International Monetary and Financial Committee

Tenth Meeting
October 2, 2004

Statement by Mr. Siniscalco

Statement by the Honorable Domenico Siniscalco
Minister of Economy and Finance and Governor of the IMF for Italy
Speaking on behalf of Albania, Greece, Italy, Malta,
Portugal, San Marino, and Timor-Leste
(Preliminary)
International Monetary and Financial Committee
Washington, D.C., October 2, 2004

The Global Outlook

The Annual Meetings of the IMF and the World Bank take place this year in a context of unprecedented global economic growth. The world is not only growing at a rapid pace but the recovery is broadly based.

Some areas and countries, like China and India, which have successfully joined the process of trade globalization, are continuing to expand at considerable rates. Sub-Saharan Africa, the poorest region in the world, is expected to grow by 4.7 percentage points in 2004, and by 5.6 over the next year.

In the industrialized world, Europe is the only region experiencing difficulties in taking full advantage of the international recovery. Persistent structural rigidities and delays in implementing the Lisbon reform agenda are hindering potential growth.

The growth momentum would benefit from progress in the WTO negotiations that have recently been given a fresh impetus.

Despite the favorable outlook, global imbalances are showing little sign of adjustment as markets continue to finance such imbalances. Oil prices remain high and extremely volatile due to persistent oil market exposure to shocks. In addition to these global risks, several emerging market economies remain vulnerable to further interest rate increases given the still very high level of debt and the persistence of currency and maturity mismatches.

In **Italy** the economy continued to expand in the second quarter of 2004, although the growth rate declined to 0.3 percent from the 0.5 percent of the previous quarter. The upturns in exports and investment have replaced private consumption as the main engines of growth. Despite the recent slow-down in world trade, traditional sectors of the “made in Italy” continued to enjoy strong growth. Furthermore, some strengthening of the recovery in the Euro-zone and the stabilization of the Euro contributed to the improvement of the foreign sector.

Data for the last two quarters confirm that a new investment cycle is under way as the corporate sector recovered from the 2002-03 downturn and has overcome the aftermath of the expirations of the incentive scheme introduced in 2001 to boost capital spending.

Inflation has declined from 2.7 percent in 2003 to 2.3 percent, despite higher oil prices. The Italian economy has been able to absorb the impact of higher oil prices better than other OECD countries because of its lower energy/GDP ratio and stricter regulations that slow the spread of energy prices through the economic system; as a result, the inflation differential with the Euro-zone has narrowed.

Recently Parliament approved a supplementary budget in order to keep the deficit below the 3 percent ceiling in 2004. These measures (worth about 0.5 percent of GDP) are not expected to have a sizeable impact on the recovery. Indeed, the Italian economy seems on target to reach the 1.2 percent growth rate in 2004. Growth is expected to accelerate to 2.1 percent in 2005 as a result of the steady recovery of investment and exports and some increase in consumption. Although a clear improvement over the meager results of the previous years, the growth rate projected for the Italian economy in 2005 will remain somewhat lower than the European average. This reflects, in part, tighter fiscal policies (among the three largest Euro area countries, only Italy has kept the deficit within the limit of the Stability and Growth Pact). The loss of competitiveness which occurred in the past few years is also hampering growth, as the economy is adjusting to the new realities of a low inflation and stable currency system. To some extent, the erosion of competitiveness is the other side of the sizeable gains in employment of the past few years. As output recovers, the increases in unit labor costs will converge towards the European average. The long-term fiscal sustainability will be greatly enhanced by the recent adoption by Parliament of the Reform of the Pension system, which will raise the requirements for early retirement as of 2008; meanwhile, eligible workers will receive generous incentives to postpone their early retirement.

