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Ministero dell'Economia e delle Finanze
Italy

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

Statement by the Honorable Giulio Tremonti

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; a Dual Recovery

Although economic conditions have improved markedly during the past several months, the recovery of the global economy remains fragile and proceeds at varying speeds across and within regions. The multi speed recovery is characterized by robust growth in the emerging and developing countries, while in most advanced countries, the upturn continues to be critically dependent on unprecedented fiscal and monetary stimulus. However, rather than pointing to a separation or a "decoupling" of the world economy, the key features of the current recovery confirms the interdependency that bound together the various economies. For example, the resumption of strong capital inflows towards the emerging markets reflects their relatively better macroeconomic prospects compared to the sluggish growth expected in advanced countries. Conversely, the substantial increase in commodity prices is an important source of growth in producing countries, but, at the same time, it represents a significant drag in the recovery of the importing ones.

We share the expectation that, for the foreseeable future, growth will remain below pre-crisis levels. This scenario is particularly relevant for those countries that in the last decade exceptionally strong growth rates that, with hindsight, appear now the result of misguided policies. Not only were those rates unsustainable, but they have inflicted extensive damages to public and private sector balance sheets that it will take years to repair. This adjustment process will tend to revalue the unimpressive, but steadier performances of those countries that have avoided the excesses of the boom-boost cycle.

Albeit slowly, several advanced countries are making progress in overcoming the worst effects of the crisis. In addition to the fiscal and monetary stimulus, the recovery in these countries has been supported by a strong inventory cycle in the second half of 2009 and the upturn in exports; this has been an important factor, particularly in countries that have large manufacturing sectors such as Germany and Italy. However, despite the recent improvements, economic conditions are far from normal and the recovery is held back by powerful forces.

Considering the dual nature of the global recovery, policy recommendations should be carefully calibrated according to the circumstances of each region and each country. Specifically, countries that have returned to strong growth rates and enjoy excessive current account surpluses should increase domestic demand to sustain global growth. As robust growth in some emerging countries risks stoking inflationary pressure and financial bubbles, they should consider adopting greater flexibility in nominal foreign exchange rates.

In light of the still fragile recovery in most advanced countries, fiscal stimuli planned for this year should be fully implemented in those countries where there is still fiscal space. At the same time, countries with high deficits and debt levels facing large increases in risk premia need to start consolidation without delays.

Coordination among countries will be necessary in order to mitigate the negative spillovers stemming from the impact of domestic tightening on exports of other countries as well as the excessive deficits and unsound fiscal frameworks on interest rates and risk premia. The G20 Framework for Strong, Sustainable and Balanced Growth represents an important tool to foster better coordination among national macroeconomic policies. Furthermore, the euro area Heads of States and Government have recently committed to a strong coordination of economic policies and to improving rules and mechanisms to prevent and resolve economic and fiscal imbalances. Going forward, reinforcing and complementing the existing framework, which has generally led to results which, in spite of significant deteriorations in the last two years related to the global financial crisis, still compare relatively well at a global scale, would help prevent and resolve fiscal imbalances.

2. Developments in the Constituency

Due to the limited exposure to the turmoil of the international financial markets and to the collapse of the real estate sector, the worst effects of the crisis have been only temporary on the **Italian economy**. Italy's large manufacturing sector and its dependency on imported energy have magnified the effects of the sudden collapse of world trade and the sharp increase in commodity prices in the first phase of the crisis. However, having hit the bottom of the cycle by the middle of last year, the Italian economy is now recovering broadly in line with the rest of Europe. GDP rebounded in the third quarter of 2009 and, after a brief pause in the following months, the recovery appears back on track according to recent indicators.

Net exports and investment that were a sizeable drag on the economy in 2009 are leading the recovery. Exports are propelled by the upswing in global demand led by Asia, while investment are spurred by the improved outlook for demand, historically low real interest rates, and fiscal incentives introduced during the crisis. According to recent business surveys, inventories are still below normal levels, thereby providing ample scope for a further increase.

Far reaching structural reforms introduced in previous years have substantially increased the flexibility of the labor market; thus unemployment has been declining steadily despite relatively slow economic growth, reaching a low of 5.9 just before the global crisis. Since then, the unemployment rate has been raising but much less than in other European countries. Temporary measures have been adopted to broaden the scope of the employment protection scheme, preventing a more substantial loss in human capital. Active labor market policies are also expected to help the reallocation process within the economy.

