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**Statement by Minister of Finance Christine LAGARDE,
in her capacity as Chairwoman of the EU Council of Economic and Finance Ministers**

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Statement by Minister of Finance Christine LAGARDE,
in her capacity as Chairwoman of the EU Council of Economic and Finance Ministers,
to the IMFC 2008 Annual Meeting

1. I submit, in my capacity as Chairwoman of the EU Council of Economic and Finance Ministers, this statement which focuses notably on the world economy – and in particular the outlook and policies for the European Union -, and the implementation of the IMF's Medium Term Strategy.

Economic Situation and Outlook

2. The global economic expansion is decelerating in reaction to the shocks that have hit the world economy - mainly the rise in oil and other commodity prices and the housing and financial market turbulence - but also due to a cyclical adjustment after a period of high growth. The current situation is characterised by a large degree of uncertainty and there are downside risks. The main current challenge is to restore confidence in financial markets and to safeguard financial stability.

3. In the EU, GDP growth also weakened in the first half of 2008. Subdued economic activity is expected also in the second half of 2008, reflecting in part the weakening of global growth and elevated commodity prices, the deeper and more prolonged financial turmoil and a housing correction in several EU countries. These developments caused confidence to deteriorate, capital costs to increase further and consumer price inflation to surge, putting a brake on domestic demand. Meanwhile, declining world demand and the strength of the euro together with other factors have weighed on external trade. The near term outlook for GDP growth is relatively weak and it may take some time before growth returns to potential. The balance of risks is tilted to the downside, mainly due to external factors and the continued stress on financial markets. But the EU economies are generally better equipped than in the past to avoid a recession, due to reforms carried out in the past and overall healthy balance sheets.

4. Inflation in the EU has risen markedly over the past year, mainly due to the dual impact of soaring prices for oil and agricultural commodities which have impacted strongly prices of energy and processed foods. Headline inflation is projected to average 3.8% in 2008. The recent decrease in oil and food prices and the economic slowdown together with the base effects turning favourable, should contribute to alleviate inflationary pressures and inflation could be at a turning point. Inflationary pressures have started to moderate in a number of countries, partly reflecting a marked decline in energy and other commodity prices. Inflation expectations are diminishing and remain anchored to price stability. The recent intensification of the financial crisis has augmented the downside risks to growth and thus has diminished further the upside risks to price stability.

5. In this context, it should be ensured that inflation induced by higher prices of oil, food and other commodities does not become entrenched in inflation expectations. It is important to avoid second-round effects on wages and prices, also taking into account the still high levels of capacity utilisation and relatively tight labour markets in several countries. Our major policy response to the current energy shock facing the EU economy must be one that facilitates the structural adjustment towards a low carbon and highly energy-efficient economy. Measures to mitigate the impact of high oil prices should focus on the poorer sections of the population and remain short-term and targeted. It is equally important to avoid policy interventions that distort prices and therefore prevent economic agents from undertaking the necessary adjustments. The transparency of oil markets should be improved. Beyond any short-term measures, it is essential to continue to pursue an active policy to improve energy efficiency and encourage energy savings both at the EU and Member States' level.

6. Key challenge at the current juncture is to restore confidence in financial markets and to safeguard financial stability. It is also important to ensure sound macroeconomic policies and continue to pursue structural policies aimed at raising potential growth and employment and improving the resilience to adverse cyclical developments. Sound macroeconomic policies, in line with the Stability and Growth Pact are essential to enhance EU's growth potential and to create more room for manoeuvre in economic downturns and, in addition, reduce public debt levels before the budgetary effects of ageing set in. With sound budgets, a return to price stability and continued structural reform, the EU economy will be on track to continued robust growth after the current adjustments. Moreover, the EU will continue to promote the openness of markets and work to deliver the adequate response to energy- and climate-related challenges.

7. The EU coordinates its responses, taking into account national specificities. In this context, the EU addresses macroeconomic and structural policies, financial markets as well as external aspects:

a) Restoring confidence in financial markets

- One year into the financial turmoil, important financial markets continue to suffer from low liquidity. Throughout the current financial crisis, central banks have engaged in continuous close consultation and have cooperated in unprecedented joint actions such as the provision of liquidity to reduce strains in financial markets.

