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On behalf of Albania, Greece, Italy, Malta, Portugal, San Marino, Timor-Leste

Statement by the Honorable Tommaso Padoa-Schioppa
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 Economy

The global economy has continued to weaken under the impact of the turmoil in the financial markets and the sharp deterioration of the US economy. The recent events indicate that while the US sub-prime credit market remains at the center of the current crisis, substantial spillovers are affecting the rest of the financial markets and, through different channels, the global economy.

The current difficulties of the **US economy** go well beyond the normal business cycle. The collapse of housing prices and the drying up of other forms of consumer credit could lead to a prolonged retrenchment of private consumption, the main engine of growth. The magnitude of the potential disruption explains the swift and unprecedented measures taken by the authorities to restore confidence and stabilize the markets. The expansionary policy measures enacted will help cushion the effects of a protracted downturn. However, restoring confidence and stabilizing the markets requires prompt action to address the structural weaknesses in financial regulation, supervision and accounting practices.

The increasing strains on the global financial system have been felt by the **Euro area** economies. Recent data points to a downward revision of growth, although to a lesser extent than in the US economy. Relatively strong economic fundamentals, including fiscal consolidation and employment growth, will contribute to support domestic demand, which remains the main driver of growth. Risks remain tilted to the downside, particularly those stemming from a more severe deterioration of credit conditions due to a possible larger-than-projected exposure of some EU banks to the US financial distress. The budgetary improvement achieved in the past few years will allow several countries to let the automatic stabilizers work to their full extent, to counter any deterioration of economic activity.

Emerging and developing countries have continued to perform above their potential; however, they are not insulated from either the financial turmoil or the slowdown in the advanced economies. Accordingly, policymakers should be ready to counteract any sizable downturn, targeting their policy response much more selectively than in previous experiences. In addition, countries with a large trade surplus and diversified economies would benefit from a greater exchange rate flexibility, which would accelerate the expansion of domestic demand while containing the role of the external sector as the primary driver of the economy.

The recent reduction of the US current account deficit, thanks to the sharp depreciation of the US dollar and lower demand, has contributed to reduce **global imbalances**. However, the risks of any abrupt unwinding of global imbalances have increased, given their size and current uneven adjustment pattern, as well as the seriousness of the financial disruption. Therefore, while the agreed framework remains a suitable strategy to deal with imbalances in the medium term, any deviations from it should be temporary and aimed at restoring confidence and at ensuring stability.

2. Italy

Italy's economy grew in 2007 at 1.5 percent, down from 1.9 percent in 2006. Since the summer of 2007 economic activity has slowed significantly, as a result of a deceleration of domestic demand spurred by the indirect effects of the global financial turmoil, and estimates of Italy's GDP growth for the current year have been revised downward significantly. Medium-term prospects for the Italian economy are mixed. Italy appears to be less exposed to the downturn in the credit market than many other industrialized countries, and there is no evidence of credit crunch or tightening in credit conditions to firms and households. However, negative global headwinds have brought to the fore Italy's structural weaknesses, which are constraining potential growth, despite the substantial progress in the reform process made in recent years.

Moving to the breakdown of growth, private consumption was stronger in the first half of 2007, but then weakened in the final part of the year due both to the moderate increase in nominal wages and to rising inflation. Real disposable income should continue to grow modestly over the near term, negatively affecting consumption performance. Investment in machinery and equipment grew by 0.2 percent in 2007 and is expected to remain sluggish in the first part of the current year. Capacity utilisation has declined. Business confidence has softened significantly since April 2007, although to levels close to its historical average.

The appreciation of the euro has not prevented a positive (though small) net export contribution to GDP growth in 2007. The trade balance improved throughout 2007, notwithstanding a deeper deficit in the energy component. Export activity remained strong, as did growth in export prices. Italian exporters appear to have been able to restructure their production and upgrade the quality of their products, thereby commanding higher prices, and thus to remain competitive on a global scale. Overall industrial production has nevertheless weakened substantially since the summer of 2007 and leading indicators point to a weak performance in the first part of the current year. Unemployment continued to decline in 2007, reaching a seasonally adjusted rate of 6.0 percent in the fourth quarter of 2007, a historical low. Major differences still exist in the geographical, age and gender distribution of unemployment. In 2007, public finance performed better than expected. The net borrowing of the general government stood at 1.9 percent of GDP, 0.5 percentage points below the official target set in September. Similarly, the ratio of public debt to GDP declined to 104 percent, against a target of 105 percent. The primary surplus reached 3.1 percent of GDP.

