# International Monetary and Financial Committee

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**Statement by Thierry Breton**
**Minister of Economy, Finance and Industry, France**
On behalf of France

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**International Monetary and Financial Committee (IMFC) Singapore – September 17, 2006**

Dear colleagues:

Since our last meeting on April 22, 2006, the rebalancing of global growth has been confirmed. During the first half of the year, the euro zone experienced one of its strongest periods of growth, driven by robust domestic demand. The slowdown in the U.S. economy is now clear (particularly in the real estate market), Japan has put an end to deflation and its growth is now based largely on domestic demand, and Asia continues to enjoy sustained growth. Nonetheless, the risks discussed at our previous meeting are still present. Tensions still persist in the oil market and an interruption in supply remains a possibility; current account imbalances continue to grow and carry the risk of an abrupt adjustment through exchange rates or risk premiums.

The materialization of these risks would have serious repercussions on our economies. We must develop cooperative strategies so as to contain these risks, thus preventing them from becoming a reality and identify the best joint response, should they in fact occur. Here, the IMF's role is pivotal. In an economic context in which growth is sustained but latent imbalances are intensifying, the Fund's surveillance mission remains crucial. It must continue to play its role in identifying risks and solutions. Its efforts over the last several months to improve this core area of Fund activity are particularly welcome. Furthermore, to facilitate full cooperation by each of its members and be able to propose win/win solutions to known risks through its own rules of operation, the IMF has successfully undertaken an ambitious reform of its governance and may embark upon the first phase of reforming its quotas and votes in 2006.

France is pleased that the IMF, thanks to the strategic review launched by its Managing Director, was in a position to take concrete steps which will enable it to reaffirm its central position in the international monetary and financial system. We must therefore reinforce our efforts to strengthen its legitimacy, effectiveness, and universality.

## I/ DESPITE THE FAVORABLE MACROECONOMIC SITUATION, THE PERSISTENCE OF CERTAIN RISKS REQUIRES THAT WE SPARE NO EFFORT IN SEEKING WIN/WIN SOLUTIONS TO DEAL WITH THEM AS EFFECTIVELY AS POSSIBLE.

### 1.1. Global growth should remain strong in 2006 with a reduction in the disparities in growth among advanced countries.

On the whole, France shares the IMF's views on robust growth in the world economy in 2006, followed by a downturn in 2007. The possible reasons for this slowdown include the impact of past monetary tightening and the cooling of the real estate market in the United States, as well as an overly accommodating policy mix in the euro zone. The effect of past oil price increases will also put the world economy at risk, while the rise in the cost of credit will curtail the possibility of relying so heavily on debt to support demand. Fortunately, the rise in energy prices does not seem to have caused inflationary pressures for the time being, either in the euro zone where inflation is under control or in the United States where it is fueled mainly by rental prices.

The global economy is also expected to become more balanced across geographic regions. In the emerging Asian countries, growth remains sound, the euro zone is dynamic, Japan's economy has overcome deflation and is entering a period of balanced growth; and, finally, the United States is experiencing a slowdown. The evolution of the U.S. economy will depend in particular on the rate of corporate investment. While the low level of long-term rates and the high level of profits and the current level of production capacity are incentives, the expected slowdown in the economy will negatively affect demand.

By contrast, the trend in the euro zone is towards an accelerated activity during the first half of the year, with domestic demand in particular sustained both by household consumption and by corporate investment (thanks to financially sound enterprises). This trend should continue at least until the end of 2006 with the creation of jobs and moderate inflation, both of which contribute to increased purchasing power. This trend is also related to the major reforms in the labor and goods and services markets.

France is also currently enjoying a robust recovery : the latest GDP releases suggest a domestic demand which remains dynamic and improving trade performances. All in all, we expect French GPD to grow within a range between 2% and 2.5% in 2006. These figures are in line with the current IMF forecast (+2.4%) which falls in the upper side of our own range.

### 1.2. However, there could be a sharper downturn in the world economy in 2007 if the decline in the U.S. real estate market is more pronounced and if oil prices continue to rise.

The scenario of a slowdown in the world economy, while keeping, however, high growth rates, is based on a number of factors, in particular the controlled slowing of the U.S. economy (without a collapse in real estate prices); a euro zone that is not excessively penalized by fiscal austerity (Germany in particular) and whose currency does not suffer from a disorderly adjustment of exchange rates as a result of global imbalances; and, finally, oil prices that are not subject to any new sudden increases.

