International Monetary and Financial Committee

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

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International Monetary and Financial Committee (IMFC)
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Dear Colleagues,

The general macroeconomic scenario for the world economy shows a more pronounced slowdown than what was expected last September. Since our last meeting, several important risks have materialized. The adjustment in the United States housing sector has proved to be more sustained than we envisaged, turbulences in financial markets continue to weigh on a rapid recovery, all countries have been confronted with higher than expected commodities and food prices.

Europe, while not immune from the global slowdown, should expect a limited spillover of the United States slowdown. Domestic demand remains strong and European countries should, at this juncture, reap benefits from their consistent effort to implement structural reforms. Emerging markets have also shown resilience to the global downturn.

In view of the uncertainties around the global outlook, cooperation between authorities managing risks at stake, notably the coordination between central banks, is key to put the world's economy on the track of a rapid recovery. The IMF's analytical and advisory role is vital in that respect. To fulfill that role with greater efficiency, it is important for the IMF to change the way in which it works. France welcomes the important reforms undertaken by the institution under the leadership of Dominique Strauss-Kahn.

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1/. The world economy should feel the negative impact of the financial crisis over the coming months, before experiencing a gradual recovery in 2009.

1.1. The recent financial turmoil and the renewed inflationary pressures should lead to slower economic activity worldwide.

In the recent years, the US experienced a strong debt-financed housing boom that ended in 2007 with a slowdown and decline in housing prices. The subsequent rise of defaults on mortgages led to a sharp re-pricing of risk on financial markets. This had an adverse impact on balance sheets of financial institutions, especially in the banking sector which has experienced, since last summer, several episodes of liquidity shortage. The resulting financial shock has two major components whose consequences which should affect the world economy throughout 2008:

- *A credit supply shock*. Credit has already become more costly as higher inter-bank rates have been passed through to interest rates faced by the private sector. This shock could be amplified by quantitative restrictions as banks and financial institutions try to restore their balance sheets and restrain access to credit for households and corporations. This should especially harm real estate and productive investments.
- *A financial wealth shock* caused by the stock market falls since last October. Lower asset prices could hamper productive investment throughout the world and, added to the decrease in housing

wealth, reduce as well household consumption, especially in the US where household wealth is one of its major drivers.

Even if the US authorities reacted promptly and adopted monetary and fiscal measures aiming at sustaining economic activity, the credit shortage should play a prominent role in the slowdown of corporate investment in the US. It will also contribute, until end 2008, to the contraction of real estate investment, also fuelled by an on-going decrease of housing prices.

Elsewhere, even if the current burst of inflation, mainly induced by the rise in energy and food prices, should hamper household consumption, several major economies should resist to the current downturn. In particular, the euro area should keep a dynamic domestic demand, fuelled by the passed good performance of its labour market. This relative vigour of European economies along with a sustained economic activity in Asia should partially compensate the moderating effect on the world trade exerted by the US slowdown.

In this context, France has already chosen to sustain economic activity by reinforcing the household purchasing power through an increase in labour supply and reinforced competition which should limit inflation. This policy should be seen as a contribution to the collective effort to limit the current slowdown.

1.2. The end of the housing market correction backed with the moderation of inflation should lead to a gradual rebound in 2009.

The beginning of 2009 should be marked by the end of the housing market correction in the US as real estate investment start to grow again in the first quarter and housing prices go back to a positive trend by the end of the year. The withering effect of the stimulus package on consumption should limit its rebound in early 2009, but things should improve afterwards, helped by the moderation of inflation. Decreasing inflationary pressures will be felt across all major economies, leading a bounce back of private consumption. Past interest rate cuts as well as less restrictive credit conditions – following the restoration of balance sheets in the banking sector–will have positive effects on investment. These favourable orientations of domestic demand should also contribute to a rebound of world trade. All in all, activity is expected to gradually converge to potential in the US and in Europe.

1.3. Beyond the steps already taken to address the current financial turmoil, we need to implement further reforms that will both promote transparency in the financial sector and increase the sense of responsibility of stakeholders.

France welcomes the FSF report, which is delivering substantial results on several topics. With the turbulence still in progress and possibly spreading to new parts of the financial sector, authorities have to show that they are taking what is happening very seriously, both in answering the present problems and in addressing the structural issues identified.

Among the most notable outputs, the Basel Committee commits itself to release enhanced standards on liquidity risk management by July but also, in a longer timeframe, to reinforce the capital requirements applying to securitization and structured products exposures. The Basel Committee should also undertake thorough reviews on other risks identified in the current events, such as concentration or reputation risks.

The issues surrounding credit rating agencies also deserve to be addressed in an expeditious way. Among them, two need to be singled out in priority: potential conflicts of interest and a clear differentiation between ratings of "plain vanilla" debt instruments and structured products through different scales.

