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Statement by Honorable Domenico Siniscalco
Minister of Economy and Finance and Governor of the IMF for Italy
On behalf of Albania, Greece, Italy, Malta, Portugal, San Marino, and Timor-Leste

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The Global Economy

Global growth, while moderating to a more sustainable pace, is likely to remain strong despite the downside risks, particularly the persistently high level of oil prices.

Growth has also become more unbalanced. While projections for the US and Emerging Asia are better-than-expected, forecasts have been significantly revised downwards for the euro area and Japan. Current account imbalances have widened. Budget and current account deficits in the US are at historically high levels and are steadily increasing. Long-term interest rates continue to remain subdued, but this trend could soon change as inflationary pressure increases.

Emerging market economies have strengthened their debt positions. However, major vulnerabilities in many of these markets remain, and might suddenly deteriorate if the global environment turns less benign and imbalances show no sign of adjustment.

While a disorderly adjustment of global imbalances remains a risk scenario, policy action to prevent this scenario must continue.

Global adjustment, in the current situation, requires fiscal adjustment in the US, growth-enhancing reforms in Europe and Japan, and moving towards greater exchange rate flexibility in emerging Asia. However, this approach needs some conditions: greater ownership as well as further understanding the timing of adjustment. This is an area where surveillance should be more effective. Global imbalances largely reflect saving and investment imbalances. Adjusting saving and investment takes time, as it reflects deep stock adjustment.

The main contribution that Europe can make to reducing global imbalances is by contributing more forcefully to global growth. Higher growth in Europe requires further structural reforms, in labour, capital and product markets as well as higher investment and total factor productivity.

The **Italian economy** has been experiencing a period of subdued growth, which extended beyond the pattern of traditional economic cycles. Although GDP growth accelerated from 0.4% in 2003 to 1.2% last year, this result is unsatisfactory. The current difficulties reflect long-standing structural problems, including high public debt, high taxation as well as the loss of competitiveness stemming from the increase in real exchange rates. Hence, growth is the key priority of economic policy.

In the past few years the Italian government has been implementing a series of reforms needed to address the challenges arising from the new economic environment, including a rapidly ageing population and growing competition from the emerging countries.

The original EU Stability Pact has imposed tight constraints on economic policy, also due to insufficient adjustment in the expansionary phases of the cycle. The ambitious objectives of the Lisbon Agenda have not pushed an effective strategy for growth and employment. This institutional framework has changed in the past few weeks.

In full respect of the European Treaty provisions, the new Stability Pact rejuvenates the economic rationale of the budgetary rules. It explicitly takes into account the country-specific economic and budgetary conditions, and the implementation of structural reforms, allowing temporary deviations from the medium-term objective or defining the adjustment path to achieve it. These factors are also to be considered when assessing compliance with budgetary discipline together with "all relevant factors", most notably public investment and the overall quality of public finances. In order to avoid pro-cyclical polices, adjustment efforts should be higher during "good times", and more limited in bad times.

As one of the earlier proponents of these changes, the Italian government intends to adhere fully to the spirit of the new Pact.

The new Stability Pact entails some risks as well as important opportunities. The greater flexibility allowed to member states in managing their own finances could increase the risks of wider spreads, as financial markets try to gauge the true impact of their fiscal policies. It is therefore essential to retain market credibility. To this end, the Italian government will renew its efforts to achieve the medium-term objectives and a substantial reduction in public debt, with the aim of bringing it below 100% of GDP.

To this aim, growth is essential. The revamped strategy of the Lisbon Agenda parallels the growth-enhancing policies pursued by Italy in the past few years. Important reforms have been launched including the reform of the labour market, producing an increase of more than 1.2 million jobs since 2001. Unemployment at 8% has reached a six-year low, while inflation, currently at 1.9%, is slightly below the European average.

The reform of the Pension System approved by Parliament last year will raise the retirement age by five years as of 2008. Other features of the reform include the use of the deferred severance payments to fund the social security second pillar. Furthermore, very strong incentives have been offered to workers who choose to delay their retirement by at least two years; they will receive a 33% increase in their net take-home pay. So far, the scheme is credited with a 10% decline in the number of early retirements, a percentage that could increase further as additional workers become eligible for the incentives.

