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Statement by Giulio Tremonti
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

After a prolonged period of rapid growth and stable inflation, global economic conditions have deteriorated sharply in the past few months. Financial markets have been hit by the most serious crisis in decades. Several advanced economies are on the verge of recession and growth rates in leading emerging economies have eased substantially. Triggered by sharp increases in commodity prices, worldwide inflation has reached levels not seen in several decades.

A remission of the multiple shocks affecting the global economy does not appear imminent. Indeed, all of the available indicators point to furthered deterioration in economic activity in the months ahead. For the world economy to enter a new phase of expansion, a number of pre-conditions must occur; financial markets must stabilize and resume their normal function of providing credit to economic activity. Real estate markets in several countries, notably in the US, also should stabilize. Similarly, commodity prices and excessive volatility should be reduced. Assuming that substantial progress on these issues will be achieved in the next few months, it is possible to expect a gradual recovery of the global economy in 2009.

In the **US,** Congress' approval of the $700 billion rescue plan stands as an important step towards restoring confidence in the financial markets. The off-loading of illiquid instruments tied to the sub-prime mortgage should allow banks to restore their balance-sheets and resume normal lending. This is all the more important as there are clear signs of a sharp decline in private consumption. Exports, the main driver of growth in recent months, would not be sufficient to carry the US economy forward in the current context of the weakened global demand.

Economic activity in the **Euro Area** has weakened substantially in the past few months due to multiple factors, including softer global demand and the impact of the financial crisis. However, the comprehensive structural reforms implemented in the past several years and relatively strong corporate balance sheets, should allow the European economies to cushion the impact of the global slowdown better than in previous occasions. Should downside risks to the economic cycle materialize, letting automatic stabilizers fully work would provide the necessary support to the adjustment process without compromising the recent efforts to complete the fiscal structural adjustment by 2012 at the latest.

The weakening of the global economy is taking a significant toll on **Japan**. At the same time, the limited exposure of the Japanese financial system to the global financial crisis and the retrenchment of the housing sector, combined with relatively strong corporate balance sheets, make the Japanese economy better equipped to sustain the impact of a generalized economic downturn. Measures aiming to sustain economic activity in the short term must be consistent with the objective of achieving financial consolidation in the long term.

Most **emerging market economies** will continue to grow at robust, albeit reduced, rates. Most of these countries are experiencing a sharp acceleration in inflation due to overheated economies and the spike in commodity prices. These trends call for a tightened policy mix, which would preserve the recently-achieved macroeconomic stabilization. Fiscal policy restraint should be accompanied by well-targeted and non-distortionary measures to cushion the impact of commodity and food prices on the poor. In countries with substantial current account surpluses, greater flexibility in the exchange rate would contribute to rebalancing the sources of growth; boosting domestic demand and reducing the over-reliance on exports will contribute to addressing the issue of global imbalances.

Although the size of the **global imbalances** has recently declined, the risks of their disorderly unwinding remain considerable, particularly in the context of the financial crisis. Despite some recent easing, the euro remains substantially overvalued, particularly vis-à-vis key currencies in Asia. The recent real appreciation of the remimbi goes in the right direction, but much more is needed to bring it close to the fundamentals of the Chinese economy.

2. Developments in the Constituency

Italy's GDP rose 1.5 percent in 2007, slightly more than its potential. Since last summer, economic growth has weakened as a result of both global headwinds - the financial crisis and sharply rising commodity prices - and structural issues.

Following stronger-than-expected expansion in 1Q08, GDP contracted by 0.3 percent quarter-on-quarter in 2Q08. Both domestic and external demand weakened. Exports suffered from both lower world demand, especially from industrialised countries, and the past appreciation of the euro. Sharply rising energy and food prices weighed on households' real income thus restraining private consumption, particularly of durable goods. Construction investment dropped by 0.9 percent over the previous quarter, highlighting the ongoing adjustment in the housing sector. The latest available data for 2008 point to slightly decreasing house purchases and prices versus the previous year, especially in metropolitan areas. Weak household demand comes along with soft mortgage lending, which in July recorded a modest reduction over the same month of 2007. Within fixed investment, machinery and vehicle categories rebounded in 2Q08 over the previous quarter, though not enough to compensate for the drop in construction investment.

Overall, most leading indicators point south though some others appear to have stabilized (consumer confidence and services, and retail confidence). Economic performance is projected to remain weak in the second half of 2008. For the whole year of 2008, GDP growth has been revised downward to 0.1 percent from the 0.5 percent estimated before the summer. Similarly, growth is estimated at 0.5 percent in 2009, down from the previouslyexpected 0.9 percent. In 1Q08 the labor market recorded mixed performance: the rate of unemployment rose to an unadjusted 7.1 percent as a result of both strong increases in labor supply (2.2 percent over the same quarter of 2007) and more contained job creation (1.1 percent over the same quarter of 2007). At the regional level, there are no significant differences in economic performance, though the labor market was somewhat weaker in the South of Italy. According to national data accounts, employment growth was still favorable in 2Q 08. The unemployment rate is projected to decline to 6.0 percent in 2008 from 6.1 percent in 2007.

