International Monetary and Financial Committee

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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,
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1. The Global Economic Outlook

Since our last meeting the global crisis has intensified and widened. The disruptions in the financial markets have been compounded by a generalized economic downturn, the most severe in generations. Prompt and unprecedented policy reactions and coordinated measures taken at the international level have been fundamental in stabilizing the financial markets and containing the impact of the downturn. Two key features of the current crisis - massive financial disruptions in systemic countries and the synchronized nature of the downturn - have made the recession unusually long and suggest that it will be followed by a relatively slow recovery. Nevertheless, there are encouraging signs that conditions in the financial market are gradually improving and that the intensity of the recession is abating.

Several countries, including those of this constituency, have adopted comprehensive measures to support economic activity and restore normal conditions in the credit markets; these policies are expected to produce tangible results soon. Whenever possible, additional fiscal stimulus should be implemented through well targeted and temporary measures, without jeopardizing debt sustainability in the medium-term. However, what is important at this delicate juncture is to restore confidence, as consumers' confidence and trust among financial markets participants are essential conditions for speeding-up the recovery.

Although it is premature to draw conclusive policy recommendations from a crisis which is far from over, some initial lessons are already obvious; the most basic one is that flawed incentives, excessive leverage and extensive interconnections in modern financial systems have huge macroeconomic consequences. The perimeter of regulation of financial markets should be broadened, greater disclosures are necessary and the entire system of regulation/surveillance requires a macro-prudential approach. Monetary authorities should broaden their view, taking into consideration asset price movements, credit booms, leverage and the building of systemic risks. Systemic concerns regarding the international economy should be reported directly to policy makers, empowered to take action. Cross-border arrangements for financial regulation and crisis response should be strengthened. Given the size of international transactions, the resources available to the Fund and other institutions to help countries weather short-term liquidity strains should be augmented and procedures for providing assistance better defined.

The **US economy** remains at the center of the storm. Activity is expected to contract sharply in 2009 and a gradual recovery is not expected before 2010. Rising unemployment, tight credit conditions and a sharp decline in asset prices have negatively impacted consumption in the final months of last year. However, there are signs of an improvement in household sentiment and a modest revival in consumer spending. The American Recovery and Reinvestment Act includes massive spending programs as well as tax credits for the vast majority of households. In addition to the fiscal stimulus package, the Administration has proposed a joint private-public sector effort to remove toxic assets from banks balance sheets with the aim of reestablishing the normal functioning of the financial markets.

Growth in the **Euro Area** has declined sharply in the past several months and a protracted period of weakness is expected throughout 2009. The retrenchment in international trade has severely affected the area. Economic activity should gradually recover in 2010 as a result of the substantial fiscal stimulus measures already adopted, some improvement in consumer confidence and the gradual normalization of conditions in the credit markets. **Eastern European Countries** are facing the most severe challenges since they embraced a market-based economy, on account of their heavy reliance on capital inflows and because of vulnerabilities built up during the boom years. In these countries, the risks associated with the retrenchment of foreign investment have led to a substantial widening of sovereign spreads and gaps in budgetary financing. In order to preserve the remarkable socio-economic achievements of the past several years it is essential that these countries stabilize their economies and resume sustained growth. The IMF, together with the European Union, has a key role to play in this region as trusted advisor and provider of financial support.

The impact of the crisis on other **emerging market economies** has been much more severe than expected, notably in Asia, despite the fact that several countries of this region enjoy strong fundamentals and generally sound banking systems. Emerging market countries have been affected by the crisis mostly through the sharp decline in international trade and financial flows; thus, policy measures have focused on financing exports and support domestic demand.

2. Developments in the Constituency

In the wake of the global crisis, **Italy**'s GDP contracted by 1.0 percent in 2008. Economic activity began to weaken in the first half of last year as a result of the sharp increases in oil prices and the strengthening of the euro. The full impact of the global crisis hit the Italian economy in second half of last year. Despite a relatively healthy banking system, the low level of indebtedness of private sector and a mild correction of the housing market, the Italian economy has not been immune from the effects of the worsening global crisis and tightening credit conditions.

