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Statement by Tommaso Padoa Schioppa
Minister of Economy and Finance, Italy
On behalf of Albania, Greece, Italy, Malta, Portugal, San Marino, Timor-Leste

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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

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1. The Global Economic and Financial Outlook

The global economy has continued to grow at a rapid pace with a more balanced contribution by all regions.

The rate of growth in the US economy has slowed down toward its potential, although inflation remains above the comfort level of the monetary authorities. By contrast, the upturn in Europe has been stronger and broader-based than expected, fueled by domestic demand and in particular by investment, which is replacing exports as the main engine of growth. The Japanese economy has continued to grow at a satisfactory pace and the end of deflation has allowed the Central Bank to normalize monetary policy. Emerging Market Economies and Africa contributed to the strength of the global economy.

Although the outlook for the global economy remains favorable, downside risks have increased in recent months. These include the possibility of a sharper decline in the US housing market and persistently high and volatile commodity prices. Furthermore, global imbalances have continued to grow, increasing the risk of a sudden and disorderly unwinding.

Addressing global imbalances is a common responsibility of all the main players of the global economy. Accordingly, the Euro-area is committed to pursuing their strategy of structural reforms, which—over time—should strengthen both the demand and supply side of the economy, thus increasing the European contribution to global growth.

Despite recent improvements in the US budgetary position, more structural adjustments are necessary to raise the national saving rate. These will provide a major contribution in reducing global imbalances and will foster fiscal sustainability in the long term.

Japan should continue to pursue fiscal consolidation and implement key structural reforms in order to substantially boost consumer confidence and lift the growth potential.

The favorable external position and the large amount of reserves accumulated by the largest Asian countries call for greater exchange rate flexibility. Finally, the oil-producer countries should take advantage of the current favorable conditions to address their long-standing infrastructural needs, and in particular upgrade their facilities in the oil sector.

2. Economic Developments in the Constituency

In Italy, the first half of the current year started on a strong footing, after stagnation in 2005. Real GDP growth rose 0.7 and 0.5 percent quarter on quarter in the first and second quarter of the year respectively. With the projected slight moderation in the remaining part of 2006, GDP growth is estimated to reach 1.6 percent, marginally in excess of the 1.5 percent included in the 2007-2011 Economic and Financial Planning Document (DPEF) approved by Parliament in July. This compares with a flat reading in 2005.

There is an ongoing shift in favor of domestic demand. Consumption will benefit from the expected increase in household real disposable income, which in turn is underpinned by rising employment income. Over time, it should also benefit from lower inflation stemming from liberalization in the goods and services sectors.

On the external side, the continuing strong performance in world trade and a gradual recovery in Italy's competitiveness will lend support to export activity. The contribution to GDP growth by external demand is however projected to be close to zero in 2006 and slightly negative thereafter due to stronger imports. Further improvement in the labor market is anticipated in the current year, with an employment increase of 0.6 percent as opposed to the 0.4 percent contraction recorded in 2005. Growth rates of about 0.7-0.8 percent per year are anticipated thereafter. Unemployment will continue to decline slightly.

Compensation of employees per head will likely accelerate to 3.0 percent in the current year as a result of the latest contract renewals both in the public and private sector, while labor cost will decelerate relative to 2005 due to a reduction in the tax wedge. Productivity is expected to gradually increase, for now mostly for cyclical reasons, and contribute to moderate the increase in unit labor costs to 1.9 percent versus the 2.4 recorded in 2005. On the private consumption deflator metric, inflation will likely increase to 2.5 percent in 2006 from 2.3 in 2005, as a result of sharply higher import prices. Thereafter, inflation will likely edge down to 1.7-1.9 percent, as moderation in wage growth and a gradual acceleration in productivity will keep a lid on unit labor cost increases.

The government aims to structurally enhance economic growth, improve its budgetary position and pursue social fairness during 2007-2011. In June, it introduced a legislative initiative to foster competition in some goods and services sectors by reducing regulation and liberalizing access to the market. The Budget Law for 2007 will introduce further measures along these lines.

