International Monetary and Financial Committee

Thirty-Fourth Meeting
October 8, 2016

IMFC Statement by Pier Carlo Padoan
Minister of Economy and Finance
Italy

On behalf of
Albania, Greece, Italy, Malta, Portugal, and Republic of San Marino

Statement by Mr. Pier Carlo Padoan

Minister of Economy and Finance, Italy

Speaking on behalf of Albania, Greece, Italy, Malta, Portugal, San Marino

International Monetary and Financial Committee

Washington, October 8, 2016

Developments in the Constituency

In the first half of 2016 macroeconomic conditions continued to improve in all the countries of the constituency. The recovery remained strong in Malta, and moderate in Italy, Portugal and Albania. Following years of recession, GDP in Greece has returned to growth in the second quarter of this year and the activity in San Marino is showing signs of improvement. According to the most recent indicators, the positive cyclical phase in the constituency should continue also in the second semester of the year.

While relatively modest – with the notable exception of Malta – the economic recovery has been so far rather job-rich. In all countries of the constituency employment is being created and unemployment rates are gradually declining, though they remain unacceptably high, particularly among the young, in most of our countries. At the same time, the unemployment rate in Malta attained new lows, falling below 4 percent during the summer, while the strong economic expansion continues to attract a robust inflow of foreign workers, especially from other European economies.

The gradual improvement of labor market conditions in the constituency has supported domestic demand, particularly private consumption, while the investment recovery remained generally lackluster with the only exception of Albania, which is benefitting from strong FDIs. The slowdown of international trade is taking a toll on the contribution to growth from net exports. Notwithstanding, the external current account position is projected to remain in surplus in Italy, Malta, Portugal, and broadly balanced in Greece. The current account deficit has widened only in Albania, mainly due to import-intensive FDIs, but it is expected to narrow over the medium term.

Inflation remains subdued and below target everywhere. However, the disinflationary pressures stemming from past energy price decreases should gradually fade away and the inflation rate is expected to rise gradually over time.

Going forward, consolidating and strengthening the recovery is a critical objective across the constituency, not least because growth is a key ingredient to address the remaining legacies of the crisis – including in the financial sector.

Strong and sustainable growth requires further ambitious and comprehensive reforms, which are a top priority for the countries of the constituency. Much progress has been achieved in many areas, but the positive effects on growth coming from such reforms – including through the much needed recovery of the investment cycle – will necessarily take time. This said, the authorities of the constituency remain committed to complete their reform agenda.

Yet, even when appropriately sequenced, structural reforms cannot address the substantial lack of demand which is characterizing the current juncture, as suggested by the protracted weakness of inflation. To support demand monetary policies should remain accommodative, and pro-growth fiscal policies should be pursued, while assuring the critical objective of strengthening the soundness of public finances. Looking ahead, the countries of our constituency remain committed to ensuring a declining public debt-to-GDP ratio.

The Board completed the seventh and eighth reviews of the IMF-supported EFF program with Albania in May and August 2016, respectively. At present, SDR 238 million have been made available under the program. The first review of the ESM Financial Assistance Agreement with Greece was successfully completed in May 2016. The successful completion of the second review due in October 2016 would mark a further step on the way to recovery.

Developments in the Members of the Constituency

Italy: The economy has continued to recover at a moderate pace (0.8 percent year-on-year) in the first half of 2016. Growth was supported by private consumption, while investment after having picked up in 2015 continued to improve even if marginally. Italian exports rebounded in the second quarter, but their growth in the first half was muted by a slowdown in non-EU export markets.

The latest indicators suggest that the recovery should continue in the second half of the year. Industrial production increased in July, business confidence edged down in the early summer but recovered in September. Sentiment in the service sector remains relatively high. The latest official real GDP growth forecasts are 0.8 percent for 2016 and 1.0 percent for 2017.

Inflation remains subdued and still below the Euro area average. Looking forward, the disinflationary pressure stemming from past energy price decreases should gradually fade.

Employment has recovered more strongly than GDP. In the second quarter of 2016 it was up 2 percent year-on-year (439,000 units). Importantly, youth employment is growing above average. Positive signs are coming also from the participation rate. The unemployment rate is on a downward trend (11.4 percent in August).

