Fiscal Policies, Devaluations and Exchange Rate Regimes
The Stabilisation Programmes of Ireland and Greece

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Abstract: This paper contrasts the stabilisation programmes of Ireland and Greece in the 1980s and draws out lessons for the design of such programmes in small open economies. Programmes relying on government revenue increases are judged to be less likely to succeed than those based on expenditure reductions. The contribution which devaluation in the initial stages of such a programme can make is also emphasised, but only in the context of a regime with established anti-inflationary credibility.

I INTRODUCTION

A mong the economies of the European Community, Ireland and Greece are as close as can be to the proverbial textbook "small open economy". Both are extremely open, and both are too small in traded goods and assets

markets to have any influence on developments in the rest of the world.

In the 1970s, like the rest of the OECD, both the Irish and Greek econo-
mies suffered from the stagflation that accompanied the first oil-shock. Their
largely accommodating macroeconomic policies during that period weakened
their public finances, and left them extremely vulnerable to the second oil-
shock and its aftermath.

Since then, their experiences could not be more different. Ireland opted to
participate fully in the exchange rate mechanism of the EMS, while Greece,
not being at the time a member of the EEC, continued with the independent
"crawling-peg" policy it had been following since 1975. In 1982 Ireland
embarked on a programme of fiscal consolidation, while Greece followed an
"unorthodox" policy mix, based on expansionary fiscal policies. In both
countries, a series of stabilisation programmes, involving different features,
were introduced in the 1980s. Between them Ireland and Greece have tried
almost all possible types of programme.

In this paper I examine the contrasting experiences of Ireland and Greece
to shed more light on the main controversies surrounding the design of
stabilisation programmes in small open economies. Because of the different
exchange rate regime between Ireland and Greece, and the different fiscal
policy responses, this comparison can be used to examine the differences
between "gradualist" and "cold-turkey" approaches, the importance of credi-
bility, the role of the exchange rate regime and the implications of alternative
methods of stabilising the public debt to output ratio.

I personally have a much better understanding of Greece than Ireland, as a
large part of my research efforts in the last ten years has been directed
towards understanding the nature of aggregate fluctuations in Greece, as a
case study of a small open economy (see Alogoskoufis, 1982, 1985, 1986, 1990;
Alogoskoufis and Christodoulakis, 1991). My own primary interest in the
comparison between Ireland and Greece lies in identifying the main features
of the "successful" Irish stabilisation of 1987-1990. The method I employ in
the paper is largely non-formal, although I use a number of important in-
sights from formal models, and refer to the lessons from formal econometric
exercises.

The rest of this paper is in four parts. Section II introduces the main facts
regarding the macroeconomic experiences of Greece and Ireland in the 1980s,
with special reference to their policy responses following the second oil-shock,
and the two stabilisation programmes that each country has been through.
The differences identified relate to the methods employed to stabilise the
public debt to GDP ratio, the use or not of devaluation before stabilisation
programmes, and the exchange rate regime during the stabilisation effort. In
Section III I delve deeper into the fiscal issues, identifying the reduction in

government expenditure rather than tax increases, as one of the main differences between the second, and "successful", Irish stabilisation of 1987-89, and the "failed" (Dornbusch, 1989) first Irish and two Greek stabilisations. In Section IV I look at the rôle of the devaluations that preceded the second Irish stabilisation, and the first Greek stabilisation of 1985-87. I argue that the devaluations were another important feature contributing to the relative success of these two programmes, compared to the other two. In Section V I look at the rôle of the exchange rate regime. I attribute Ireland's success in achieving a sustained reduction in inflation to the fact that it is a committed member of the exchange rate mechanism of the EMS, as opposed to Greece that has followed an accommodating "crawling peg" policy since 1975, lacking anti-inflationary credibility. Finally, Section VI contains some concluding remarks.

II THE STABILISATION PROGRAMMES OF IRELAND AND GREECE

Both in Ireland and in Greece policymakers tried to spend their way out of the first oil-shock of the 1970s. This left their economies extremely vulnerable to the second oil-shock. In 1982 the Irish coalition government made a serious attempt at macroeconomic stabilisation through fiscal consolidation. However, Greece's incoming socialist administration tried an "unorthodox" policy of engineering a wage explosion, institutionalising almost full wage indexation, and trying a fiscal expansion that caused public expenditure to rise from about 33 per cent of GDP in 1980, to 48 per cent in 1985.

By 1985 both the Irish "stabilisation", and the Greek "expansion" had run into trouble. Ireland had been through a prolonged recession (see Figures 1 to 4) which reduced its inflation rate and dented its current account deficit only at the cost of a dramatic increase in unemployment. Greece's expansionary fiscal and accommodative monetary and exchange rate policies resulted in the persistence of inflation, the deterioration of the current account, but almost no visible benefits on GDP growth or unemployment. In fact, in the light of disinflation in the rest of the OECD, Greece's inflation differential widened significantly.

