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Statement by Tommaso Padoa-Schioppa
Minister of Economy and Finance Italy
On behalf of Albania, Greece, Italy, Malta, Portugal, San Marino, Timor-Leste

Statement by the Honorable Tommaso Padoa-Schioppa
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Speaking on behalf of Albania, Greece, Italy, Malta,
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1. The Global Economic and Financial Outlook

The world economy will continue to expand at a sustained pace, albeit at a slightly lower rate than in 2006. Growth has become more balanced across the regions and this trend will further consolidate in the coming months. The decline in commodity prices from their peak has helped contain inflationary pressures despite the strength of the labor market, reflected in the steadily decreasing unemployment rate to low cyclical levels. The benign financial market has continued to be supported by strong demand and limited inflation expectations. The recent increased volatility in the capital markets might, however, suggest some reappraisal of risk factors by investors. The difficulty of the US sub-prime mortgage sector has generated only a limited impact on the broader economic and financial markets. However, considering in particular that credit spreads are still at historically low levels, a sizeable reassessment of risks at a global level remains possible; hence the situation should be closely monitored by monetary authorities and financial supervisors.

The **US economy** is projected to remain below potential throughout 2007. The current trend might further weaken, should the housing market fail to stabilize. So far, consumption has been supported by a steady job creation and by healthy household balance sheets. Thanks to higher-than-expected tax revenues, the fiscal deficit has declined at a faster rate than originally planned. Combined with the depreciation of the US dollar and stronger growth in other regions, the fiscal consolidation has contributed to produce a moderate reduction of the non-oil trade deficit. This trend could be the initial step towards a more substantial correction of the large current account deficit, which is projected to decline only somewhat.

Supported by a buoyant domestic demand, the growth in the **Euro area** is showing solid momentum, and GDP growth is projected to remain above potential. While uncertainties remain about the nature of this recovery, the strengthening of the domestic demand might signal that the implementation of the Lisbon agenda is paying dividends. Strong revenue growth has accelerated the fiscal consolidation undertaken by the Euro area’s larger economies, which have brought the deficit below the three percent of GDP threshold. However, the adverse demographic trend requires further fiscal efforts for ensuring long-term sustainability, which still remains to be secured.

Notwithstanding some occasional setbacks, the recovery of the **Japanese** economy appears well established. Economic fundamentals have substantially improved and the GDP growth is projected to remain close to potential. Strengthened corporate balance sheets, high profits and strong job creation are the main factors for a sustained and high domestic demand.

Supported by strong exports and a steady increase in domestic demand, growth has remained robust in all **emerging market economies.** China's and India's economic performance continues to be impressive with a double-digit growth rate. Nevertheless, the rapid credit expansion in several countries remains a serious concern, as a sudden reappraisal of risk factors could lead to a rapid capital reversal.

In **Africa** strong domestic demand, the expansion of the non-oil sector and the improved economic policy will continue to underpin strong growth, despite somewhat less favorable commodity prices.

The risks facing the global economy remain tilted on the downside, though they appear to be more balanced than at the time of last September's meeting. The major risk remains an accelerated slowdown in the US economy, exacerbated by its persisting external imbalance, and its consequences at a global level.

A more balanced composition of demand in advanced economies and the depreciation of the US dollar have somewhat reduced global imbalances. They are however projected to remain large, leaving unchanged the risks for a disorderly unwinding. While the US dollar has depreciated against all EU currencies, its value has remained basically unchanged against the currencies of countries with a substantial and growing current account surplus. Greater exchange rate flexibility in Asia will contribute to foster a more balanced composition of demand across all regions and eventually lead to a smooth unwinding of current imbalances.

2. Economic Developments in the Constituency

In Italy, the economy recovered sharply in 2006. GDP rose 1.9 percent, following five years of stagnation (0.7 percent on average in the period 2001-2005). GDP growth was mainly driven by domestic demand. Due to the remarkable jump in export activity in the final quarter of 2006, the net export contribution to growth for the whole year turned positive again.

GDP is expected to rise by 2.0 percent this year, also as a result of a sizeable carry-over effect (1.2 percentage points). This would effectively imply some moderation in the pace of growth during the course of the year. Conditions are increasingly supportive for a strengthening in domestic demand. Consumer confidence continued to rise in February and March, with a moderate upward trend now in place since mid-2005. Consumption should also benefit from the good performance of the labor market and from lower inflation. On the external side, despite an expected deceleration in world trade, export activity should be supported by a gradual recovery in Italy’s competitiveness. The contribution to GDP growth by external demand is however projected to be only marginally positive in 2007 due to stronger imports.

