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Statement by Mr. Tremonti
on behalf of Albania, Greece, Italy, Malta,
Portugal, San Marino, and Timor-Leste

Statement by the Honorable Giulio Tremonti
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Speaking on behalf of Albania, Greece, Italy, Malta, Portugal, San Marino, and Timor-Leste

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Challenges for the International Financial Community

The main feature of the current global outlook is that growth is picking up but imbalances are not narrowing and, to a large extent, risks are increasing. Global imbalances need to be addressed through a credible and cooperative approach entailing restoration of budget balance in the US, stepping up of structural reforms in the euro area, banking and corporate sector reforms in Japan, and more exchange rate flexibility in emerging Asia.

A major contribution to reducing global payment imbalances should come from higher growth in the euro area, generated by more aggressive and effective supply side reforms. However, it is important to keep in mind that reforms take a long time to yield results.

Increased exchange rate flexibility in emerging Asia is crucial to contribute to the orderly correction of global imbalances as well as to facilitate more balanced and sustainable growth in the Asian region.

The IMF remains a key institution in this context. Its function and characteristics should be further enhanced, including through reinforcing and better protecting its preferred creditor status.

Surveillance and Crisis Prevention

IMF surveillance is an essential tool for the strengthening of crisis prevention. The 2004 biennial review is an opportunity to reinforce surveillance in order to meet the challenges posed by the global economy and global capital markets.

Reinforcing the analysis of debt sustainability is a key element to underpin the Fund's capacity to timely unveil vulnerabilities and avert financial crises. The 2004 biennial review should also help identify effective mechanisms to separate surveillance from lending activities in program countries and to bring about the desired "fresh perspective" in the country assessment. To this end we encourage the IMF to set up a new organizational structure that ensures that DSA, including different policy scenarios, is pursued independently from lending decisions.

The level of disclosure of Fund surveillance should be improved, especially by pursuing a progressive increase in the rate of publication of surveillance reports and Board documents and minutes. This would help surveillance achieve one of its main tasks, namely to spread information to market participants about the Fund's assessment of its members' situations.

We encourage the Fund to explore the possibility of introducing strengthened monitoring procedures and tools. This could be the appropriate way to fill the gap between standard surveillance and program conditionality as well as to cope with the increasing demand for the Fund's technical assistance and advice in the absence of program financing. In the same vein precautionary arrangements within normal access can be very effective in adding strong incentives for good policy implementation.

The analysis of systemic interdependencies should be strengthened. Regional surveillance and monitoring of the regional implications engendered by the performance of systemically important countries may be the channel to unveil and stress country interdependencies as potential sources of financial contagion.

Playing an increasing role in international financial markets, offshore financial centers (OFCs) merit heightened attention in the surveillance process. Recent market failures have shown that OFC operations can be misused to the detriment of overall financial stability and integrity. Therefore, we welcome the decision of the IMF Executive Board to make the OFC assessment program an ongoing component of the IMF work. Such a renewed Program should be aimed at assessing and effectively strengthening regulatory, supervisory, cooperation and information exchange arrangements of OFCs. The process should be pursued with the highest degree of transparency in such a way that matters of common concern are preemptively addressed before vulnerabilities and risks materialize. Italy has a close interest in the matter and has recently set forth concrete suggestions on how to make the IMF Program as effective as possible.

Crisis Resolution

Effective crisis resolution should aim at re-establishing market access for the debtor country as a top priority. The implementation of the new procedures for exceptional access will help avoid debtor countries' and market participants' excessive reliance on the financial support provided by the IMF financing.

The introduction of CACs in international bonds issued has been a most welcome step. EU Member States committed since April 2003 to use CACs in all international bond issues. Consistently with this commitment, Italy started to issue bonds with CACs, under the New York Law in July 2003. Many Emerging Market Economies, including Mexico, Brazil, Uruguay, Korea and South Africa have issued bonds with CACs. We encourage other countries to follow these examples.

However, there are many aspects of a debt restructuring which are not solved with the introduction of CACs. Further substantial work is needed on a comprehensive sovereign debt restructuring mechanism to make the process more orderly and predictable.

The implementation of the IMF Lending into Arrears policy should be strengthened, including through specific reports on the Fund's assessments of the countries' compliance with the Good Faith criterion. These reports, issued regularly at each program review, should be published.

The Role of the Fund in Low-Income Countries

The Fund has a relevant role to play in supporting low-income countries to achieve the Millennium Development Goals. We welcome the recent Board's discussion on how to refine the Fund's instruments and their financing to support low-income countries in their efforts.