The key economic and financial objectives for the medium-term have been set-out in the Planning Document (Dept 2005-2008) recently approved by Parliament and confirmed in the Draft Budget for 2005 approved by the Government on September 29th. They include the goal of keeping the deficit safely below the 3 percent limit of the Stability Pact; a balanced current budget; the gradual reduction of the debt from the current 106.2 percent to 99.3 percent by 2007 and the increase of the primary surplus toward 5 percent by 2007. Fiscal consolidation will no longer depend on exceptional measures, which will be phased-out in 2005, but rather on permanent adjustments to current expenditures.

The 2005 Draft Budget represents a shift from the traditional approach; in the past, most of the fiscal corrections were concentrated on few expenditure items, mostly related to capital expenditures, leaving unchecked the spontaneous growth of current expenditure. The new guidelines of the 2005 Budget set a 2 percent limit for the overall increase in current expenditures, allowing for a few exceptions in areas such as welfare; for example, expenditures for pension will increase by 3.9 percent. Furthermore, the explicit acceptance of the "golden rule" allows deficit spending only for capital investment.

The overall 2 percent increase in expenditures is higher than the target inflation but lower than the expected 4.4 percent increase in the nominal GDP. Tax revenue is projected to raise by 3.5 percent. Thus, the fiscal framework is consistent with the objective of raising the primary surplus.

To sustain consumption, the Government is committed to enhance the purchasing power of households. In order to raise medium-term growth, the Government is planning to enact the second phase of a comprehensive tax reform; starting in 2005, personal tax will be lowered and the number of tax-brackets reduced to just three over a two year period. The tax-rate cuts will be fully funded by cuts in current expenditures. Fiscal consolidation and the structural reforms will help to improve confidence and enhance growth.

During 2003 and the first half of 2004, **Albania** has strengthened the macroeconomic stability and further advanced structural reforms. Growth remains solid at 6.0 percent and it is expected that the economy will continue to grow at this rate for the medium-term as well. A very careful monetary policy followed by the Bank of Albania assured that inflation remained within the range of 2-4 percent.

The successful privatization of the Savings Bank and the consolidation of the banking sector in Albania will definitely catalyze the development of the private sector, foster stronger competition, and provide better services to the population. The fiscal consolidation process remains on track, while further efforts are focused on improving the tax administration and revenue collection. The authorities are strongly committed to speed-up the implementation of reforms, particularly in the areas of governance, institution building, and poverty reduction.

In **Greece** growth remained robust in 2003, mainly led by domestic demand compensating for weak exports. Investment spending, underpinned by low interest rates and strong construction activity associated with the Olympic Games, was the major contributing factor, but consumer spending also remained on a rising trend. Labor market conditions improved slightly during the course of 2003, while inflation decelerated; however, the differential vis-à-vis the euro-area average remains at relatively high levels, thus gradually eroding the competitiveness of the economy. Economic activity is expected to slow down marginally in 2004 and 2005, albeit remaining well above the euro-area average, mainly on the back of easy monetary conditions, the faster implementation of the CSF III, and the revival of world trade.

Fiscal consolidation in the near future remains a key concern of the Greek government. The far-reaching auditing of fiscal accounts launched in March resulted in an upward revision of the general government deficit and debt for the period 2000-04. Apart from the reclassification of tax receipts and EU transfers, along with a correction regarding a transfer of the Postal Savings Bank to the state (all pertaining to 2003), the revision of the deficit was based on the downward revision of social security fund surpluses (after conducting a new survey) and the proper recording of military equipment expenditure in fiscal accounts. Debt was revised upwards as a result of a reduction of intra-governmental debt (mostly due to the downward revision of assets held by pension funds) along with the inclusion of previously unrecorded capitalized interest payments. These revisions have led to a welcome increase in transparency that provides a more solid basis for the assessment of the fiscal policy stance.

The Greek government is committed to correcting the current situation as rapidly as possible, aiming at a deficit for next year below the 3 percent limit. This effort will be based on wage moderation for the public sector, the reduction of operating expenditure for Ministries, and measures to contain costs and borrowing by public organizations and enterprises. A tax amnesty has also been announced, while significant savings will be achieved because of cuts in the military budget and, most notably, because of the drastic reduction in Olympics-related expenditure.