In October 1985 Greece adopted its first serious stabilisation programme of the 1980s. The drachma was devalued, a draconian incomes policy was put in place, and a programme of tax increases and increases in the prices of public utilities was adopted at the same time in order to reduce the budget deficit. These measures were accompanied by important modifications in the wage indexation scheme, that excluded imports from the index, and based indexation on expected future inflation rather than past inflation. The "crawling peg" rule was also changed, as it was announced that exchange rate policy
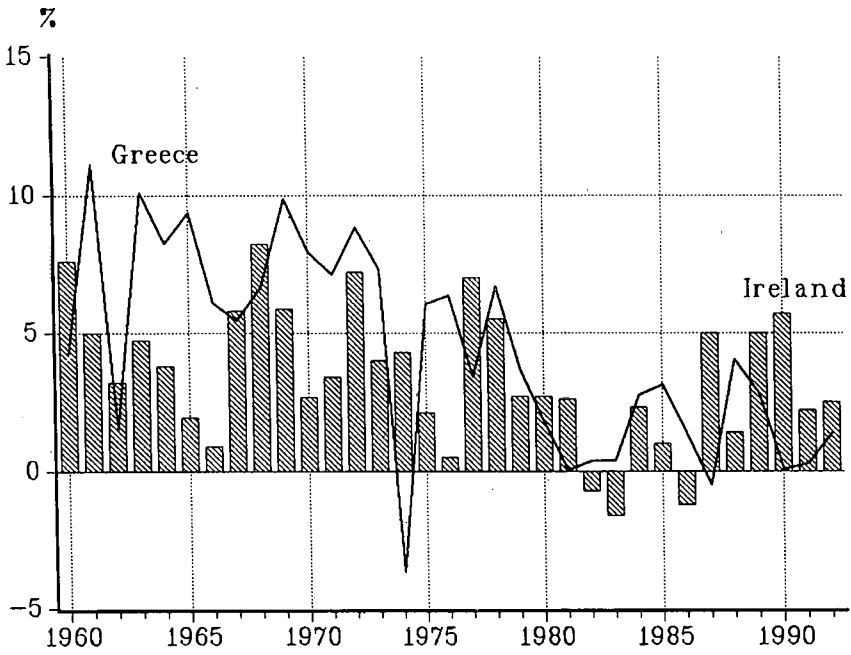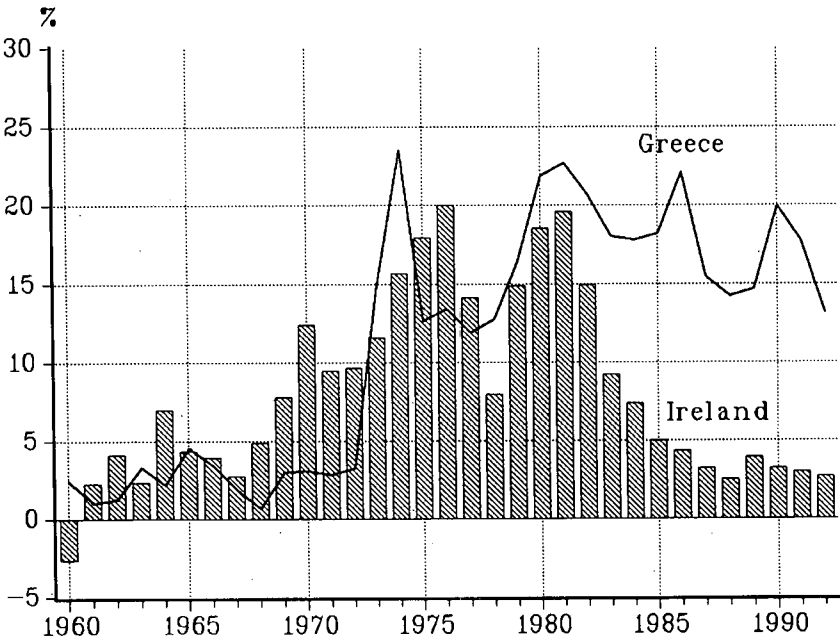
Figure 1: *The Growth Rate of GDP*
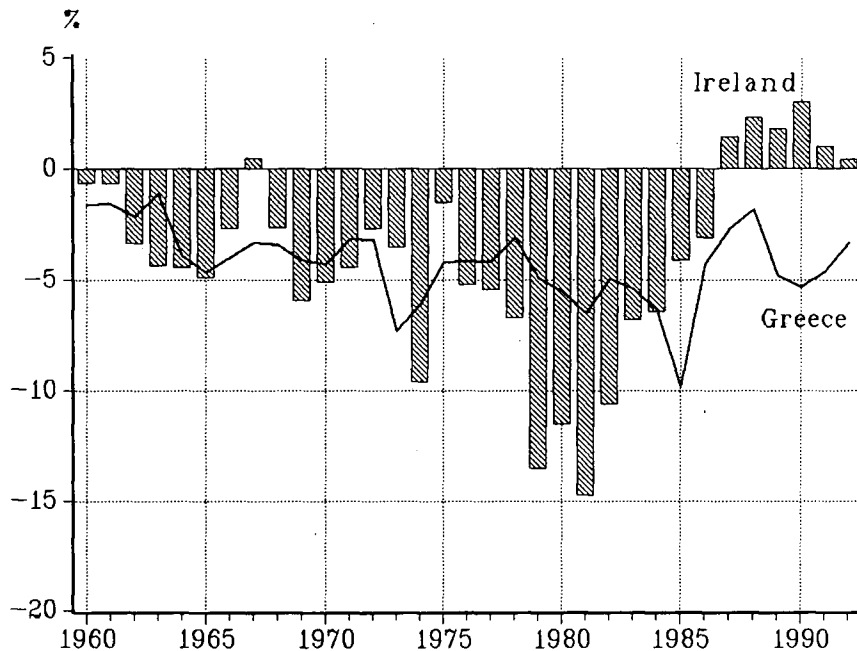

Figure 2: *Consumer Price Inflation*

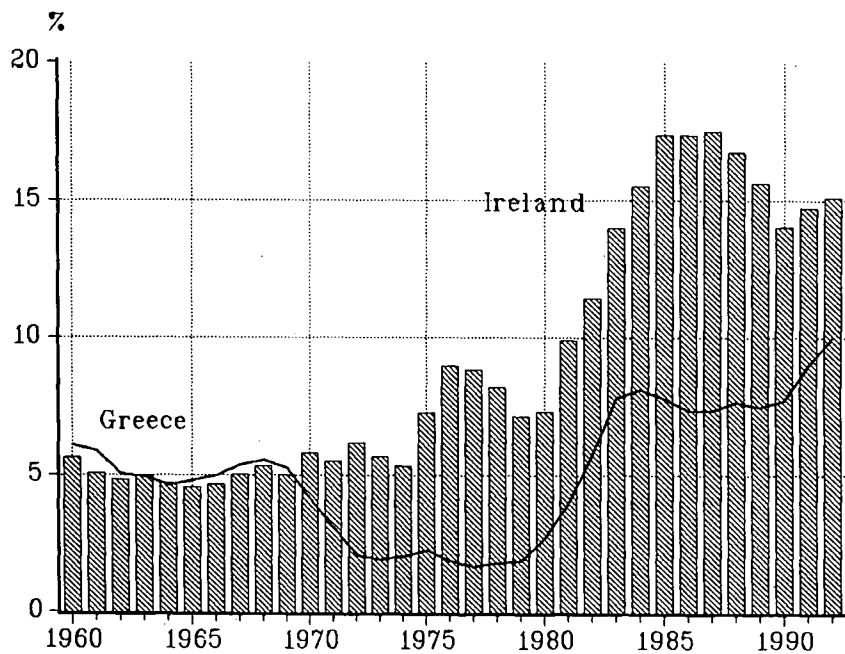Figure 3: *The Current Account / GDP Ratio*

Figure 4: *Unemployment Rate*

would fully accommodate inflation differentials in order to stabilise the real exchange rate at the lower level achieved after the devaluation. These measures were endorsed by the EC, which provided a loan in two tranches to finance the increased balance of payments deficits that preceded and followed the 1985 elections.