The Fund's concessional lending capacity after 2005 should remain broadly in line with the projections outlined by Fund Staff. Consistently, we are in favor of a self-sustained PRGF to be topped up with additional bilateral resources, if needed.

We support strengthening efficiency and selectivity in the use of PRGF resources. The encouraging experience with PRGF arrangements raises the issue of how to support countries with a good reform record to consolidate their results. In this respect, precautionary PRGF or low-access arrangements may be well placed.

We support work to strengthen the Debt-Sustainability Analysis in LICs as a useful complement to the Enhanced HIPC Initiative, which addresses unsustainable debt on an *ex post* basis. The new framework should be a reference for the donors and the concerned countries and should provide guidance for new borrowing decisions.

The Italian Economy

2003 has been disappointing for the Italian economy, as the tentative signs of recovery, which surfaced last Fall, were not confirmed in the following months. The relapse in the recovery was largely due to the sudden downturn in private consumption, which has been until recently the mainstay of the economy. Declining exports continued to hamper the recovery; the sluggish demand affected investment, which continued to decline throughout 2003. In the last few months a number of exceptional factors have contributed to depress confidence and curb domestic demand, including the near collapse of the largest Italian food company – PARMALAT – whose losses amounted to more than 1 percent of GDP and threatened the savings of thousands of small investors and the loan portfolios of several large banks.

The weakness of the Italian economy also reflects more fundamental problems. The strength of the euro and the sluggish growth of Italy's major trading partners are preventing an export-led recovery, which in previous cycles had a major role in lifting the Italian economy out of the doldrums. Despite the steady increase in employment and the tax cuts introduced with the first phase of the fiscal reforms, disposable income has been eroded by relatively high rates of inflation. Thus, it is not surprising that consumers have tightened their spending, depriving the economy of a much needed stimulus.

For two years in a row, the Italian economy has been stagnating as GDP grew by a meager 0.3 percent in 2003, slightly lower than the 0.4 percent recorded in 2002. The lack of success in riding the strong upturn of the world economy is a source of concern and suggests the need to adopt decisive measures to break out of the current low-growth path. The program of economic reforms underway will increase productivity, improve the competitiveness of the Italian economy and raise its growth potential. However, in the short-term it is necessary to jump-start the recovery by provoking a supply-side shock to the economy, including income tax cuts.

Although low by historical standards, inflation remains substantially above the European average, eroding the competitiveness of the Italian industry. Inflationary pressures have been fuelled by the peculiar circumstances surrounding the introduction of the euro which resulted in a much larger “rounding” adjustment than in other countries; in some cases, items of daily consumption all but doubled, leading to a widespread feeling that actual inflation is much higher than that indicated by the official statistics.

Despite the sluggish economy, employment continued to grow in 2003, as a result of the reforms introduced in the past few years, which have substantially increased the flexibility of the Italian Labor Market. Last year 220,000 new jobs were created and the unemployment rate declined to 8.5 percent, well below the Eurozone average.

The outlook for the Italian economy has been clouded by the disappointing results of the last few months and the uncertainty surrounding the recovery in other European countries. Some of the factors responsible for holding back private consumption in 2003 may continue to have a negative impact on growth in the first quarter of this year; however, a gradual improvement is expected from the second quarter onward. Although the pace of the recovery should accelerate throughout the rest of the year, the low starting point makes it unlikely that GDP growth will average more than 1.2 percent in 2003. This result will represent a clear improvement over the near-stagnation of the last two years, but it still puts the growth rate substantially below the potential of the Italian economy.

Slower than expected economic growth will negatively affect public finances, as the Deficit-to-GDP ratio could reach 2.8-2.9 percent in 2004. In addition to keeping the overall deficit under control, the Italian government is committed to accelerating the substitution of the one-off measures with structural measures, which will produce lasting improvements on the Budget. Further progress in reducing the debt is expected from privatization and from the allocation of the proceeds of other asset disposal to the reduction of debt rather than to the deficit. The program of economic reforms will continue with the imminent approval by Parliament of the Pension Reform. A comprehensive reform of the financial sector has already received broad bi-partisan support, while the government is preparing additional measures to complete the Fiscal Tax reform started in 2002. The objective is to simplify the tax-structure and bring the tax burden in line with that of other countries which have implemented successful supply-side reforms. Any reduction in taxes will be fully funded by reducing expenditures in other areas such as the numerous programs of "corporate welfare", some of which have outlasted their original usefulness. Explicitly excluded from the cost-cutting drive are spending for the welfare system, national security, R&D and higher education.