On the fiscal side, the 2016 general government budget deficit is now projected at 2.4 percent of GDP, only marginally above the 2.3 percent target in the Stability Program and down from 2.6 percent in 2015. The deficit target for 2017 is 2.0 percent of GDP. Although 'fiscal space' is limited, the government has found the resources to finance both growth-enhancing measures and welfare programs. In addition, public investment in infrastructure will be increased using resources drawn in part from cuts in current expenditure.

The Italian banking sector is on the way to a steady recovery. During 2016 credit supply to the private sector has been improving. Italian banks' stock prices have come under pressure in the summer due to external factors and to concerns about the high share of NPLs. Volatility has been heightened by Brexit and by concerns about the EBA stress tests. However, the latter confirmed that Italian banks are safe and well-capitalized. Results signaled weaknesses in only one bank, which will be recapitalized according to a plan the ECB approved in July.

The ratio between bad loans and the total amount of credit has stabilized. Improvements are clearly visible in the manufacturing and trade sectors. Incentives for developing the market of NPLs came from the state guarantee scheme for securitized bad debts (GACS) and from the Atlante funds. The latter raised capital among banks and insurance companies in order to take part in recapitalization of weaker banks and in the securitization of NPLs.

As for structural reforms, the Jobs Act has improved employment opportunities while enhancing labor market flexibility. A comprehensive education reform was launched in 2015 in order to improve human capital and competitiveness. The reform of public administration aims to enhance the efficiency and productivity in the public sector.

Boosting investment is a key component of the comprehensive policy approach adopted by the Government to lift actual and potential output. Italy is making good use of the Juncker Plan and has also launched a comprehensive plan named 'Finance for Growth' to support business development. Investment incentives were also enacted with the 2016 Budget and will be continued in 2017, with a special emphasis on new and interconnected technologies related to the Industry 4.0 paradigm.

Albania: The Albanian economy is continuing to recover, while its underlying fundamentals are improving. The Albanian authorities have also met all their commitments under the existing IMF-supported program, which serves to underpin the country's economic policies and a large part of its structural reform agenda.

Growth is supported by investments in large FDI-financed energy-related projects, the pickup in private consumption and high tourism revenues. On the other hand, merchandise exports continue to suffer the negative terms of trade shock stemming from low commodity prices. The fiscal balance was positive in the first half of the year, due to a cyclical upturn in revenues and spending under-execution. Despite a strengthening recovery, economic growth remains below potential and overall inflationary pressures are subdued. The 12-month CPI inflation rate was at 2 percent in September.

The policy mix continues to focus on fiscal adjustment, while supporting growth through monetary easing. The authorities remain committed to gradually reducing the public debt ratio and to ensure the credibility of the fiscal framework. The fiscal consolidation strategy is based on broadening the tax base, strengthening tax administration, and improving tax compliance. Recent steps in these directions – such as the electricity sector reform and the fight against informal economy – are yielding results. Measures are also taken to strengthen the public investment framework, including careful cost-benefit analysis of projects, and to introduce fiscal sustainability rules into the budgeting process. In addition, the political consensus for the judiciary reform is an important milestone in ensuring reform momentum and reducing legal uncertainty. The challenge now is to sustain efforts in advancing the many reforms that have been undertaken in the past few years to finally achieve a business environment conducive to growth and job creation.

The current accommodative stance of monetary policy provides a favorable environment to implement structural reforms. Lending has gathered pace, supported mainly by domestic currency lending, though NPLs continue to drag on credit growth. In spite of that, the banking sector remains stable, liquid, profitable and well-capitalized. Addressing the NPL issue is a top priority for the authorities, as testified by the continued substantial progress in the implementation of the related comprehensive action plan.

Looking forward, the underlying growth drivers appear to be strengthening. Financial conditions and economic sentiment are improving, and external risks have partially mitigated. In addition, the easing of the terms of trade shock and continued structural reforms are expected to give a further boost to economic growth in medium-term. Notwithstanding, downside risks remain, mainly stemming from the external environment and domestic vulnerabilities on the fiscal side. In this context, the Albanian authorities are committed to maintain a policy mix based on monetary expansion and fiscal consolidation. They intend to further upgrade Albania's growth potential by further strengthening fundamentals and continuing to pursue an ambitious reform agenda.