The Italian economy is expected to escape most long-term effects of the crisis. The 2009 recession reflected mostly the temporary collapse of the world trade, now on the rebound. Furthermore, Italy does not require sweeping structural adjustments to its financial sector, nor a re-balancing between saving and consumption. Debts levels in the private sector, and in particular among households, are low by international standards and Italian banks have weathered the crisis much better than those in many other countries. Moreover, the rise in the budgetary deficit has been much smaller than in most other advanced economies. This leaves the Italian economy with less need for deleveraging and bodes well for a gradual recovery.

Fiscal policy during the crisis has been characterized by great prudence as dictated by the high level of public debt. Fiscal measures have broadly been budget neutral, i.e. new expenditures were compensated by equivalent spending cuts. Supportive measures were aimed at ensuring the functioning of the banking system and allowing credit to flow to firms and households, speeding up payments of the public administration to suppliers, accelerating the implementation of budgeted investment plans, and temporarily enlarging the scope of social safety nets. The decline in economic activity due to the crisis has pushed the net borrowing rose to 5.3 percent of GDP in 2009, up from 2.7 percent in 2008. It is expected to gradually decline below the 3.0 percent Maastricht threshold by 2012. The debt/GDP rose to 115.8 percent, from 106.1 percent in 2008 and is projected to decline steadily downwards from 2011. The stabilization of fiscal imbalances will be greatly facilitated by the temporary effects of the crisis and the measures introduced to support income and employment, most of which will automatically expire over the next three years. Resumption of positive growth rates should also expedite fiscal consolidation. The prudent stance of fiscal policy has been acknowledged by markets' participants; after an initial surge in the midst of the crisis, Italy's government bond yield spreads have narrowed markedly and have been largely unaffected by recent concerns of sovereign risks in other European countries.

Like other South Eastern European (SEE) countries, **Albania's economy** was quickly affected by the global economic and financial crises. The crises put to the test the country's macroeconomic equilibrium, its financial system stability, as well as the business models and the financial sustainability of the private sector. Albania managed to sustain positive economic growth and preserve the pillars of macroeconomic and financial stability. Such a performance resulted from both positive initial conditions and the rapid response of the Albanian authorities. Healthy balance sheets in the financial and non-financial sectors; stable inflation and inflation expectations; and moderate public debt levels, allowed for countercyclical fiscal and monetary policies. The Bank of Albania lowered the policy rate, provided unlimited liquidity, and improved access to its refinancing operations.

In spite of these measures, the GDP growth progressively slowed down during last year. Economic developments in Q4 suggest positive economic growth throughout the year, in the 2-3 percent region. The slowdown is mainly attributed to lower investment and export activity. Industry and construction were the most exposed sectors of the economy to the crisis.

The current account deficit contracted by 3 percent in 2009. However, at 15.3 percent of GDP, this deficit remains one of the main vulnerabilities of the Albanian economy. International reserves sustained the level of the previous year, covering 4.2 months of imports. The contraction of foreign currency inflows led to a depreciation of the exchange rate, especially during the first half of the year.

Fiscal policy reinforced its expansionist stance, sustaining the country’s economic activity but simultaneously exerting more pressure on financial markets. The budget deficit rose to 7 percent of GDP in 2009. Despite the challenging conditions of lower domestic demand, exchange rate depreciation and financial sector turbulence, the Bank of Albania managed to successfully achieve its CPI inflation target during 2009.

Deposit withdrawals were the first sign of contagion from the financial crisis. It started at the beginning of the last quarter of 2008 and continued through the first months of 2009. They not only affected the Albanian banking system and financial, but also resulted in lower financial intermediation - and at a higher cost - by the banking system. The average annual growth rate of credit to the private sector fluctuated around 13 percent, compared to 44 percent in the previous year.

The Albanian authorities took adequate measures aiming at institutional and financial system stability. The Law on Deposit Insurance was revised to increase the insured amount of deposits. This proved to be an important milestone in restoring confidence in the financial system. In addition, the authorities revised the regulatory framework in order to improve supervision, on site examinations, in-depth balance sheet analysis of individual banks and banking system as a whole, as well as increased cooperation with domestic and foreign counter-institutions. Overall, these measures successfully managed to preserve financial stability in the economy. The Albanian banking system remains liquid, profitable and well-capitalized.