- In this context, the ECB, together with the Federal Reserve, the Bank of Canada, the Bank of England, the Sveriges Riksbank and the Swiss National Bank, has announced reductions in key policy interest rates on 8 October. The Bank of Japan has expressed its strong support of these policy actions.

- A key priority in the international agenda is to continue our efforts to restore confidence in the markets, inter alia, by fully implementing the recommendations made by the FSF and the ECOFIN roadmap. This said, important progress has been made at both the international and European levels in all of the four priority areas for policy action identified by the FSF recommendation and the October 2007 Ecofin Roadmap. At EU level this progress will translate in concrete proposals What is needed includes:

- Financial institutions should continue to make efforts to improve disclosure of their exposure to risks, and those efforts still need to be properly addressed by banking supervisors;

- To further strengthen the existing prudential framework and risk management in the financial sector, in the context of the revision of the Capital Requirement Directive (CRD), covering important areas such as risk management, supervisory framework for cross-border groups, preparing for crisis management and enhanced requirements for risk-transfer activities;

- To ensure that the risks associated with the Originate and Distribute Model are properly mitigated;

- To improve the functioning of markets, including transparency and the incentive structure, also addressing the issues of conflict of interest raised in respect of credit rating agencies;

- To improve valuation standards. Work is ongoing at international level to ensure that the financial reporting framework functions properly with clear guidelines on valuation methods for financial instruments and related disclosure that can be applied consistently across institutions;

- To monitor the potential pro-cyclical effects of the prudential framework and assess whether remedial measures are needed.

The EU member states also continue working on the improvement of its supervisory and crisis management framework so as to make further progress in the convergence of key supervisory rules and standards in the EU as well as in the supervision of cross-border groups. To this effect, the ECOFIN Council has adopted roadmaps for policy action, which are broadly on track and in the process of being adopted. A new Memorandum of Understanding on cooperation for financial stability, preparing for the management of cross-border crises was signed in June 2008 among the relevant authorities. It is also important to promote convergence of the Deposit Guarantee Schemes in the EU. In this respect, the Commission will urgently bring forward a legislative proposal and the Ecofin Council already agreed that all Member States would, for an initial period of at least one year, provide deposit guarantee protection for individuals for an amount of at least 50 000 euros, acknowledging that many Member States are determined to raise their minimum to 100 000 euros.

As a short-term and urgent complement to the implementation of the Ecofin roadmaps, the Ecofin Council also designed other immediate responses to the current troubled situation in the financial sector:

- Finance Ministers agreed to support systemic institutions including through recapitalisation, in a coordinated manner. To protect the depositors' interests and the stability of the system, they stressed the appropriateness of an approach including recapitalisation of vulnerable systemically relevant financial institutions. The EU Member States are prepared to act accordingly, following common principles (including timeliness of intervention, protection of tax payer's interest, recognition of the responsibility of the management and of the shareholders, legitimate protection of the interests of competitors).

- Taking note of the flexibility in the application of mark to market valuation under IFRS outlined in recent guidance from the IASB, the EU will seek to apply this new guidance immediately.

- The Council also welcomed the Commission's continued commitment to act quickly and apply flexibility in state aid decisions and to develop guidance on this issue in the context of the turmoil.

b) Supporting growth in a sustainable manner - macroeconomic and structural policies

- The EU economic policy strategy remains oriented towards improving the conditions for non-inflationary growth and job creation. At the current juncture, safeguarding price stability and contributing to restoring an environment supportive to monetary policy is important. In the EU, public finances have been improving in general, with the average budget balance improving from a deficit of 1.4% in 2006 to a deficit of 1.1% of GDP in 2007. EU Member States are committed to meet their medium-term objectives in line with the Stability and Growth Pact. The EU has a solid budgetary framework and overall the budgetary situation has recently improved, thereby providing more room for manoeuvre in many Member States. Therefore, the relatively large automatic stabilisers in the EU can help cushion the slowdown; while respecting the 3% of GDP deficit threshold. In countries facing a more a severe slowdown, and where room of manoeuvre exists, temporary and targeted measures may be taken, notably towards those most affected by the current economic situation. Prudent fiscal policies remain essential, in particular in view of the challenges of population ageing.