The deficit-to-GDP ratio is forecast to decline to at least 4.0 percent in 2006 from 4.1 in 2005. The general government debt is projected to remain below 108 percent of GDP in 2006. The Italian government is committed to reduce the deficit-to-GDP ratio to below 3 percent in 2007, with a 1.6 percentage point cyclically-adjusted reduction in 2006-2007, and bring the debt-to-GDP ratio below 100 percent of GDP by 2011. The planning document (DPEF) envisages a total of €35 billion (2.3 percent of GDP) in spending cuts and higher revenues and €15 billion (1.0 percent of GDP) in spending for growth-enhancing policies for

2007. More recently, in light of a structural improvement in tax revenues, the government has revised the size of the budget measures to a total of €30 billion.

Albanian's macroeconomic performance remains solid. With the exception of the supply-induced disruptions related to the difficulties in the electricity sector, the county has enjoyed a prolonged period of sustained growth. The estimated GDP growth in 2006 remains robust, at 5 percent. Despite the increase in oil prices, inflation remained subdued. Retail prices increased, on average, by 2.4 percent in 2005 and are expected to remain at the same level this year. The authorities are determined to preserve the current, prudent macroeconomic policies and further enhance the quality of the budget and the credibility of the monetary framework. The external current account deficit remains high and is expected to reach 8 percent of GDP this year (excluding official transfers), despite the strong and consistent inflow of remittances (which are about 15 percent of GDP).

The fiscal stance was restrictive in 2005 and budget execution was tight in the first half of 2006. The supplementary budget, recently approved, allocated the relevant "contingent expenditure" in high-quality capital spending, tax relief, and debt reduction. The authorities recognize that improving budget debt management is crucial. In the short term, the main problem is the strong private sector credit growth. However, the banking system is liquid, profitable, and well capitalized, while the non-performing loans are low. The Bank of Albania is encouraging banks, through moral suasion, to adopt stricter debt service-to-disposable income ratios and prudent loan-to-value ratios.

Greece's growth performance has been very strong recently, exceeding the Euro-area average by a wide margin. Growth has been underpinned by a sharp fall in interest rates in the run-up to Euro-area membership and subsequent easing by the European Central Bank. Domestic demand has been supported by rapid growth in private sector credit, as well as by significant infrastructure spending. Strong capital formation, high labor productivity growth, and significant immigration have all contributed to an expansion of the economy's supply potential. Tourism and shipping have been the fastest-growing sectors in recent years.

GDP growth amounted to 3.7 percent in 2005 and is expected to accelerate slightly in 2006 and 2007, supported by the continued recovery of the Euro-zone economy. Improved competitiveness is key to sustaining rapid growth and closing the gap in living standards with Western Europe. To this end, the government has launched several initiatives aimed at promoting competition, reducing administrative barriers, and cutting corporate taxes while improving tax administration.

Fiscal consolidation remains a key priority. A fiscal audit launched in March 2004 resulted in an upward revision of the general government deficit and debt for the period 1998-2004. While revealing an excessive deficit, the audit also helped improve transparency and provided a solid basis for assessment of the fiscal stance. Having already achieved significant progress in 2005, the government is committed to correcting the excessive deficit by end-2006 and making further progress toward a balanced budget in subsequent years. Fiscal consolidation has relied on wage moderation and other measures to contain public spending, and a broadening of the tax base.

The **Maltese** economy is projected to grow by 1.6 percent in 2006, against 2.5 percent in 2005. This rate of growth, below potential, mainly reflects the persistent weakness in external demand and tourism. In 2006 the current account-to-GDP ratio is expected to be 12.5 percent, lower than the 13.1 percent observed in 2005. The capital and financial account, on the other hand, should register a significant surplus underpinned by inflows of foreign direct investment and capital transfers, particularly from the EU. Inflation is expected to remain this year at about 2.9 percent, mainly as a result of higher energy prices. The authorities are fully aware that the adherence to a fixed exchange rate policy, the efforts to align the economy closely with that of the European partners, and the need for reducing the public debt require a high-quality program adjustment.