Ireland's new stabilisation programme, the *Programme for National Recovery*, was announced two years later, in October 1987, although many of its components were in place earlier. This was characterised by similarities, but also sharp differences compared with the first stabilisation attempt in 1982-85. First it contained an important tax reform, that reduced the disincentive effects of taxation, and was based on sharp reductions in government expenditure rather than tax increases. Initial estimates suggested a reduction in nominal government expenditure by 6 per cent. The second important difference between the first and second Irish stabilisations was that the second was accompanied by a sharp devaluation of the Irish pound in the EMS that improved international competitiveness.

The Irish programme was introduced at almost the same time as the Greek socialist government *de facto* abandoned the 1985 programme. The Minister of National Economy, and architect of the programme, was forced to resign in November 1987, in a clear signal that after two years of austerity, fiscal and pay restraint were to be abandoned. By the 1989 elections, although inflation in Greece had fallen somewhat, the public sector deficits had soared again, wages were running ahead of inflation, and the prices of public utilities had been kept artificially low.

The second Greek stabilisation, which is still under way, was adopted after the elections of April 1990. Its centrepiece is a programme to turn the primary fiscal deficit into a small surplus in order to stabilise the public debt to GDP ratio. Wage indexation has been de-institutionalised, and an austere incomes policy in the public sector was put in place. Like in the first Irish and Greek stabilisations, the programme emphasised revenue increases rather than the expenditure reductions as the means to reduce the budget deficit. No devaluation preceded it, and the anti-inflationary policy rests on a less than fully accommodative "crawling-peg", a policy championed by the Bank of Greece. This policy has been in place since the middle of 1989.

As can be seen from Figures 1 and 4, there have been sharp differences between the first and second Irish stabilisations. Whereas, in the first there was a prolonged recession and unemployment exploded, the second has been followed by a boom that reduced unemployment. Despite the devaluation inflation hardly rose, whereas the current account moved into surplus for the first time since the devaluation of 1967.

On the other hand, the experience of Greece, during its first stabilisation of

1985-1987 has more similarities with the first rather than the second Irish stabilisation. There has been a recession in 1986 and 1987, and the current account improved significantly. However, there have been important differences. The reduction in inflation has been modest and short-lived, and unemployment did not show anything like the increase displayed in the case of the first Irish stabilisation, although the fall it displayed after 1984 was checked.

It is very early at this point to have a full assessment of the second Greek stabilisation, especially as the post-1990 data displayed in the Figures are estimates from the July 1991 OECD *Economic Outlook*. These, and other estimates, suggest that the inflation rate and the current account deficit are indeed improving slowly, and the unemployment rate is rising sharply. In this respect, the second Greek stabilisation is very similar to the first Irish one.

To summarise, the data displayed in Figures 1 to 4 suggest that the two Greek stabilisations, especially the second one, are more like the first, "failed" Irish stabilisation, to use the expression of Dornbusch (1989), rather than the more recent "successful" one. In addition, the anti-inflationary gains in any of the two Greek stabilisation programmes, have been nowhere near to the gains in the case of Ireland during 1982-1985. Below, I shall attribute the differences to three factors.

First, I shall argue that the main difference between Ireland's first programme, and the two Greek programmes on the one hand, and Ireland's second programme on the other, lies in the method of reducing the public deficit. The Greek programmes and Ireland's first rested on revenue increases rather than reductions in public expenditure. This caused a reduction in both private consumption and investment, causing the recessions and the improvements in the current account deficit. On the other hand the second Irish stabilisation consolidated the public finances through credible reductions in government expenditure. This, and the associated tax reform, signalled the taxes in the future would be lower than otherwise and caused private consumption and, more importantly, private investment to increase. As a consequence there was no recession.[1]

My second argument is about devaluations. Here the difference is between Ireland's first programme and Greece's second, which were not preceded by devaluation, and Ireland's second and Greece's first which were. The initial devaluation mitigated the recessionary impact of the fiscal adjustments, by

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1. It has to be noted that the Greek authorities announced a tax reform that simplified the income tax system and reduced income rax rates in January 1992. However, this was done without any associated reductions in government consumption. Thus, the tax reform may not be seen as permanent, unless it is soon accompanied by credible measures to reduce public consumption.

providing a boost for the traded-goods sectors. To the extent that the gains in competitiveness were not considered to be transitory, they provided a further boost for private investment in the traded goods sector. By contrast, in the case of the first Irish programme the traded goods sector was squeezed as competitiveness deteriorated. This exacerbated the rise in unemployment. Similar effects seem to have followed the second Greek stabilisation up to early 1992.

My third argument deals with the anti-inflationary policies. Here the main difference is between both programmes in Ireland and both the programmes in Greece. Ireland has been a committed member of the exchange rate mechanism of the EMS right from the start. This has helped it to gain and retain credibility in its counter-inflationary efforts. This credibility in the fight against inflation persisted even outside the periods of the stabilisation programmes. Greece, on the other hand has been accommodating its inflation differentials through exchange rate policy. In particular, during the 1985-87 stabilisation it was expressed policy that the nominal exchange rate would fully accommodate inflation differentials with the rest of the world. As a result, Greece has had no credibility in its efforts to reduce inflation. Outside the periods of stabilisation programmes its relative inflation rate has soared, and it has only been through incomes policies that temporary reductions in inflation have been achieved.

III STABILISING THE PUBLIC DEBT-TO-GDP RATIO

I start with fiscal policy, since one of the primary objectives of both the Irish and Greek stabilisations has been the stabilisation of the government debt-to-GDP ratio. The stabilisation of the government debt-to-GDP ratio is an important precondition for macroeconomic stability in general, as in a small open economy unsustainable public debt can lead to unsustainable external debt and high inflation.

To understand this point, we shall make a small detour into modern theories of public finance. To the extent that the private sector is forward-looking in its consumption behaviour, and there is ample econometric evidence supporting that, it engages in consumption smoothing. This eventually stabilises the ratio of private sector assets to income. Thus, since the ratio of private sector assets to income eventually gets stabilised, an unsustainable supply of liabilities by the public sector (public debt) will result in unsustainable national (private and public) borrowing from abroad, or running down of foreign assets. This is another way of referring to the unsustainability of current account deficits (see for example Blanchard, 1985). In addition, a high and rising government debt-to-GDP ratio creates incentives

to governments for a surprise monetisation of government debt, or other forms of default. These incentives are usually anticipated by bond-holders, who demand increased premia in order to hold the paper of a heavily indebted government. When faced with widespread expectations of monetisation, a government has two unpleasant options: the first is to give in and monetise the debt. In this way it validates the expectations of the private sector and the monetisation takes place. The second option is not to monetise, in which case inflation expectations are not realised, but real interest rates rise, increasing the cost of servicing the debt and reducing private sector investment. In this way governments painfully builds-up a reputation, and, as they do, interest rate premia may start falling (see Calvo, 1978). In such cases additional measures to stabilise the debt help the process of persuading the private sector that the government does not intend to monetise its debt, and ease the burden of the adjustment.