- The re-launched Lisbon strategy reinforces the Union's priorities of achieving growth and employment by promoting knowledge and innovation, unlocking business potential and attracting more people into the labour market and creating more jobs. The structural reforms have had positive effects. In particular, the overall positive labour market developments suggest that structural reforms have improved the functioning of labour markets. Nevertheless, strengthened reform efforts are needed in many countries to achieve higher rates of sustainable growth and employment creation in the long run and to cope with the challenges of globalisation and of ageing.

- Progress in implementing structural reforms in product, labour and services markets will strengthen the resilience and adjustment capacity of the economy through increased flexibility and by increasing growth potential. In particular, reforms in product and service markets - notably in retail services - are aimed at safeguarding competitive prices, thereby supporting the purchasing power. Also, improved labour market flexibility, and mobility can contribute to a quicker adjustment of the economy. As regards the services markets, the adoption of a new EU directive on services is a major step towards the deepening of the internal market. Progress is also being made in enhancing the integration of European financial markets in the context of the Financial Services Action Plan. The European Investment Bank (EIB) will adopt a series of reforms to strengthen its financing of SMEs.

c) Contributing to a more favourable international environment

- In spite of a partly cyclical easing, global imbalances remain an important challenge. All major countries and economic areas have to play their part to resolve them in a manner compatible with sustained global growth. This is a joint responsibility. Some progress have been made in the implementation of the policies agreed multilaterally, but more needs to be done - including increased savings in the US (both public and private); growth-enhancing structural reforms in the EU and Japan; measures to increase domestic investment in oil exporting countries, increased consumption as well as the full use of exchange rate flexibility in some emerging economies with large surpluses. Action to mitigate the impact of the current financial turbulence should not risk aggravating these imbalances. The IMF should continue to follow and assess developments and the implementation of the agreed strategy through its surveillance activities.

- On international trade policy, the EU remains fully committed to constructively pursuing the Doha negotiations with a view to reaching an ambitious, balanced and comprehensive agreement. Maintaining and strengthening the multilateral trade system based on the WTO is of key importance for growth and employment prospects of the global economy, as well as for development.

- An effective, efficient and equitable response to the challenges of climate change and its economic consequences require international collective action. Through an integrated and harmonised approach to climate and energy policy, based on cost-effective competition, diversification of sources, subsidiarity and cooperation between Member States, the EU is committed to transforming Europe into a highly energy-efficient and low greenhouse-gas emitting economy. We invite all countries to contribute on the basis of differentiated responsibilities and respective capacities. In most of the world energy use is much less efficient than in the EU, due to *inter alia* lack of or inappropriate oil and carbon pricing and regulation, and there is substantial scope for increasing energy efficiency and avoiding waste, thereby at the same time mitigating emissions, improving energy security and enhancing economic development. The development of emissions trading and the creation of a global carbon market can play a powerful role in achieving cost-effective emissions abatement in developed and developing countries. A key challenge in promoting environmental sustainability will be to ensure that this transition to a low-carbon economy is handled in a way that is consistent with sustainable development, especially in developing countries, competitiveness, security of supply, as well as sound and sustainable public finances.

IMF Medium-Term Strategy

8. EU Member States welcome the progress made over the last months in restructuring and refocusing the IMF. They fully support the Managing Director's efforts to fully implement the reform agenda of the Medium-Term Strategy, and will continue to contribute constructively towards finding an agreement on the remaining open issues. As a result, we are confident, the IMF will be in a much better position to fulfil its mandate by better responding to member's evolving needs and addressing the new challenges posed to the global economy in the 21st century.

