# International Monetary and Financial Committee

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**Statement by Mr. Pier Carlo Padoan**
**Minister of Economy and Finance, Italy**

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

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## Developments in the Constituency

Against the background of the weakened euro area business cycle, the economic conditions across the countries of the constituency have been mixed. On the basis of the most recent data, in 2014 GDP is expected to increase in Portugal, Malta, Albania, and – for the first time in six years – Greece. Economic activity will remain subdued in Italy and San Marino. Projections for 2015 point to the acceleration of GDP in all the countries of the constituency on the back of the gradual rebound of domestic demand and the continued increase of exports.

With the only exception of Albania – whose deficit is nonetheless broadly financed through foreign direct investments – current accounts are expected to be in surplus in 2014 across the members of the constituency. Such a positive outcome reflects significant competitiveness gains achieved through the implementation of relevant structural reforms.

Despite the reforming efforts and a few signs of stabilization, the labor market conditions remain generally difficult, except for Malta which benefits from a robust job creation. Youth unemployment is unacceptably high in several countries.

Sizeable output gaps – mostly reflecting weak domestic demand – are taking a heavy toll on price dynamics. Low levels of inflation are featuring in all members of the constituency, albeit to different degrees. Recent data indicated a slight negative inflation in Greece, Italy, and Portugal. Price dynamics is expected to gradually recover over the course of 2015, though remaining well below the official target.

Fiscal strategies remain prudent and consolidation is broadly ongoing with the final aim of reducing high public debt ratios. The pace of adjustment has been made more attuned to the current economic conditions and attention has been paid to devising more growth-friendly fiscal policies.

The financial sector continued to strengthen across the constituency. Banks' capital ratios increased and the liquidity situation improved. This notwithstanding, credit conditions remain generally tight, again with the exception of Malta where financing flows to the real economy kept rising. The forthcoming results of the ECB Comprehensive Assessment of the euro area banking system will dispel remaining uncertainties, thereby providing a contribution to a possible easing of credit conditions.

There remain two IMF-supported programs in the constituency, given that Portugal successfully exited from the Economic and Financial Adjustment Program on June 30, 2014. In July, the fifth

review of the program with Greece was approved, while in the same month the first review of the Fund's arrangement with Albania was endorsed by the Executive Board.

**Developments in the Members of the Constituency**

**Italy.** Real GDP growth posted two consecutive, albeit small, contractions in the first two quarters of this year. This outcome, which was below expectations, prompted a sizable revision to the official forecasts in September, with GDP now projected to decrease by 0.3 per cent in 2014.

In the first half of this year, and despite a moderate growth of private consumption, domestic demand continued to decrease, reflecting the drop in investment. Foreign trade performed relatively well despite the slowdown of exports, which was partly related to the effects of the geopolitical tensions in Eastern Europe. The current account surplus continued to improve and is projected to move above 1 per cent of GDP by the end of this year, and to remain close to that level thereafter.

In recent months, the unemployment rate has hovered around 12.5 per cent. The youth unemployment rate has reached historically high levels and is now over 40 per cent. Employment has broadly stabilized.

Last August the inflation rate moved below zero for the first time since 1959. While this outcome mostly reflected the negative dynamics of the volatile components of the index, other spending categories also featured very low inflationary pressures.

Despite some improvements, financial conditions remain restrictive. Credit flows are still contracting and persisting uncertainties continue to inhibit the recovery of investment expenditure. In a context of very weak demand, the supply-side reform efforts pursued in recent years have yet to bear fruits.

According to most recent indicators, the economic outlook remains fragile. Overall official projections point to a further small GDP contraction in the third quarter of 2014 and to a stabilization of output in the last quarter of the year. In 2015, growth is expected to resume at a level slightly above 0.5 per cent.

The cyclical upturn will be supported by a number of factors. Bank lending surveys suggest that financial institutions are becoming less risk adverse and bank credit could start expanding again in 2015. A contribution is also expected from the policy actions adopted by the ECB. These developments will favor the recovery of investment, which will add up to the expected further strengthening of consumption. Foreign demand will continue to increase.