Regarding financial institutions' transparency, the effort of the FSF to bring out best practices for disclosure of exposures and risks is a very relevant initiative, which needs to be pushed forward. Similar efforts should be devoted to the work regarding valuation methodologies. With markets remaining quite illiquid, both financial institutions and auditors have significant difficulties for valuating structured products. Substantial guidelines are therefore urgently needed on this issue.

The high level of financial markets integration necessarily calls for enhanced coordination of authorities both to prevent and manage emergency situations.

In this respect, the call of the FSF call for a better communication from the financial authorities towards the industry about the risks identified is particularly welcome. In terms of supervision especially for cross-border groups, more exchange of information and cooperation is certainly needed. However, before crafting any global arrangements in this respect, it seems appropriate to push forward current efforts being undertaken both at the EU-level and in the US to improve the existing framework.

There would be significant merit in pushing forward reflection on the "originate to distribute" model: obviously, risk management and transparency appears not adequate for most of the links of the lending and securitization process. In this respect, France welcomes the US authorities move to better regulate their domestic credit sector. However, this should not prevent the FSF to comprehensively tackle the issue.

More generally, it seems necessary to come back on the general approach underpinning our current work. On all the issues we are addressing now, there will be numerous organizations to correct, models and methodologies to amend, regulations and frameworks to review. But financial stability and good functioning of the markets is also and perhaps chiefly about the stakeholders' behavior: they should permanently exert their own judgment and assume fully their responsibilities, without unduly relying on third parties or techniques that are not fully understood.

In this perspective, it is essential to improve transparency and promote standards which identify clearly the respective responsibilities. In the same way, France believes that any intervention to address the present turbulence should aim at empowering the industry and the investors for preventing and tackling themselves current and future issues, and not fostering the belief that in the end, there will always be public action and public money to make the damage good.

2/. IN THIS CHANGING ENVIRONMENT, THE IMF IS CURRENTLY DEMONSTRATING ITS CAPACITY TO ADAPT ITS GOVERNANCE AND FINANCIAL MODEL TO NEW NEEDS AND REQUIREMENTS FROM ITS MEMBERS.

In the context of the current financial turmoil, facing the emergence of new financial solidarities at the regional level, the IMF has engaged an ambitious reform process. By reforming its governance, through the quota and voice reform, the Fund is aiming at rebalancing the equilibrium in favor of dynamic economies, most of which are emerging economies, and, equally important, at enhancing the voice of poor countries.

Second, the Fund has launched a refocusing of its missions and the modernization of its internal processes, whereas its financing is being put on a more sustainable footing. Ultimately, the goal remains to help the Fund adapting to new challenges in order to better serve its member countries.

2.1. France welcomes the agreement reached on quota and voice reform which will reinforce the Fund's legitimacy.

France—one of the major contributors to the reform—welcomes and supports the proposed Resolution of the Board of Governors on the Reform of Quota and Voice in the IMF. This reform will reinforce the Fund's governance and France will support it in the Board of Governors. France commends the leadership of the Managing Director on this complex issue and his personal involvement that was decisive in reaching agreement.

The adoption of a new formula is, as such, a significant step forward with regard to the complexity of the current five formulas. Through the allocation mechanism which has been proposed by the Fund, the reform will result in a significant realignment of quota and voting shares focused on dynamic emerging market countries. Equally important, low-income countries will benefit from the tripling of basic votes, which will rise their voting power, and from the additional measures that will be implemented thanks to the Amendment to the Articles of Agreement: first, the introduction of a mechanism that maintains the share of basic votes in total voting power; second, the prospect for the two African Executive Directors to appoint an additional Alternate Executive Director. France shares the view that these measures are key to ensure the effectiveness of low income countries' appropriation process.

Although we strongly believe that some technical aspects of the reform are still not consistent with the principles of the Fund, notably the inclusion of a blended GDP variable including GDP measured at PPP, we acknowledge that the proposed reform package succeeded in reaching a difficult balance between the differing views and priorities of the membership. The flexibility shown by most members is worth being welcomed: it is a sign of a commitment to a more credible, legitimate and effective institution. France, like other industrialised countries, has made substantial concessions in the course of the discussions, with the view to building a compromise broadly acceptable. France, together with the UK, is proud to be the main individual contributor to the reform. The EU participates fully to the reform thanks especially to voluntary foregoing of quota shares.

Looking forward, France considers that further ad hoc increase will intervene under the framework of general reviews and that the Fund's liquidity needs will have to be taken into account prior agreeing on any further adjustment.

While the quota and voice reform in the IMF is a very significant achievement, the first of its kind in the IMF and in other international institutions, France is of the view that the World Bank should engage quickly its reform process with the same aim to enhance voice and representation of developing countries.