To boost the competitiveness of the Italian economy, the government recently submitted to Parliament a package of measures aimed at improving the business environment by updating the bankruptcy laws, cutting companies' administrative costs, expanding the capital markets with the launching of the pensions' second pillar, improving infrastructure and enhancing human capital.

As far as the 2005 and 2006 budgets are concerned, the priority of the government is to keep the deficit under control, to reduce taxes hand in hand with current expenditure, to reduce public debt, by means of higher primary surpluses and divestitures. Tax reform will continue, also by means of a phasing-out of IRAP on labour costs.

During 2004 and early this year, **Albania** has focused on maintaining macroeconomic stability, strengthening the monetary and budget policy frameworks, and improving the investment climate.

Growth has recovered to about 6 percent and inflation has declined to an annual rate of 2.2 percent. The value of the Lek has continued to rise, reflecting increased confidence, and the current account has improved. This performance has been supported by sound monetary and financial sector policies, fiscal consolidation, and structural reforms in selected areas. Public indebtedness has declined steeply by 9.5 percentage points of GDP since end- 2002, to 55.25 percent of GDP at end-2004.

The growth contribution from industry has been modest. Although the current account deficit narrowed from 10 to 7 percent of GDP during 2002-2004, it still remains high—as does the goods and services trade deficit, which was 23 percent of GDP in 2004. The trade gap has largely been covered by migrant remittances and other private and official transfers from abroad, buttressing incomes and domestic demand.

Over the medium term, on the assumption of an improved investment climate, growth may remain close to its historical 6 percent trend. This expansion is predicated on rising exports and productivity, the speeding-up of structural reforms, and the strengthening of financial intermediation and private investments. Reforms to improve the efficiency of tax administration and budget expenditure are envisaged to protect fiscal consolidation gains, while gradually permitting greater expenditure on health, education, infrastructure, and poverty alleviation. As export earnings and domestic savings expand, the external deficit is projected to resume a downward trend.

In **Greece,** growth remained robust in 2004, led by strong domestic demand. Investment spending was the main contributory factor, underpinned by low interest rates and strong construction activity associated with the Olympic games, although consumer spending also remained buoyant. Growth is projected to remain strong in 2005-07, averaging 4 percent per year, as private investment takes up much of the slack generated by the end of the Olympics spending. In particular, private investment would be supported by lower corporate taxes, new investment incentives, Private-Public Partnerships, and an improvement in the business climate through cuts in red tape and streamlined business regulation. Inflation decelerated in 2004, though remaining above the Euro area average.

Fiscal consolidation remains the key policy priority of the Greek government. Following the completion of the fiscal audit which led to a substantial upward revision of the fiscal figures, Greece submitted to the EC an updated Stability Programme in March 2005. The programme targets a reduction of the general government deficit from 6.1 percent of GDP in 2004 to 3.5 percent in 2005 and to below 3 percent in 2006 and beyond. Thus, the fiscal framework remains consistent with a gradual reduction in Greece's relatively high debt ratio. Fiscal consolidation is to be achieved mostly through spending cuts. In addition, a package of indirect tax increases took effect in April 2005. The government also remains committed to accelerating privatization and opening up previously protected markets to competition.

GDP growth rate in 2004 reached 4.2%. Investment increased by 4.9%, contributing 1.3 percentage points to GDP growth. The pace of investment growth was slower than projected in the SGP 2003, due to decelerating construction activity in the second half of the year, while private building activity, on the other hand, rebounded at the end of the year after decreasing significantly during the first semester.

Private consumption growth, although decelerating, remained robust in 2004 at 3.3%, down from 4% in 2003. New private passenger car registrations increased by 15.7%, and credit expansion to households continued rising rapidly at a rate of 28.5%.

As far as the external balance is concerned, exports and imports increased in real terms by 10.0% and 8.2%, respectively, and the contribution of the external sector to GDP growth registered a negative figure in the order of 0.46 percentage points. Buoyant shipping receipts and tourism receipts, however, contributed to a decline in the current account deficit.

Total employment (according to the Labour Force Survey using a new sample based on the results of the 2001 Census) increased in 2004 by 2.8%, but the higher increase in the labour force (3.6%) resulted in an unemployment rate in the order of 11%.