3.1 *Fiscal Consolidation through Increased Taxation: Ireland, 1982-85*

The debt-to-GDP ratio in Ireland had been rising continuously between 1977 and 1981, from the already high initial level of about 70 per cent of GDP in 1977 (see Figure 5). One of the primary objectives of the 1982-85 stabilisation programme was the stabilisation of the rising debt-to-GDP ratio. The
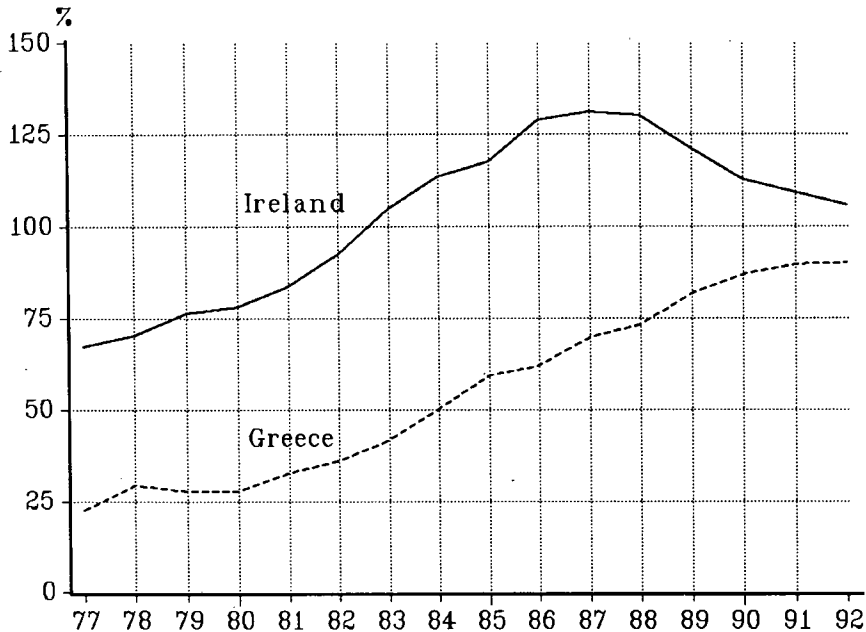

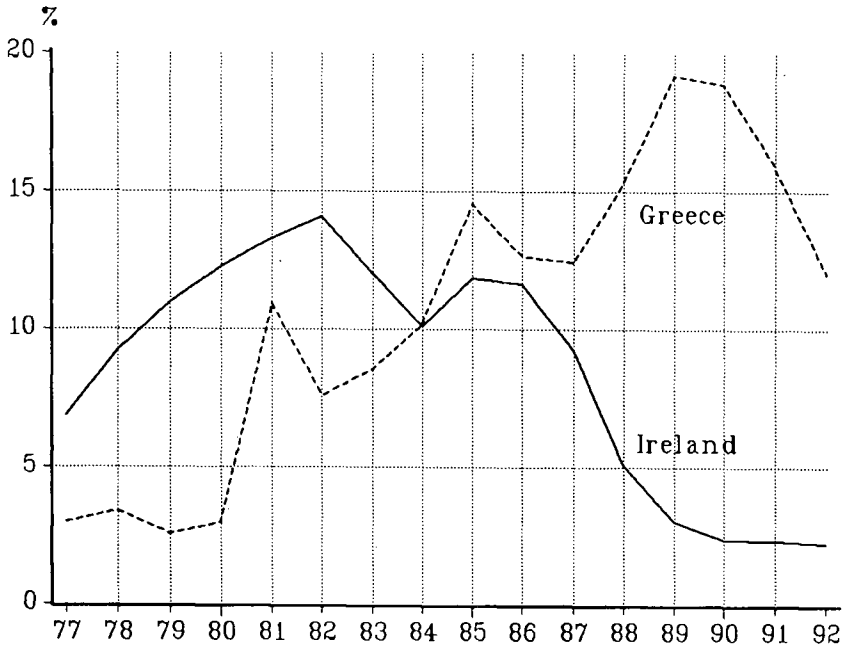Figure 5: *Government Debt / GDP Ratio*
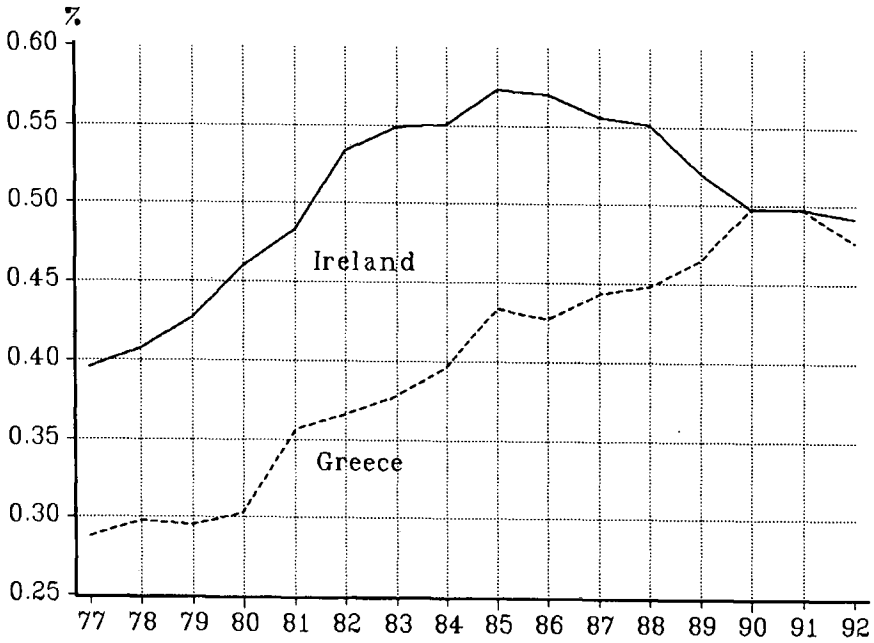
Figure 6: *Government Deficit / GDP Ratio*

Figure 7: *Government Expenditure / GDP Ratio*

government deficit was cut from 14 per cent of GDP in 1982 to 10 per cent in 1984 (Figure 6). Government expenditure did almost nothing to contribute to the deficit reduction, as it rose slightly from 53 per cent of GDP in 1982 to 55 per cent in 1984 (Figure 7). This rise was unintended, as a large part of it was due to the rise in expenditure on unemployment benefits. The deficit reduction took place through a rise in taxes, which increased government revenue from 45 per cent of GDP in 1982 to 49 per cent in 1984 (Figure 8). Although Ireland's primary deficit was zero in 1984 (Figure 9), public debt still kept rising as a share of GDP, because of the negative growth rate in 1982 and 1983. Thus, the objective of stabilisation of the public debt-to-output ratio was not achieved during this period.