In the U.S., short-term indicators for the real estate market show a net deceleration in price increases and a decrease in the number of transactions. The impact on growth will be felt through the slackening of residential investment, and the impact on consumption through the wealth effect and the drying up of mortgage refinancing opportunities. With the end of monetary tightening in sight, the risk of an overly abrupt downturn will likely be mitigated.

In the euro zone, the policy mix should be tightened. The large countries should make a substantial fiscal effort (including a tax increase in Germany, which could slow consumption in 2007) to reduce their public deficits. The extent of the impact of these efforts on domestic demand (in Germany in particular) is a potential dampening factor. It should nonetheless be limited, given the results of the surveys of business owners which show their confidence in the rate of activity. The business climate remains very positive. The financial soundness of companies should help sustain investment. All in all, the slowdown in activity in the euro zone next year should be limited.

Our economies have been able to absorb the increases in commodity prices thus far, but continually rising prices entail a major risk, especially since surplus production capacity is scarce and geopolitical tensions raise the risks of supply interruptions.

## 1.3. <u>The pursuit of robust growth is undermined by persistent risks, which we must limit by implementing the appropriate policies.</u>

### *1.3.1. In light of the risk related to energy prices, we should continue to strive to make our economies more energy efficient and to strengthen transparency in the oil market.*

To deal with possible price hikes, for example in the case of severe supply constraints, each of our economies must make an individual effort to ensure that our total demand for energy, as well as the share of oil in that demand, react well to price changes. This can be achieved by reducing energy intensity and the part fossil fuels play in our economies, by implementing—as France regularly proposes—national strategies to improve energy efficiency.

Besides, it is also the responsibility of producer and consumer countries alike to ensure that oil production is also price-sensitive. This requires a strengthened dialogue with producer countries to improve the global framework for investment in oil production and downstream industries (refining).

Finally, a more transparent market (including as regards data on production, consumption, and stocks—as is in the works with the Joint Oil Data Initiative—as well as for the estimation of reserves) improve the quality of expectations and thus ensures a better match between supply and demand, which would lead to more regular and predictable changes in the prices of natural resources as they are depleted. The gradual replacement of oil products with alternative energy sources, which requires investment, could therefore be accomplished more effectively.

### *1.3.2. Global economic imbalances continue to pose the risk of a sudden adjustment and an increase in protectionist pressures that would undermine global growth.*

The United States continues to benefit from the savings of other regions of the world—notably the emerging Asian and oil-producing countries—to finance its consumption, as illustrated by its unprecedented current account deficit.

There is a broad consensus that these financial flows are unsustainable in the long run, particularly because the financial markets cannot handle the constant growth of U.S. external debt. However, no one knows what degree of disequilibrium the financial markets can bear.

Furthermore, the loss of competitiveness of the developed countries vis-à-vis the emerging Asian countries, as demonstrated by the deteriorating U.S. external balance, also has an impact on the populations who see themselves as losers in the globalization process. In light of these difficulties, some propose that we revert to protectionism, especially in countries that are losing much of their market share to emerging country exports.

Our responsibility at this stage is to address the risks that these thresholds of tolerance, of markets as well as populations, be reached one day. Disequilibria in current account balances are at the root of this risk. The remedy therefore lies in implementing policies that promote a soft rebalancing of world saving and investment. Despite the widening U.S. deficit, we must applaud the commitments made on both sides of the Atlantic to deal with this and call for the pursuit of efforts already under way.

The steady decline in the household saving rate in the United States and the weak increase in public saving are causes for concern, as the IMF staff has pointed out. I believe that the U.S. authorities are fully aware of this danger, and all the measures aimed at reducing their fiscal deficit are steps in the right direction. These efforts must be pursued, because the global economy is not yet shielded from a disorderly adjustment of global imbalances that would have a negative effect on the growth of the entire world economy.

The limited revaluation of the yuan in the summer of 2005 and its slight appreciation since then, also point to a reduction in global imbalances. However, the move in this direction is still relatively limited. It is also in China's interest to continue along this path as the threat to domestic financial stability posed by an inflexible renminbi seems to have increased in recent months. This policy must be accompanied by measures to stimulate domestic demand in China, for example by reforming social systems to reduce precautionary saving and overhauling the financial system to stimulate private investment.

Since the euro zone presently enjoys a balanced current account, its role in correcting global imbalances will continue to be marginal. However, it must fully shoulder its responsibilities with regard to global growth. All the reforms undertaken in the last several years, particularly in France, to improve the functioning of the markets, reduce fiscal imbalances, ease the constraints on investment, and enhance the operations of the labor market are bearing fruit, as the most recent quarters clearly show.