Greece: In 2016 the Greek economy has shown first signs of stabilization and recovery. In the second quarter GDP returned to growth (0.2 percent over the previous quarter). The unemployment rate, while still high in absolute terms, dropped to the lowest level in four years (23.4 percent in June, down from the peak of 27.5 in 2013). Deflationary pressures are also easing, and bank deposits have been recently on a rising trend, following the completion of the first review of the ESM Financial Assistance Agreement. The government is currently clearing €1.8bn out of €7.2bn of government arrears accumulated over the years, and a further €1.7bn are expected for this purpose by mid-October.

The second review of the ESM Financial Assistance Agreement is scheduled to start in October. On its completion, Greece will receive a further disbursement expected in the order of €6bn. The review will revolve around 56 key deliverables in the following areas: public finances, safeguarding financial stability, structural reforms to enhance competitiveness and growth, and the modernization of State and public administration.

Specifically, the government will be tasked with reforming the corporate insolvency law, the opening-up of certain specific professions, and dealing with the energy sector. The labor market reform will also be central to the government's agenda, as will the newly created Hellenic Corporation of Assets and Participations.

At the same time as the second review will be taking place, debt relief discussions will continue and substantial progress is expected by the end of the year. At the Eurogroup on May 25th consensus finally formed on how to assess the sustainability of Greek debt and on a way forward to discuss possible measures to ensure its long term sustainability. A decision was made to break down intervention into short term and medium term measures, and consider further long term measures as necessary to ensure the issue of debt is tackled once and for all.

Following the successful completion of the first review the ECB reinstated the waiver of minimum credit rating requirements for marketable instruments issued or guaranteed by the Hellenic Republic, which would lead to an increase in liquidity in the Greek economy, promote credit expansion, lower Government Bond yields and reduce the overall cost of funding.

All these developments should ultimately feed in the final objective of removing capital controls and regaining access to international capital markets. In this respect the government recently completed a first significant phase by lifting all restrictions on early, partial or total repayments of loans with credit institutions, essentially eliminating one of the three main pillars of capital controls in Greece. The relaxation of the second pillar – limitations on withdrawals of cash – is also ongoing and will be followed by gradual relaxation of the third and final pillar, namely the ability to transfer funds abroad.

Going forward, the successful completion of the program reviews, the potential access to QE, debt relief, the return of deposits and the consequent expansion of credit, as well as significant further relaxation of capital controls, should all reinforce the process of economic stabilization and recovery.

Malta: The Maltese economy continued to expand strongly in the first two quarters of 2016, with real GDP growth averaging 4.1 percent, following 6.2 percent growth in 2015. Growth continued to be driven by domestic demand, particularly investment and private consumption.

Labor market conditions remain favorable, with continued strong growth in labor supply and in employment. These continue to benefit from the increasing presence of foreign workers, measures that encourage labor market participation and initiatives addressing skills shortages. The unemployment rate has attained new lows, falling below 4 percent in July.

These favorable labor dynamics notwithstanding, wage and price pressures remain contained. Annual inflation, measured on the basis of the Harmonized Index of Consumer Prices (HICP), averaged 0.9 percent during the first seven months of the year, down from 1.2 percent in 2015, largely reflecting more moderate increases in food and services prices.

The current account of the balance of payments remains in surplus, driven by a positive balance on the services account. Over the four quarters to March, the current account surplus was equivalent to 1.8 percent of GDP.

According to the Pre-Budget Document published in August, the general government deficit is expected to narrow to 0.7 percent of GDP this year, from 1.5 percent in 2015. The debt-to-GDP ratio is also set to decline, to 62.4 percent in 2016. Both ratios are expected to fall further in the following two years, with the deficit ratio reaching a close-to-balance position in 2018 and the debt ratio falling below 60 percent.

The financial system continues to benefit from a robust pace of economic expansion, prudent business practices and macro-prudential measures which are designed to mitigate potential systemic risks. Bank liquidity and capital ratios remain comfortably above minimum regulatory thresholds, and non-performing loans, while relatively high, declined. During 2016, a Central Credit Register was set up, which should facilitate the assessment of credit risks. A Development Bank is also being established, which should support the development of productive sectors in the economy.