Following the higher-than-expected energy and food import prices, consumer inflation has moved up since the end of 2007, reaching 4.1 percent year-on-year in August. Also core inflation rose as a result of higher prices in services linked to energy commodities (air and sea transport services, restaurants, and hotels), hovering around 3.0 percent in the summer months. In 2008, consumer inflation is now expected to reach an average of 3.7 percent.

Despite weaker GDP growth, the end-September public finance report, confirmed the general government net borrowing target for 2008 at 2.5 percent of GDP, as well as the achievement of the medium term objective in 2011. The primary surplus is expected to gradually improve, reaching 4.6 percent of GDP, while the debt-to-GDP ratio is forecast to decline below 100 percent, reaching 98.4 percent in 2011.

Sound macroeconomic and structural policies, underpinned by Fund programs, have laid the groundwork for the impressive progress made by the **Albanian economy** over the last decade. Per capita GDP growth in U.S. dollar terms has more than doubled and graduation from IDA is forthcoming. Inflation has declined toward the European average. Growth is projected to remain robust in the current year and, equally importantly, is broader-based. Upbeat trade is following export diversification in both markets and products. Credit growth, identified as a major risk in the past, has been somewhat contained, but remains relatively strong. Most of the widening of the current account deficit in 2007 reflected temporary factors and the gap is expected to decline to below 5 percent of GDP in the medium-term.

Timely monetary policy tightening, complemented by appropriate regulatory measures, was crucial in order to reach macroeconomic stabilization. On the fiscal side, while implementing supply-side tax reforms, major improvements in tax administration have contributed to strengthening public finances, boosting the revenue-to-GDP ratio, and lowering the public debt. The 2008 budget sets a deficit ceiling of 5.2 percent of GDP that does not generate a fiscal impulse; this gap should decline to 3.0 percent as early as 2009. Significant contingency reserves of about 1.5 percent of GDP are in place to protect the 2008 budget outcome. The authorities stand ready, in consultation with the Fund, to take further actions should the fiscal deficit target be in jeopardy,

The authorities are now focusing on the medium-term policies and reforms necessary to sustain private sector-led growth and ensure financial stability. They intend to address the business climate, governance, and institutional weaknesses through a wide range of reforms. The persistently strong performance under the PRGF-EFF-supported program confirms their commitment.

In **Greece,** GDP growth is expected to slow from 4.0 percent in 2007 to 3.4 percent in 2008 and to 3.0 percent in 2009 in response to negative spillovers from the global credit crunch and adverse external environment. Domestic demand growth slowed significantly this year in response to higher interest rates and soaring commodity prices and, given external developments, is not expected to recover in 2009. Following significant fiscal consolidation in 2005-07 under the excessive deficit procedure, slowing growth and rising interest rates took their toll on public finances. As a result, the general government deficit is expected to rise to 2.3 percent of GDP in 2008, well above budget projections. The government took immediate action to reverse the deterioration through a package of tax measures aimed at broadening the tax base and fighting tax evasion. This package, approved by Parliament in September, included the introduction of a tax on dividends and capital gains. These measures are expected to contribute to reducing the deficit to 1.8 percent of GDP in 2009.

The **Maltese** economy remained generally buoyant during the first half of 2008, although the growth rate over this period decelerated to 3.3% from 3.8% in the same period of 2007. The main factor contributing to this deceleration was the downturn in economic activity in Malta's major trading partners which continued to have an impact on external demand. Thus a further contraction in merchandise exports was only partly compensated for by exports of services. The latter continued to expand significantly reflecting the establishment in Malta of a growing number of firms which provide a wide variety of specialized services. Thus notwithstanding it was domestic demand which continued to be the driver of economic growth, as both private and public consumption increased notably. For the year as a whole, the economy is expected to register a growth rate of around 3%.

The upward trend in inflation persisted during the first half of 2008, mainly on the back of surging energy and food prices. Evidence of second round effects remains notably absent and, though HICP inflation is expected to peak at around 4.5 percent during 2008, price pressures should ease in the latter part of the year.

