for which the interest rate and the terms for the repayment of the principal and the payment of interest are determined at the time of issue. The bonds referred to in category IV of the Nomenclature are those issued by both public and private bodies.

Collective investment undertakings

Undertakings:

- the object of which is the collective investment in transferable securities or other assets of the capital they raise and which operate on the principle of risk-spreading, and
- the units of which are, at the request of holders, under the legal, contractual or statutory conditions governing them, repurchased or redeemed, directly or indirectly, out of those undertakins' assets. Action taken by a collective investment undertaking to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.

Such undertakings may be constituted according to law either under the law of contract (as commond funds managed by management companies) or trust law (as unit trusts) or under statute (as investment companies).

For the purposes of this Directive "common funds" shall also include unit trusts.

Investments in real estate

Purchases of buildings and land and the construction of buildings by private persons for gain or personal use. This category does not include loans secured by mortgages but it does include rights of usufruct, easements and building rights.

Natural or legal persons

As defined by the national rules.

Financial institutions

Banks, saving banks and institutions specializing in the provision of short, medium and long-term credit, and insurance companies, building societies, investment companies and other institutions of like character.

Credit institutions

Banks, saving banks and institutions specializing in the provision of short, medium and long-term credit.

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