3. Other Countries of the Constituency

Albania has been growing rapidly for several years. In 2007, growth accelerated to 6 percent despite large external shocks, which were a real “stress-test” for the economy and a convincing proof of both its good momentum and the ability of Albania's authorities to manage such shocks. The authorities are committed to preserving this successful macroeconomic performance by maintaining responsible fiscal and monetary policies, as well as to retaining their strong track record with the Fund. This year's temporary increase in the budget deficit is entirely due to the acceleration of capital spending in order to complete a major road project. Contingency reserves to the tune of 1.5 percent of GDP have been set up to straitjacket the 2008 targeted budget deficit (5.2 percent of GDP) and a mid-term review would be used to effect any required adjustments in the event of risk of breaching the ceiling. To further strengthen the macroeconomic framework, the authorities are committed to address the financial difficulties of KESH, the Albanian Power Company, a main risk to the 2008 budget outcome. Testament to this commitment is the new structural benchmark of reducing the company’s quasi-fiscal losses to 1.2 percent of GDP by mid-June 2008. The authorities are also fully aware that the privatization of KESH’s distribution arm can represent a sustainable solution to the energy problems, and efforts are under way in this regard under the advice of the IFC. In 2007, the Bank of Albania has increased three times its policy rate in order to rein in the rapid credit growth and curb inflation risks. As a result, inflation expectations remain well anchored. So far monetary policy had to be supplemented by prudential and regulatory policies in the face of some weaknesses in the monetary transmission channel. The authorities are fully aware that, in a rapidly changing financial system, the transmission mechanism of monetary policy has to be improved. To this end they are placing a high importance on the development of interbank and secondary markets for public securities, and a delivery versus payment system is being designed and the Fund’s technical assistance has been requested. Finally, a new National Strategy for Development and Integration for 2007-2013 has been adopted, which, as recognized by the IMF and World Bank staffs, represents a significant improvement over the previous PRSP for 2003-06.

In **Greece,** GDP growth remained robust at 4.0 percent in 2007, led by strong exports and business fixed investment, but is expected to slow somewhat to 3.6 percent in 2008-09 in response to negative spillovers from a weaker external environment. Growth has become more sustainable in the past three years through a shift away from debt-financed expansionary fiscal policy toward supply-side reforms aimed at increasing productivity and potential growth. Private investment has been supported by lower corporate tax rates, investment incentives, public-private partnerships, and an improvement in the business climate. Rising employment and real wage gains have underpinned consumption growth. These policies succeeded in sustaining the growth momentum and reducing unemployment despite substantial fiscal tightening.

Fiscal consolidation advanced significantly in 2006-07, bringing the general government deficit below the 3 percent of GDP threshold. This was achieved through spending restraint and improved tax administration, while personal and corporate tax rates were reduced. The deficit is budgeted to decline further to 1.6 percent of GDP in 2008, in line with the Government's objective to achieve a balanced budget by 2010. Improved budgetary procedures, such as performance/program-based budgeting, are expected to improve control and efficiency of public expenditure in the medium term. A pension reform law passed by Parliament will streamline the administration of the pension system and contribute to its long-term sustainability.

On January 1st 2008 **Malta** adopted the euro. This major economic event is expected to result in substantial benefits for the Maltese economy, including a reduction in exchange rate risks, lower transactions costs, and greater macroeconomic stability. In view of the euro adoption, the monetary authorities lowered official interest rates, bringing them in line with those in the euro area at the end of December. The currency changeover itself was smooth and successful, partly benefiting from the decision of the Maltese authorities to maintain the Maltese lira rigidly fixed to the euro at the central parity rate under the ERM II. This parity, in fact, was established as the final conversion rate for the entry into the euro area.

During 2007 the Maltese economy performed strongly: real GDP grew by 3.8 percent, underpinned by buoyant domestic demand, especially private consumption, and, to a lesser extent, by net exports, particularly tourism. In 2008, however, economic growth is expected to decelerate to below 3.0 percent as private consumption moderates in response to slower growth in real disposable income. Despite higher oil and food prices, inflation averaged 0.7 percent in 2007. Nonetheless, as price pressures are expected to persist, this year the inflation rate should rise to over 3 percent. Against the background of a relatively strong economic performance, private sector employment increased in 2007 and the unemployment rate dropped further to 6.2 percent. In 2008, labor market conditions should ease somewhat reflecting the slowdown in economic activity: employment growth should decelerate to around 1 percent from about 2.7 percent in the 2007 and the unemployment rate should rise to 6.5 percent.