#### *1.3.3. The abundant supply of liquidity must be gradually reduced, bearing in mind the effects on growth.*

The current global cycle of tight monetary policies follows a period of substantial liquidity growth. These expansionist policies were justified, notably in combating the risk of deflation and recession. They have achieved their goal in that regard. Unfortunately, they have also contributed to serious global financial imbalances: inflation of asset prices, particularly real estate, excessive risk-taking, etc.

Once the risk of recession had faded, macroeconomic policies should have reverted to a neutral monetary and financial stance in order to limit the negative impact on the financial sphere. But the current tightening has not influenced long-term interest rates, which remain far below their macroeconomic determinants.

The reasons for this situation are numerous and difficult to quantify: the central bank’s credibility in combating inflation has kept inflation expectations low, and macroeconomic stability and financial integration can account for the decline in risk premiums and foreign borrowing. Less positive factors are also at work in this configuration in which money still has little value despite the tightening. The strategies of change in the Asian countries are no doubt contributing significantly to this decline in long-term yields, as reflected in the large share of official purchases of U.S. Treasury bills.

In this context, we must guard against sudden hikes in long-term interest rates, but we must also ensure that these rates rise effectively to assuage certain behaviors. Indeed, barely profitable and highly risky investments abound in the global economy, as evidenced by the resurgence of nonperforming loans in China, the development of "interest only" loans in the United States, the particularly low level of risk premiums borne by businesses with the lowest ratings, etc.

While at this stage the risks are no doubt more microeconomic in nature, the Financial Stability Forum (FSF) and the IMF must continue to monitor them, especially since recent history shows that microeconomic shocks may have macroeconomic repercussions. Economic policies must play their part in gradually reducing excess liquidity in the global economy.

### *1.3.4. Lastly, we must continue our efforts to strengthen international financial transparency.*

Economic growth is based on the confidence of economic operators. Such confidence cannot be dictated by decree; rather, it rests on the foundations of steadily increasing market transparency. Governments together with the IMF must work in that direction. The IMF participates in the international surveillance of offshore centers through a permanent program established in November 2003. While this surveillance is coordinated with other stakeholders within the framework of the FSF, the Fund's work is key to it.

This is why it is essential for the assessments planned by the IMF to go forward without delay. To that end, France also supports the IMF initiative aimed at gathering quantitative information on offshore financial activities. It is also essential for the detailed assessment reports to be systematically published or, at least, for the list of countries that do not publish their reports and/or do not participate in the IMF initiative on information-sharing be made public.

Achieving financial transparency also requires meaningful action to combat money laundering and the financing of terrorism, an area in which the IMF must play out its role fully and maintain the efforts it has undertaken thus far. Accordingly, the IMF should ensure that its Financial Sector Assessment Program continues to have an anti-money laundering component, focusing not just on existing regulations but also on ensuring that those regulations are actually enforced. These assessments must be planned in coordination with the FATF. Moreover, assessments made on the basis of new FATF recommendations cannot be implemented merely by updating earlier documents. I am pleased to note the recent decision taken by the Executive Board to reaffirm these principles.

## II / THE STRATEGIC REVIEW OF THE IMF PROVIDES AN OPPORTUNITY TO ENHANCE THE FUND'S LEGITIMACY AND EFFECTIVENESS AS IT ENDEAVORS TO PROMOTE INTERNATIONAL FINANCIAL STABILITY AND SOLIDARITY.

Since September 2005, based on the IMF Managing Director's proposals in his report on the strategic review, we have been working together on an extensive reform of the IMF designed to place it at the forefront of efforts to manage globalization. Gearing the IMF's operations to economic, commercial, and financial globalization is a priority at stake for France: the IMF needs to remain the guarantor of international financial stability and solidarity.

That is why we must work together in three directions: (i) adapt the IMF's operations to enhance its legitimacy and better reflect the changing world economy, (ii) improve the functioning of the institution to make it more effective, (iii) strengthen the universal character of the IMF, which now—more than ever—needs to be a truly global institution.

### 2.1. **To enhance the IMF's legitimacy as an institution, its governance must be adapted to reflect more closely the realities of the global economy.**

Enhancing the IMF's legitimacy is a prerequisite for ensuring that IMF member countries have confidence in the Fund and its effectiveness. But before the Fund's legitimacy can be enhanced, two things are required : improving the member countries' representation through the reform of quotas and basic votes, and strengthening the political legitimacy of the institution by promoting the role of the IMFC.

