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Statement by Ms. Christine Lagarde
Minister of Economy, Finance and Employment, France
On behalf of France

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of Economy, Finance, and Employment
International Monetary and Financial Committee (IMFC)
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Dear Colleagues:

The general macroeconomic scenario has changed little overall since our last meeting in April 2007. The main development concerns activity in the United States, where the slowdown appears to be more pronounced and more sustained than we envisaged. The risks that this scenario entails seem to be less evenly distributed now than they were in the spring. Current account imbalances are entering a phase of very gradual correction, but the turbulence on financial markets this summer entails a risk, especially regarding the extent of the expected slowdown.

In view of these uncertainties, a cooperative approach to managing risks is essential to reducing the likelihood of their becoming a reality and to holding them in check should they materialize. The IMF's analytical and advisory role is vital to ensuring a rapid return to balanced growth among the major regions of the world and to further reductions in imbalances. Thanks to the Strategic Review and the reforms undertaken, the IMF intends to equip itself with the necessary tools to attain those objectives and meet the expectations of its members.

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1/. DESPITE THE SLOWDOWN IN THE UNITED STATES, GLOBAL ECONOMIC ACTIVITY SHOULD LARGELY REMAIN STRONG IN 2007 AND 2008.

The central banks reacted swiftly to this summer's turbulence on financial markets, thereby averting a liquidity crisis. It is still too early for a full assessment of the impact of the crisis on the real economy. Accordingly, the most optimistic scenario is that global economic activity will remain relatively strong in 2007 and 2008. However, the slowdown in the United States is expected to be more pronounced than we envisaged some months ago. Two factors could contribute to this: first, a more sustained and more extensive adjustment is possible in the housing sector; secondly, the downside risk could be exacerbated by the fallout from the financial crisis.

1.1. Despite the slowdown in the United States, the global economy should grow at a satisfactory pace in 2007.

Activity in the United States began to slow down in mid-2006, when its annual growth rate fell below 2 percent. The downturn is due to three main factors: (i) an appreciable reduction in housing investment led to a sharp decline in activity in the construction sector; (ii) the accompanying slowdown in industrial activity had repercussions for private investment: between the second quarter of 2006 and the second quarter of 2007, investment in machinery and equipment stopped growing; (iii) finally, household consumption slowed appreciably in the second quarter of 2007, reflecting a lower wealth effect due to the slowdown in real estate prices.

That was the backdrop to the summer's financial market turbulence, which subsequently "revealed" the existence of the subprime risk. There is a danger that this upheaval could lead to further contraction of United States domestic demand. In fact, this episode is leading banks to weigh risks more carefully which, in a context of a healthy financial sector and low corporate debt, could be expected to weigh most heavily upon the demand of households, which appear to be highly indebted.

In Asia, activity should stay buoyant. Growth in particular could remain strong in an emergent Asia only marginally affected by the slowdown in the United States. This is especially true of China where, despite the measures recently taken by the authorities to avoid the risk of overheating, activity is expected to remain very brisk, driven by investment and exports that are benefiting fully from the region's growing trade integration.

In this environment, despite a disappointing second quarter, euro area growth should bounce back in the second half of 2007, driven by strong domestic demand: the healthy labor market should benefit household consumption, the business climate remains at an historically high level, and current production capacity utilization rates suggest that there will be appreciable growth in investment. Some of the euro area's buoyancy is cyclical in nature. But it also comes from the structural reforms that we have introduced in recent years (reform of the pension and health systems, of the markets for labor and goods and services, etc.). These reforms have unquestionably raised the euro area's growth potential.

1.2. With the factors causing the 2007 slowdown becoming less acute, activity should gradually pick up in the course of 2008.

In 2008, while the factors impeding economic activity may become less acute, especially in the U.S. real estate market, growth should gradually regain its full potential and world trade should pick up.