In 2009 the **Greek economy** entered a recession following a period of sustained output expansion. Growth had been primarily based on increases in aggregate demand fuelled by the easier availability of credit to households, enterprises and the public sector at the lower interest rates which accompanied the expected and ultimately successful adoption of the euro. This expansionary phase co-existed with high and persistent budget and current account deficits. This, in turn, reflected the steady erosion of competitiveness over several years and underlying structural distortions. It is clear that while the financial and economic crisis has had an adverse effect on macroeconomic variables and market sentiment, the current difficulties in the Greek economy are largely endogenous.

The recession has led to a sharp increase in the deficit of the general government; from 2 percent of GDP, as initially envisaged by the 2009 budget, to an estimated 13.6 percent. This was the result of the bigger than expected economic downturn, shortfalls in revenue collection, expenditure overruns as well as of endemic deficiencies on collecting taxes, controlling expenditures and fully recording data in official statistics. Against this background, the Greek authorities has undertaken an ambitious fiscal consolidation effort, spelled out in the latest Stability Program, and aimed to bring the deficit below 3 percent of GDP by 2012. Several measures have been already undertaken and planned to restore the credibility of Greek statistics and data, as well as strengthen its medium-term effort to overhaul the budget process, ensure permanent expenditure reductions, and create a fairer and more effective tax system.

The fiscal consolidation effort for 2010 is front-loaded, with a 4 percentage point deficit reduction in 2010, and underpinned by an ambitious program of structural reforms in budget design and execution, expenditure controls, the tax system, social security, policies to create conditions for sustainable growth, promote private sector development and create a more transparent and efficient public administration. As a result public debt is expected to initially stabilize and start declining thereafter. Examples of specific measures include a 10 percent cut in wage entitlements in the public sector, a hiring freeze for 2010 followed by a 5:1 rule (one person hired for every five retirements) from 2011 onwards, the termination of a large number of short-term contracts in the public sector, a 10 percent reduction in operating expenditures for line Ministries, a percent reduction in the budget item relating to social security and pension funds, as well as a significantly declining path for military expenditures. In addition to the commitment under the Stability Program, a package of additional deficit reduction measures amounting to 2 percent of GDP were announced in early March safeguard the fiscal targets against macroeconomic and financial risks.

Despite these efforts, financial markets are requesting high risk premiums to hold Greek sovereign debt, with interest spreads between Greek securities and benchmark German bunds under pressure. This risks jeopardizing the authorities' fiscal consolidation process. Therefore, in accordance with the statement of 11 April 2010 on the support to Greece by euro-Area Member States, the Greek authorities have recently requested discussions with the European Commission, the ECB and the IMF on a multi-year program of economic policies building on the ECOFIN conclusions of February that could be supported with financial assistance from the euro-area Member States and the IMF.

The global recession in 2009 also left its mark on the **Maltese economy**, although the downturn was less severe than that experienced by most other EU Member States. Malta's GDP contracted by 1.9 percent largely as a result of a decline in domestic demand, as investment fell significantly. Government consumption registered negative growth while household consumption expanded at a modest pace. The drop in world trade also impacted on Malta's exports, which continued to decline. However as imports fell more substantially, the contribution of net exports to GDP growth was positive.

The recession in Malta appeared to bottom out in the second half of the year as quarterly GDP growth returned to positive territory. During 2010, the Maltese economy is projected to continue to recover, albeit at a modest rate. Investment and exports are expected to be the main drivers of growth.

With the labor market characterized by weaker conditions, employment dropped slightly. The rate of inflation, which had risen above 4% in 2008, receded significantly in the second half of the year. While inflation has picked up recently in response to a rebound in energy prices, underlying inflation remains low and stable.

The downturn in economic activity also had an adverse impact on public finances, especially tax revenues. Nevertheless, compared with the previous year when the deficit rose sharply to 4.6 percent of GDP mostly as a result of one-off factors, the fiscal position in 2009 improved, although at 3.8 percent of GDP, it was well above the threshold embodied in the EU's Stability and Growth Pact.

During 2009 the Government implemented a selective fiscal aid package which provided financial assistance to specific manufacturing firms, thus supporting employment, while encouraging them to restructure and precede with their investment initiatives. After the privatization of the shipyards, the Government also continued to follow up on its policy of reducing or terminating subsidies to particular sectors. The authorities remain committed to fiscal consolidation, especially in the light of the projected economic recovery over the next two years. However, due to the ongoing impact of the economic slowdown in 2010, the fiscal deficit is projected to remain at around the 2009 level.