The Outlook in the Other Countries in the Constituency

During 2003, **Albania** strengthened macroeconomic stability and further advanced structural reforms. Growth recovered to 6.0 percent and inflation maintained an annual rate of 2.3 percent, reflecting favorable export performance and a stable exchange rate. The reserves have continue to increase, amounting to over US$ 1 billion, which is more than the 4.5 months of imports target. The fiscal consolidation process remains on track, while further efforts are focused in improving tax administration and revenue collection. Remarkable progress has also been achieved on the structural front, including the successful privatization of the Savings Bank and the improvement in the power sector. Going forward, the Authorities are strongly committed to speeding up the implementation of reforms, particularly in the areas of governance, institution building, and poverty reduction.

Economic growth in **Greece** accelerated in 2003 to 4.2 percent, which is estimated to have been the highest rate of growth both within the European Union and among the 30 member states of the OECD. Economic activity was supported by strong increases in private consumption and gross fixed capital formation and, to a lesser extent, a recovery in exports of goods and (notably transportation) services and high growth in public consumption. The pace of job creation picked up in 2003 and the unemployment rate declined to about 9 percent.

Despite the growing utilization of productive resources, the rate of inflation eased to below 3.5 percent in 2003 (and less than 3 percent in the first quarter of 2004), while the external current account deficit narrowed marginally to 5.7 percent of GDP. On the other hand, fiscal indicators weakened in 2003, with the general government deficit rising to just under 3 percent of GDP (as compared with 1.4 percent of GDP in 2002) and the primary surplus declining by nearly 2 percentage points of GDP.

The sustained rapid pace of economic growth in recent years has been facilitated by the consolidation of generally stable macroeconomic conditions, following the country's entry into the euro area, the gradual implementation of major structural reforms and the significant inflow of EU-community support funds. These developments enhanced the medium-term growth perspectives of the Greek economy and contributed to a progressive improvement in business and consumer confidence. Additional factors that played an important role in 2003 were the persistence (since the end of 1999) of a relatively accommodative monetary stance, which fueled (for the third consecutive year) a rapid expansion of credit to the private sector, the unexpectedly sharp relaxation of fiscal policy and an acceleration of the preparations for the Athens 2004 Olympic Games.

It is expected that economic activity will continue to grow at a rapid pace in 2004, assisted by the marked improvement in the global macroeconomic environment and the direct and indirect benefits of the Olympic Games. As a result, the rate of unemployment is likely to continue to fall. On the other hand, the fiscal accounts are not expected to show much improvement and pressures on productive resources may well intensify further. This may inhibit further progress in lowering the rate of inflation and narrowing the adverse differential relative to average inflation in the euro area.

In **Malta** economic activity in 2003 is estimated to have contracted by 1.7 percent after expanding by 2.2 percent in the previous year. Growth in private consumption slowed down sharply in the first nine months of the year, partly reflecting depressed conditions in the labor market and the uncertainty created by the EU referendum and general elections in the early part of 2003. Consumption picked up in the final quarter ahead of the increase in the standard VAT rate (from 15 percent to 18 percent) scheduled for the start of 2004.

The weakness of the export-oriented sectors led to job losses, especially in the manufacturing sector. This pushed the rate of unemployment in 2003 up to 7.9 percent from 6.8 percent The rate of inflation dipped to 1.3 percent, mainly reflecting the impact of stable imported inflation and lower prices of seasonal food items and clothing.

The fiscal deficit remained expansionary and was exacerbated by a decision to implement a far reaching restructuring plan in the shipbuilding and ship repair sector. The inclusion of this restructuring transaction boosted the deficit to 9.7 percent of GDP from a projected 6 percent.

During 2003 the Central Bank eased its policy stance, reducing the central intervention rate by 25 basis points on three different occasions at the 3 percent level. The decision was supported by further growth in the Central Bank's net foreign asset position, a low interest rate environment overseas and subdued inflation and economic activity in Malta.

In 2004 the Maltese economy is expected to return to positive growth, although below potential. The pick-up is expected to be driven by the external sector and investment. The budget deficit is projected to decline to around 5.7 percent of GDP in 2004. Fiscal tightening, in particular, the increase in the standard VAT rate, should have a dampening effect on consumption and on imports.