3.2 *Stabilisation through Cuts in Expenditure: Ireland 1987-90*

During the second stabilisation of 1987-90 the fiscal mix was different. Government expenditure was cut from about 55 per cent of GDP in 1988 to 50 per cent by 1990, while the tax reform meant that government revenue fell from 51 per cent in 1988 to 48 per cent in 1990. The government deficit fell from 5 per cent to 2.3 per cent of GDP, while the earlier primary deficit was turned into a surplus of 7 per cent of GDP in 1990 (Figures 6 to 9).

I have argued elsewhere (Alogoskoufis and Christodoulakis, 1991; Alogoskoufis and van der Ploeg, 1990b), that a tax financed stabilisation of the government debt to GDP ratio results in a much slower reduction in the current account deficit, and a much slower increase in the rate of growth than a stabilisation that is achieved through a reduction in government consumption. The reason is simple: When tax revenues rise to reduce the deficit of the government, national savings increase by less than the reduction in the deficit, since the higher taxes are partly paid through a reduction in private savings. This is not the case when the deficit is reduced through a reduction in government expenditure, because the reduction in government expenditure does not have first-order effects on private savings. Thus, the increase in national savings is equal to the reduction in the government's deficit. To the extent that national savings are used to accumulate foreign assets and physical capital, the current account, which is the net rate of acquisition of foreign assets, improves, and the growth rate, which is the result of physical (and human) capital accumulation rises.

There are further, supply-side, reasons as to why tax financed fiscal stabilisations may be harmful. Since we do not live in a world with lump-sum taxes, revenue increases result in a more distorted private economy. First, the rise in business taxes (actual or expected) reduces capital accumulation and economic growth. Second, rises in payroll, income and indirect taxes increase the natural rate of unemployment, by driving a wider wedge between labour
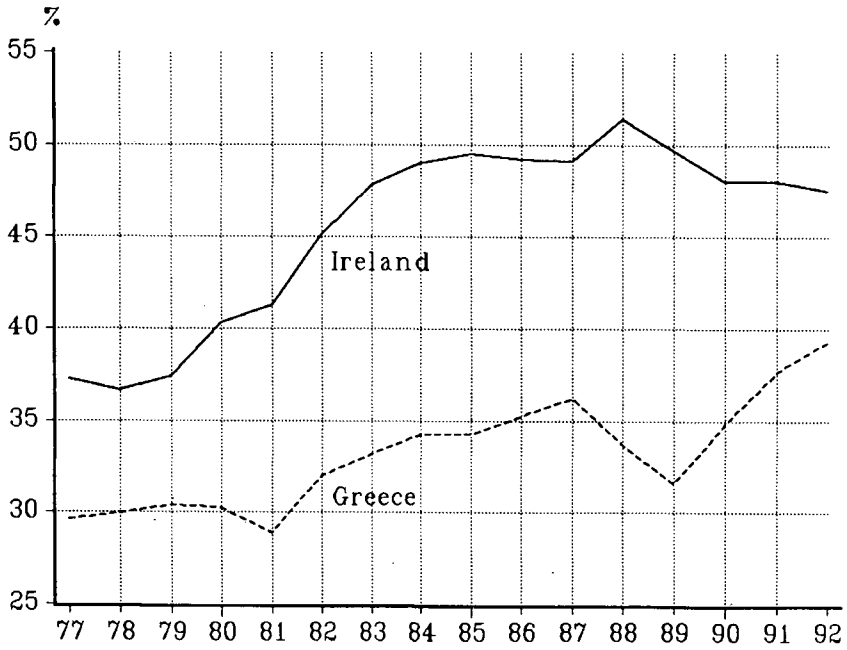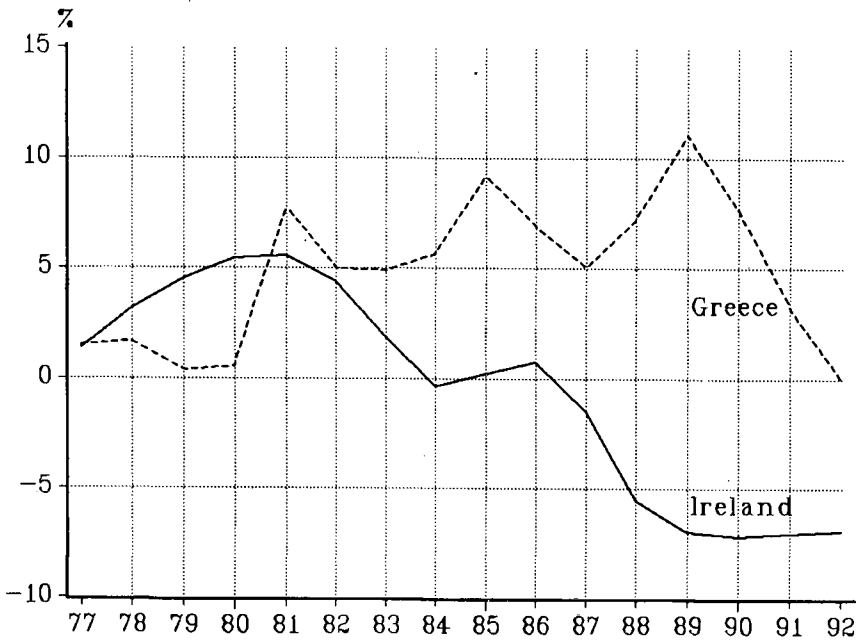
Figure 8: *Government Revenue / GDP Ratio*

Figure 9: *Primary Government Deficit / GDP Ratio*

cost and take-home pay and increasing wage pressure. Thus, the increased distortions due to taxation may also explain both the investment slowdown up to 1987, and the rise in unemployment (see Dornbusch 1989 and Newell and Symons, 1990 on that).

3.3 *Stabilisation without Fiscal Adjustment: Greece 1985-87*

We now turn to the case of Greece, where the government debt-to-GDP ratio was only about 35 per cent of GDP in the early 1980s. The low level of the debt initially may partly explain the scant concern that the incoming socialist government showed for fiscal deficits in 1981.