### *2.1.1. The reform of quotas and votes at the IMF is a key step toward achieving member country representation that more closely reflects changing global economic balances.*

The agreement that has been reached on an extensive reform of IMF governance is excellent news. Beyond raising the quotas for four countries as well as increasing basic voting rights, it addresses another absolutely essential point: the reform of formulas. We know that this is an extremely challenging exercise, as it is both highly technical and fundamentally political, with no member caring to see its importance diminished under the new calculation formula. A similar exercise was conducted between 1999 and 2002, but without success. This time around, we must all work hard to achieve a result within the time allotted, in other words, by the spring of 2008 at the latest.

All in all, developing and emerging countries are the main direct beneficiaries of this reform of IMF governance. This seems eminently reasonable to us. It is true that Europe and France will both see their quotas decline. However, we have agreed to support this effort in order to help implement a reform which, in our opinion, is a prerequisite for ensuring the institution's credibility in the eyes of all its members.

Indeed, this agreement should pave the way to strengthen the Fund's legitimacy among all its members and, consequently, their adherence to the collective rules of the global economy which the Fund oversees. For several years now, we have observed a growing distrust of the Fund on the part of a number of countries. One of the main criticisms voiced by these countries to the Fund was that they had insufficient say in these decisions. These criticisms should incite the IMF to engage in some soul-searching and ponder a more equitable distribution of power at the Executive Board. The reform adopted in Singapore foresees raising the quotas of China, Mexico, Korea, and Turkey as of end-2006. As a result, their role in the Fund's decision-making will more accurately reflect their newfound economic power.

### *2.1.2. Efforts to strengthen the political legitimacy of the Fund should be pursued, for example, in the context of a reform of the IMFC.*

The establishment of the International Monetary and Financial Committee in 1999 was truly instrumental in expanding the role of the political authorities in the definition of the IMF's strategic orientations. However, the IMFC's effectiveness would be greatly enhanced if it were given meaningful decision-making authority. Once done, the IMFC's role and distinctive importance would be strengthened and the IMF's political legitimacy would increase. France wishes to make further progress in this area; for example, it supports the idea that the IMFC should be called upon each year to develop the mandate setting the priorities for the Fund's surveillance activities.

## 2.2. <u>Second, the effectiveness of the IMF's actions must be strengthened.</u>

In addition to strengthening the legitimacy of the IMF, the effectiveness of its instruments should be enhanced. In the context of the strategic review, we should focus our efforts on two areas: the Fund's surveillance function and the strengthening of its insurance role.

### *2.2.1. A far-reaching reform of the IMF's surveillance function is under way.*

Surveillance is one of the areas that the IMF Managing Director sought to emphasize in the strategic review. France welcomes this approach, as it takes us beyond the significant progress recently achieved with the launching, for example, of the so-called balance sheet approach (which should help to better identify vulnerabilities in our economies), financial system surveillance, and the development of a new framework for analyzing the sustainability of the debt of poor countries.

Current discussions aimed at bringing these initial steps to a conclusion are proceeding smoothly, even though the details still have to be carefully worked out. At the April 2006 IMFC meeting, the concept of an annual remit charting a course for surveillance was put forward. It is France's wish that the staff, the OMD, the Executive Board, and the IMFC be closely involved in this effort. Furthermore, France is concerned that in addition to adoption by the IMFC, the Board retain a clear leadership role, as well as, simultaneously, a role in implementation.

With respect to strengthening multilateral surveillance through improved coordination between macroeconomic surveillance and financial surveillance, on the one hand, and between multilateral, regional, and bilateral surveillance, on the other hand, as well as taking better into account the spillover effects of economic policies, the IMF Managing Director has proposed the establishment of a new multilateral consultation procedure with a view to address issues collectively with systemically important members. This initiative is a step in the right direction, even if the practical details still have to be worked out, particularly regarding the resulting messages to be sent. Further work on this procedure should be decided in light of this experience.

The Fund is endeavoring today—particularly through a proposed revision of the 1977 decision on exchange surveillance—to pay closer attention to exchange rate issues (a key element of the Fund's mandate) when assessing member countries' policies and in its analysis of the risks weighing on the international monetary system and financial stability. France hopes that the ongoing discussions lead to a renewed focus on this key component of surveillance, through a broader approach to policies conducive to external macroeconomic stability. This surveillance should also more closely reflect the increasingly important role of the emerging countries. Lastly, the Fund's jurisdiction should be expanded to include capital account issues, with a view to promoting orderly capital account liberalization. We should therefore consider revisiting the fundamental principles underpinning macroeconomic surveillance, to better address the needs involved, which are not new, but which the current globalization process has once again brought to the forefront. This enhanced surveillance will have a vital role to play in the prevention of financial crises.