Increased international competitive pressures are expected to result in further industrial restructuring. Unemployment is expected to continue to increase. Inflation is projected to surge, temporarily, to around 3 percent, in response to the one-time effects of the hike in the VAT rate. Underlying inflation is expected to remain stable at around 2 percent.

The Central Bank of Malta's monetary policy strategy will continue to aim at price stability through the exchange rate peg. The Maltese lira continues to be pegged to a currency basket, made up of the euro, the pound sterling and the US dollar, with weights of 70 percent, 20 percent and 10 percent, respectively. It is expected that the Maltese lira will enter the ERM II by the beginning of 2005.

In 2003, the **Portuguese** economy was in recession. Recovery is expected for 2004 with most recent projections pointing at a GDP growth rate of about 1 percent.

During 2003 important adjustments were reached concerning the excessive deficit in general government accounts and the level and growth of private sector debt. Therefore, the sharp slowdown in aggregate demand was a necessary element of the adjustment process: consumption and particularly investment were significantly hit, declining in real terms in 2003 (-0.7 percent and –7 percent, respectively).

External developments were insufficient to compensate for internal adjustments of this scale, as activity was subdued in the euro area, in particular in some of the main Portuguese trading partners, and the euro appreciation affected exports to non-euro markets.

The need to restore public finance soundness and fulfill the commitments associated with the Stability and Growth Pact marked the fiscal policy followed by the Portuguese authorities.

As a result of significant efforts on both the revenue and the expenditure sides, some of the former of a one-off nature, the fiscal deficit ratio stood at 2.8 percent in 2003, and is expected to remain below 3 percent this year.

The cyclical position of the economy affected developments in the labor market. The unemployment rate increased to 6.4 percent in 2003, employment decreased and wages became more moderate. These developments were reflected in consumption demand. The significant negative growth in investment was due to public expenditure cuts, the need to improve corporate sector balances and low expectations concerning economic activity.

All these developments contributed to a significant reduction in the external deficit already in 2003, a trend that is expected to continue in the present and subsequent years.

The weakness in economic activity, increased moderation in wage negotiations (induced also by public sector wages), and the appreciation of the euro led to a decrease in Portuguese inflation to 3.3 percent in 2003, reducing the deviation vis-à-vis the euro area average. This evolution was also observed in the first months of 2004.

Portuguese banks proved resilient to the unfavorable developments that occurred in recent years, namely growing uncertainty and hesitant domestic and global recovery and their impact on financial market developments. In 2003, conditions were more positive for the banking and insurance sectors: favorable developments came from international financial markets and from the improvement in Portuguese households and corporate balances. Moreover, prudential supervision measures (in connection with provisioning and disclosure) and the enhancement of banks' risk management practices (reflecting national supervision authority criteria and the preparations toward new international standards and best practices) are to be mentioned.

In **San Marino** the previous weakening in the economic activity that occurred in conjunction with sluggish international growth has led the authorities to discuss thoroughly with the Italian and EU authorities, in light of ever-increasing cooperation, the development of new and advanced sectors of activity that could most benefit the small and open economy of San Marino by increasing its competitiveness vis-à-vis its current and potential trading partners.

At the same time, the emphasis made by the authorities on identifying the most valuable sources of growth for their economy is underpinned by their objective to reach a balanced budget, in the context of a fundamentally solid fiscal position of the Government.

In **Timor-Leste** the effects of reduced international presence (UNMISET), a decline in agricultural production (reflecting a delayed 2002 rainy season and subsequent flood damage) and the declining pace of reconstruction activities led to a contraction of real GDP by 3 percent in 2003.

The return of normal weather conditions is expected to partly offset the impact of the winding down of the international presence, leading to a modest upturn in real GDP of 1 percent in 2004. A seasonal increase in the supply of basic agricultural goods was responsible for the reduction of inflation to 4 percent in December, after hovering at about 8-10 percent during the first half of 2003. The public sector deficit is expected to reach some 8.8 percent of GDP in FY 2003/04, 2.7 points higher than in FY 2002/03. While below-budget oil/gas revenues were offset by stronger import duties, a less rigorous expenditure control led to a faster than originally envisaged growth in expenditures. The higher deficit will be fully financed by larger-than-budgeted donor assistance and a drawdown of cash balances, aided by the government's mid-year budget review decision to cut expenditures and tighten their control.

The banking sector continues to expand, as a third commercial bank started to operate and micro-financing operations have gained momentum, contributing to a substantial increase in bank deposits. Bank lending has increased, representing 38 percent of deposits in December (as compared to 10 percent in January 2003).