Employment growth is expected to decelerate in the current year (1.0 percent as opposed to 1.6 percent recorded in 2006). Unemployment will slightly decline to 6.3 percent versus 6.8 percent in 2006. Unemployment already reached 6.5 percent at the end of 2006. Compensation of employees per head will likely decelerate to 2.3 percent. Productivity is expected to increase, mostly for cyclical reasons, and contribute to moderate the rise in unit labor costs to 1.2 percent versus 2.3 percent recorded in 2006. The private consumption deflator is projected to decelerate to 2.0 percent in 2007 from 2.7 percent in 2006, as a result of an expected strong reduction in import prices.

Over the medium term, GDP is anticipated to grow at about 1.6-1.7 percent, with a projected gradual increase in potential growth due to enacted and forthcoming reforms. The expected recovery in productivity growth and continuing moderation in wages should reduce unit labor costs and help restore Italy's competitive position over time. While decelerating, employment growth is expected to remain robust at about 0.8 percent per year; unemployment will continue to decline. Inflation will likely remain below the 2.0 percent threshold throughout the forecast horizon.

Net of one-off effects (the European Court of Justice on VAT deductibility and the consolidation of ex-ISPA debt), the government's net borrowing declined from 4.2 percent of GDP in 2005 to 2.4 percent in 2006, partly due to good performance in fiscal revenues and a reduction in expenditure. The Italian government remains committed to continue to reduce the deficit, in line with the EU recommendations, and to reach a balanced budget, bringing the primary surplus to close to 5 percent of GDP and the debt to below 100 percent by 2011.

Combining a structural acceleration of potential growth with social fairness is the key objective of the government for the rest of the legislature (2007-2011). In this context, further fiscal consolidation, in line with the European recommendations, is necessary to guarantee that both growth and fairness are sustainable. Legislative initiatives to foster competition in some goods and services sectors by reducing regulation and liberalizing access to the market should gradually pay off over time. A further group of measures was approved by the government in February and further measures are expected over the coming months.

The Albanian economy continues its strong path towards economic and structural consolidation. In 2006, despite the pronounced slowdown in construction and the residual effects of the electricity supply-induced disruptions, economic growth is estimated to be at about 5 percent. Trade performance strengthened significantly, thanks to the recovery of the traditional sectors helping to maintain the current account deficit at 7.6 percent of GDP. Inflation, which by the end of 2006 was at about 2.5 percent, remaining within the 3 percent target of the Bank of Albania, has been kept under control by two recent 25-basis point hikes in interest rates. On the fiscal side, relevant administrative efforts aimed at increasing the tax base yielded tangible results; namely, in 2006 tax revenues reached 23 percent of GDP from 22 percent. The responsible fiscal stance has contributed to reduce the primary deficit to only 0.3 percent of GDP and further reduce the total public debt to 55 percent. The banking system is liquid, profitable, and well capitalized. The tightening of the supervisory and regulatory regimes supported a robust credit growth and helped contain nonperforming loans.

In **Greece,** growth remained robust at 4.3 percent in 2006, led by strong exports and buoyant business fixed investment, and is expected to be sustained at about the same rate in 2007-09. Growth has become more sustainable in the last couple of years, through a marked shift away from demand management based on debt-financed expansionary fiscal policy toward supply-side reforms aimed at increasing productivity and potential growth. Lower corporate taxes, investment incentives, public-private partnerships, and an improvement in the business climate through streamlined business regulation helped support private investment. These policies succeeded in sustaining the growth momentum after the 2004 Olympic Games despite substantial fiscal consolidation.

Fiscal consolidation advanced significantly in 2005-06. A front-loaded adjustment effort brought the deficit to below the 3 percent of GDP threshold within two years, in compliance with the requirements under the Excessive Deficit Procedure – a cumulative adjustment of 5.2 percent of GDP. The bulk of the adjustment was achieved by expenditure restraint, while improvements in tax administration and indirect tax increases resulted in higher revenues even as corporate tax rates were cut. The general government deficit reached a 10-year low of 2.6 percent of GDP in 2006, and is budgeted to fall further to 2.4 percent of GDP in 2007. The quality of fiscal adjustment is set to improve, as one-off measures amounting to 0.4 percent of GDP in 2006 are replaced by permanent measures in the 2007 budget. Despite the progress achieved, the Greek authorities acknowledge that the debt burden remains high. They thus remain committed to continuing the fiscal consolidation effort to achieve balance or better by 2012.