Lending framework

9. Over the course of time, and in response to new types of financial crisis and evolving needs of members, the IMF’s lending mechanism has turned into a broad catalogue of facilities and financing terms. Despite the variety of lending instruments, the demand for financing in the last few decades concentrated on a small number of facilities. In addition, the

present cost structure of IMF lending provides incoherent incentives regarding the volume or duration of Fund loans. EU Member States welcome the review of the IMF's financing role, and are looking forward to a broad and thorough discussion. A reform should aim at enabling the IMF to better respond to countries' adjustment needs by establishing an integrated and consistent lending framework that sets appropriate incentives and enhances the reputation and mandate of the IMF, while preserving the revolving nature of IMF resources as well as its catalytic character.

10. We underline that the approach should be comprehensive, including lending instruments, charges policy, reserve policy, the level and maturity of access and criteria for exceptionality. In developing reform proposals it needs to be taken into account how these issues interrelate, and individual questions should not be isolated from what they may imply for other areas:

- Regarding *instruments*, the reform should aim to simplify and streamline the lending framework in order to provide clear signals to the markets, reduce its complexity, and strengthen its effectiveness, while enhancing the flexibility and adequacy of IMF financing. This may imply eliminating instruments, and we agree that in particular the CFF is a candidate in this respect. The outlined new instruments raise a number of questions regarding their design, their consistency and how they relate to the IMF's mandate, which require further discussion.

- *Conditionality* should be tailored to countries' adjustment needs, but safeguarding the Fund's resources remains key. Also, the principle of uniformity of treatment needs to be preserved. We do not see a role of the IMF in using collaterals, primarily since it does not fit into the IMF's mandate; also, in case of crisis, typically there is a lack of usable collaterals.

- We are ready to consider increasing *access limits* as part of the reform package. In particular, the discussion should take into account the exceptional access framework the policies on maturities and charge, and the need to set up proper incentives for an early reimbursement of IMF resources.

Surveillance

11. Surveillance is the core competence of the IMF, and particularly relevant in the present economic context. The 2007 Surveillance Decision over member's policies was a major step in refocusing and reinforcing the IMF's surveillance framework, and we encourage management and Board to ensure the effective and even-handed implementation.

12. EU members welcome the Triennial Review of bilateral surveillance, and broadly share the analysis presented in it. The priority areas identified in the review are indeed those where further improvement is most warranted:

- Regarding *risk assessment*, we agree that the analysis should be improved. However, prudence is needed in communicating the results, so as not to provoke adverse market reactions. The objective of risk assessment should be to identify imbalances and vulnerabilities at an early stage, to promote focussed corrective action.

- On *financial surveillance*, a better integration of financial sector and macroeconomic stability issues in the surveillance activities, including on the transmission channels between real and financial sectors, is key. Notably, the findings of FSAPs should be better integrated into Article IV reports. This could be complemented by a strengthened collaboration and synergy with the FSF and other international bodies.

- A strengthened surveillance of the *multilateral dimension* – in regional and multilateral terms - is necessary to take into account the impact of globalisation and the increased spill-over effects. In this respect, we welcome the recent steps taken to strengthen the analysis of cross-country issues and of linkages between national and international policies, and we encourage the IMF to continue along this road.

- The assessment of a member's *external stability* should not be restricted to exchange rate developments. We encourage the IMF to ensure that its analysis remains comprehensive, taking into account the overall macroeconomic situation and established macroeconomic and structural policies. Emphasis should be on the consistency and sustainability of the overall policy mix.

- On surveillance over *exchange rate policies*, we welcome the guidance provided by the Managing Director on the operational aspects; however, the upcoming revision of the guidance note should also address the operational aspects for currency unions. We expect that the ad hoc consultation procedure will contribute towards formalising and facilitating intensive discussions with the members concerned, as a complement to the regular Article IV consultations. This should enable staff and management, with appropriate involvement of the Board, to strengthen the exchange rate oversight mandate of the IMF and to come to final conclusions within a limited timeframe, which is key for an even-handed implementation. We fully support plans to strengthen the analytical tools for exchange rate assessments, as state-of-the-art analysis is a pre-condition for the IMF's credibility.