In the United States, housing sector activity could well be stagnant while the stock of unsold housing gradually dwindles and household demand for housing remains low. The upturn in activity is not expected to be felt until some time in the following year. The property market downturn and the slowdown in the industrial sector are expected to continue acting as a damper on job creation. Household consumption will experience lower activity in those two sectors and property prices will slow down appreciably compared with past levels. Owing to weak household demand and the uncertainties surrounding growth following the pressures on financial markets in the summer of 2007, corporate investment will recover only gradually, buoyed up by capacity utilization rates that are above their historical average as well as by high profits.

Driven by China and India, the boom in the emerging Asian countries should continue. However, activity in China and India is expected to slow down. China will no longer benefit as much from its rapid integration into the global economy: its market share gains will be smaller because the effects of its joining the WTO will become less pronounced and the restructuring of production facilities— which promotes productivity gains—will diminish. Activity in Japan should be buoyed up by the upturn in consumption that began in 2007, possibly as a result of increased job creation and wage restraint.

In this environment, euro area growth should be close to its potential and largely attributable to the vibrancy of domestic demand: wage acceleration and continued labor market improvement should ensure strong growth in consumption. At the same time, exports should benefit from the recovery in international trade.

2/. THE TURBULENCE ON THE FINANCIAL MARKETS DEMONSTRATES HOW IMPORTANT IT IS FOR THE INTERNATIONAL COMMUNITY TO STRENGTHEN GOVERNANCE.

In this key scenario, the risks for growth now appear to be more on the downside than they were a few months ago when they appeared to be better balanced overall. Some of the risks that we identified at our previous meetings have become a reality, especially those affecting the financial sphere. There are conclusions to be drawn from this, especially on the subject of governance.

2.1. Market normalization will require gradual absorption of world liquidity.

In recent years, financial markets have been marked by the very rapid pace of innovations. This is a welcome trend that should not be called into question: in principle it promotes growth and stability. These innovations in effect allow better allocation of capital in the global economy, they promote access to the credit market for those who had previously lacked such access, and finally they spread the risk among economic transactors.

However, the development of these financial innovations has been accompanied by excesses, the most blatant of which concern the mortgage derivatives market in the United States. These excesses are attributable to at least two factors: first, the abundant liquidity in the global economy, which led to less effort in distinguishing between good and bad risks, and second, weak governance of these new markets, in which asset prices no longer reflected the risk actually involved.

Global financial markets are now in a phase of normalization following a period when an increasing number of indices placed a high value on financial assets. The tightening of financial conditions in the main zones of the global economy, which began with tighter monetary policies in the runup to the summer, has continued with higher risk premiums since July. This trend is a sign that markets are assessing risks better than they did in the past. The trend should be accompanied by a gradual reduction in world liquidity.

2.2 While the turbulence on markets may not significantly alter the macroeconomic outlook, there are lessons to be learned about market governance.

Although at this stage caution is still warranted, we thought it best to share our initial analyses of the consequences of financial turmoil, especially as I see a broad consensus emerging in reaction to the recent problems.

Essentially, methods of financing the economy have diversified and changed considerably in recent years. In particular, the securitization of loans has acquired considerable importance in volume terms, and the practical mechanisms have become markedly more complex as successive innovations have appeared on the credit market. The advantages of this development are undeniable.

However, it is in everyone's interest to ensure the continued strength of these methods of financing. The current turbulence demonstrates that substantial adjustments are necessary in the behavior or organization of the various participants in the securitization process, and perhaps even in their regulation. In a way, what is commonly termed "structured financing" has gone through a period of growing pains, but now the time has come to reach adulthood.

The current disruptions on financial markets stem from a lack of information about the real nature of the risks involved and from the excessive delegation of basic responsibility for risk assessment. As I see it, we should work toward two objectives:

- enhancing market transparency, and
- ensuring that all participants in the financial market are held fully accountable.

Specifically, the following avenues should be explored:

- First, it seems to me that we should take a very close look at the regulation of institutions that generate and grant loans with the intention of subsequently assigning them. By definition, these institutions have less incentives to control credit risk than a traditional banks, which must keep loans on their balance sheet.