Economic activity in Malta is projected to remain robust over the coming years, though moderating following the strong growth achieved in 2015. Growth in 2016 is expected to be supported mainly by domestic demand. Inflation is expected to remain close to 1.0 percent in an environment of subdued external price pressures, but should approach 2.0 percent later as international commodity prices normalize and a tight labor market begins to affect wages.

Portugal: The recovery of the Portuguese economy is ongoing, benefiting from the wide-ranging reforms undertaken in recent years and a modest expansion throughout the euro area.

GDP continues to grow at a moderate pace in Portugal, following the end of a prolonged recession in mid-2013. Despite some deceleration in recent quarters, the year-on-year growth rate stood at 0.9 percent in the first semester of 2016, mostly supported by domestic demand. For the year as a whole, IMF projects GDP to grow by 1 percent. The improvement in labor market conditions is proving to be sustained: employment continues to increase persistently and the unemployment rate, which stood at 10.8 percent in the second quarter, is well below the peak recorded in early 2013. Recent data on the evolution of the external trade balance is also encouraging, with a widening surplus in the first half of 2016.

Notwithstanding these positive developments, economic growth is still hindered by elevated debt levels across sectors, which also weigh on banks' balance sheets given their role as intermediaries. While fiscal adjustment is ongoing and both households and firms proceed with deleveraging, renewed determination is required to effectively reduce indebtedness. At the same time, the Portuguese banking system still needs additional efforts to deal with its main challenges – reduce the high level of NPLs and regain sustained and sufficient levels of profitability, in the context of a difficult macro-financial environment. These challenges are shared by many banks in the euro area, thus demanding a comprehensive Europe-wide approach, which would certainly favor the efforts being undertaken at the national level.

Against this background, the authorities reaffirm their strong commitment to sustain economic growth through adequate policies. Sound public finances, financial stability and social cohesion are key pillars on which a competitive economy is built, calling for continued and concerted action on all fronts.

San Marino: Following years of recession, the economy of San Marino is showing the first signs of recovery. The number of companies operating in the territory is increasing and the volume of their economic activities is growing, as reflected in the reduced recourse to instruments for temporary unemployment support. In August 2016 the unemployment rate stood at 8.3 percent, down by 1.2 percentage points over the same month of 2015. Economic indicators for domestic demand, such as the total number of vehicle registrations, have increased significantly in the first eight months of the year compared to the same period in 2015.

Public finances continue to show signs of stabilization. In 2015 the State registered a substantially balanced budget and the deficit for 2016 is expected to remain at moderate levels, while measures to reduce current spending and consolidate revenues continue to be implemented. For 2016-2018, budget resources have been allocated to infrastructure projects deemed strategic for economic development, while remaining consistent with the principle of a prudent fiscal policy.

San Marino has made important progress in aligning with international standards of transparency and tax cooperation; it is among the countries engaged in the exchange of tax information based on OECD and FATCA standards and has been recognized for its compliance with AML/CFT standards. The relations with the Italian Republic have normalized, as demonstrated by the inclusion of the country in the Italian tax white list and in that of other countries in connection with the adoption of AML/CFT measures. Negotiations to conclude an association agreement with the European Union started in March 2015 and are still under way.

Since the third quarter of 2015, the banking sector has experienced a decrease in deposits; however, no signs of liquidity tensions or stress at a systemic level have emerged. In this context, the Central Bank of San Marino is constantly monitoring liquidity profiles. The adoption of an overall strategy for the management and resolution of non-performing loans is one of the priorities for strengthening the system, as also recommended by the recent IMF Article IV Mission. Restructuring and consolidation processes of financial sector operators are being carried out with specific actions by the Central Bank in order to verify banks' asset quality and capital levels. In this context, San Marino welcomes the technical assistance received by the IMF. Together with the actions aimed at strengthening the system, the authorities are strongly committed to developing an overall strategy for the reform and international re-positioning of the financial sector in order to increase its efficiency and competitiveness. Moreover, the work to adjust the San Marino banking and financial legislation to international principles is still in progress, with particular reference to the acquis of the European Union.