Meanwhile the Maltese banking system emerged from the financial turmoil relatively unscathed and without the need for any support measures from the Government. This was due to the fact that it had limited exposure to toxic assets and relied to a large extent on retail deposits to fund its lending activities. The major banks continued to record healthy profits during 2009, and their capital ratios remained well above statutory requirements.

Overall, the Maltese economy has shown a fair degree of resilience to the downturn in global economic activity and continues to be supported by a generally robust financial system. The adoption of the euro has shielded the economy from speculative flows and enhanced its capacity to withstand external shocks. In the medium term, economic growth is expected to return close to its potential.

In **Portugal**, GDP declined by 2.7 percent in 2009, less than the average contraction in economic activity recorded in the euro area. Unemployment increased sharply, reaching 10.1 percent in the fourth quarter. Macroeconomic imbalances affect the country's ability to take full advantage of the global recovery and, therefore, growth prospects for 2010 are modest, at 0.4 percent.

In 2009 government finances deteriorated strongly, as in other advanced countries in general and in the euro area in particular. The deterioration results, in part, from discretionary fiscal support to economic activity and the operation of automatic stabilizers, in line with the European Economic Recovery Plan. In addition it reflects a significant shortfall in tax revenues.

After a 3-year period of successful budgetary consolidation, the public deficit ratio increased from 2.8 percent in 2008 to 9.3 percent in 2009 and, in the same period, the public debt ratio increased from 66.3 percent to 76.8 percent. For the euro area average, the corresponding ratios increased from 2 to 6.3 percent for the deficit, and from over 69 to over 78 percent for the debt.

The Portuguese authorities are well aware of the challenges ahead and the recently adopted Stability and Growth Program for 2011-2013 comprises credible measures that should bring public deficit again to less than 3 percent of GDP by 2013 and resume structural consolidation.

Sound initial conditions, including negligible exposure to toxic products, absence of property bubbles, and appropriate business models, allowed the banking system to cope well with global financial shocks. In tandem with international and European initiatives, the Portuguese authorities took action to address vulnerabilities and in particular raised capital standards, while keeping the sound supervisory and regulatory framework.

The international economic crisis, resulting from the global financial crisis, has also had a severe impact on the economic and productive sectors of the **Republic of San Marino**. This is reflected, for example, by the use of wage supplementation benefits (*Cassa Integrazione Guadagni),* in particular in the industrial sector. The unemployment rate has increased, though it is still lower than in most European countries.

Against this background, the San Marino Government has adopted several measures to support employment and reduce public expenditure, and it has already prepared a draft law to reform the current tax system, which should be adopted next June. Furthermore, the Government has stated its strong commitment to support the banking sector, particularly by giving priority to the implementation of measures that are designed to strengthen its stability, supervision and transparency, and that fully comply with the highest international standards.

In this regard, the authorities underscored that the Central Bank of San Marino is strengthening its Supervision Department, while the Government is reviewing the regulatory framework to enhance the independence of the institution. The initiatives adopted are in line with the recommendations made by the International Monetary Fund following the Financial Sector Assessment Program, undertook by San Marino in November 2009.

As a demonstration of the political course undertaken by the San Marino Government, 23 Agreements have been signed in the form of DTA or TIEA based on the 2005 OECD model. All these agreements have been ratified by parliament. Consequently, the authorities note that bank secrecy can no longer be invoked when bilateral agreements on exchange of information on tax matters are in force. Moreover, the authorities emphasize that they continue to update and strengthen the legislative framework to combat money laundering and terrorist financing, in accordance with the Recommendations of the Financial Action Task Force (FATF) and the Moneyval Committee of the Council of Europe.

Estimates for economic growth in **Timor-Leste** during 2009 are not yet final, but indications are that aggregate demand has remained strong on the back of government spending, in particular public investment in infrastructure. 2009 has been declared ‘the Year of Infrastructure’ by the authorities of Timor-Leste. Aside from the oil and gas sector, limited external linkages have meant that the country remains sheltered from the effects of the global economic crisis. With prices somewhat picking up at the end of 2009, headline inflation reached 3.2 percent during the last quarter of 2009. Year-on-year inflation in December 2009 stood at 1.8 percent.