After a long period of steady improvement, conditions in the labor market have started to weaken, as employment declined by 0.1 percentage points and the unemployment rate reached 6.7 percent in 2008. Private consumption decreased 0.9 percent and investment declined by 3.0 percent. Exports declined by 3.7 percent and imports contracted even more so that net external demand gave a positive contribution to growth.

Notwithstanding some signs of stabilization, the outlook for the remaining part of the year remains highly uncertain. In line with projections for other major countries, Italy's GDP is expected to post a contraction in 2009, perhaps in excess of 4.0 percent. This projection reflects the disappointing results of the forth quarter of last year as well as the outlook for the global economy, particularly as regards international trade. The labor market is likely to deteriorate throughout 2009.

The Italian government has intervened promptly and effectively to counteract the disruptions in the financial markets, to ensure a regular flow of credit to the private sector and to support overall demand. The fiscal measures already adopted are well targeted and of a temporary nature; they aim at supporting low-income households and accelerating the implementation of infrastructure investment. Taking into account the effect of the automatic stabilizers, the overall impact of the fiscal stimulus is in line with that of other European countries. Since the Italian financial sector is healthier than in other countries, the impact of supportive measures on the budget is relatively limited; accordingly both the deficit- and the debt-to-GDP ratios are expected to increase less than in other advanced countries.

As the domestic construction and financial sectors did not experience the disruptions that occurred in other countries, the Italian economy should be in a relatively stronger position to reap the benefits of the global recovery expected in 2010.

The **Albanian** economy has enjoyed a positive and non-inflationary growth period during the last decade. The world economic and financial crises had a negative impact on the Albanian economy and the confidence of its economic agents in the last quarter. However, in 2008 economic growth was in line with the initial forecasts of 6% and inflation remained within the 2-4% target of the Bank of Albania.

The current account deficit amounted to 14.9 percent of GDP, affected mainly by the fast rise in imports and the slowdown in remittances in the second half of 2008. In the end, foreign currency inflows have sufficiently contributed to close the balance of payments in positive values. In light of the progress in fiscal administration and the maintenance of economic growth, budget revenues have increased while the fiscal deficit has remained in the control and within acceptable parameters. The level of the public debt broadened during 2008, mounting to 55.9 percent of GDP, compared to 52.8 percent the previous year.

The last quarter of 2008 increasingly put forth the effects of the global crisis in the Albanian economy. The uncertainty induced by the turmoil in the global financial system was reflected in the withdrawal of part of the deposits from the banking system in this period. It created liquidity problems followed by upward pressures on interest rates. Further, it has influenced the banks' disposition to lend which was reflected in a slowdown of the credit growth rate. This trend, combined with the fall in remittances hint at a slowdown of economy in the fourth quarter. In response, the Bank of Albania undertook measures to inject liquidity and preserve the public's confidence in the banking system. Also, it tightened the supervision regulations, aiming to preserve and to strengthen the financial stability of the system. These measures resulted effective, and the Albanian banking system was able to withstand successfully the first shocks of the global economic and financial crisis.

The **Greek** economy has proven to be more resilient compared to many other economies around the world, but the repercussions from the international financial crisis are unavoidably felt also on Greece. Although the financial system is sound, a significant slowdown in real GDP growth is expected this year on the back of decelerating domestic demand and exports. Fiscal consolidation is a key policy priority of the government, with emphasis on containing primary expenditure through structural measures. Specific measures along these lines are included in the 2008 update of the Stability and Growth Programme and additional measures have been announced more recently, including a wage freeze in the general government. The second pillar of the economic policy strategy entails strengthening the growth potential of the Greek economy by means of structural reforms. Emphasis is placed on accelerating productivity growth, including though reforms to improve the business environment, cut red-tape, increase the efficiency of the public sector and enhance innovation. Also, special attention is given to improving the educational system, along with training, re-training and life-long learning programs, and on rebalancing labor market policies towards active labor market interventions.