The recovery in the **Maltese economy** appears to be firmly established, with an annual growth rate of 2.9 percent in 2006, only marginally lower than the 3 percent level registered in 2005. Over the year, the consumer price index fell marginally to 2.8 percent from 3 percent in 2005; however, inflationary pressures eased remarkably in the last quarter of 2006, as the impact of higher energy prices dissipated. The rate of unemployment remained virtually unchanged at 7.3 percent. Growth was mainly driven by external demand, reflecting a turnaround in the performance of the semiconductors industry, the expansion of new manufacturing industries, and the further development of the services sector. Provisional figures for 2006 indicate that the current account deficit narrowed to 6.3 percent in 2006 from 8.3 percent in 2005. In 2007, economic growth is expected to accelerate slightly to 3.1 percent, mainly as a result of more robust domestic demand, driven by higher private consumption and stronger investment, both public and private. However, net exports are also expected to contribute to growth. Inflation is projected to drop to 1.6 percent, while a slight decline in the unemployment rate to 7.2 percent is also projected.

In the area of public finance, the Government continued to rein in the fiscal deficit in line with its medium-term consolidation program. The deficit, in fact, was estimated at 2.6 percent of GDP in 2006, compared with 3.1 percent a year earlier. Public debt was also lower, at 66.7 percent of GDP from 72.4 percent of GDP in 2005.

The Central Bank of Malta (CBM)'s monetary policy strategy continues to focus on maintaining the exchange rate peg. The Maltese lira continued to be fixed rigidly to the Euro at the central parity rate of LM 0.4293, in line with the Maltese authorities' unilateral commitment to maintain this fixed rate throughout the lira's participation in ERM II, which began in May 2005. This was accomplished without undue pressure on the country's external reserves, while domestic interest rates continued to converge to those prevailing in the Euro area: the CBM's central intervention rate currently stands at 4 percent, just 25 basis points higher than the European Central Bank's main refinancing operations rate.

In early March, 2007 the Maltese authorities requested that the European Commission and the European Central Bank assess Malta's eligibility for full participation in the EMU. It is the objective of the Maltese authorities to adopt the Euro by January 2008.

In 2006, economic activity in **Portugal** accelerated to 1.3 percent from 0.5 percent in 2005. Growth was export led, reflecting favorable global conditions, particularly in the Euro area. In contrast, domestic demand growth was very moderate, contributing to the necessary adjustment of macroeconomic imbalances. Economic growth is projected to increase gradually over time, leading in the end to the resumption of real convergence to EU levels.

The general government deficit declined to 3.9 percent of GDP in 2006, substantially below the ratio previously envisaged in the Stability and Growth Program. The updated version of this Program maintains the authorities' commitment to reach a deficit below the 3 percent reference value and the abrogation of the excessive deficit procedure by 2008, and meeting the medium-term objective of the Stability and Growth Pact by 2010.

Employment growth was 0.7 percent in 2006, while unemployment increased slightly to 7.7 percent of the labor force.

Inflation increased to 3.0 percent in 2006, corresponding to a 0.8 percentage-point differential vis-à-vis the Euro area annual average. The delayed effects of 2005 VAT increases, developments in oil prices in the first half of 2006 and methodological statistical corrections contributed to the inflation outturn. Meanwhile, inflation came down to 2.3 percent in February.

During 2006, an FSAP exercise on Portugal was concluded. The FSSA report emphasized the soundness, competitiveness and quality of management of the Portuguese financial system. In particular, banking sector indicators compare well with other European banks and stress tests revealed its resilience. The organization, effectiveness and compliance with international standards of the supervision and regulatory arrangements and practices were also stressed.

Following the 2006 mutual evaluation exercise, supervision and the legal framework were also appraised as sound, comprehensive and largely compliant with best practices in the Financial Action Task Force report on anti-money laundering and combating the financing of terrorism.

As for structural reforms, Portugal's main challenges concern the consolidation of public finances. Recent efforts include the revision of employment conditions of public servants and the reform of health services. The authorities are also keen on creating a favorable business environment, having implemented several measures in order to simplify and modernize legal and administrative procedures.

In 2006, the economic activity of **San Marino** continued to expand at a fast pace. The GDP grew at about 5 percent, while inflation has remained subdued at about 2 percent, in line with that of the Euro area.

Through the 2007-09 multiyear budget of the consolidated public sector (which includes public enterprises), the San Marino Government will continue to implement its policy aimed at shifting resources from current to capital spending in order to modernize the economy. As a result, in the 2007 budget, capital spending will increase remarkably compared to previous years. Moreover, the Government has recently finalized an ambitious tax reform plan with a view to broadening the tax base and to ensuring a more equitable tax regime.