Despite the softening economic conditions, the labor market remained robust with employment rising by 3.2% in the first half of 2008 as structural reforms aimed at increasing labor flexibility continued to have a positive impact, especially with regard to female participation. Furthermore another positive development was the fact that employment growth was attributed entirely to job creation in the private sector. Reflecting these developments, the unemployment rate in the first half of 2008 declined to 5.8% from 6.4% at the end of 2007. In 2008 as a whole, the rate is expected to remain below the 6% level.

The progress achieved in fiscal consolidation in recent years has culminated in a general government deficit of just under 1.8% of GDP in 2007. There might however be some slippages in the government shortfall during 2008 due to larger subsidies to the energy sector as a result of the surge in oil prices, increases in public sector wages, and the introduction of an early retirement scheme for shipyard workers.

While the introduction of the euro on January 1, 2008 has reduced exchange rate risks for Malta's small and open economy, particularly at a time of considerable turbulence in international financial markets, the Maltese authorities recognize the need to introduce further supply side reforms aimed at enhancing competitiveness. In particular, efforts are being directed towards improving the quality of human capital and introducing further flexibility measures in the labor market in order to achieve higher productivity levels. Institutional restructuring in the public sector, privatization and a reduction in government subsidies are additional reforms on the government's agenda aimed at strengthening the workings of product and factor markets.

In 2008, economic activity in **Portugal** slowed down considerably in line with the euro area and the global economy. International turbulence in financial markets associated with tighter financing conditions, the appreciation of the euro, the global trade slowdown, and the strong increases in oil and commodity prices had a significant dampening impact on the Portuguese economy. Both internal and external components of demand contributed to the deceleration in 2008. In particular, the investment recovery initiated in 2007 was halted and external demand for Portuguese exports remains subdued. The continuation of sound macroeconomic policies and structural reforms are crucial to protect the Portuguese economy from the current turbulence and to strengthen its competitiveness and growth potential. International developments related to food and fuel markets kept an upward pressure on prices. The inflation rate increased to 3.0 percent in the first eight months of 2008, but stands as one of the lowest rates in the eurozone. The differential vis-à-vis the euro area, which had already turned negative, is now below -2 percentage points. This is a favorable development towards the improvement in the competitiveness of the Portuguese economy.

Budgetary consolidation, aimed at a budget position close to balance over the medium term, is also crucial to reinforce competitiveness. The general government deficit declined to 2.6 percent of GDP in 2007, again correspondent to an adjustment larger than envisaged in the stability program. The consolidation, based mainly on expenditure reduction, is set to continue in 2008, and a 2.2 percent deficit ratio is expected. The unemployment rate stood at 7.3 percent in the second quarter of 2008, down from the first quarter and from 2007 figures. Except for long term unemployment, other labor market indicators showed positive developments, including an increase in the participation rate and in employment, and a reduction in the number of unemployed.

The Portuguese banking system has been resilient in the face of the ongoing financial turmoil. The direct exposure to the sub-prime segments is low and securitization is used to a lesser degree than elsewhere. A pro-active supervision and a prudent approach by banks concerning capitalization, liquidity, and exposure have been followed. Credit standards reported by banks have been tightened and adjustments in non-financial corporations and households are underway. Portugal has kept the pace of its national reform program, with fiscal consolidation and competitiveness as priorities. The reform of public administration, which envisages a more flexible and efficient allocation of civil servants, is among the most recent measures. Other measures include the labor market reform, the educational and training system, the modernization of infrastructures, and the implementation and updating of the technological plan. Portugal is also focused in reducing its energy dependency.

In the first six months of 2008, the economic performance of the Republic of **San Marino** continued to be strong, despite the high uncertainty surrounding the global economy. Preliminary data point to a GDP growth in the neighborhood of 4 percent and a decline of the unemployment rate to 2.5 percent. By the end of 2008, however, the economic activity in the Republic is expected to weaken somewhat, as growth in its major trading partners slows down. On the fiscal front, higher revenues and continued progress in reducing current expenditure led to a further improvement of the fiscal position. At the end of the current fiscal year, the central government balance is expected to record a small surplus. In June 2008, a major progress was the adoption of a new and comprehensive Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) law, which will contribute to strengthen the international standing of San Marino's financial system. Indeed, drawing from the EU Directive 2005/60/CE and the recent recommendations from the Financial Action Task Force (FATF), the new law improves the existing legislation by reflecting the highest international standards.

In **Timor Leste,** following a contraction in 2006, real non-oil GDP is estimated to have rebounded by 8 percent in 2007, and the economy has remained buoyant in 2008. Growth has been driven mainly by government spending, with improvements in security conditions providing additional support. Consumer prices climbed by 9 percent in 2007, more than double the rate from 2006, and continue to rise mainly as a result of high global food costs. Nevertheless, inflation has been lower than Timor-Leste's trading partners and the real effective exchange rate developments have been muted. Although the banking system is sound, comprised only of branches of large foreign banks, low loan quality continues to hamper the provision of credit.