Fiscal policy over the last three years has supported growth. The key challenge is managing the abundant petroleum income in order to develop a sustainable non-oil economy. In 2009, the government reallocated approximately US$70 million from a power project, due to implementation adjustments, to small- and medium-sized infrastructure works. The Referendum Package, as it is called, was designed to provide contracts for around 700 projects to domestic companies across the country. Spending growth in 2010 is planned to slow down, and the government is looking to improve the quality of government spending and non-petroleum receipts through increased compliance.

On the structural front, a draft Transitional Land Law was approved in March 2010 that should establish a regime to identify and regulate land ownership, an essential precondition for private sector development.

3. IMF Issues

In view of the multiple challenges facing the global economy and the uncertainties of the post-crisis world, the opportunity to discuss a possible broadening and updating of the Fund role, both in surveillance and in lending, to ensure the stability of the international financial system and sustainable growth strategies is most welcome. Finalizing the fourteen review of quota by January 2011 as well as completing the broader governance reform as a wide-ranging package is also a top priority in the months to come. As the recent crisis has amply demonstrated, the Fund is quite able to react quickly to changing circumstances; we would like to see this flexibility preserved and introduce amendments to the Articles of Agreements only when other less cumbersome approaches, including Board decisions, are not possible.

Future Financing Role of the Fund

Over the years, the Fund has shown remarkable flexibility to adapt its role and functions to the changes in the international economy and to the evolving balance of payments needs of its members. This flexibility was confirmed by the lending reforms introduced in the past months. The sharp increase in Fund resources during the crisis and the reforms of the lending toolkit have indeed made a significant contribution to stabilize financial markets.

While there is scope for exploring further reforming options, and we welcome the ongoing work on the future financing role of the Fund, we believe that the basic functions of the IMF should be preserved and its lending toolkit should be used to support the necessary adjustments in countries that have a temporary balance of payments need. Accordingly we are prepared to examine the pros and cons of the various reform proposals constructively but at the same time, we would like to reiterate our position that, at this stage, we are not ready to support a role of the Fund as an insurance provider or a lender of last resort. We are also skeptical that this is even technically possible, considering that the Fund does not have the authority to commit unlimited funds. Moreover, radical changes in the functions of the Fund involve huge moral hazard problems, and require appropriate attention to be paid to how to preserve its financial integrity.

Global Financial Safety Nets

The crisis offered valuable lessons to strengthen the global financial safety nets. Countries can insure themselves against shocks in different ways. We agree that that the first line of defense against shocks is represented by increasing countries' resilience through improved policies and institutions. In this respect we believe that the surveillance role of the Fund can and should play a primary role.

Financial instruments can also help manage shocks. It is clear that the IMF can play a role in this domain too. However IMF lending is only one element of a broader financial safety net at the global level, which also includes self-insurance through reserve accumulation, bilateral foreign exchange rate swaps arrangements among major central banks, regional reserve pools, and SDR allocations. On the whole, this array of tools has worked well and proved adequate to cope with the current crisis.

On reserve accumulation, we note that it has been an effective option for emerging market countries with a flexible exchange rate regime to protect them from the crisis. However, it is not clear if reserves are accumulated for self-insurance purposes or as a by-product of other macroeconomic policy objectives. Deeper analysis on reserve accumulations, including a discussion on optimal levels of reserves, is therefore imperative.

Going forward, we expect that many emerging market countries will continue to accumulate reserves for a variety of reasons, far in excess of the total amount of short-term external debt. Moreover since we believe that this benchmark does not necessarily capture the complex dynamics arising in a liquidity crisis; we should be cautious to reach conclusions and aware that any realistic reform of the lending role of the Fund is unlikely to change countries' incentives to accumulate reserves.

Reform of the Lending Toolkit

The Flexible Credit Line (FCL) has been an important innovation and has been well-received by the markets. However, as the FCL was established only a few days before the G-20 London Summit, when G-20 Leaders committed to tripling IMF usable resources, it is therefore difficult to disentangle the effects on sovereign spreads of the introduction of the FCL from the effect of the tripling of resources. In this context, we should be cautious in assessing the instrument's effectiveness and in promoting its strengthening. The mere existence of the FCL (coupled with larger IMF resources) seems to have caused positive externalities to global markets, and countries do not even need to apply for the facility in this context. The limited number of countries that have requested the FCL so far is not a sign of failure for the facility, but it rather seems to confirm its generalized positive effect.