Provisional GDP data for **Malta** point to an acceleration in economic activity in the first three months of the year when a growth rate of 2.2 percent was recorded. This turnaround was driven primarily by external demand as both private and government consumption expenditure contracted. Exports of goods and services grew by over 10 percent, mainly on the back of buoyant manufacturing activity with both the electronics and pharmaceutical sub-sectors recording a higher volume of sales.

Over the year as a whole the Maltese economy is expected to grow by close to 2.0 percent after contracting by a marginal 0.1 percent in 2003. Growth is expected to be driven mainly by exports, as external demand continues to pick up, and by government investment. Private domestic demand, on the other hand, is expected to remain weak as consumption is forecast to decline further in response to lower household disposable income, the latter reflecting lower employment levels as the economic restructuring process gains momentum.

The balance of payments is expected to improve, but the contraction in the current account deficit registered in the first half of the year should be reversed to a large extent as a result of a rise in imports related to oil products and capital machinery and equipment reflecting government investment expenditure. The current account deficit in 2004 is thus expected to remain close to 6 percent of GDP. However, official financial assistance from overseas, particularly the EU, in connection with infrastructure projects is expected to boost capital inflows. Consequently, the country's external reserves are expected to rise, though at a much slower rate than in 2003.

Meanwhile inflation is forecast to increase to about 3 percent, mostly under the impact of an increase in the standard value added tax rate from the beginning of the year and higher oil prices. This notwithstanding, core inflation is expected to remain just above 1 percent. The fiscal deficit is projected to decline from 9.7 percent in 2003 to 5.2 percent this year, reflecting a substantial increase in government revenue and slower growth in government consumption expenditure.

The Central Bank of Malta continues to aim at achieving price stability through a monetary policy strategy geared to a fixed exchange rate. The Maltese lira is pegged to a basket of three currencies, with the euro the dominant component with a weight of around 70 percent. Malta became a member of the EU in May 2004 and is expected to join ERM II some time next year. During the first nine months of 2004, the Bank kept the central intervention rate unchanged at 3 percent as there were no signs of underlying pressures on the exchange rate. In addition, domestic demand remained weak while core inflation was stable.

Portugal. A combination of internal factors, in particular associated with the need to correct major imbalances affecting both the private and public sector, is the main explanation to the prolonged period of low growth rates, culminating in a recession in 2003. External conditions were insufficient to counterbalance this effect as the Portuguese main partners in the euro area also underwent low levels of activity and only recently began a mild recovery.

Recent projections point to a 1.2 percent growth rate of GDP in 2004 and recovery is expected to strengthen in 2005. In contrast to 2003, internal demand, in particular investment and private consumption, has been the main driving force for this year's increase in activity, while external demand had a negative net contribution to growth. This last result was induced by a strong increase in imports.

The Portuguese authorities are committed to the fulfillment of the Stability and Growth Pact, not least because the consolidation of public finances is instrumental to return to a sustainable growth path and real convergence towards the euro area.

In 2003, Portugal was able to reduce the deficit to 2.8 percent of GDP and put an end to the excessive deficit position under the terms of the Stability and Growth Pact. For 2004, some of the measures previously used were no longer available. Tight control was imposed on the expenditure side, involving both public consumption and public investment, and as a result the deficit ratio is expected to remain just below 3 percent.

However, structural measures are crucial to maintain public finances on a sustainable path. Some steps were already introduced, including the control of current expenditure, public administration reform and restrictions on local authorities' level of indebtedness, but further action is needed in order to face future pressures coming from social security.

The inflation rate continued its downward trend and the 12-month average CPI stood at 2.5 percent in August. This result was also favored by wage moderation, mainly induced by the freeze of public sector wages and, more generally, by the assessment of conditions in the labor market: total employment increased only marginally and the rate of unemployment remained level, at 6.4 percent of total labor force.

