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

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of Economy, Finance, and Industry
International Monetary and Financial Committee (IMFC)
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Dear colleagues,

Since our last meeting on September 17, 2006, the rebalancing of global growth has been confirmed. Global growth remains robust and the slowdown of the world economy under way since mid-2006 should be overcome by the end of the year. While there are signs of diminishing current account imbalances, the risk of an abrupt adjustment through exchange rates or risk premiums persists. There is also a risk that protectionist tensions materialise.

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. France supports continued implementation of the IMF's strategic review launched by its Managing Director two years ago. It will enable the IMF to reaffirm its central position in the international monetary and financial system.

1/. Global growth is rebalancing rapidly since last summer with stronger activity in Europe and a slowdown in the United States and Japan

- **Global growth should remain robust with a modest slowdown in 2007**

Prolonging what we have experienced during the two previous years, global growth was very robust in 2006. The main innovation since last summer lies in the fact that growth has been rebalanced between major economic areas.

The United States has been experiencing a soft landing since the middle of last year, under the influence of the housing market downturn, which will probably continue to act as a drag on the economy for much of 2007. In Japan, the economy looks slightly less vigorous than expected**,** with household consumption slowing since 2005. However, the end of deflation is a reality: investment is buoyant and business credits are steadily increasing. At the same time, growth in emerging Asia appears to have slackened very slightly at year-end, after a year of exceptional growth.

Conversely, the cyclical upturn that began at the end of 2005 in the euro area appears to have been confirmed and to have gathered strength, with growth overtaking that in the United States at the end of 2006 (and also that in Japan), for the first time since the 2000-2001 American recession. This vigour stems mainly from the strength of domestic demand and, at year-end, exports. The most dynamic element within domestic demand has been investment, stimulated by a number of factors, especially low long-term interest rates and high production capacity utilisation rates. Consumption remained equally buoyant in 2006, driven by a high level of job creation. Part of the buoyancy is cyclical, but another part seems to reflect the benefits of our structural reforms (pension system, labour and product markets, healthcare and financial sectors) which could begin to boost potential growth. Business climate indicators confirm this decoupling: whereas in the United States the composite manufacturing industry indicator fell perceptibly in 2006 to the point of indicating a contraction of activity, in the euro area it advanced throughout practically the entire year of 2006 and has increased further at the beginning of 2007.

The slowdown in US domestic demand and falling oil prices have lowered inflationary pressures. In the euro area, inflationary pressures are limited. Germany's 3-percentage point increase in VAT has mechanically boosted core inflation in the first half of 2007, with the impact on euro area inflation estimated to be 0.3 percentage point. As for now, this has been hidden by the effect of the decrease in oil prices. Core inflation would then abate in 2008 as the effects of the VAT rate increase wear off. Aggregate inflation is expected to remain below 2% in 2007 and 2008.

- **In 2008, factors responsible for the 2007 slowdown should fade and activity accelerate.**

In 2008, as the main negative forces at work in 2007 in the main regions (US housing slowdown and fiscal tightening in the euro area) fade, growth would likely go back to its potential rate without stoking inflationary pressures, and global trade would pick up once more.

In the United States, the housing market slowdown is expected to last during a large part of 2007. The US soft-landing scenario in 2007 is the most likely one, but it could be invalidated if a deterioration in the American housing slump in 2007 were to squeeze consumption sharply, leading to heavy job losses in other sectors of activity, notably in industry. Some recent data show this scenario cannot be ruled out, in particular if the excess of demand is more pronounced than estimated before, in relation with a downward revision of potential growth for the future but also for the past few years.

In the euro area, on the one hand a tighter policy mix may be a factor that could challenge the decoupling vis-à-vis the United States from persisting in 2007. Even if the German economy still seems slightly affected by the VAT rate increase when one looks at aggregate inflation (thanks to base effects connected with energy prices), this has well and truly begun to feed partially through to prices; on the other hand, so far the risks are rather on the downside. Conversely, in the United States, the uncertainty concerns rather the possibility of stronger growth: employment and investment are buoyant, and business and consumer confidence remains at high levels.

The United States' growth profile would be partly replicated in emerging countries given the importance of trade in fueling their growth. Likewise, Japan will be penalised in 2007 by a slowdown in exports to America and emerging Asia, so that growth will depend on domestic demand. Consumption has however remained fragile but a faster pick-up in wages and a drop in Japanese household savings are possible, bringing the rate back down to its level of two years ago and more in line with reduced uncertainty over growth. Should this be the case, Japanese economic growth would be more buoyant.