The severe downturn affecting the global economy also had an adverse impact on the **Maltese economy**, which is very dependent on its external trade. However, against this hostile environment the Maltese economy was, to a large extent, protected from exchange rate risks by its integration into the euro area, from the beginning of 2008 and by the fact that its financial system was relatively sound and stable.

This notwithstanding, annual real GDP growth more than halved from 3.6% in 2007 to 1.6% in 2008, due to a significant fall in both investment and net exports. Consumption on the other hand continued to expand and is expected to slow down substantially this year. With net exports also expected to record negative growth, output for this year is projected to expand only marginally if at all. In the labor market conditions remained favorable for most of 2008. However, they began to deteriorate towards the end of the year. Despite the slowdown in economic activity inflation remains high in Malta, standing at 3.9% in March

2009. With regard to fiscal developments, the general government deficit widened in 2008, after three years of steady consolidation. This largely reflects two one-off expenditure items.

In view of the worsening economic outlook, the government has revised its medium-term fiscal strategy, postponing the achievement of a balanced budget until 2011. The Government intends to use public investment to develop the infrastructure and enhance the quality of human capital. It has also taken selective measures aimed at providing support to key sectors of industry that have already been hard-hit by the economic slowdown. The government also perceives the current recession as an opportunity to introduce further structural reforms aimed at making the economy more competitive. Thus following the restructuring at the shipyards it intends to liberalize the public transport system and to cut down on subsidies particularly to the energy sector.

The global crisis reached **Portugal** in the last quarter of 2008. In fact, quarterly GDP growth turned negative, -1.8 percent, and for the year as a whole the growth rate was zero. For 2009, the projections point to a 3.5 percent decline in GDP.

Like many other small open economies, Portugal is highly sensitive to the abrupt slowdown in global demand. Moreover, several of its most important partners, including other economies in the euro area, are also enduring a recession period.

At the same time, pessimistic domestic expectations about economic prospects and uncertainty undermine consumers and investors confidence. Together with high levels of households and non-financial corporations' indebtedness, these factors brought domestic confidence indicators to very low levels by historical standards.

As member of the euro area, Portugal benefits from expansionary monetary policy associated with ample liquidity and rapid reductions in interest rates. However, persistent turmoil in international credit markets and heightened uncertainty have been reflected in larger spreads and tighter credit standards and the reduction in official rates has not been fully passed on to borrowers. In general, borrowers and lenders are rebalancing their exposures, while the increase in non performing loans has been quite contained.

In line with decisions and principles adopted at the EU level, the Portuguese authorities introduced a number of measures with a view to strengthening the national financial sector and supporting sound banks capital resilience towards the international financial crisis. Alongside with public guarantees and the protection of depositors, these measures contribute to restore confidence while ensuring the functioning of the credit channels.

In 2008, Portuguese fiscal deficit was reduced to 2.6 percent of GDP and the decision on the excessive deficit under the Stability and Growth Pact was abrogated. However, in 2009, a significant deterioration is expected, as the budget balance is adversely affected by the functioning of automatic stabilizers and by discretionary fiscal policy measures used to attenuate the economic and social impact of recession.

Inflation fell sharply in the last quarter of 2008, beyond developments associated with energy and food prices. Consumer price inflation was very close to zero in both January and February of 2009, below the EU average. The unemployment rate increased 0.4 percentage points to 7.6 percent of the labor force in 2008.

While recognizing the importance of targeted temporary measures to provide some relief against the worse impacts of the recession, it is necessary to keep a medium term perspective. Moreover, long lasting adjustments must be resumed. Restoring sustainable public finances and improving the competitiveness of the economy remain critical challenges.

Despite the sharp deterioration of the external environment, in 2008 the macroeconomic performance of the Republic of **San Marino** remained positive. The latest estimates confirm that real GDP should grow by 2 percent, and that the fiscal accounts should remain in balance reflecting stable revenues. Since the end of 2008, however, the global crisis has started to adversely affect the economic activity. After years of gradual decline, the unemployment rate increased reaching 5 percent in February 2009; in the same period, the number of companies that made use of the unemployment protection schemes, such as "cassa integrazione" and "mobilità", recorded a sharp rise. Against this background, the government is firmly committed to implement well-designed measures to limit the negative impact of the global crisis on the Sammarinese economy without undermining long-term fiscal sustainability. Accordingly, the 2009 budget makes significant resources available to support the corporate and household sectors, and to increase investment, including in infrastructure and renewable energy sources.