- Second, rating agencies play a vital role in the process. They should therefore ensure that the information they receive is reliable. They should also establish rules to prevent particularly egregious conflicts of interest and see to it that the rules are followed. Moreover, thought should be given to requiring these agencies to pay closer attention to liquidity risks.

- Third, the transparency of securitization packages and of the characteristics of the underlying loans is crucial to the strength of the system. More transparency is needed, and it is likely that a certain degree of standardization of both packages and reporting will be required, as seen on other markets.

- Fourth, the financial institutions that put these packages together generally provide liquidity support. For banks, these risks will be taken more fully into account from a prudential perspective with the introduction of Basel II next year in Europe. Other financial centers should be encouraged to adopt this new prudential standard without delay.

- Fifth, these disturbances remind us once again of the essential role performed by the proper management of bank liquidity risks. These risks have changed drastically as a result of the broad movement toward the marketization of assets. The time has come to modernize the relevant international standards by basing them on stress scenarios.

- Sixth, hedge fund operations are not a factor in this crisis. Even so, there are similarities, particularly in terms of the exposure of banks to the risks posed by complex and changing structures, the workings of which are sometimes opaque. The effort undertaken at the initiative of our German partners should continue.

- Seventh, accounting standards have evolved in parallel with the movement toward marketization, with the result that the "mark to market" technique is now widely used. However, current upheavals may raise questions concerning the actual reliability of this technique when markets are quite shallow, not to mention short-lived. The essential informative value that market prices provide is beyond dispute, but a more cautious approach seems to me to be necessary.

In this connection, I welcome the initial efforts of the Financial Stability Forum, prompted by its chairman, which have led to the discussion of some of these topics. The next step is to deepen this discussion and expand it to address related issues. I also believe that this work should be completed as soon as possible so that the relevant conclusions can be drawn.

2.3. Macroeconomic policies should continue to promote the stability of the global economy.

In addition to strengthening the operational foundations of the financial market, macroeconomic policies should track unfolding developments. They should continue to promote greater stability without losing sight of the impact on growth: in particular, this entails minimizing fluctuations in economic activity; similarly, the correlation of risks between financial markets and the macroeconomic environment need to be better managed. These policies should also aim at reducing current account imbalances. More specifically, countries with growing current account surpluses should let their currencies appreciate in real terms; efforts to rebuild public and private saving in the United States should continue.

In this context, and in keeping with the strategy developed by the IMFC, the euro area's main contribution to global macroeconomic stability will entail the spirited pursuit of reforms that will quickly bolster economic activity. This is France's focus, especially in the last few months: the government's reform program is quite ambitious. It is designed both to strengthen labor force mobilization and boost productivity, whether the reforms target the labor market, the market for goods and services, or the innovation sector.

3./ To improve the IMF's capacity to respond and adapt to the changing realities of the global economy, all IMF shareholders must remain committed to the success of the reforms in progress.

Despite the favorable performance of the real and financial fundamentals of the global economy, the need for stabilization and coordination of economic policies is more apparent than ever. With this in mind, in September 2005 the IMF undertook a broad-based reform and a redefinition of its responsibilities. The aim of the Strategic Review launched by Managing Director Rodrigo de Rato is to reform the operation and core functions of the IMF. France supports the efforts made in this context to provide the IMF with a new system of governance, a financing model that is sustainable in the long term, and functions as well as instruments attuned to the new global economic environment.

France believes that these reforms form a coherent, balanced and comprehensive package, which should be pursued at a steady pace, while ensuring that no important aspects are overlooked.

3.1. The reform of IMF governance should be continued, to enable the Fund's shareholders to adjust to the changing realities of the global economy while protecting the position of the poor countries.