2/. WHILE RISKS TO GLOBAL GROWTH ARE RECEDING IN THE GLOBAL ECONOMY, THE RECENT FINANCIAL TURMOIL CALLS FOR INCREASED VIGILANCE

The risks to growth are very similar to those identified in our previous meetings even if the rebalancing of global growth is probably a mitigating factor. The recent turmoil on financial markets recalls that significant risks persist and that they are highly correlated. Excesses of the past could be hidden by the long period of strong growth we have experienced over the last years.

Despite tighter monetary policies in major economies, long-term interest rates remain low, hence stimulating liquidity in the global economy. It is associated with a very low price for risk in financial markets.

We now have substantial microeconomic evidence of astonishingly low risk pricing in various markets. Such incidences have multiplied at the end of 2006. One example is the expansion of the subprime mortgage market in the US at a time when the housing sector was obviously already contracting. The large capital inflows in developing markets or in private equity are to a lesser extent other examples.

The Financial Stability Forum and the IMF should continue to identify the risks and monitor them, especially since recent history shows that microeconomic shocks may have macroeconomic repercussions.

Macroeconomic policies must help monitor the increase in global liquidity and reduce the risks on financial markets, bearing in mind the effects on growth.

- They must aim at stabilising the global economy: by reducing fluctuations of output and the variability in the real economy, in reducing financial volatility. They should aim at reducing output gaps where necessary.
- We also need to reduce the degree of correlation of risks between the macro economic scenario and markets. In this respect, we should continue to monitor thoroughly the policies aimed at reducing global imbalances.

The risk of a disorderly adjustment of global imbalances is not likely to materialise in the short run. Nevertheless, actions to reduce these imbalances should be pursued with determination, since adjustments costs would be very high in an adverse scenario.

To prevent this risk, country currencies with large and growing current account surpluses should appreciate in effective terms. Appreciation should be accompanied with continued reforms to rebalance growth towards domestic demand.

While there were signs at the end of 2006 that the U.S. current account deficit had stopped deteriorating, the steady decline in the household savings rate is a cause of concern although the rapid reduction of the public deficit more or less compensated for it last year. The efforts to reduce the fiscal deficit should be continued. Measures in favour of increased private savings would also be central.

The euro area has already done a lot in line with the IMFC strategy including a renewed impetus to reform since the relaunched Lisbon Strategy. This momentum is not bound to come to an end rapidly and European economies are dedicated to further improve their labour, product and financial markets in the coming years.

3/. In this context, we should not loosen our efforts to implement the IMF's medium-term strategy and to move on discussing IMF's long-term financing.

Even if the world economy has been experiencing solid growth for several years and the outlook remains favourable, we should not infer from these positive developments that a new paradigm is under way: it would indeed be misleading to consider that the international financial system would be sheltered from crises in particular in emerging countries. Therefore we must pursue our efforts to guarantee that the Fund remains able to fulfill its tasks and thus to achieve its Strategic Review, bearing in mind that the various aspects of this reform are linked together.

- **France is looking forward to thoroughly discussing IMF's long-term financing on the basis of the very good proposals made by the Crockett report.**

In recent years, the stock of IMF lending has experienced a very sharp decline reaching a 25-year low putting the sustainability of the Fund's financing model at risk. France supported the short-term solutions brought to the table last year, though pointing out that more ambitious measures would have to be considered rapidly. We expected a great deal from the discussions of the group of eminent persons set up to address this issue, in order to safeguard the Fund's financial base and to make IMF operations remain effective. And the Crockett report on IMF's long-term financing is indeed very much welcome. France shares the view that three main financing models can be used to specify the nature of the IMF's new resources: the IMF as a financial institution, as a service provider, and as a provider of global public goods. We share the main assumption that various financing sources matching these different functions should be mobilized to solve the financing gap which could reach SDR 245 million in 2010.

A few solutions, which are likely to backfire in the medium term, need to be ruled out: cutting the interest rate paid on countries' reserve tranche positions; increasing the rate of charge; overhauling the mechanism for setting the rate of charge; using Fund's reserves to finance administrative expenditures ; charging an annual fee linked to quotas. Three measures could reduce the IMF's financing requirement, but they are not sustainable solutions: using resources from the burden-sharing mechanism to finance the Fund's operating expenditures ; halting the accumulation of precautionary reserves when the ratio of precautionary balances to credit outstanding exceeds a given threshold ; charging for technical assistance.

The most worthwhile solution is to sell a fraction of the IMF's gold stock and immediately put the proceeds into the Investment account and use the interest. If further financing were required, some of the IMF quotas could be put into the Investment Account. These two solutions create a compromise between the IMF as a financial institution and the IMF as a supplier of global public goods. We are looking forward to discussing these options on the basis of a rapid proposal from IMF staff after the Spring Meetings. In any case, notwithstanding the fact that we should stick to previous efforts to control expenditures, we should not use the upcoming discussions on long-term financing to put aside the Fund's core missions again.