The average HICP inflation rate was 3.0% in 2004, remaining higher than the euro area average, reflecting strong domestic demand, a positive output gap and higher energy prices. The inflation differential between Greece and euro zone declined to 0.9%, down from 1.3% in 2003 and 1.6% in 2002.

In the area of public finances, the general government deficit outturn was 6.1% while the general government debt reached 110.5% of GDP. Both figures show a large deviation from the targets set in the 2003 SGP, mainly due to the impact of the statistical revisions and an overshooting of expenditure related to the Olympic Games as well as other under-budgeted items, along with a significant shortfall in revenue compared to what had been budgeted.

Economic growth in **Malta** in 2004 recovered to 1.5% after contracting by 1.8% in the previous year. The recovery in economic activity in 2004 was primarily driven by domestic demand although the expansion in both investment and consumption was modest. Exports were stronger over the year but the overall effect of the external sector on GDP was negative as imports of goods and services increased at a faster pace. Slow growth in public consumption reflected the Government's efforts to restrain growth in public expenditure in line with its medium-term fiscal consolidation programme. The recovery in economic growth led to a drop in the unemployment rate from 7.6% to 7.2%. At the same time inflation rose to 2.8%, though this was mostly attributable to higher fuel prices and the rise in the VAT rate.

Developments in the balance of payments were characterised by a sharp rise in the current account deficit to 10.1% of GDP. The latter was partly attributable to the deterioration in Malta's terms of trade, mainly due to the sharp rise in oil prices in the second half of the year and higher imports of consumer goods as the remaining import levies were removed following Malta's EU accession in May 2004. Meanwhile, an increase in net outflows on transfers reflected Malta's annual payment to the EU budget in line with its membership obligations. However, this was offset by inflows of grants in the capital account, reflecting the fact that Malta remains a net beneficiary of structural and cohesion funds from the EU. With the capital and financial account registering a lower surplus, the shortfall on current account was mostly financed by the Central Bank's external reserves which fell by about 5% over the year.

During 2004, the Central Bank's monetary policy objective continues to be price stability, with the fixed exchange peg the Bank's intermediate target. In 2004 the Maltese lira remained pegged to a currency basket consisting of the euro, the pound sterling, and the US dollar, with weights of 70%, 20%, and 10% respectively. Throughout the year the Bank left its central intervention rate unchanged at 3%, as domestic demand remained weak, while underlying inflationary pressures remained subdued.

Economic growth in 2005 is expected to strengthen further to 1.8%. A Government measure, aimed at increasing output through a reduction in the number of public holidays, is expected to be a major factor driving growth. It is expected to contribute to a reduction of unit labour costs and thus enhance competitiveness, particularly in the export-oriented sector. As a result, exports are expected to rise substantially, although there could be downside risks to such expectations if external demand in Malta's major EU trading partners does not pick up sufficiently. At the same time, import growth is expected to slow down in response to weaker consumption by both the private and public sectors, the former as a result of lower growth in disposable income and the latter as a result of the ongoing fiscal consolidation process, for the fiscal consolidation process is likely to have a negative impact on domestic demand in the short term. Notwithstanding these developments, the current account of the balance of payments is still expected to record a large deficit, partly because of negative terms of trade, as oil prices continue to rise, and also because public capital expenditure is projected to increase significantly in 2005. The shortfall on the account should, however, be financed to a greater extent than in the previous year, by substantial inflows of EU and other bilateral funds.

The strong recovery in exports is expected to be reflected in a slight reduction in unemployment. Inflation, meanwhile, is expected to ease from the relatively high rate of 2.8% experienced in 2004. It is, nevertheless, still expected to remain slightly above the 2% level, mainly as a result of higher energy prices.

It is the intention of the Maltese Monetary Authorities to enter the Exchange Rate Mechanism (ERMII) later this year. This will involve a change in the exchange rate arrangement replacing pegging to a currency basket by a total linkage of the Maltese lira to the euro.

After the 2003 recession, the **Portuguese economy** recovered in 2004, especially in the first semester. Economic activity slowed down in the second half of the year, prompting a downward revision of initial estimates for 2004. Considering the year as whole, GDP growth was 1.1%. Domestic demand, which had fallen in 2003, recovered strongly, while the contribution of net exports to growth turned negative. The latter was mainly due to a sharp increase in imports. This also contributed to interrupting the adjustment process of the current account observed since 2002.