The banking and financial sector has been experiencing significant changes, mainly reflecting the upgrading of domestic legislation in banking and financial matters as well as the improvement of Central Bank regulations. The new legislative and regulatory provisions and the enhanced supervisory power of San Marino's central bank have contributed to further consolidate the soundness of the system, while promoting new business activities such as savings and insurance management.

San Marino's Government remains strongly committed to the fight against money laundering and terrorist financing. To this end, the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) legislation has been continuously updated in line with relevant international standards.

The turmoil that recently resurged in **Timor Leste** is now contained. The security situation is stable and Timor-Leste recently held a presidential election. The deterioration of the security conditions in 2006 seriously hindered the growth momentum. Real non-oil/gas GDP growth is estimated to be slightly negative for 2006, despite an end-year boost in public spending and international aid. Despite crisis-related supply disruptions, inflation jumped to just under 6 percent by the end of 2006.

Driven by high world prices, large oil- and gas-revenue inflows have led to sizeable surpluses in the external current account and in the fiscal position, notwithstanding the sharp increase in government spending. With the aim to preserve oil and gas wealth for future generations -- while releasing resources to underpin the Government’s development strategy in a sustainable way -- a Petroleum Fund was introduced in mid-2005, together with a long-term savings policy, following international best practices. Budget spending has complied with the authorities’ saving policy.

Notwithstanding recent considerable progress, widespread poverty and unemployment highlight vulnerabilities. Timor-Leste needs to build up infrastructures, to strengthen institutions and human capacity, and to increase humanitarian assistance. These necessary changes, along with the promotion of non-oil/gas productive activities, are essential to tackle the current vulnerabilities. To achieve this objective, the support of the international community is crucial.

3. Progress in Implementing the Medium-Term Strategy

3.1 Surveillance: a Renewed Commitment by the Membership

Surveillance is a key Fund tool to prevent crises and promote macroeconomic stability. We welcome the further progress achieved in improving the surveillance framework and aligning it to best practices. The revision of the 1977 Decision on exchange rate surveillance is a central pillar of the new framework. It will contribute to foster the quality and the effectiveness of surveillance by sharpening its focus, strengthening its candor, and ensuring evenhandedness.

The effectiveness of the new surveillance framework strongly hinges on the willingness of the entire membership to closely re-tie its relations with the Fund and to step up its cooperative approach. A broad and strong support is the *sine qua non* of ensuring the successful implementation of the framework across the whole membership.

Without creating new obligations, the new framework will help move to a more selective and forward looking approach for surveillance, focusing on member countries' medium-term policy framework. This would foster the dialogue between staff and authorities on the strengths and shortcomings of members' policies while facilitating the identification of alternative solutions. In the European Union, the current practice of focusing the assessment and peer review on the medium-term policy framework, provided by the Stability and Convergence Programs, has yielded positive results and valuable input to policymakers.

Implementing sound fiscal, monetary, and exchange rate policies aimed at spurring growth will contribute to external stability. The focus on the external effects and spillovers of systematically important domestic policies should become the anchor of surveillance.

The analysis of equilibrium exchange rates helps in assessing the sustainability of balance of payments. While we are open on how to improve the current framework, we support a further refining of the current toolkit as well as the extension of the assessment of exchange rate equilibrium to emerging market members.

We believe that a remit will help narrow down the general principles of surveillance and translate them into a limited number of economic and operational objectives, which are more relevant for the global economy at any given time. We thus support the proposed governance model, by which the Board identifies the key priority issues; and the IMFC, providing its input, will ensure the necessary political support.

Finally, we support further multilateral consultations, as a valid framework to foster multilateral debate, identify a comprehensive action plan and promote a coordinated response by the relevant actors to global issues.

3.2 A New Quota Formula for a Fairer and More Balanced Representation

Since last September's meeting, we have been making progress in implementing the second stage of Governance reform. Recent discussions on the quota formula laid out the key objectives to be met by the new quota formula. A broad agreement on the required amendments of the Articles of Agreement to increase basic votes has been reached. We also agreed that the voting power of the low-income countries should be preserved and, possibly, enhanced.

The new quota formula should ensure a balanced distribution of quotas to all Fund members, while boosting the quota shares of the most dynamic economies. We firmly uphold that the quota formula has to be grounded on solid economic principles and that it has to be able to capture its multiple functions, in particular the members' potential capacity to lend to the Fund and to borrow from the Fund. Beyond the transparency and simplicity characteristic identified in Singapore, we believe that additional principles should steer our work on the choice, definition, and weight of variables.