Portugal confirmed its interest in participating in the FSAP initiative. Following other euro-area countries, Portugal considers it important to undertake an FSAP as a way of evaluating and improving the regulatory environment of the financial sector. It should be stressed that Portuguese banks coped successfully with a new structural framework associated with the monetary union and showed remarkable resilience to the unfavorable developments in global economy and financial markets in the past few years.

San Marino. Recent data suggest that the economic recovery is under way, reflecting an improved international economic environment.

As a part of a medium-term strategy, the authorities have started a thorough discussion in the country and with their international partners on how best to promote economic growth in San Marino in light of ever-increasing international cooperation that could benefit their small and open economy by strengthening its competitiveness vis-à-vis its current and potential trading partners. Along these lines, the administration has been very active in the area of international cooperation, and has pursued a number of agreements in the area of economic cooperation and saving taxation.

The conduct of fiscal policy has been aimed to ensure a fundamentally sound fiscal position of the central government with the fiscal adjustment continuing in the years ahead through balanced-budget targets. This is part of a wider strategy for ensuring a stable economic environment where investment can thrive.

In this setting, the authorities envisage a greater role for the financial sector in contributing to the Sammarinese economic growth. They have been active in strengthening the institutional and supervisory framework of the financial sector in accordance with international standards and have sought, in this regard, greater international scrutiny.

Timor-Leste. Available data indicates that the Timorese economy has had some volatile movements. Initially the country suffered a 37 percent decline as a result of the wholesale destruction and dislocation before and after the referendum; the economy improved by 51 percent in 1999-2000; and by 5 percent in 2001-02. The economy contracted in 2002-03 by about 2 percent as the United Nations and other operators scaled down their presence, which focused mainly on relief, rehabilitation and administration, and in 2003-04 the economy is estimated to continue contracting at about 2 percent as the international presence reduces further. The economy's contraction that began in 2002 will abate and growth will begin to recover in 2005, led by levels of public spending, including construction and other investment-related activities, as well as recovery in private activity. For the period of 2003-07 we estimate the average annual growth of GDP to be 1.6 percent per year in real terms. One has to take into consideration that the Timorese economy is starting from a low base. Any precipitous decline in external assistance will have a significant negative impact on the economy and the fragile institutions that have been conscientiously put in place and nurtured during the past five years. Although the Timorese public administration is new, it has already revealed a high level of transparency and accountability in its finances, and good procurement procedures.

The Government is making a good effort to maintain public expenditure at sustainable levels and is seeking support at current levels from development partners, until substantial revenues from the Timor Sea begin to flow. The capacities of the civil service, the private sector and civil society organizations are improving but are still limited. Continued technical assistance is critical to ensure service delivery and the proper functioning of public systems and institutions. Timor-Leste is taking positive steps towards reducing its reliance on external assistance and expects this to occur as it accrues substantial Timor Sea revenues, currently projected to materialize from 2008 onwards.

The petroleum reserves will be used to finance a level of government expenditure on a sustainable basis and the Government is cognizant of the necessity to utilize part of these funds for public investment, such as in the creation of infrastructure to better serve the current and future development of the Democratic Republic of Timor-Leste.

Crisis Prevention and Surveillance

Even in a favorable environment, the Fund continues to play an essential role in identifying and monitoring vulnerabilities. Surveillance is a crucial element in the Fund's work on crisis prevention. Significant progress has been achieved over recent years but more needs to be done.

We urge the full implementation of the framework for assessing debt sustainability. Debt Sustainability Analysis (DSA) must become a common feature of all Article IV consultations. The Fund should undertake DSA independently of lending decisions. This may require organizational changes in the Fund's departments.

Balance Sheet Analysis should also be used more extensively to complement the DSA as a means of detecting currency and maturity mismatches.

Analyzing exchange rate regimes remains a central task for Fund surveillance. A better identification of the linkages between the exchange rate and the country's policy requirements would strengthen the Fund's advice on exchange rate issues.