**Albania.** The Albanian economy is recovering. Economic growth picked up during the first half of 2014, as a result of continued export growth and stronger private demand. Improved confidence, stronger balance sheets as a result of the clearance of public arrears, and better financing conditions have spurred the increase in private consumption and investment. On the

other hand, fiscal consolidation measures have been well absorbed. Nonetheless, the Albanian economy still operates below its potential, which in turn is reflected in continued undershooting of the consumer inflation objective. The main vulnerabilities remain contained, as the public debt trajectory is under control and the high current account deficit continues to be financed by foreign direct investments. Financial stability is benefitting from the economic recovery, the amelioration of the external financial environment, and the measures undertaken under the financial sector assessment program (FSAP) agenda to strengthen the legal environment and the governance of financial institutions. The financial system remains well capitalized and able to withstand potential domestic and foreign market pressures. Overall, Albania has met the important objectives of the Extended Fund Facility program with the IMF.

In order to counteract weak underlying inflationary pressures and the persistent negative output gap, monetary policy has continued to be expansionary in 2014. During the first half of the year, the Bank of Albania cut by 50 basis points its policy rate, bringing it to a historical low of 2.5 percent.

In compliance with its medium term strategy, the fiscal policy pursued a strong consolidation in 2014. The new fiscal package – which aimed at increasing tax compliance, introducing progressiveness and removing distortions in the tax system – helped increase government revenues. Public arrears accumulated from previous years are being paid off, in compliance with the IMF program. This notwithstanding, the Albanian authorities remain aware that public debt is high – currently above 70 per cent of GDP – and they are determined in their commitment to put it on a decreasing path.

Medium- to long-term perspectives for the Albanian economy remain sound on the back of continued efforts to enact structural reforms and decrease the vulnerabilities in the energy sector. Prudent macroeconomic policies underpinned by the IMF program and the EU accession process create a suitable platform for sustainable long-term growth.

**Greece.** In recent years the country has made substantial progress in fiscal consolidation, in international competitiveness and in the implementation of structural reforms. In 2014 such progress has become more apparent. After six years of contraction, GDP is forecast to turn positive in 2014 and the recovery is projected to continue in the following years. Unemployment is expected to level off and start declining in 2014 for the first time since the onset of the crisis. Inflation will remain negative this year, much lower than the euro area average. In the external sector, the current account balance has moved from a deficit of 14.9 per cent of GDP in 2008 to a small surplus in 2013, which is expected to be maintained (or slightly increased) in 2014. By end-2013 Greece had recovered the entire cumulative loss in cost competitiveness vis-à-vis the euro area that it experienced in the period 2001-2009.

The progress in fiscal consolidation was better than anticipated. Between 2009 and 2013, the general government deficit declined by 12.4 percentage points of GDP (from -15.6 to -3.2 per cent) while the primary deficit declined by 11.2 percentage points (from a deficit of -10.4 per cent to a surplus of 0.8). This constitutes the biggest and fastest ever recorded fiscal adjustment

by an OECD economy. In 2014, the general government deficit is expected to decline to 2.9 per cent of GDP, while the primary surplus is forecast to double to 1.6 per cent of GDP. In addition, between 2009 and 2013 Greece reduced its structural budget balance by 16.7 percentage points of GDP, culminating to a structural surplus of 2 per cent, which is the largest in the EU-28.

The outlook for the banking sector is steadily improving and rating agencies have raised Greece's sovereign credit rating. In addition, after four years of absence from the bond markets, the Greek Government issued 5-year bonds in April 2014 and 3-year bonds in July 2014 with great success.

Significant structural reforms have been implemented in recent years, such as in labour and product markets, health sector, pensions, business environment, public administration, tax governance, energy and justice. As a result, Greece is the country with the biggest improvement in the OECD "Product Market Regulation" indicator, and it consistently improves its ranking in the "Doing Business" indicator of the World Bank every year.

**Malta.** After having expanded by 2.9 per cent in 2013, the Maltese economy continued to grow at a solid pace during the first half of 2014, with real GDP increasing at an average annual rate of 3.4 per cent. The expansion was mainly driven by domestic demand, particularly investment, although private and government consumption also contributed. To a lesser extent, net exports supported growth during this period.