On the subject of quota reform, France is pleased to note that the discussions have progressed since Singapore, where it was agreed that significant progress should be made in realigning members' quotas with their relative positions in the world economy while ensuring that the Fund has adequate liquidty to achieve its purposes. These progress are the proof of the goodwill of many around the table, who have made substantial concessions in a spirit of consensus building and to preserve a dynamic process. Consistent with this agreement, the focus should be on realigning countries' shares – in order to increase the shares of dynamic economies many of which are emerging countries - rather than groups', the increase of quota shares being an outcome of the process. Of course, a number of issues still need to be resolved, but the options on the table are now quite clear. The first, which is to adopt a compressed calculation formula incorporating a PPP-GDP component (25 percent), has its supporters among the Fund's shareholders, but France believes that such a formula is inconsistent with the quota objectives. On the other hand, the two-pillar approach, in which the calculation formula is linear and supplemented with an objective PPP-GDP inclusive criterion, seems more promising in several respects: first, it preserves the integrity of the formula, which must be based on principles consistent with the Fund's objectives and not reward economic policies diverging from those objectives; it also represents a compromise, as the proposed inclusive criterion incorporates certain elements that some shareholders insist on; it allows for a rebalancing of voice equivalent to the compressed PPP-GDP formula; and, finally, it results in a quota redistribution consistent with the expectations emerging from the September 2006 meetings in Singapore and the April 2007 meetings in Washington.

France believes that the initial phase of the reform should be seen merely as a first step. Nevertheless, it is only fair that the four countries that benefited from the first phase not see their voice diminished in the second phase. Finally, to ensure that the reform also benefits the poorest countries and that their combined voice is considerably augmented—based on realistic assumptions—, France proposes that the basic voting rights be tripled. In the aim of achieving the reform within the timetable adopted in Singapore, I believe it is important to underscore that every concession is part of a comprehensive package and, equally important, that what has been agreed before can't be undone, at the expense of an expeditious, constructive, credible and fair process.

3.2 France supports the adoption of a financing model including a broader income base and more effective expenditure restraint.

With the improvement in the global economic situation, the IMF in recent years has come face-to-face with the limits of its financing model. The Fund's reliance on its lending operations to finance its budget exposes it to income risks in the medium and long terms: sizable loans have been paid back and the stock of IMF credit has reached its lowest level in 25 years. In 2010, unless reforms are implemented, the IMF is projected to face a financing gap of SDR 265 million.

To address this significant challenge, the Managing Director Mr. de Rato called upon a committee of eminent persons, chaired by Sir Andrew Crockett, to propose new and more diversified sources of income to ensure that the IMF has a sustainable base for its operations. As part of the Strategic Review, the committee submitted a cohesive set of recommendations last January that effectively addressed the issues involved. These recommendations have been broadly well received by the Executive Board. In July and again in October 2007, shareholders had an opportunity to discuss the preliminary staff proposals made on the basis of the Crockett report.

From the outset, France has supported most of the proposals in the report. It is France's belief that these all-important discussions must now take a decisive step forward. Implementing the new model will take time. As a consequence, the Executive Board should move on expeditiously. The Executive Board should also seize this opportunity to make the financial model of the Fund transparent and simple. This new model will also call on a thorough review of the governance framework, especially with regards to the risk management. At the same time, management and staff have been invited to propose new measures for achieving further reductions in the administrative costs associated with the IMF's functions. France is convinced of the need to focus on expenditure and revenue simultaneously: long-term progress in financing will be impossible unless both aspects are addressed on an equal footing and in accordance with an integrated approach. Doing both exercises is necessary to secure a long-term sustainable financing of the institution. For this very reason, it is critical that further progress towards a new income model is not delayed unduly. The priority, today, is for all shareholders to be actively involved in the ongoing discussions, for the IMF's long-term future is at stake.

However, this exercise must not be conducted at the expense of key elements of today's Fund mandate, in particular its involvment in Low income countries. This is why we do not support the resuming the reimbursement of administrative expenses of the PRGF-ESF Trust. We are however open to innovative proposals that could contribute to resources for the PRGF Trust.