Fiscal consolidation was maintained in 2007 with the deficit falling below 2 percent of GDP. Looking ahead, the Government's medium-term program envisages a budget position close to balance by 2009 and a surplus of 0.9 percent of GDP for the following year. These targets will be achieved mainly through spending restraint, and will allow the general government debt/GDP ratio to decline to below the 60 percent level. The narrowing of the budget deficit in 2007 also favored a reduction of the deficit on trade in goods and services, which was cut by almost half to 2 percent of GDP from 3.7 percent in 2006. It is expected to increase moderately in 2008 to 2.6 percent. Finally, the Maltese authorities recognize the importance of structural reforms to sustain economic growth in a single currency area. They are thus committed to reform product and factor markets so as to enhance competitiveness through innovation and improvements in productivity.

In 2007, economic activity in **Portugal** accelerated with the growth rate increasing to 1.9 percent, from 1.2 percent in 2006. Unlike the previous year, the main contribution to GDP growth came from domestic demand, driven by the recovery of investment, while external demand moderated, due mainly to a more subdued external demand for Portuguese exports. This pattern may continue in 2008 and 2009, supporting the recovery path, notwithstanding heightened uncertainties now surrounding the global economy. Portugal made good progress concerning the correction of fiscal imbalances. As in 2006, the general government deficit declined more than envisaged in the previous update of the stability program, falling below 3.0 percent of GDP in 2007. The correction of the excessive deficit could be recognised this year, while the medium-term objective of the Stability and Growth Pact, a structural deficit ratio of 0.5 percent, which is planned for 2010, will require additional efforts. In 2007, the unemployment rate increased to 8.0 percent of the labour force. The share of long-term unemployment declined but is still close to 50 percent. Employment increased only slightly, 0.2 percent, as total factor productivity was the main driver of GDP growth. Inflation declined to 2.4 percent in 2007, a 0.6 percentage point reduction vis-à-vis 2006. While last year pressures coming from oil prices were counterbalanced by the appreciation of the euro, high demand and uncertainties in the oil markets, coupled with the delayed effect of developments in food prices, may adversely affect price developments in 2008. The Portuguese banking system has been resilient in the face of the recent financial turmoil. Although not directly exposed to the sub-prime segments, banks, facing the deterioration in financing conditions and increasing uncertainty, tightened credit standards. According to Portugal's national reform program, the priorities of structural reforms are the consolidation of public finances, the efficiency of the educational system and the modernisation of the labour market. During 2007, progress was observed in the reform of old age pension schemes and public administration, including an extensive use of modern technologies and cutting of red tape, while other measures were implemented aiming to reduce drop-out rates, increase students' attainment levels, and improve labour force skills.

In 2007 **San Marino**'s economic performance was strong, with nominal GDP growing by 6.3 percent with respect to the previous year and unemployment falling to 2.5 percent (from 3.3 percent in 2006). Looking ahead, the main downside risks to the economic outlook stem from the consequences of the recent financial turmoil on the global economic growth and further surges in commodity prices. On the fiscal front, the Government remains committed to reducing the share of current spending over total expenditure by 1.7 percent in 2008 and 2009. This would make available additional resources to sustain the development of key sectors for San Marino's growth prospects, including tourism and commerce. The Government also intends to increase investments in infrastructure and sources of renewable energies. In the financial sector, the authorities are engaged in updating and strengthening the regulatory and supervisory framework to maintain the sector's soundness and stability, while promoting new lines of business such as insurance and mutual funds.

Following negative growth in 2006, non-oil growth is estimated at 8 percent for 2007. Growth was driven mainly by public sector and reconstruction spending. **Timor-Leste** remains highly vulnerable to external and domestic shocks. Staff project growth of slightly below 5 percent over the medium-term, well below potential or the 7-8 percent needed to address high levels of poverty and unemployment. The recent improvement of the security conditions could boost some recovery in private sector activity throughout 2008. Rising food and fuel prices increased inflation pressures during 2007. Annual inflation rose to 8.6 percent in 2007, more than double the average inflation rate in 2006, boosted by higher food and fuel prices. Although the banking system is sound, comprising only of branches of large foreign banks the low loan quality continues to hamper the provision of new credit. The 2008 budget maintains the generally sound policy framework. Total expenditure is broadly unchanged and in line with the sustainable use of petroleum revenue. The new government has placed greater emphasis on meeting short-term needs with public transfers directed at, among others, refugees, veterans, and the elderly. However, weak administrative capacity continues to lead to poor budget execution. The offshore hydrocarbon sector has not been affected by the recent unrest and, therefore, Large oil/gas revenues continue to accrue. A robust and highly transparent framework for managing petroleum revenues is in place, including a petroleum fund. The Greater Sunrise oil/gas field (long-term revenue potential of about $10 billion) could commence production by 2014, although serious questions still remain about the project's financial viability, and the feasibility of the government's proposals for a refinery in Timor-Leste.