San Marino has since long pursued a structural reform agenda that led to the adoption of the tax, pension and labor market reforms. While it is desirable that such an agenda is completed within a reasonable time frame, since August 2016 the Government can only perform ordinary activities due to an early termination of the legislature. General elections have been scheduled for November 20. Therefore, the next government resulting from the new parliamentary majority will be responsible for determining the economic policy interventions for the next legislature.

IMF governance and resources

The recent quota database update presented by IMF staff confirmed that the current quota formula is capturing well the main developments in the world economy, which is a critical feature in order to enhance the Fund's representativeness. At the same time, we remain open to constructive discussions on the 15th General Review of Quotas and a new quota formula, reiterating that they should be approached as an integrated package and with the objective of preserving the IMF as a quota-based institution.

At the same time – and considering of critical importance that the Fund remains adequately resourced, broadly maintaining its current lending capacity – the membership is called to consider the possibility for a renewal of the IMF's temporary borrowed resources. At this regard, Italy and Banco de Portugal, as NAB participants, look forward to the discussion on the possible renewal of the New Arrangements to Borrow (NAB). As for the Bilateral Borrowing Agreements – to be intended as a third line of defense after the quotas and the NAB – Italy is prepared to commit subject to parliamentary procedures to a new agreement with the IMF in accordance with the newly proposed framework for an amount equal to EUR 23.48 billion. To enhance burden sharing, we expect that similar assurances will be provided by a broad set of countries, also outside of the European Union.

On a related matter, and as a general principle, we believe that voluntary financial contributions from member countries should be appropriately recognized in the upcoming quota and governance discussions.

The IMF lending toolkit

In the context of the discussions about the state of the Global Financial Safety Net (GFSN) started earlier this year, a reflection about the adequacy of the current lending toolkit of the IMF may be warranted. Any such assessment should start with an accurate evaluation of the existing facilities before moving to consider the possible need for the design of new ones. In both cases the evaluations should be based on whether the facility under examination: *(i)* contributes effectively to addressing the challenges faced by the membership; *(ii)* adds value to the IMF toolkit, or whether it rather represents a potential overlap – to be carefully avoided – with other facilities available either from the IMF or from other IFIs. We would put particular emphasis on the latter point, stressing that the Fund should remain focused on its mandate. Relatedly, we also highlight that the assessment of any possible new facility should include a detailed analysis of its potential demand from the membership and, importantly, the consequent impact on the Fund's resources. Against this background, and mindful of their different institutional mandates, it would be important to investigate ways to enhance the cooperation between the IMF and Regional Financial Arrangements (RFAs), while taking account of the RFAs' specific mandates, and between the Fund and other creditors, particularly IFIs.

Strengthening the Post-Program Monitoring (PPM) framework

We welcome the recent revision of the PPM framework. While the previous framework allowed for a rather effective scrutiny of economic policies and circumstances thereby flagging potential risks to the external viability of countries with substantial outstanding credit to the Fund, there still were some shortcomings on its application and design, with room for both strengthening and streamlining.

In this context, introducing a threshold based on the IMF's balance sheet will ensure that countries with significant outstanding credit, whose potential non-payments would pose material risks to the Fund, are closely monitored. Streamlining the reports, which shall have a more risk-based approach, and reducing the frequency of the PPM to once in any 12-month cycle – in addition to the regular Article IV consultation – will guarantee that Fund's resources are efficiently utilized.

Low-Income Countries (LICs) policy issues

The Fund must continue to play a central role in support of its most vulnerable and poorest members. In this context, we look forward for the conclusions of the ongoing work on the Debt Sustainability Framework (DSF) for LICs. The revision of the framework comes at a time of great uncertainty and heterogeneous economic performance among LICs. The aim of the reform should be to enhance the timely and accurate identification of risks while ensuring that countries are not unduly constrained in their development and investment agenda. To this end, having an encompassing view of all the various determinants of public debt sustainability is critical. In particular, beyond the level of the debt-to-GDP ratio, we deem as crucial a close evaluation of its dynamics, which empirical evidence shows to be relevant in determining the likelihood of a possible debt crisis.

On a different matter, which is relevant both for some LICs and for a broader set of the membership, we would like to express our support to the ongoing work and analysis at the IMF on correspondent banking issues and look forward to further discussions.