Robust economic activity was reflected in the performance of the labour market. During the first half of 2014 employment increased by 1.6 per cent on average with job creation strongly supported by the services sector. The unemployment rate eased, standing at 5.8 per cent in the second quarter of 2014.

Despite buoyant activity, inflation remained moderate. Following a brief acceleration in the first quarter, annual harmonized consumer inflation fell to a low of 0.4 per cent in May, largely under the impact of a reduction in electricity tariffs. It has accelerated slightly more recently, driven by movements in services prices, reaching 0.8 per cent in August.

The general government deficit-to-GDP ratio fell below 3 per cent in 2013, as revenue outpaced expenditure. At the same time, the debt ratio rose to 73 per cent of GDP. The Government remains committed to further fiscal consolidation, aimed at achieving a balanced budget in the medium-term. From an institutional perspective, Parliament recently enacted the Fiscal Responsibility Act, which lays down tighter domestic fiscal rules and establishes an independent fiscal council.

The current account of the balance of payments, which had recorded a surplus in both 2012 and 2013, remained positive during the first half of 2014, as a positive balance on services offset net outflows on the goods and income accounts.

The financial sector remained sound and stable, with the core deposit banks reporting capital buffers well in excess of the regulatory thresholds. Liquidity levels were ample and residents'

deposits continued to grow. Credit growth remained positive, supported by lending to both general government and the private sector.

The outlook for the Maltese economy remains favourable, with real GDP expected to continue growing at around 2½ per cent both this year and the next, mainly driven by domestic demand. Inflation is set to pick up gradually, while remaining moderate, at below 2 per cent throughout.

**Portugal.** The country has successfully exited from the Economic and Financial Adjustment Program on June 30, 2014. During the past three years, program implementation was strong amidst difficult economic conditions, unfavorable external developments and high levels of uncertainty and volatility. Market access was reestablished and following the Constitutional Court's negative ruling on certain budgetary measures of the 2014 budget, the Portuguese government decided to forego the last program disbursement, while reaffirming its firm commitment to the fiscal targets and to an ambitious reform agenda.

The most recent data confirms the recovery begun in mid-2013. In the second quarter of 2014, real GDP grew by 0.3 per cent, quarter-on-quarter, reversing the fall in economic activity registered in the previous quarter (the only negative figure observed since the last quarter of 2012).

An annual GDP growth rate of 1.0 per cent is projected for the current year, after a negative growth rate of -1.4 in 2013. Real growth is expected to accelerate to 1.5 per cent in 2015. The recovery should reflect a gradual rebound in domestic demand and continued strong growth in exports. Deleveraging is projected to continue, given the still high levels of indebtedness in both public and private sectors. Portugal needs indeed to register a further increase in its net lending position. While remaining at extremely high levels, especially for the young people, the unemployment rate has been gradually declining since the second quarter of 2013, and employment is recovering. Inflation is projected to remain at low levels.

An ambitious structural reform agenda was implemented during the Program, with important reforms taking place in both product and labor markets and a significant strengthening in the regulatory framework. Progress is also ongoing relating to the strategy to facilitate corporate debt restructuring. Building on these efforts, continued progress is still of the essence.

Banco de Portugal (BdP) remains fully committed to its role of safeguarding financial stability and continues to closely monitor the soundness of the Portuguese banking system, as shown by the significant increase in banks' solvency ratios and the resilience of deposits during the crisis. The recent resolution measure applied by BdP to Banco Espirito Santo (BES) was crucial to preserve financial stability. While it is far too early to draw final conclusions, existing signs point to contained systemic implications and low sovereign contagion, despite the complexity and size of the financial institution under resolution. Excluding BES, banking system profitability became positive in the second half of 2014, although at a low level, and solvency levels remain broadly robust.