The medium-term outlook points to moderate non-oil growth, but with significant uncertainty. Staff project growth of about 5 percent per year over the medium-term. Attaining the 8 percent growth needed to effectively address high levels of poverty would require an increase in well-planned investment spending and improvements in the business environment. Budget appropriations have been increasing rapidly but a weak administrative capacity continues to constrain effective delivery. Timor-Leste is also highly vulnerable to external and domestic shocks, and is greatly dependent on petroleum revenue.

The key challenge is managing the abundant petroleum income in order to develop a sustainable non-oil economy. In line with high global energy prices, government revenue from oil and gas surged to 340 percent of non-oil GDP in 2007. Although a development plan has yet to be agreed upon, the Greater Sunrise field could commence production around 2015 and possibly double government revenue. The difficulty will be to translate the large but temporary income from hydrocarbon extraction into lasting results. A robust and highly transparent framework for managing petroleum revenue is in place, including a petroleum fund.

3. IMF's issues

Surveillance

The current financial crisis and its widespread ramifications call for a comprehensive analysis of the underlying trends, a clear assessment of the macro-economic risks, and the implications of policy measures. No other organization has the breadth of expertise and experience of the IMF in providing a multilateral perspective and in analyzing the macro-financial linkages of the current crisis.

As the recently concluded triennial surveillance review indicated, the Fund's advice continues to be crucially relevant to the global debate on economic policy, and its surveillance is highly valued by the membership and financial markets. Much progress in the effectiveness of the Fund's actions has taken place, particularly as a result of the increased focus on the financial sector and the treatment of exchange rates, which has become more prominent and has been supported by sharper analytical tools. However, the current challenges facing the global economy require further improvements in the analysis of the financial markets and in assessing the risks and global spillovers. Accordingly, we welcome the Managing Director's Statement on Surveillance that sets out the future priorities.

Given its broad range of expertise and multilateral perspective, the IMF is in a unique position to analyze its members' financial systems and identify structural vulnerabilities. Therefore, it could make an important contribution, in collaboration with the FSF and other international institutions, in redesigning the rules of the global financial system in the aftermath of the current financial crisis.

The Fund's Lending Role

Although the Fund's lending has reached historically low levels, the Fund still has an important function to play in this area. In addition to its potential role as "lender of last resort", the Fund plays a critical role in certifying the quality and viability of members' policies to keep their economies on a sustainable path. Therefore, conditionality should remain the key pillar of the lending framework, as a crucial device to foster the implementation of the program, and to provide a strong and credible external anchor. Moreover, conditionality remains essential to safeguard the IMF's resources and to ensure uniformity of treatment across membership. Against this background, we welcome the recent efforts to streamline conditionality and to focus on the most crucial features of the program as well as the IMF's core areas.

With regard to the lending framework, the current multi-facility framework seems to ensure enough flexibility to address the different and peculiar members' needs along the different stages of economic development. There might be room for improving the framework through streamlining some of the current instruments rather than adding additional ones. Notwithstanding, a signaling tool directed to middle-income countries with strong performance and solid policy reform programs could be explored. The experience with the Policy Support Instrument (PSI), though only preliminary and partial, would be useful in the designing of this new facility.

An insurance facility is another possible candidate to strengthen the overall framework, but further analysis is needed, including the existence of potential demand. Given the diversity of the membership and the unpredictability of crisis, designing qualification criteria is a challenging task. We also doubt that they would remain adequate and credible enough to provide positive signals to the market. Despite these misgivings, we are open to discussing ways to design an insurance facility which could be attractive to users through ensuring rapid and substantial assistance while safeguarding the IMF's resources. The new instrument should be fully incorporated into the exceptional access framework, which has been a valid vehicle to timely address crises while designing successful exit strategies.

We finally welcome the new recently redefined Exogenous Shock Facility. The new window for rapid access would make the facility more suitable to respond in a timely fashion to support the most vulnerable members hit by shocks.

The IMF Corporate Governance

After the recent progress on quota and voice, the modernization of the IMF governance structure is the next institutional issue to be addressed. The report by the Independent Evaluation Office (IEO) on governance of the IMF raised a number of issues that deserve careful consideration. We welcome the preliminary work done by the Executive Board in setting out a working plan with the view to follow-ups on some IEO proposals and to identify alternative options. The establishment of a Task Force would facilitate carrying the work agenda forward in a comprehensive and timely fashion. Furthermore, the committee of eminent persons, appointed by the Managing Director, would provide input and fresh ideas on how to better reshape IMF governance and to reflect the changes in the global economy. We look forward to making concrete progress by the 2009 Annual meetings.