In line with the medium-term fiscal program, the authorities are committed to reducing the fiscal deficit substantially, despite the weak GDP growth. The deficit-to-GDP ratio should be 2.7 in 2006 and 2.3 in 2007. Accordingly, the public debt-to-GDP ratio is projected to be around 74 percent in 2006. The authorities are committed to rationalizing public spending over the next two years in the areas of public employment, health care, and social benefits, although they prefer, as the staff's paper candidly highlights, different implementation actions, or a more cautious pace, than those suggested by staff. On structural reforms, the authorities are committed to a wide range of measures to increase the growth potential and competitiveness of the economy.

In **Portugal**, GDP growth is projected to accelerate to 1.2 percent in 2006, following a weak performance in 2005. The ongoing recovery is mainly driven by a significant improvement in the performance of exports, which could increase by almost 8.5 percent. A modest growth rate of 0.8 percent is also projected for domestic demand, as the fall in investment continued, albeit at a slower pace, while both public and private consumption decelerated.

In order to improve its competitiveness in the global economy and strengthen its resilience against external shocks, it is crucial to enhance the production pattern of the Portuguese economy. Sustaining the recovery and resuming real convergence towards the Euro area average depend on overcoming the main imbalances in the economy. That means giving special emphasis to fiscal consolidation and the implementation of structural reforms aimed at increasing the flexibility and competitiveness of labor and product markets, as well as at preserving the sustainability of social security.

In 2006, the inflation rate is projected to increase, reaching 2.6 percent. This corresponds to a temporary pause in the process of reducing the gap vis-à-vis the Euro area average. As the impact of the 2005 VAT increase and of developments in energy prices fades away, and provided that wages remain on a moderate path, inflation should decline in 2007.

For 2006, the fiscal deficit is expected to be reduced by 1.4 percentage points, to 4.6 percent of GDP, while public debt dynamics still imply an increase in the debt-to-GDP ratio. Information available thus far, reported to the first half of the year, is consistent with the targets envisaged in the budget and with commitments under the Stability Program for 2005-2009. According to the latter, Portugal is expected to curb the excessive deficit and return to a deficit below the Stability and Growth Pact 3 percent reference value by 2008.

As regards relations with the IMF, besides regular bilateral surveillance, in the context of article IV consultations, an FSAP was recently undertaken. This exercise implied a thorough and complete analysis, covering economic, financial and risk elements, including the performance of stress tests, as well as the organizational arrangements and technological platforms in use and the quality of the regulatory and the supervision frameworks. According to a published preliminary assessment, the Portuguese financial system is sound, stable and well supervised. This favorable view extended to banks and insurance, to the securities sector and also to the systems for settlements and payments.

In **San Marino**, the priorities of the new, recently-appointed Government are the consolidation and the further development of the economic and manufacturing sector consistently with the environmental, territorial and labor market features of the country. In this regard, particular importance is attached to the finalization and implementation of the new legislation – adopted in November 2005 – on financial and insurance services, which will fully comply with international standards and transparency.

On budgetary issues, the Government remains strongly committed to reducing the impact of current expenditures so as to increase the resources available for investment in infrastructures and development of the San Marino economy. Particular attention is currently being devoted to framing a network of bilateral treaties with several countries in the field of economic cooperation and avoidance of double taxation.

Finally, the San Marino authorities also remain strongly committed to fight terrorist financing and money laundering in close cooperation with the relevant bodies of the UN and Council of Europe.

Recent unfortunate events in **Timor-Leste** have now largely been countered and the security situation returned to normal. However, the social and economic consequences of this instability period will have to be tackled, for which purpose the authorities are counting on the continued engagement of the international community.

Until this recent setback, non-oil economic activity was recovering, while inflation remained subdued and sizeable oil/gas revenues supported comfortable fiscal and external balances. A Petroleum Fund was introduced in mid-2005, together with a long-term savings policy, following international best practices. These arrangements aim to preserve oil/gas wealth for future generations, while releasing resources to underpin the Government's development strategy in a sustainable way.