As Figure 5 demonstrates, government debt was pushed-up quite sharply between 1980 (28 per cent of GDP) and 1985 (59 per cent of GDP). The 1985-87 stabilisation programme did very little to dent the growth of the debt. Deficits fell only slightly between 1985 and 1987, from 14.5 per cent of GDP in 1985 to 12.4 per cent in 1987. The growth of government expenditure was checked only for one year (1986), and, as in the case of Ireland's first stabilisation, the tiny fiscal adjustment achieved was exclusively through a rise in government revenue, from 34 per cent of GDP in 1985 to 36 per cent in 1987. It has to be noted, however, that the primary deficit fell by more than two percentage points of GDP between 1985 (9 per cent of GDP) and 1987 (5 per cent). This was due to both economic growth in 1987, and to reductions in government expenditure other than interest payments.These reductions have been more than offset by the higher interest payments. The point remains that Greece did not experience anything like the increase in unemployment experienced by Ireland in 1982-85. On the other hand, the fiscal adjustment was insufficient to stop the rise in the debt-to-GDP ratio. We shall return to these points below.

3.4 *Greece after 1990?*

The stabilisation package adopted in 1990 is forecast by the OECD to result in a reduction of the primary deficit from 7.5 per cent of GDP in 1990, to 3.2 per cent in 1991, and zero by 1992. In Alogoskoufis and Christodoulakis (1991) we have calculated that elimination of the primary deficit was a necessary condition for the stabilisation of Greece's government debt-to-GDP ratio. Already, there are new doubts and uncertainties as to whether these forecasts will be achieved.

It is important to note, however, that in contrast to the second Irish programme, the current programme in Greece is neither sharp enough to ensure the credibility of the government, nor based on expenditure reductions. As with the first Irish and Greek programmes, the brunt of the adjustment is to be borne by measures that increase revenue. The OECD forecast is for

government revenue to rise from approximately 31 per cent of GDP in 1989 to 39 per cent in 1992. Government expenditure is forecast to fall from 52 per cent to 49 per cent of GDP in the same period. Given the Irish experience with the first programme, the "omens" are not good. The fiscal adjustment seems to be insufficient to stabilise the debt-to-GDP ratio, and whatever adjustment seems to be taking place takes the form of increases in revenues. The only expenditure reductions are due to incomes policy in the public sector, which are unlikely to be permanent.

IV THE ROLE OF DEVALUATIONS

I next turn to the rôle of initial devaluations in the stabilisation pro-grammes. Devaluation has long been considered an appropriate adjustment policy in the presence of internal and external imbalances, as, in contrast to monetary and fiscal policy, it is an "expenditure switching" policy that shifts demand and production towards domestic goods. In the traditional open economy macroeconomics literature, the combination of devaluation and mon-etary and fiscal policy is considered adequate to restore both "internal and external balance".

Modern macroeconomics has cast considerable doubts on the efficacy of devaluations. The main argument is similar to arguments about the neu-trality of monetary policy in the presence of rational expectations. An anticipated devaluation will be reflected in wages and prices in advance and will have no effect on real variables. It will only be unanticipated devalu-ations that will affect relative prices, and hence output, unemployment and the current account. This argument carries additional force in the case of small open economies which are price takers in international markets. In that case the relative price of domestic tradeables is exogenous and cannot in any case be affected by a devaluation. The only relative price that can be altered by a devaluation is the relative price of tradeables and non-tradeables, and if the share of tradeables is high, a devaluation cannot have a large effect on international competitiveness. For example, I have calculated in Alogoskoufis (1990) that in the case of Greece, even if domestic wages do not react at all to a devaluation, the maximum increase in international competitiveness following a 10 per cent devaluation is equal to 3 per cent. I expect that similar orders of magnitude would apply for Ireland, which also has a sizeable traded goods sector and is a price taker in international goods markets.

Despite this relative ineffectiveness, if devaluation is combined with a temporary incomes policy, as devaluations almost invariably are, it can pro-duce an improvement in international competitiveness that will persist and be helpful at the start of a stabilisation programme. It will improve profit
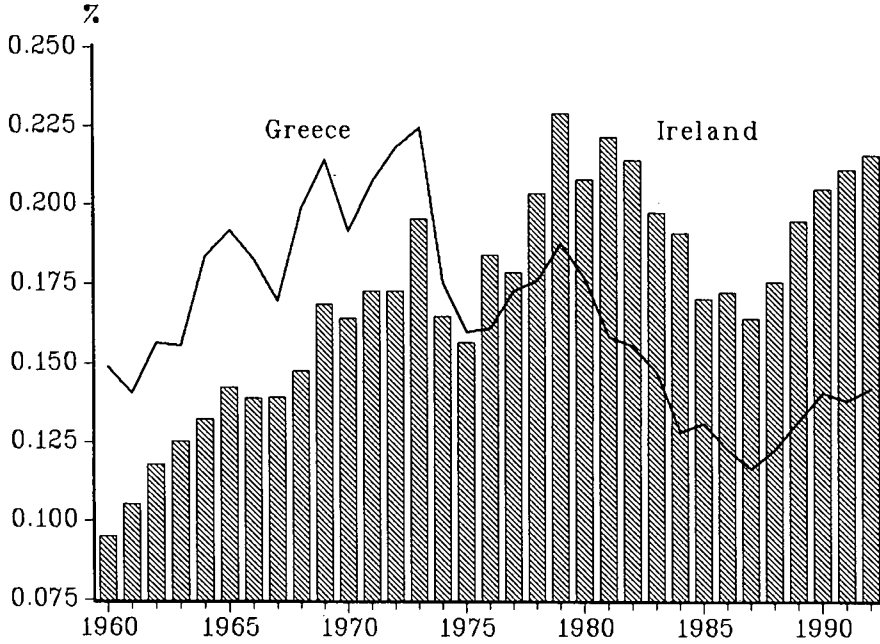
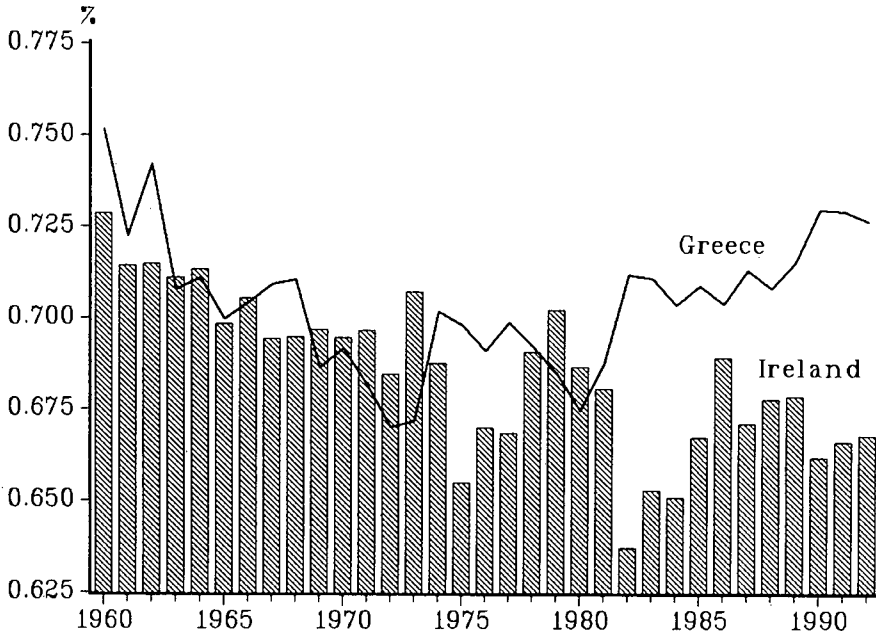Figure 10: *The Private Fixed Investment / GDP Ratio*