We welcome the growing emphasis on the regional aspects of surveillance, in order to take into account the global impact of the economic conditions and policies of the systemically important Fund members.

We support Policy Monitoring Arrangements (PMA) as the means of addressing the demand of countries pursuing sound policies and that can benefit from stronger IMF signals to markets or donors, while not requiring Fund financing. PMA should have the same standards as a borrowing program and entail the same level of conditionality and involvement of the IMF Board.

Crisis Resolution

Although emerging market economies have become more resilient to individual shocks, the Fund should continue to work to improve the framework for crisis management and resolution.

The procedures for exceptional access should be fully implemented. These procedures will help prevent debtor countries and market participants from placing excessive reliance on the financial support provided by the IMF.

For countries benefiting from IMF financial assistance, the definition of sound exit strategies from IMF programs is essential to avoid the prolonged use of the Fund's resources. This includes better program design, macroeconomic and structural conditions to achieve debt sustainability, more effective conditionality and a careful consideration of the timing to regain market access.

Experience with Argentina's debt restructuring suggests that a more comprehensive approach to sovereign debt restructuring is needed. Progress has been achieved in introducing Collective Action Clauses in the international bond issues of emerging market economies under the New York jurisdiction. Some advanced countries have played a role in leading by example. Italy introduced CACs into its international bond issues in July 2003.

Despite the progress achieved, more work is still required on timely, orderly and effective restructurings that ensure an appropriate involvement of the private sector.

More clarity is needed on the Fund's policy for Lending Into Arrears. The Fund should only lend into arrears if a debtor country makes a significant policy adjustment in an effort to resolve arrears, and engages in negotiations with its private creditors in good faith to restore debt sustainability. In particular, the criteria for judging "good faith" should be better spelled out and made more operational, including by specifying the key elements of a constructive dialogue.

In Argentina, despite strong growth and fiscal performance, compliance with the IMF program approved in Dubai remains unsatisfactory. The 2005 budget still falls short of a return to the path needed for debt sustainability. On the structural front there is no significant progress on revenue sharing, strengthening the fiscal responsibility law, tax reform or the renegotiation of utility concessions which still raises World Bank concerns. There are signs that reforms are actually going in the opposite direction. Negotiations with creditors have not progressed, as required under the Fund's Lending into Arrears policy.

The program with the Fund is currently suspended. We urge the authorities to maintain close contact with the Fund and to make progress with the structural agenda, without which the current recovery will not be sustainable.

The Role of the Fund in Low-Income Countries

The Fund has a key role in helping Low-Income Countries achieve the Millennium Development Goals, by providing policy advice, technical assistance, and temporary balance of payments concessional support.

Surveillance needs to be tailored more effectively to the specifics of low-income countries, by looking into how a country's policies relate to the broader context of the MDGs and which corrective actions—if any—should be taken in that setting. The new framework for debt sustainability in low income countries should guide country authorities in defining policies, and inform the decisions of multilateral and bilateral donors.

In the next few months important decisions should be made concerning the future of the Poverty Reduction and Growth Facility (PRGF). After 2005 the resources available for the PRGF might prove to be inadequate to satisfy the expected demand, without additional bilateral financing. The Fund should explore the option of additional contributions from member countries in order to preserve its concessional lending capacity, while taking account of the need for more selectivity in PRGF loans.

We must work together to help countries that are moving from concessional financial assistance to a surveillance-based relationship with the Fund, including by exploring the possibility of ensuring precautionary access to PRGF resources.

The Fund needs to be engaged in a constant dialogue with other development partners. In this respect, it could leverage upon its catalytic function and help mobilize additional aid flows for low-income countries.

The HIPC initiative has so far succeeded in committing substantial debt relief to heavily indebted countries. Thanks to the recent extension of the sunset clause, the remaining countries will also join the initiative. Debt deterioration in countries that have already benefited from debt relief under the initiative should be closely monitored. Broader creditor participation should be stimulated in order to ensure fair burden-sharing.