Against this background, we see the current flexibility regarding the FCL's access and duration as appropriate. The access is already exceptionally high, and the existence of caps adds to the predictability of the instrument and contributes to safeguarding the Fund's resources. In addition, we have strong reservations regarding proposals to lengthen the duration of automatic access and to allow multi-year arrangements with annual reviews. Regarding the costs, we are not fully convinced by the proposition to lower the charges, as we have no evidence that high costs were behind low demand for the FCL. Furthermore, such reform would represent a major exception to the general rule established in the Articles of Agreement on equality of charges, and it would therefore entail a rather cumbersome decision-making process.

In trying to meet the needs of countries with good policies, but not good enough to access the FCL, we must be mindful of the risks of moral hazard as well as the need to preserve the Fund's resources. Accordingly, countries that do not meet the FCL eligibility criteria should continue to be subject to ex-post conditionality. Pending further research, we are open to considering if there is room for further streamlining of ex-post conditionality in High Access Precautionary Arrangements (HAPAs) for countries that are near to FCL qualifiers and eventually the creation of a special window within HAPAs, to be used for precautionary purposes only, for countries that meet qualification criteria but would also be required to commit to a set of policies addressing vulnerabilities (Precautionary Credit Line).

In general, we have strong reservations on the proposal of establishing a Multi-country Swap Line (MSL). We remain perplexed by the "unilateral offer" nature of this facility; so long as countries are the ones determining whether they need assistance, then they should approach the Fund accordingly. Moreover, we are concerned by a number of other potential problems related to this new proposed facility, including sending the wrong signals, moral hazard, and the potentially very high impact on Fund resources.

On more innovative reform options, we appreciate IMF's thinking outside the box, however we approach the more "radical" proposals with caution as all of them would require changes in the Articles of Agreements, contain significant resources implications, and/or entail the use of SDA resources. More importantly, almost all of them would fundamentally change the role of the Fund into that of lender of last resort or global insurer, something we have been disputing all along.

Surveillance

Increased financial interconnectedness among countries calls for strengthening Fund surveillance and its multilateral component in order to reinforce the Fund's crisis prevention abilities. This goal also requires buttress financial sector surveillance and the analysis of macro-financial linkages. We reiterate our willingness to discuss with an open and constructive mind the recent ideas floated by staff to achieve these objectives.

More precisely, a new Multilateral Surveillance Decision (MSD) can certainly represent a procedural improvement, not least because it would provide guidance on, *inter alia*, the scope of multilateral surveillance, the type of analysis carried out by staff, the selection of countries to be covered by spillover reports, and the power of the Fund to initiate multilateral consultations on systemic issues. However, we are concerned that the adoption of an MSD may turn out as a time-consuming process.

We also see merits in producing spillover reports to complement Article IV reports for countries "*whose policies or circumstances significantly impact the system*". The most promising quality of such spillover reports lies in their potential to raise the members' awareness of their responsibility towards preserving global financial stability. In so doing, they may increase the traction of surveillance by strengthening the incentives to conduct an effective peer review process. We believe that the main findings of a spillover report should be briefly recalled in the companion Article IV report, as is currently the case for the conclusions of the Financial System Stability Assessment.

In any case, we consider it imperative that the renewed emphasis on multilateral surveillance does not detract from a further strengthening of bilateral surveillance, which should remain one of the mainstays of the Fund's crisis prevention activities. In fact, the ability to detect outward spillovers is to a significant extent a by-product of a thorough analysis of domestic conditions, policies, risks and vulnerabilities. Multilateral surveillance remains thus reliant on valuable input from bilateral surveillance. Further progress on all the operational priorities set forth in the Statement of Surveillance Priorities remains warranted.

In this regard, the crisis has most vividly showed that financial sector issues and policies are crucial to ensure global stability. To improve Fund's financial sector surveillance, we support making the FSAP and regular updates a mandatory part of surveillance for all countries, building on the flexibility offered by the new modular assessments. Close and pragmatic cooperation between the Fund and the FSB, in line with their complementary roles and mandates, is also instrumental in improving the Fund's analysis of macro-financial linkages and related risks to global stability.

Improving the traction of surveillance remains a priority. We believe that the IMFC could be the natural vehicle to engage policy-makers and help overcome the lack of policy dialogue on outward spillovers, cross-country themes/sectors and, more generally, multilateral surveillance. An endorsement by the IMFC of the findings of multilateral surveillance, including spillover reports, could improve its traction.