Figure 11: *Private Consumption / GDP Ratio*

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margins in the traded goods sector and shift demand and resources towards tradeables. One of the lessons of recent "hysteresis" models of trade and growth (see Krugman, 1991, for example) is that even temporary shocks can have permanent effects in the presence of increasing returns to scale. A real devaluation can be a shock whose beneficial effects may persist in the presence of increasing returns.

Of the four stabilisation programmes that are the focus of this paper, two were preceded by devaluations, and two were not. As can be seen from Figure 10, private investment turned around following devaluations. This was the case both in the second Irish stabilisation, and in the first Greek stabilisation, albeit with a lag in the case of Greece. It was not the case in the first Irish stabilisation and does not seem to be the case yet in the second Greek programme either. As I argued before, the increase in investment in the case of Ireland could be attributed to expectations of lower taxation, following the reduction in expenditure and taxes, and in particular in the expectation of lower future taxes. However, this cannot be so in the case of the first Greek stabilisation. The increase in profitability following the sustained real devaluation of the drachma (see Figure 12 for example), coupled with limited financial deregulation, can be the only explanation for the Greek case. It thus appears that a real devaluation at the start of a stabilisation programme may be quite important for the success of the programme, and may have been quite important in the case of Ireland, especially in the light of the real appreciation of the Irish pound, both between 1977 and 1982, and between 1984 and 1986.

It has to be noted that the bilateral real exchange rate against the D-mark in Figure 12 overstates the amount of the real appreciation of the two currencies, especially until the mid-1980s. The effect of the EMS has been that all EC countries participating in the system have experienced real appreciations *vis-à-vis* Germany. Giavazzi and Giovannini (1989) suggest that this may have been the price that these countries had to pay in exchange for Germany's anti-inflationary reputation, which they borrowed by participating in the system. When the appreciation of the other currencies is taken into account, then one realises that movements in the real value of the Irish pound and the Greek drachma are probably overstated in Figure 12. The calculations of Giavazzi and Pagano (1990) suggest that the real appreciation of the Irish pound *vis-à-vis* other EMS currencies between 1979 and 1982 was about half of that depicted in Figure 12. However, the broad trend and the turning points are similar. An interesting case from the point of view of Ireland is the UK, since it is Ireland's major trading partner. The real exchange rate *vis-à-vis* the UK is depicted in Figure 13. This shows a significant real depreciation of the Irish pound between 1979 and 1981 (this was due to the
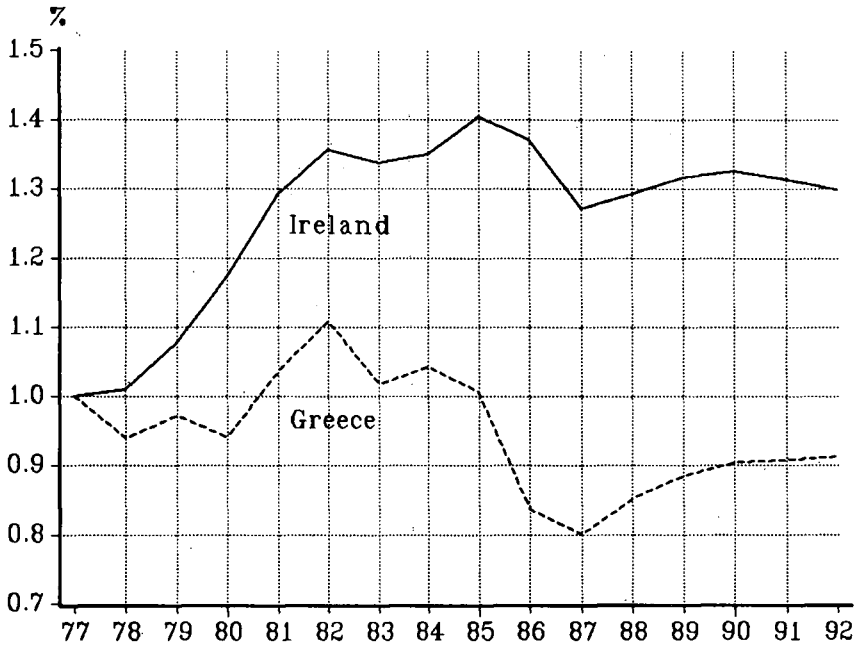
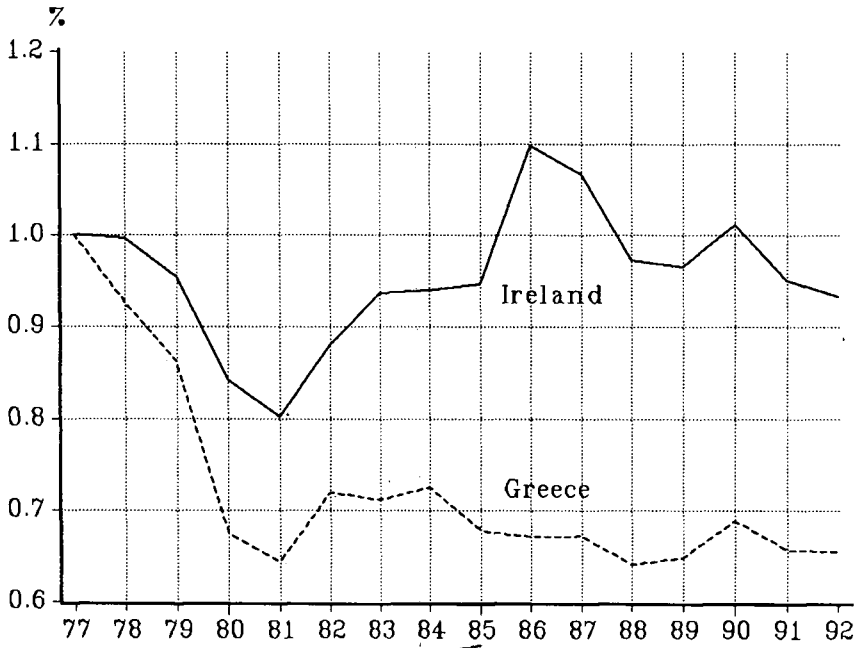Figure 12: *Bilateral Real Exchange Rate with Germany, 1977=1*

Figure 13: *Bilateral Real Exchange Rate with the UK, 1977=1*

real appreciation of the British pound following Mrs Thatcher's policies). This
depreciation was reversed however at the start of the first Irish stabilisation,
further contributing to the overvaluation of the currency during the so-called
"failed" first stabilisation in Ireland.