- **Therefore we support the continuation of an ambitious reform of the IMF to make the institution able to cope with new developments of global economics. In this respect, the Strategic Review should be seen as a global package.**

Regarding the quota reform, it is crucial to bear in mind a few key principles for our work at this stage.

First, we agreed in Singapore on "capturing members' relative position in the world economy". In doing so, we did not refer to any specific group of countries but to an individual case-by-case appraisal. I do think that if we want to reach a consensus, it is critical to strictly follow these guidelines, otherwise we would confuse the objectives of the reform with its possible outcomes. I think there is also broad agreement to consider that any formula should provide incentives for members to pursue policies that are coherent with the objectives of the Fund and of a well-functioning international financial system.

Against this background, our assessment of the relative merit of each variable should draw on a "principles-based approach", and not on an ill-conceived attempt of reverse engineering. In my opinion, this "principles-based approach" would have two main implications: first we do not support using GDP at PPP or a blended MER-PPP GDP; second, FX reserves should not be included within the formula. At least, we should introduce a cap on this variable. If we are to keep reserves in the formula as a way to reward a country's capacity to contribute to the Fund's resources, then we should also include other indicators of a country's capacity to contribute to the Fund resources, such as contributions to the PRGF Trust Fund. This would then materialize the link between voting power, new responsibilities, and strengthened support to the Fund's activities.

I recognize however that a formula based on these principles may not result in calculated quota shares that are broadly acceptable to the whole membership. To reach this result, we should consider other ways, for example, using a compression factor could be envisaged : almost all emerging countries would get a higher new calculated quota in a scenario with compression compared with a scenario with blended GDP. And low income countries' share would be significantly higher with compression than with a blended GDP including PPP. We should therefore consider compression very seriously. The second way to increase the weight of emerging countries would be to increase the weight of variability in the formula: this would benefit most of emerging countries.

France supports the efforts underway to improve the effectiveness of Fund's surveillance.

We consider surveillance as one of the top priorities to be dealt with in the strategic review and we notably welcome the Fund's approach to pay closer attention to exchange rate issues as a key element of the Fund's mandate in assessing member countries' policies and in its analysis of the risks weighing on the international monetary system and financial stability.

We welcome the efforts made by the Fund to pursue the review of the 1977 decision as a good opportunity to express the membership's support for the work done by the Fund. It should make clear that surveillance is right in encompassing all policies, not only exchange rate policies *stricto sensu*, to focus on spillover effects and to reinforce the link between bilateral and multilateral surveillance. The Fund's proposals are based on stimulating inputs: they aim (i) at reinforcing even-handedness, for example with a shift of focus from mere exchange rate policies – which do not address countries with flexible exchange rates – to a broader scope of domestic policies that can generate misalignments; (ii) at focusing attention on external stability (including cross-border spillovers) and (iii) at addressing fundamental misalignments when clearly documented and identified.

France also supports the Fund's latest proposals concerning the remit – independence – accountability framework currently under consideration at the IMF. We share the view that, in line with last April's IMFC statement, the remit should be set on an annual basis by the IMFC, on a proposal made by the Executive Board. It should provide guidance on the priorities set for the Fund's surveillance to be implemented together by the Staff, Management, and the Board. This however does not imply a significant change in the way surveillance should be organized.

Finally France supports the efforts made by the Fund to improve surveillance in its various aspects (coordination between macroeconomic and financial surveillance, between multilateral, regional, and bilateral surveillance) and considers the multilateral consultation procedure established by the Managing Director as a way as such to address issues on a renewed basis with systemically important members.

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 for that we should be grateful. 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 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 leveled at precautionary instruments. Under these conditions, we fully support its implementation at the earliest opportunity.

Finally, the Fund's commitment to Low-Income Countries should remain a key priority.

We believe that the Fund should remain universal both in its membership and in its instruments. Much has been done in recent years to adapt the Fund's instruments in the wake of the Multilateral Debt Relief Initiative and we do not see any case for a sudden change as suggested in the Malan Report: indeed, the PRGF should keep playing a central role and the IMF should remain strongly involved in poor countries. The Fund contributes to reaching the Millennium Development Goals, by building an appropriate macroeconomic environment conducive to stability and effective use of aid flows and preventing the adverse effects of exogenous shocks. It also has a vital role to play in managing the consequences of the debt relief initiative and the increase in aid flows to poor countries. Finally, 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.

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In today's strong and dynamic economic context, France believes that the IMF still has a significant role to play to safeguard international financial stability and solidarity. Therefore, pursuing the implementation of the Fund's Strategic Review clearly is a priority and we broadly support the Managing Director's approach as the right way to enable the IMF to meet today's challenges and enhance its legitimacy, effectiveness, and universality.