In the last year, San Marino strengthened its financial system by adopting a new and comprehensive Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) law in line with the relevant EU Directives and recommendations of the Financial Action Task Force (FATF). Going forward, the government is determined to ensure a steadfast and effective implementation of the new legislation.

The performance of **Timor-Leste**'s economy remained very strong in 2008. On the back of a marked improvement in security, higher government spending, and a good harvest, real non-oil GDP is estimated to have grown by some 12½ percent in 2008. Moreover, while inflation is always a concern when spending increases rapidly, consumer prices are now stabilizing. In the financial area, the three fully licensed commercial banks reach only a small segment of the population and, with non-performing loans stuck at about 30 percent of the total since late 2006, credit remains depressed. Being branches of foreign parents, the banks do not appear at risk. Efforts are being made to assist banks in resolving non-performing loans and to facilitate further expansion of the banking network into the rural areas.

Timor-Leste has been isolated from much of the global economic crisis but is not unaffected. As petroleum revenue represents about 95 percent of total government income, the country is highly exposed to oil prices and these have plummeted along with global growth. By emphasizing transparency and sustainability, the Petroleum Fund has been a cornerstone for sound management of the country's resources. Recognizing the importance of developing the non-oil sector, Timor-Leste is determined to reform the business environment in order to enhance competitiveness and to promote a self-creating private sector employment through public investment.

3. IMF's Issues

The most severe financial and economic crisis in decades has triggered a prompt and coordinated response by the international community**. Some of the measures advocated by the G20 leaders have been entrusted to the Fund**, including greater financial assistance to its members, more stringent surveillance and increased efforts to reform financial markets. The increased responsibilities of the Fund underscore the need for broader representation and greater political ownership.

<u>Surveillance</u>
Surveillance is at the center of the Fund's activities in crisis prevention. The crisis has highlighted the crucial importance of cross-country interdependencies and the need to fully understand their implications for sound policy advice. Thus, it is essential to strengthen the multilateral and regional dimensions of surveillance. Additionally, surveillance should focus on the interaction and the transmission of risks between the financial sector and the real economy. This requires a closer integration of the Article IV reports with the Financial Sector Stability Program (FSAP). The FSAP, in turn, needs to become more flexible and risk-oriented. To this end, it is also important to closely link the FSAP assessments with the new Early Warning Exercise (EWE) carried out jointly by the Fund and the Financial Stability Board. The EWE provides the Fund with an additional tool to strengthen its surveillance activities, whose effectiveness, however, hinges on a more intense and candid dialogue with member countries.

<u>IMF lending framework</u>
As part of its efforts to assist its members to cope with the crisis, the Fund has recently revamped its lending capability, including a new facility - the Flexible Credit Line (FCL). The prompt utilization of the precautionary scheme of the new facility by a number of emerging countries confirms its attractiveness for countries that do not have immediate balance of payments problems, but want to be able to obtain quickly foreign reserves, should the need arise. Ultimately, the success of the new facility will hinge on achieving the proper balance between its built-in flexibilities and the need to safeguard Fund's resources. This

requires the involvement of the Board at an early stage of the process, the strict application of the prequalification criteria (ex-ante conditionality), as well as strict monitoring of the appropriate level of overall access. While we welcome the effort to streamline conditionality, we would caution against loosening further the pre-qualification criteria beyond what has been established. While ex-ante conditionality seems to be appropriate for countries with good track records and sound economic fundamentals, traditional conditionality should continue to be the centerpiece of IMF lending in order to safeguard Fund's resources, to ensure that programs are implemented in a timely and effective way, and to secure equal treatment to all member countries.