The essential aim is to build up infrastructures, institutions, the capacity of human resources and an environment conducive to private sector-led growth, within a framework of transparency and good governance. Relying also on continued support from the international community, this long-term strategy is expected to allow for much-needed job creation and the progressive improvement of currently difficult social conditions.

Buoyed by favorable price and production developments, the oil/gas sector is estimated to have reached about the same size of non-oil GDP in 2005. Despite significant oil/gas revenues, a major acceleration of non-oil investment was still being conditioned by administrative, infrastructure and institutional constraints. That resulted in a current account surplus equivalent to 90 percent of non-oil GDP in 2005 and a Central Government budget surplus equivalent to 76 percent of non-oil GDP in the fiscal year of 2004/05.

3. Medium-Term Strategy: the implementation phase

3.1 Bringing surveillance back to the center of the Fund's mandate

Strengthening surveillance is essential to increase the effectiveness of the IMF activity to foster sound economic policies and prevent disruption in the global financial system. Focused surveillance and timely policy advice can help members detect and address critical vulnerabilities.

In light of the new challenges posed by the increased integration of global economic and financial markets, last April the IMFC agreed on the need for a new framework aimed at strengthening IMF surveillance and making it more effective, independent, and accountable.

A new vehicle for multilateral consultation has been established to complement other surveillance approaches with the aim to provide a new forum for multilateral debate that could foster agreement on policy actions.

The focus of the first multilateral consultations is on global imbalances. We welcome the policy dialogue involving China, the Euro Area, Japan, Saudi Arabia, and the United States, and we look forward to the results of these discussions, which can lead to a broad consensus on measures that would sustain growth and contribute to the orderly unwinding of imbalances.

There is a clear need to revisit the *1977 Decision on Surveillance over Exchange Rate Policies* and establish a new framework for surveillance that will provide unifying guidelines, clarify procedures, and prioritize the issues. The revision of the preamble of the 1977 Decision will offer an opportunity to reiterate the commitment to IMF surveillance member states have undertaken under the Articles of Agreement.

Financial market and exchange rate issues should be brought back to the core of surveillance activity. We welcome the increasing commitment of the institution to upgrade the Fund's work on financial issues. Keeping up with the rapid development and deepening of the financial and capital markets is a serious challenge. There is ample room for improvement to forge a consistent framework where financial and traditional macroeconomic analysis are well-structured and integrated.

With the spreading of globalization, the interactions between domestic and international economic development are substantially increased. Yet, the impact of domestic policies on the international stability as well as the nature of cross-border spillovers have not been well understood. Focusing on the issues that affect external stability would provide adequate boundaries for the policy areas subject to Fund surveillance and promote priorities for both the institution and membership.

More effective surveillance should be accompanied by more independence and accountability. Setting an annual remit on surveillance as the IMFC proposed last April will help identify both the priorities to be achieved in the medium term and a proper assessment framework. This will strengthen the IMF's communication strategy and foster its accountability to the general public to fully implement its mandate and to be at the forefront in dealing with global issues. Identifying the remit and monitoring the results should be the responsibility of the Executive Board under the IMFC's political guidance.

3.2 Quota and voice: a comprehensive and balanced package

The legitimacy and credibility of any organization hinges on a wide and fair representation of its whole membership, and the IMF is no exception. A full involvement of members in the decision-making process should be ensured, particularly when multilateral issues are at stake and a close multilateral cooperation is required.

The resolution of the Board of Governors is of fundamental importance to strengthen IMF governance. The immediate ad-hoc quota increase in favor of the most underrepresented members is an initial step and confirms the commitment of the institution in that direction.

In the coming months, the work on the quota formula should proceed rapidly since its results will lay the foundation to implement a second round of ad-hoc quota increases directed to address the other substantial critical cases of under-representation.

The new quota formula should be simple and transparent. It should reflect appropriately the position of member countries in the economic and financial system while taking into account the different functions of quotas. The level of the gross domestic product and degree of openness are crucial in capturing the weight of member countries in the world economy and their responsibilities in the functioning of the global markets.