The structural rebalancing process of the Portuguese economy is still ongoing, and while the more favorable environment and financing conditions facilitate the adjustment, significant challenges still lie ahead, given the high level of imbalances built up before the crisis. Going forward, a strong commitment to the agreed goals and targets, on the back of sound and consistent policies and a stable institutional framework, are of the essence to correct remaining imbalances, namely to put public and private debt on a clear downward trajectory, and to achieve strong and sustainable growth and employment in the medium to long run.

**San Marino.** Despite the persistently difficult economic and financial situation, a few signs of a possible economic recovery emerged both in the production and in the financial sector.

The latest economic data still show a negative trend, although at a decelerating pace. In particular, productive activities have recently slightly increased. This notwithstanding, the unemployment rate rose to 8.0 per cent in June 2014; in the same month, inflation remained weak at 1.3 per cent. Overall, GDP is expected to decrease by 1 per cent in 2014.

The adjustment of public finances is ongoing. The Government plan provides for interventions in various areas. The main focus is on the entry into force of the reform of direct taxation – contributing to an increase in tax revenues – coupled with an expenditure review of the Public Administration and Public Entities – which is the result of an in-depth study conducted by a specific group of experts. The public spending review already led to a notable cut in total expenditure, allowing to halve the 2013 budget deficit with respect to the initial projections (down to 17 million 500 thousand euro). A further reduction to 15 million is expected for 2014. Finally, upon completion of the feasibility study for the introduction of the VAT system replacing the current single-stage tax, the draft law was terminated. The subsequent legislative procedure will be started in the coming months, following discussions with social partners.

In addition to these structural measures, a law for attracting foreign investment has already been adopted. Furthermore, the reform of the law on trade was approved with the aim of encouraging and attracting entrepreneurial activity in the territory.

Against the backdrop of the removal of San Marino from the "black list" of the Italian Republic, San Marino remains strongly committed to further strengthen economic and financial relations with Italy.

In 2014, the process of consolidation of the banking and financial sector continued through capital increase operations, showing a substantial improvement in terms of liquidity and a moderate recovery in profit margins. The accession of San Marino to SEPA (Single Euro Payments Area) on February 1, 2014 – without benefitting from the postponement to July allowed by EU authorities – confirms the responsiveness of the Institutions and of the banking system to meet the challenges of the European integration.

In this regard, the recent ratification by the Italian Parliament of the agreement on financial cooperation between Italy and San Marino is another fundamental element to open up the system in a framework of shared rules. The completion of this process is expected with the signing of a

Memorandum of Understanding on banking and financial supervision between the two central banks. More generally, the adjustment of legislation and regulation in the banking and financial industry is continuing, in line with the provisions of the Monetary Agreement signed with the European Union in 2012 and subject to an annual joint review with the European Central Bank and the European Commission.

San Marino is strongly committed to a process of internationalization and continues to adjust to international standards also in the field of exchange of information. In this regard, it is expected to sign the FATCA intergovernmental agreement with the United States of America by the end of this year; it is also involved in the Group on the automatic exchange of information of the OECD Global Forum and is taking part in the negotiations of the new European Directive on Savings Income.

**Role of the IMF**

**Surveillance**

*Triennial Surveillance Review (TSR).* According to the analysis presented by the Triennial Surveillance Review discussed in September, the numerous reforms introduced since 2011 – the year of the last TSR – have been largely successful in enhancing the effectiveness of Fund's surveillance. Overall, the work initiated three years ago continues to be in progress and, as a consequence, further changes to the current framework should be at the margin. Among the refinements that should be considered at this stage, the most relevant are: further strengthening the analysis of risks and spillovers, and of the assessment of external sectors; continued efforts to better integrate bi- and multi-lateral surveillance, also through an improved coordination and communication of the main messages; deepening the understanding of macroeconomic and financial trends, and the ways in which they interact; expanding the toolkit of surveillance activity, including through the use of balance sheet analysis as far as data availability allows it; strengthening the expertise on selective macro-critical structural issues and improving the leverage on the advice from other international organizations and local experts; possibly establishing a mechanism for country authorities to report concerns on lack of evenhandedness in order to allow the Fund to undertake prompt and resolute efforts whenever robust evidence emerges.