The inflation rate declined to an average of 2.5% in 2004, therefore continuing to converge towards the euro area level. The differential between the two rates stands at 0.4 percentage points. A combination of euro appreciation and moderate wage settlements protected the Portuguese economy from second round pressures of oil price increases on inflation.

In 2004, the labour market conditions remained subdued: the unemployment rate increased to 6.7%, while more significant positive effects of the recovery on employment are expected to come, as usual, with a time lag.

Fiscal policy reflected the need to comply with the limit set by the Stability and Growth Pact for the public deficit ratio. In 2004, the fiscal deficit was 2.9% of GDP, while the cyclically adjusted deficit was 1.4%, which was slightly better than in 2003. However, excluding one-off and extraordinary revenue measures, the fiscal deficit would have remained around 5%, about the same level as in the previous year.

Although decelerating, end-of-year figures point to a 2.5% increase of credit to non-financial corporations, while credit to households, mainly for housing purposes, increased by 9.2%. Banks improved their capital structure and increasingly used securitization as a way of reducing financing needs.

Driven by both internal and external demand, the recovery is expected to strengthen in 2005 and GDP is projected to expand by 1.6%.

A new more flexible labour market code went into effect this year, while other long-due reforms are still being discussed. Overcoming the fiscal imbalance remains critical to resuming sustainable growth at higher rates.

San Marino. The actions taken by the San Marino authorities over the course of the past few years to foster the competitiveness of the economic system and the pursuit of a balanced budget policy have brought about the start of discussions with various other countries to conclude agreements on double taxation and the reciprocal protection of investments and, more generally, focused economic cooperation. On fiscal policy, the provisions adopted have helped to improve the financial situation of the State, forecasting that for the current year the objective of budget equilibrium will be met.

Furthermore, last December San Marino finalized an important Agreement with the European Community on the taxation of income from savings for non-residents, accompanied by a Memorandum of Intent aimed at safeguarding San Marino's own financial system while at the same time integrating it with the European system. The Agreement and the Memorandum of Intent were ratified by the San Marino Parliament on March 16, 2005.

The authorities are also continuing to combat money laundering and the financing of terrorism, according to accepted international standards, by updating the relevant legislation accordingly.

In **Timor-Leste,** cautious macroeconomic policies and the measured implementation of structural reforms underpinned a recovery of non-oil/gas economic activity in 2004, while inflation remained subdued and large inflows of oil and gas revenues allowed for a significant improvement of the fiscal and external outlooks. The challenge to East Timor is to pursue its post-conflict recovery and to ensure that oil and gas revenues are put to best possible use − addressing widespread poverty and the urgent need for capacity building, but also preserving value for future generations and helping the sustainable growth of non-oil/gas activities, while maintaining macroeconomic stability.

Non-oil/gas GDP is estimated to have grown by 3.4% in 2004, after contracting in the previous couple of years, pushed by a recovery of agriculture and strong banking activity. Inflation continued to fall to an end-of-period rate of 1.8% in December 2004, from 9.5% in 2002 and 4.2% in 2003 − reflecting the stability of non-fuel import prices and moderate domestic demand, as the UN presence continued to decline. Oil and gas revenues amounted to 74% of non-oil/gas GDP in 2004 − to be followed by a four-year period when such revenues are expected to average almost 55% of non-oil/gas GDP.

Such a level of inflows had a big impact on several fronts, allowing for positive gross national savings (9% of non-oil/gas GDP in 2004, against -29% the previous year), a major reduction in the external current account deficit (from 60% of non-oil/gas GDP in 2003, excluding external assistance, to 18% in 2004) and a large increase in the central government budget surplus, excluding donor-financed investment expenditures (from 10% of non-oil/gas GDP in 2003/04 to 72% in 2004/05). Broad money, however, accelerated only slightly (growing by 25%, from 22% in 2003), as the large increase in net external assets was compensated by a contraction of net credit to the government, even allowing for a major increase in credit to the private sector (USD 70.5 million in December 2004, against USD 22.1 million in 2003 and USD 5.1 million in 2002).