Future *General Reviews of Quotas* should address progressively the discrepancies between the actual and the calculated quota in a more systematic and transparent way, but any decision to increase quotas should continue to be triggered by the actual liquidity needs of the IMF.

In line with the Monterrey commitment, the increase in basic votes will contribute to give more voice to low-income countries and to further enhance their real participation in the decision-making process. We strongly support at least a doubling of basic votes to protect the existing voting power of low-income countries. It should be fully implemented by the time the second ad-hoc quota increase takes place, at the latest.

3.3 Emerging Market Economies and the Fund: is there any progress?

The quota increase for the most underrepresented emerging market countries and the ongoing efforts to fully integrate financial and capital market analysis in the Fund's surveillance process are significant steps toward meeting emerging market needs. The recent accumulation of a sizable amount of reserves and the establishment of regional reserve pooling arrangements have generated momentum to assess the need for an insurance facility that would allow for automatic access to large-scale financing when a crisis erupts.

The Fund should continue to explore ways to improve the access to Fund resources for countries characterized by solid macroeconomic framework and a strong track record in the presence of a sharp reversal of capital flows or market-access constraints. However, we do not see any gap in the current IMF facilities array. Furthermore, we believe that the existing facilities are flexible enough to provide the necessary financial assistance to countries that incur balance of payment problems.

The current precautionary arrangements and the exceptional access framework have helped the membership signal the strength of their policies and provide access to significant Fund resources. They have contributed to fortify domestic policies and ensure a credible and durable exit from Fund financial assistance.

While we remain open to examine constructively the proposal to establish an "insurance facility," we are still skeptical about the possibility of designing a contingent instrument able to ensure full consistency with the exceptional access policy framework, which remains the key pillar of the Fund's lending policy, and to offer the necessary safeguards for the Fund's resources. Addressing the shortcomings that emerged from the experience with Contingent Credit Lines (CCL), in particular the establishment of objective and stringent qualification criteria and the identification of a credible and ambitious monitoring structure, is essential to make this tool operational.

Finally, regarding the other key aspects of the medium-term strategy, we favor a more active and substantial involvement of the IMF in crisis resolution. An extensive review of the lending into arrears policy aimed to address the main weaknesses that emerged during the recent crises is vital to strengthen the IMF's role.

3.4 Low-income countries: a renewed commitment

The Fund has an important role to play in low-income countries (LICs), namely supporting their efforts to achieve macroeconomic stability and implement pro-growth structural adjustment. These are essential steps towards achieving the MDGs.

A set of new instruments has been created to strengthen the role of the Fund in LICs, including the Policy Support Instrument and the Exogenous Shock Facility. In addition, debt relief under the HIPC and MDRI initiatives has contributed to improve the financial position of LICs and has freed resources that can be dedicated to poverty-reducing expenditures. We share the view that the sunset clause of the HIPC Initiative should go into effect at end-2006, while grandfathering all countries that are assessed to have met the income and indebtedness criteria based on end-2004 data. We ask the Fund to explore alternative options to finance HIPC and MDRI debt relief for these countries.

Looking forward, the Fund should remain closely engaged with LICs through surveillance, capacity building, and financial assistance, focusing on the areas of its core expertise. In particular the IMF should continue to strengthen its policy advice with a view to assisting LICs in the design of a sound policy mix aimed at (i) effectively managing increasing aid flows and the fiscal and balance of payment space created by debt relief, and (ii) preserving debt sustainability. In this regard, we welcome the ongoing work to refine and enhance the Joint Debt Sustainability Framework (DSF), which is, in our view, an essential tool for borrowers and creditors alike to reach consistent financial decisions and avoid the accumulation of new unsustainable debt, particularly in post-MDRI HIPCs.

We look forward to the work of the External Review Committee. Defining an effective division of labor between the Bank and the Fund, based on their comparative advantages, and enhancing coordination are key to improving the quality of the assistance that the two institutions can provide to low-income members in their ongoing efforts to achieve the MDGs.