GDP should have a predominant weight, and its valuation at market exchange rates remains the most appropriate indicator for assessing the relative position of a country in the world economy and its capacity to contribute to the Fund's finances. We also remain convinced that openness, both in terms of trade and financial terms, should play a key role and should have adequate weight in the formula. It is a relevant meter for assessing the degree of a country's integration in the global economy and its responsibilities to *"promote economic and financial stability."* In the last decades, the role of reserves has changed significantly, and their significance in international financial markets, dominated by private capital markets and financial flows, has progressively declined. Since reserves do not represent a good proxy for indicating the contribution capacity to Fund activities, including them in the formula seems to be no longer justified.

The new formula should be robust enough to respond to future possible changes in the international economy over time, and it should not be subject to frequent revisions in the foreseeable future. Furthermore, it ought to incorporate incentives to pursue sound and credible policies, while strongly discouraging bad policies.

We need to be aware that no formula can possibly satisfy all the variety of members' specific requests. To this end, the calculated quota should remain a benchmark for closing the current gap between the members' actual quotas and their effective role in the global economy. This convergence process should continue to be triggered by the actual financial need of the institution.

3.3 A Modern Financing Model for the Fund

We welcome the Crockett committee's report on the Fund's financing, which presents an interesting package of proposals. To continue to pursue its mandate, the Fund should be equipped with a stable and diversified structure of its own resources. While expanding the income base is an urgent priority, more efforts directed to rationalize and prioritize spending are also essential steps to put Fund finances on a sounder footing. We endorse the Crockett report's call for addressing the shortcomings of the current model, which essentially relies on a single income source: the interest income from credit intermediation. While maintaining the necessary flexibility, we agree that a broad alignment between activities and funding sources should be pursued as a good budgetary practice.

We also support the proposal to invest part of members' reserves to generate income. We caution against the suggestion to relax the current strict investment guidelines in order to include riskier instruments. Members' resources need to be prudently managed and potential losses minimized. Excessive revenues from credit intermediation should not be seen as an opportunity to expand the Fund's mandate, but rather should be devoted primarily to build up reserves, considering that the agreed medium-term reserve target remains valid even in a low-credit environment.

3.4 Re-engaging with Emerging Market Economies

Adopting a new quota formula that better rewards the most dynamic members is not enough to ensure a renewed and closer cooperation with the emerging market shareholders. To respond to this challenge, more concrete progress has been made to strengthen the crisis prevention framework. The work on designing a liquidity facility to defend against rapid and substantial changes in international financial markets has progressed. While the recent discussions have been constructive in refining the various components of the proposed facility, non-trivial shortcomings still remain.

We maintain that current precautionary arrangements, though they can be improved, are adequate tools to prevent capital account crises triggered by deteriorated global financial conditions and to protect against contagion. However, should the establishment of a new liquidity facility garner wide support and the existence of a demand for it be proven, consistency with the IMF policy framework, including the relative access policy, should be fully ensured.

3.5 The Role of the Fund in Low-Income Countries

The Fund has a crucial role in assisting Low-Income Countries (LICs) in their efforts to achieve economic stability and sustainable growth. Along with surveillance and technical assistance, the Poverty Reduction and Growth Facility (PRGF) remains the key instrument in the Fund's toolkit, while the Policy Support Instrument (PSI) and the Exogenous Shock Facility (ESF) add to the responsiveness of the Fund to the specific needs of mature stabilizers and shock-hit countries.

The HIPC and MDRI initiatives have contributed to improve the financial position of LICs and to free resources for poverty-reducing expenditure and infrastructure investment. In an environment where new creditors are emerging and domestic debt is gaining prominence as a source of financing, the strengthening of the Joint Debt Sustainability Framework (DSF) is a most welcome development. The DSF is, in our view, an essential tool to guide borrowers and creditors alike in making decisions that are consistent with a sustainable debt trajectory, particularly in post-MDRI HIPCs.

We welcome the work of the External Review Committee on Bank-Fund collaboration. A clear definition of responsibilities -- based on core competences -- can go a long way in improving the quality of the assistance that these institutions can provide to their members, and to LICs in particular. At the same time, neither the Bank nor the Fund can accomplish their mission independent of one another, as their mandates are intrinsically complementary. Mutual reliance and trust should therefore be at the very heart of any efforts to improve collaboration between the Bank and the Fund.