#### *2.2.2. Furthermore, the IMF's role in the prevention and resolution of financial crises should be strengthened.*

The current international economic and financial context is a favorable one, and we should welcome it. Yet we should not jump to the conclusion that the danger of financial crises has been permanently minimized. For this reason, France favors the development of tools to enable the Fund to take on a larger crisis prevention role vis-à-vis its members, some of whom seem to be currently pursuing self-insurance or regional insurance strategies.

The IMF recently outlined the salient features of a new financial crisis prevention instrument. We believe that this new instrument avoids the pitfalls associated with the IMF's previous crisis prevention instrument, which was discontinued in 2003 (the Contingent Credit Line—CCL), and that it responds well to the traditional criticisms raised at precautionary instruments. Under these conditions, we fully support its implementation at the earliest opportunity, but no later than the 2007 Spring Meetings.

The IMF should also reaffirm its role in debt restructuring operations. Significant progress has been made in recent years in establishing direct relationships between governments and their creditors (developing collective action clauses and the implementation of principles for stable capital flows towards emerging markets and equitable debt restructuring). However, this timely strengthening of relations between governments and their creditors in no way detracts from the IMF's legitimate role in intervening in such arrangements. Today, two strategies should be followed: first, policy reform of lending into arrears, and in particular, further consideration of the good faith criterion; second, IMF's analysis of sovereign debt sustainability should be systematically requested in all cases involving debt restructuring operations.

***2.2.3. Moreover, if IMF's operations are to remain effective, concerted efforts must be made to safeguard the Fund's financial base.***

The effectiveness of IMF's actions is ultimately conditional upon its capacity to shoulder the financial costs associated with its work. The sharp decline in the stock of IMF lending in recent years—a trend that has been exacerbated in recent months by early repayments—is now placing the sustainability of the IMF's financing model at risk.

France is pleased that solutions have been found for the short term: creating an Investment Account and temporarily suspending the accumulation of precautionary reserves are the right choices at this stage. Thereafter, more ambitious measures will have to be considered. In particular, it would seem advisable to consider selling a portion of IMF's gold holdings, with immediate investment and use of the interest.

France expects a great deal from the discussions of the Committee of Eminent Persons set up to address this issue, whose proposals for more predictable and stable sources of IMF income should become available early next year. Although it is important to treat the two issues separately, it is clear that the work on the Fund's income does not relieve us of the responsibility of addressing the issue of IMF spending. France will, however, take steps to ensure that certain policies—particularly in poor countries or with regard to combating money laundering and terrorist financing—are not adversely affected by this redefinition of IMF expenditure.

**2.3. Last but not least, France remains committed to ensuring the universality of the IMF as a truly global institution.**

France believes that the IMF, which is universal in its membership, should also have universal policy instruments. The range of instruments available to the IMF in poor countries were substantially improved in 2005 with the creation of the Exogenous Shocks Facility (ESF) and the Policy Support Instrument (PSI). The implementation of the Multilateral Debt Relief Initiative (MDRI) and the decision to provide appropriate financing for the PRGF Trust for the period 2007-2011 are also welcomed.

These reforms underscore the importance of IMF intervention in poor countries, as rightly advocated by the Managing Director in his report on the strategic review. First, IMF's financial intervention contributes effectively to reaching the Millennium Development Goals, by creating an appropriate macroeconomic environment conducive to the effective use of aid flows and preventing the adverse effects of exogenous shocks. Then, by ensuring that each Article IV report, PRGF, or PSI report includes a debt sustainability analysis and by highlighting those cases where nonconcessional debts have accumulated inappropriately, the IMF has a vital role to play in managing the consequences of the debt relief initiative and the increase in aid flows to poor countries. Lastly, the issues relating to the demarcation between IMF and World Bank activities in poor countries should not be overstated. Considerable progress has already been achieved in this area, where synergies are to be preferred to strict separation.

***Conclusion***

In today's positive and more balanced macroeconomic context, for France the IMF remains a vitally important institution. Together, we must ensure that the IMF continues to safeguard international financial stability and solidarity. Accordingly, France is committed to a far-reaching reform of the IMF, aimed at equipping it to meet today's challenges and enhancing its legitimacy, effectiveness, and universality. This is why we support the Managing Director's proposed approach and trust that it will be put into practice at the earliest opportunity.