3.3 Further efforts to align the IMF's functions with the changing realities of the global economy are especially vital in the area of surveillance.

In regard to surveillance, France welcomes the reforms that have now been carried out. The adoption of a new Decision reviewing the concepts and framework for the bilateral surveillance of member countries by the IMF marks a watershed in the IMF's history. The IMF has successfully enhanced the legitimacy and effectiveness of one of the core functions in its mandate. Through "external stability" analysis of national economies, and thanks to its enhanced focus on the spillovers and "fundamental misalignments" of exchange rates, the IMF is strengthening its assessments of member country policies without creating new obligations vis-à-vis national authorities. Shareholders should pursue discussions among them and with staff to consolidate a shared understanding on the implications of the new Decision and to ensure that the decision is implemented in as fair and comprehensive a fashion as possible.

Surveillance innovations are not confined to adoption of the new decision. Henceforth, the Board will be setting surveillance priorities at intervals of three years, which will be periodically updated, examined and endorsed by the IMFC. France attaches considerable importance to integrating the various surveillance exercises. Financial sector assessment and analysis should be strengthened and used more systematically as part of each surveillance exercise.

Specifically, as recent financial market turbulence has made clear, the Fund needs to have well-designed analytical capacity to address the structural trends affecting financial markets. This analytical capacity should greatly clarify the Fund's dialogue with national authorities in connection with the Article IV consultations and FSAPs. This capacity should also be fully exercised in the multilateral surveillance exercises, to identify early warning signs of vulnerability and thereby encourage far-reaching international debate concerning appropriate remedial action.

3.4. To ensure that the IMF Strategic Review can be fully implemented, discussions regarding the Fund's role in emerging countries and poor countries should continue.

With regard to the IMF's role in emerging countries, we should first avoid reaching hasty conclusions about the impact of the current crisis on emerging countries. While we should welcome the favorable performance of these economies, the IMF should nonetheless stand ready to consider appropriate crisis prevention and resolution mechanisms. Leaving aside the recent debates on such topics as vulnerabilities or issues related to increases in capital flows, I believe that the discussions undertaken several months ago regarding the establishment of a new liquidity instrument should continue. Granted, it is not yet clear that the main potential beneficiaries of this instrument would be interested; however, this could have something to do with the characteristics of the instrument as envisaged at this time (particularly its access levels, qualification criteria, and charges). Further discussions of these parameters as well as regarding the technical issues raised during the most recent debates (in particular, the issue of the signaling effect in the event of nonrenewal) should go forward inasmuch as this is a vital component of the Strategic Review.

Regarding the Fund's involvement in low-income countries—a key issue for France—the IMF should strengthen its support provided in the form of technical assistance and advice without, however, abandoning its financial role. The Poverty Reduction and Growth Facility is now one of the IMF's basic tools. While improved coordination between the IMF and its partners in the context of the development assistance framework is a necessity, continued IMF engagement in poor countries remains essential. In France's opinion, we must not overlook the highly distinctive role performed by the IMF and the benefits which the Fund's many stakeholders derive from its activities.

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Given the trends unfolding in the global economy, whether long-term or short-lived, the IMF undeniably has a crucial role to play in support of global financial and monetary stabilization. For more than 60 years, the IMF has been a key player in the development of the global economy. The quickening pace of change and innovation has prompted the Fund to embark upon a wide-ranging reform program to enhance its legitimacy and the quality of its efforts on behalf of all categories of members and the international monetary and financial system. If we truly wish to ensure the success of the ongoing reforms aimed at enhancing the efficiency and transparency of the international monetary and financial system, all stakeholders must stand ready to engage and compromise.

In closing, France applauds the efforts of Rodrigo de Rato during his time at the helm of the IMF. In addition, France wishes to congratulate Dominique Strauss-Kahn on his recent appointment as Managing Director, and Tommaso Padoa-Schioppa on his appointment as new chairman of the IMFC. In their public remarks, both have shown a clear understanding of the issues at stake in the IMF reform process.