To conclude, it appears that the devaluations that preceded them may have
made a significant contribution to the relative success of the second Irish
stabilisation and the 1985-87 stabilisation programme in Greece.

I finally turn to the exchange rate regime during the stabilisation pro-
grammes, and to the rôle it played in the Irish disinflation, the rise in Irish
unemployment, and the persistence of inflation in Greece.

V ANTI-INFLATIONARY CREDIBILITY, UNEMPLOYMENT AND THE EXCHANGE RATE REGIME

One of the major differences between Ireland and Greece is the exchange
rate regime. Ireland has been participating fully in the exchange rate mech-
anism of the EMS, whereas Greece has been following an independent
monetary and exchange rate policy that targets the real exchange rate,
almost fully accommodating inflation differentials with the rest of its trading
partners. Ireland's inflation rate has converged to the German inflation rates,
while Greece's inflation differentials with the rest of the EC are large and
persistent.

Following Kydland and Prescott (1977), Calvo (1978) and Barro and Gor-
don (1983), modern theories of inflation suggest that whereas the mechanism
through which inflation persists is of monetary origin, the deeper deter-
minants of inflation are distortions in labour, product and capital markets.
These generate incentives for governments to try and correct them through
unanticipated monetisation and inflation. As these incentives are known to
the private sector, they affect inflationary expectations. Through the process
of wage, price and interest rate determination these expectations in turn
affect the actual inflation rate. As a result, inflation is not unanticipated, and
cannot therefore correct the distortions that were the original concern of
governments.

I have given an example before, based on the existence of high public debt.
Another example is high unemployment and current account deficits. When
the private sector feels that the government is tempted to use unanticipated
money growth and devaluations to reduce unemployment and the current
account deficit, it will entertain high inflationary expectations, which will in
turn be translated into high equilibrium inflation. By participating in the
ERM, Irish governments have gradually convinced the private sector that
they have given up the option of using frequent unanticipated devaluations

and monetary expansions to reduce unemployment and the current account. This, as Giavazzi and Giovannini (1989) and Kremers (1990) suggest has been instrumental in sustaining the low inflation in Ireland. However, in the early part of the 1980s, the anti-inflationary resolve of the authorities was not as well established as today. This may have contributed to the rise in unemployment. During the first stabilisation there was no devaluation. However, wage setters' expectations were partly based on the history of high inflation in the late 1970s, and did not fully believe pronouncements of no devaluation, or no surprise inflation. Hence wage settlements were running ahead of prices, contributing to the overvaluation, slowing down the disinflation process, and undoubtedly contributing to the rise in unemployment (Dornbusch, 1989). Once unemployment rose, labour market imperfections took over and caused the rise to persist (Alogoskoufis and Manning, 1988; Newell and Symons, 1990). The divergence between the expectations of wage setters and government policy did not exist in the case of the second stabilisation, when the anti-inflationary commitment of the Central Bank was not in doubt any more, and was not even dented by the initial devaluation.

Compare now the situation in Greece. The Greek monetary authorities have been accommodating inflation differentials almost fully. In fact, in the case of the 1985-87 stabilisation programme the policy to maintain a constant real exchange rate by full accommodation of inflation differentials was explicitly announced. This, as I suggest in Alogoskoufis (1991) and Alogoskoufis and Smith (1991) slows down the convergence to low inflation, and perpetuates inflation differentials. In the second Greek programme accommodation has been partial, but quite substantial none the less. There is little hope of Greek inflation converging very near to the EC average before the nominal value of the drachma is stabilised either unilaterally, or by entering the exchange rate mechanism of the ERM.

VI CONCLUSIONS

The design of stabilisation policies in heavily indebted economies suffering from high inflation and high budget deficits is extremely difficult. Greece and Ireland have tried between them four times, and their experiences have a number of lessons to offer.

The first lesson is that gradual fiscal adjustment programmes that rely on revenue increases rather than expenditure reductions do not seem to be very successful. The "failed" first Irish stabilisation and the "abandoned" first Greek stabilisation seem to support this conclusion. The fiscal gains that were made did not prove durable in either case. On the other hand, a sharp fiscal adjustment based on reductions in government consumption and actual

and expected reduction in income taxation seems to have worked miracles in the case of the second Irish stabilisation.

The second lesson has to do with the rôle of exchange rate policy. Whereas the first, and "failed", Irish stabilisation was attempted with an overvalued real exchange rate, the second and successful stabilisation was preceded by a devaluation that corrected the loss of competitiveness that had taken place before this programme was adopted. The same happened with the first, and relatively successful, Greek stabilisation. The initial devaluation seems to have provided a boost for the traded goods sector and for private domestic investment, a boost that counteracted, and in the case of Ireland even surpassed, the direct contractionary effects of the fiscal adjustment.

There is, however, one major difference between the Irish and the Greek devaluations, and this is the third lesson that I wish to draw. The Irish realignment took place in the context of the EMS, after a period in which Ireland had painfully gained its anti-inflationary credibility. Because of EMS participation it was not expected to lead to further future devaluations. As a result it had little negative effect on the anti-inflationary credibility of the authorities in Ireland and the Irish inflation rate was affected very little. In fact it may have had a positive effect, as the correction of the real exchange rate in conjunction with the fiscal adjustment made future realignments less likely. In contrast, the Greek devaluation of 1985 was followed by the announcement that future exchange rate policy would keep accommodating inflation differentials between Greece and its trading partners. As a result inflation in Greece was affected much more initially, despite the draconian incomes policy, and its speed of reduction was very slow because of the expected future depreciations of the drachma. It thus appears that the monetary and exchange rate regime within which devaluations take place, as well as the initial anti-inflationary credibility of the government concerned, are extremely important. A devaluation may be effective if it is believed to be the "last". If it is seen as likely to be followed by further devaluations it will not be effective, and will mostly affect inflation rather than any real variables.

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