Quota and Governance Reform: *The Size of the Fund*

Notwithstanding preliminary IMF's analysis, envisaging a doubling of quotas and the current NAB (around US$ 1 trillion in total) as an appropriate size to cope with its financing needs under a broad range of events, we do not see a strong case for increasing Fund resources any further at this juncture. Resources have been already tripled with respect to their pre-crisis levels, mainly through the NAB. This has played an especially important role in containing the international ramifications of the crisis. In addition, the current lending capacity of the Fund is very large.

In a longer-term perspective, the appropriate size of the IMF depends not only on its members' future needs (which are difficult to gauge now), but also on the specific mandate of the Fund in the field of "lending". Since the discussion on the review of the mandate is still at its preliminary stage, it is premature to assess the need for expanding its resources at this juncture.

Regardless of the overall size of the Fund, it is crucial to maintain the most appropriate balance between quota and borrowed resources. As no general quota increase has been approved since 1998, the size of quota resources has shrunk substantially relative to any metrics of the global economy (GDP, reserves, and capital inflows). Although we recognize the merits of this argument, we still maintain that the overall size of quotas should primarily reflect the IMF's long-term ability to meet member countries' balance of payment financing needs.

As a general guiding principle, we reiterate our strong call for preserving the nature of the IMF as a quota-based institution, while the NAB represents a "backstop" for IMF quota resources to be activated when quota resources need to be supplemented in order to forestall or cope with an impairment of the international monetary system. Accordingly, if a large increase in quotas is needed, the NAB should be downsized to accommodate part or all of the planned quota increase. This should be determined after the quota review is completed.

Quota and Governance Reform: *The Redistribution of Quotas*

Given the tight timeframe (a broad agreement should be reached by the next Annual Meetings) and the need to make also progress on the full range of Fund's reforms, including governance, mandate, and size, we urge the Fund to find expeditiously a consensus on the implementation of the agreement – a shift in quota shares of at least 5 percent from over- to under-represented countries to be obtained using the current formula - we reached last year in Pittsburgh and Istanbul.

The reform should aim at reducing the degree of out-of-lineless between calculated and actual quota shares, and it should not result in an enlargement of the number of under-represented countries. The current formula is a useful tool to determine which countries are over-represented and which are under-represented. Given the high degree of under-representation of emerging and developing countries, the reform will mainly result in an increase of the aggregate quota shares of emerging and developing countries.

We therefore strongly oppose reopening the debate on quota formula. It would be very difficult to reach an agreement within the tight timeframe, since it would be necessary to reconsider all aspects of the formula (weights, variables definitions, compression factor, financial contribution to the Fund, etc.), and the current formula has proven to be valid in capturing the recent growth patterns of both advanced and emerging countries (as results from the calculated quota shares updated with the WEO 2009 data used in the IMF paper).

To facilitate the required realignment of quota shares, the quota increase should include a combination of "selective" and "ad hoc" increases, with the latter being better suited to deliver the envisaged quota shifts and to protect the quota shares of the poorest.

Quota and Governance Reform: *Governance*

The reform of IMF governance cannot be addressed with a piecemeal approach. Most of the governance items are related to one another and cannot be seen in isolation. Greater political involvement of national authorities is desirable, as this would contribute to enhance the traction of the Fund's policy advice and therefore the overall effectiveness of IMF surveillance.

The Executive Board should be made more effective along two dimensions: procedures (e.g., by reinforcing the structure and mandate of its standing committees) and substance. Its work should be re-oriented from day-to-day operations towards more strategic issues, such as global policy and institutional issues, multilateral surveillance, macro-financial analysis and cross-border linkages. We do not see any compelling reasons to change the current size of the Executive Board, which strikes a reasonable balance between legitimacy and effectiveness.

The proposal of an all-elected Board is premature at this stage. An agreement on this issue would be only possible if consensus is reached on a wider set of governance reform elements, including possible changes in voting majorities. Lower voting thresholds should be part of the process to increase the legitimacy of the Fund. In particular lowering majorities to 70 or 75 percent can add to better representation and more efficient decision making.

As regards the selection of IFIs' leaders, we are in favor of an explicit statement from key countries that future senior leadership appointments will not be bound by historical conventions. The IMF and the World Bank should put forward concrete proposals concerning senior management's selection procedures. A balanced distribution of staff, in terms of geographical origin as well as professional background, would be also desirable.