2.2. Based on the recommendations of the Crockett report, the Fund adopted an integrated income and expenditure framework, which should now be integrally and progressively implemented.

Due to the improvement of the global economic situation, the IMF main revenue source, i.e. the revenue from its lending activity, clearly declined over the past decade. These developments have also direct consequences on the Fund's finance.

Following the recommendations of the Committee of Eminent Persons chaired by Sir Crockett, the IMFC demanded last October that the IMF provides both a new income and expenditure framework by the time of the 2008 Spring meetings. The IMFC also called for a medium-term budget envelope consistent with this integrated framework, with respect to the Fund's missions. France welcomes tremendous efforts which have been made by the IMF. The Managing Director's determination, the open-mindedness and commitment of all involved parties, especially the staff, deserve to be welcomed by the IMFC as they permitted an ambitious restructuring to take place.

Cost cutting has been indeed a difficult task. Yet the $100 million savings do not jeopardize the Fund's ability to engage with its members, whether industrialized, developing or poor. New revenue sources have been decided. Even if all measures proposed by the Crockett Committee have not been supported by the Executive Board, substantial progress has been made: the principle of gold sales is accepted and member countries committed themselves to vote or seek approval from their domestic legislature. Other decisions, such as the reimbursement to the General Resource Account of administrative costs of the Poverty Reduction and Growth Facility, have been adopted and all new revenue measures should now be implemented simultaneously and expeditiously. Yet, Fund's finances should be further strengthened. Therefore, if the new model fails to deliver a sustainable financing for the Fund, further considerations will need to be given to some of the recommendations made by the Crockett committee to generate additional resources. Moreover, vigilance is needed going forward on the adequacy of the new framework and on the capacity of the Fund to conduct appropriate technical assistance programs. France will pay particular attention to the capacity of the IMF to support low income countries as effectively needed.

2.3. France encourages the ongoing change in the IMF since it is a necessary condition to reach the objectives of more stability and, at the same time, more responsiveness in the international financial system.

As many member countries, in particular in Europe, France strongly supports the rethinking of the IMF's role as far as international financial stability is concerned. In order to avoid any misunderstanding, this support does not call neither for a revolution nor for one more layer of bureaucracy at the international level. On the contrary, current turbulences on financial markets imply a strengthening of the coordination between all institutions, which can have a value-added in this context: France shares the view that existing information could be more timely and effectively shared and used. New financial crises using new transmission mechanisms challenge our common knowledge and our policy responses. The Managing Director's strategy to refocus the Fund on its comparative advantage can enable the Institution to provide a new risk-based analysis, especially as far as linkages between financial and real economy are concerned. This adaptation of the Fund's role can be instrumental for other players or decision makers. Among those partners, the IMF should particularly increase its cooperation with the Financial stability forum. Both institutions should now present operational means to flexibly intensify their operational cooperation.

With regard to the IMF's role in emerging countries and performance, the IMF should stand ready to consider appropriate crisis prevention and resolution mechanisms, possibly through the establishment of a new liquidity instrument which implies further work to ensure the main potential beneficiaries of this instrument be interested (notably on the characteristics of such an instrument: its access levels, qualification criteria, and charges).

Regarding the intervention in low-income countries, more flexibility and responsiveness should also be introduced, especially when they face macroeconomic challenge that is largely beyond their control. High commodity and food prices can have dramatic consequences in non-exporting low income countries, for both their external position and on the most their populations. This concern needs to be addressed. Within the framework of the IMF's mandate, solutions can be sought. As stated by the Managing Director in Ouagadougou, last February, temporary and targeted measures could be envisaged by national authorities at the current exceptional juncture. Yet, France considers that this is part of the IMF's mandate to propose responsive intervention to support low income members in order to mitigate the impact of exogenous shocks, which can jeopardize their macro-economical stability. France therefore thinks it is worth considering more flexibility in the use of the IMF's Exogenous Shock Facility and a better integration of this instrument in the other facilities' and programs' framework of the Fund.

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In a changing environment, the IMF faces new challenges and remains a key player to address threats to international financial stability. Major steps have been taken towards a comprehensive reform package: the Fund's governance and financing will soon be renewed. Adapting new requirements from member countries and refocusing its missions, the IMF should be rapidly able to provide an even stronger contribution to the world's financial stability.

In this context of in-depth reforms, France stresses the importance to closely monitor the current process since they are simultaneously critical and difficult. Their implementation will take time and member countries have to remain constantly committed to help the Fund achieving successfully its restructuring. Therefore, the IMF will have to keep the momentum in the coming months. The IMFC's guidance will therefore be particularly helpful, to ensure that reforms that have been launched on track.