*Financial Sector Assessment Program (FSAP) Review.* Lately, the Fund reviewed also the Financial Sector Assessment Program which remains the key pillar of financial surveillance. The reforms adopted since the latest review in 2009 considerably improved the effectiveness of the framework. Above all, a clearer definition of the different components of the financial stability assessment, and the introduction of the Risk Assessment Matrix (RAM) represented relevant steps forward. The 2014 review has established that, at this stage, there is no need for further major changes to the framework, although rooms for improvement still remain. In particular enhancements might be derived from: upgrading the current toolkit; improving its analytical underpinnings; enhancing the quality of data, as well as the cooperation with national authorities

and stakeholders. With reference to the prospected implementation of a macro-financial approach to the supervisory assessment of standards and codes, a cautious evaluation is needed in order to weigh its potential benefits against the risk of overlooking significant sources of instability embedded in micro-financial principles. The final decision, which will be informed by further analysis by the staff of the IMF, will be taken in 2016 in the context of the Review of Standards and Codes.

**Fund resources**

*2012 Borrowing Agreements.* In the wake of the crisis, the 2012 Borrowing Agreements have played a key role in providing confidence that the Fund has adequate resources to meet members' potential needs. While the current Forward Commitment Capacity (FCC) appears adequate to meet foreseeable demands for IMF resources in the near term, the sizeable downside risks still lingering on the global outlook continue to make it necessary to have a second line of defense – after quotas and New Arrangements to Borrow – to support a robust global safety net. In this context, in September 2014 the Fund approved a one-year extension of the initial two-year terms of the 2012 Borrowing Agreements. Against this background, the implementation of the 14th General Review of Quotas continues to be required to better reflect the nature of the IMF as a quota-based institution.

**IMF Facilities**

*Review of the precautionary facilities*. The Fund's lending facilities include precautionary instruments, which play an important role as they strengthen the crisis prevention toolkit, create incentives for good economic management, and prevent excessive reserve accumulation. In the latest months, some additional proposals have been approved to enhance the Flexible Credit Line (FCL) and the Precautionary and Liquidity Line (PLL), completing the review of these instruments, as well as that of the Rapid Financing Instrument (RFI). With a view to improving the transparency and predictability of qualification assessments, the qualification criteria for the FCL and the PLL have been aligned. Selected indicators of institutional strength have been elaborated to complement the existing quantitative indicators already used in the qualification assessments. Moreover, an external stress index will be used in future FCL and PLL staff reports to inform the discussion of the external environment faced by the countries that request the precautionary facilities.

**Low-Income Countries (LICs)**

*Debt Limit Policy.* The Fund's engagement with the Low-Income Countries has become increasingly important over the years. In most cases, it has been crucial for its positive spillovers and its catalytic role with respect to other institutions. The Fund is presently engaged in

reforming its Debt Limit Policy, which presents the significant opportunity to improve the overall mechanism of setting conditionality on public external debt. Thus far, the reforming process has been complex but also open and comprehensive. The current approach based on developing a general-principle setting should be supported, as it ensures evenhandedness as well as clear and transparent rules. Nevertheless, such a reform will likely have a major impact on future LICs' engagements in IMF-supported programs. Therefore, it remains essential to find the right balance between the need for macroeconomic policy discretion and maintaining the right incentive to seeking concessional borrowing. Moreover, the process should not deviate from focusing on the evaluation of key characteristics such as implementation capacity, the level of transparency in borrowing agreements and the risk of debt distress. On this point, continued reliance on the Fund's Debt Sustainability Analysis is welcome.

**Policy Items**

*Collective Action Clauses (CACs).* In the context of the discussion on sovereign debt issues, in October the Board examined the staff proposals to address collective action problems in bonds issued under foreign law. Against the background of the Argentine litigation in the US courts, a modification of the *pari passu* clause was considered to exclude the obligation to effect ratable payments, along with a proposal to strengthen the CACs by introducing aggregation features to limit the possibility for holdouts to prevent orderly sovereign debt restructurings. It was noted that the euro area model of CACs is consistent with the proposals made by staff.