Facing an acute shortage of skilled human resources, as well as incipient infrastructure and dire social indicators, East Timor will continue to depend on support from the international community, while pursuing its capacity- and institution-building efforts, within a framework of transparency and good governance. Its commitment to these principles is particularly clear in the authorities' strategy for the oil and gas sector, namely, their adherence to international best practices, the almost-completed establishment of a Norwegian-style Oil Fund by July 2005 and the implementation of a long-term savings policy that is already providing a significant cushion for future generations.

Strategic Directions

We welcome the initiative taken by the Managing Director to undertake a reflection on the IMF medium-term Strategic Directions, also in connection with the implementation of the new budget process.

The Fund must remain at the centre of the international financial architecture. Its role should be reaffirmed in a context in which several countries are seeking forms of self insurance, also through reserve accumulation and regional lending facilities. We urge the Fund to further reflect on the implications of such developments in the framework of its strategic review.

Crisis prevention

Surveillance is at the heart of IMF activity. To be more effective, surveillance should be more authoritative and independent, and also more focused and selective.

The financial sector remains the core of the IMF competence and deeper coverage in this field should be pursued as well as greater integration with Article IV surveillance and technical assistance.

Debt Sustainability Analysis (DSA) and Balance Sheet Analysis should be the core of IMF activities. DSA must become a common feature of all Article IV consultations and of all IMF programmes. The Fund should undertake DSA independently of lending decisions. DSA plays a key role in signalling to the markets the repayment capacity of a country, particularly in cases where the private sector is involved and measures are needed to restore debt sustainability.

Capital account liberalization

Many countries are excessively increasing the size of their reserves for fear of the consequences of capital account liberalization in the absence of the needed institutional framework. The Fund should support countries in strengthening the terms of their participation in markets and gaining market access. The IMF should help member countries to design the appropriate sequencing of capital account liberalization. It should encourage the development of financial markets and related institutions, including supervisory activities.

Crisis resolution and financial assistance

The Fund's financial assistance framework should become more transparent, with a clear view to improving the clarity of the signals sent to the markets. Due to the increasing concentration and duration of IMF lending, efforts should be made to include the design of effective and sustainable exit strategies from Fund's assistance in the IMF programmes.

There is a strong need for the Fund to clarify its policy towards insolvent countries, starting with the principles of its Lending Into Arrears policy. This has implications on the credibility of IMF signalling to markets.

Technical assistance

Technical assistance is an important complement to IMF activities. Better TA planning and prioritization is essential, however, given resource constraints. It should concentrate on the Fund's core business areas and be better integrated with IMF surveillance.

Governance

In the context of a general review of quotas and quota shares, issues concerning the representation of developing countries could be addressed, including through an increase in basic votes.

IMF Budget

The new budget process is an important move towards a multi-year structure that should improve resource allocation towards the priorities identified in the strategic review. The present allocation of resources should not necessarily be considered as optimal. It is also important for the staff compensation review to be completed as scheduled, in order to feed into the FY 2007 budget.

Budget reform should devote great attention to the revenue side of the balance sheet: the ongoing trend towards decreased use of the Fund's resources needs to be tackled, and new forms of revenues must be identified.

IMF Support for Low-Income Countries

The Fund should remain engaged with low-income countries to support their efforts to achieve stability and growth, and reduce poverty. These are essential steps in the process towards the MDGs.

The continuing involvement of the Fund in low-income countries should be based on: the Fund's capacity to continue offering concessional lending to low-income countries, in support of their economic adjustment programmes and growth-oriented reforms.

The Fund should contribute with other bilateral and multilateral creditors to providing debt relief to the HIPC countries in the context of the Enhanced HIPC Initiative.

Additional debt relief should be granted on a case-by-case basis, starting from a clear assessment of debt sustainability on the basis of the new framework.

Debt relief could be considered in the context of a comprehensive creditor framework for multilateral debt relief and as part of a broader agenda which should include a) more and better targeted additional bilateral resources, b) the successful completion of the Doha round, c) a greater focus on policies to promote the private sector; and d) efforts to strengthen governance and improve absorptive capacity. Debt relief can contribute to achieving MDGs if it goes hand-in-hand with an increase in ODA resources.

Decisions on how to finance additional debt relief should consider the need to maintain adequate resources for the PRGF to meet demand after 2005 and to finance the HIPC initiative, also taking into account the recent extension of the HIPC sunset clause. In any case, the Fund's financial integrity should be preserved.