4. The Strategic Directions: *Less but better output*

We support the Managing Director in his efforts to refocus the IMF's activities towards its core responsibilities, with the aim to have less output, but of higher quality. We also share the view that some core business activities should be enhanced, while others should be reduced progressively. Surveillance should remain at the center of the IMF's activities, as this is the area in which the IMF can make its greatest contribution. The new Surveillance Decision provides a base for conducting and focusing surveillance. Bilateral surveillance would benefit from a closer analysis of multilateral and regional perspectives, with a greater focus on the macro-financial issues, which are country-relevant for ensuring external stability. Emphasis should be given to the fiscal, monetary and exchange rate issues, which should be the backbone of any surveillance consultation.

Current events have shown how intertwined the real and financial sectors are. Therefore, the analysis of the inter-linkages should become a centerpiece of surveillance in particular for systemic economies. Developing a system of early warning, in partnership with the Financial Stability Forum and other relevant international institutions, could help foster the IMF's involvement in this area.

The IMF's role in low-income countries, in particular after the full delivery of debt relief and their exit from lending programs, should focus on the macroeconomic framework, with a view to ensuring macro stability and long-term debt sustainability. Our focus should be on the challenges that the low-income countries are facing, including soaring commodity prices and mounting capital inflows. The experience from emerging economies in these areas constitutes a valuable asset to identify best practices, in particular for countries exiting from concessional lending programs. Strengthening our relationship with the World Bank would enhance the effectiveness of the IMF work in dealing with its more vulnerable membership.

5. The Finance Structure of the IMF: *A modern and sustainable framework*

We are grateful to the Managing Director for developing a sustainable financial framework for the institution, to be based on more predictable and diverse resources. The objective is to modernize the IMF's finance structure, making it more suitable for its evolving role.

The $100 million in expenditure cuts will provide the spending side contribution to the achievement of a sustainable balanced budget. Nonetheless, this aim cannot be achieved without modernizing our income model and expanding the revenue base. Therefore, we fully support the selling of a limited amount of gold, which will mean the transformation of a non-interest-earning asset into a source of income, while preserving the robustness of the IMF's balance sheet. We fully share the Crockett report's suggestions that gold sales should be implemented within the Central Bank Gold Agreement (CBGA), so as to avoid undue market disruption.

We remain convinced that investing a limited amount of members' quota positions could represent an important source of revenue, which would provide much needed flexibility in meeting any temporary income fluctuations. At the same time, we believe that members' quota positions should only play a residual role in filling any financing gap. To play this residual role, the needed amount of quota position for investment, within an upper limit, can be defined on an annual basis in the context of the budget discussion.

6. Quota and representation: *global economy and members' voting power are now better aligned*

Significant progress has been made in the last few months and we welcome the recent Board endorsement of the resolution of the Board of Governors, which will fulfill the key objectives of the quota and voice reform process undertaken at the 2006 Singapore meeting. The full implementation of the resolution will give a substantial boost to the quota of most dynamic economies, many of which are emerging market economies, while preserving the voice of low-income members.

The second ad-hoc increase will further contribute to the realignment of the voting power of the most underrepresented members, whose voting power has fallen well below their increased weight and role in the global economy. A substantial increase in the voting share of developing economies will be possible through a considerable increase in basic votes; the decision to triple basic votes goes well beyond the Singapore resolution commitment. Like some other advanced economies, Italy will contribute to the quota increase of the most underrepresented members by partially forgoing its own quota increase.

With this decision the IMF has remained at the forefront in adapting its governance to the rapid evolution of the global economies and will play a leadership role for other international organizations. After the quota increase, the most dynamic emerging economies will also bear a higher share of responsibility in ensuring a stable and well-functioning global economy and financial markets.