In order to further boost the Fund's lending capacity, a number of other reforms have been enacted, including the High Access Precautionary SBAs (HAPAs), the doubling of the normal access limits, and the elimination of seldom-used facilities. The effort in streamlining procedures and increasing the effectiveness of the lending tools represents an ambitious attempt to provide adequate resources to assist members overcome any contingencies. This inevitably increases the responsibility of the Fund's management and the Executive Board in guaranteeing the appropriate safeguards for the Fund's resources. In particular, effective access limits should not exceed the country's contributive capacity, since this would endanger its ability to repay the Fund. Furthermore, stringent prerequisites should be attached to any lending beyond these limits.

A review of the **facilities and conditional lending available to Low-Income Countries (LICs)** is also under way. Speeding up this process aiming at adapting the Fund's lending to the changed need of LICs is of utmost importance. The recent decision of doubling the access limits for the facilities available to LICs is an appropriate step in the right direction. Nevertheless, to prevent the build up of unsustainable debts, the procedural safeguards for determining access in individual financing requests should be strictly implemented. In particular, access limits should be strictly linked to the Debt Sustainability Analysis (DSAs), which provide an appropriate basis for assessing a country's debt vulnerabilities and its macroeconomic and public financial management capacity. In addition, the Fund's concessional resources should be sufficiently safeguarded by adopting a prudential case-by-case approach.

IMF resources

Fund financing has risen sharply in recent months and additional requests are to be expected. On the one hand, the far-reaching reform of the lending framework equipped the Fund with an efficient toolkit to respond to membership needs; on the other, **an adequate level of resources is necessary to respond to the current crisis**. The international community has recently agreed on trebling the IMF resources. It seems reasonable to provide these supplementary resources on a temporary basis. Amongst the options available to fund an increase in resources, the New Arrangements to Borrow (NAB) represents the key. Therefore, the expedited reform of the NAB, contemplating also its enlargement and operational simplification, is warranted at this juncture. On the contrary, market borrowing by the IMF entails several drawbacks, including a change in the role of the Fund, that would lend borrowed funds rather than its own capital and the possibility of becoming a competitor of sovereign borrowers. Both reasons support a rejection of this proposal.

As a bridge towards the NAB expansion, **bilateral borrowing agreements**, similar to Japan's, represents an efficient solution. The EU borrowing pledge amounting to Euro 75bn represents a further key step in this direction. A fair burden sharing across the international community is essential in the process of increasing IMF resources. This is the time for other major shareholders, both advanced and emerging market economies, to make their definite pledges, in line with their weight in the Fund and the role the intend to play in the global economy.

In addition to borrowed resources, **a new allocation of SDRs** in proportion of member's quota shares has been agreed in the context of the G-20 meeting in London . Since not all members need an increase of their international reserves, the Fund should explore mechanisms to redistribute SDRs to countries most in need and to ensure that SDR resources are appropriately used. Furthermore, it is essential that the Fund develop an appropriate mechanism to withdraw SDRs should global liquidity become excessive or inflationary.

Against this background, **an increase in the Fund's concessional lending capacity is also essential**. At their recent meeting in London, the G-20 leaders called on the Fund to come forward with concrete proposals to provide $6 billion additional concessional finance for the poorest countries over the next three years. Along with additional bilateral contributions, proceeds from gold sales could be an option. However, any concrete proposal in this respect should be consistent with the objectives of the new income model. At the same time, concessional lending should remain separate from other IMF financing; accordingly, the introduction of concessionality elements in the General Resource Account (GRA) arrangements should be avoided.

<u>IMF institutional governance</u>

In the context of the broader goal of building a more robust global architecture, **the modernization of the IMF governance structure is the next institutional issue to be addressed.** The IMF Executive Board should soon start to evaluate the various proposals on how to reform its governance, including those offered by the Independent Evaluation Office and the Eminent Persons' Committee, chaired by Mr. Trevor Manuel. The next general review of quotas, to be concluded by 2011, will be the occasion to make further progress in quota and voice reform, and in realigning quota shares of dynamic emerging market economies, building on the results already achieved with the April 2008 package that we expect shortly entering into force.