- We encourage the IMF to maintain the systematic reporting on the *follow-up to past surveillance advice* in Article IV reports, as this is a valuable instrument to assess the effectiveness of IMF surveillance and policy advice.

13. EU members welcome the statement of surveillance priorities forwarded by the IMF as an important step towards strengthening the focus of the IMF's surveillance. The objective of the statement is to set an appropriate frame in which the IMF's surveillance activities can be assessed. Towards this end, the priorities need to strike the right balance between being too vague to be relevant and too specific to be flexible. In the current macro-economic environment, financial sector surveillance is of particular relevance. For its implementation, the SSP should set out the respective responsibilities and the division of labour between staff, Board and IMFC, and should not lead to an increase in administrative burden. We encourage the Managing Director to report regularly on actions towards the surveillance priorities and on progress attaining them. To take into account a changing global economic environment, the surveillance priorities should be reviewed regularly.

Role of the IMF in LIC

14. Over the last years, the macroeconomic situation in many low income countries (LIC) has improved notably. At the same time, the changing global economic environment has created new challenges, which are currently accentuated by deteriorating global economic conditions. In this context, EU members welcome the strategic review of the IMF's role in low income countries (LIC), aimed at better responding to LIC's evolving needs. As a result, the IMF's engagement with LIC, involving surveillance, policy advice, capacity building and

access to financial assistance, including related conditionality, should become more focussed and effective. It should consider the implications of increasing volatility in commodities and financial markets to which many of these countries are particularly vulnerable. An important part of the exercise is an improved collaboration with development partners, notably the World Bank, drawing on the institutions' different expertise.

15. The work of the IMF in LICs should focus on its core competences, namely helping LIC to achieve and maintain macroeconomic stability and sustainable economic growth that are essential for further progress towards the Millennium Development Goals. This should include a strengthened emphasis on debt sustainability analysis, taking into account that countries increasingly find sources of external financing other than the IMF.

16. Modifications of the instruments targeted to LIC should be consistent with the objectives of the overall review of the IMF's lending framework. In this context, EU members welcome the modifications to the Exogenous Shock Facility that will allow LIC a more rapid access under a streamlined conditionality to address current macroeconomic shocks. Also, the PRGF has proved its adaptability in the context of the ongoing food and oil crisis by allowing a swift and timely answer in a number of countries already under programme. After the review, the set of instruments targeted to LICs should support macroeconomic and financial stabilization of these countries in a way adapted to their needs.

Income model

17. We call for the full implementation of the 2007 revised financing model, and support the proposals put forward to broaden the IMF's investment mandate. This will contribute to putting the IMF's income on a sustainable and robust footing.

18. We welcome the proposals on a new methodology for assessing the desired levels of precautionary balances.

Governance

19. The report of the Independent Evaluation Office (IEO) on IMF corporate governance raises a number of complex and interrelated issues that will require further discussion at different levels, involving the Board, staff and management, IMF members as well as other stakeholders. As outlined in the work plan proposed by the Executive Board Working Group, the questions raised by the IEO should be addressed in a coherent way, taking into account priorities and existing initiatives. We will contribute constructively towards finding appropriate responses in order to improve the functioning of the IMF. We would welcome a clearly set out timetable for how the view of the experts' group, the Board Working Group and others will be used to establish a set of reform proposals.

Sovereign Wealth Funds

20. EU Member States welcome that an agreement has been reached by the International Working Group on Generally Accepted Principles and Practices (GAPP) for Sovereign Wealth Funds (SWF). The GAPP should provide the basis for the operation of SWF, based on good corporate governance and transparency. Thus, they are an important contribution towards strengthening confidence in SWF, contributing towards maintaining an open investment environment and the efficient functioning of global financial markets. We

encourage the establishment of a committee or regular forum to ensure that the dialogue on SWF remains open and that the implementation of the GAPP is monitored.

21. EU Member States acknowledge that the process of confidence building is a two-way exercise that also builds on the commitments of recipient countries. In this context, we are fully committed to the work of the OECD in identifying investment guidelines for recipient countries, so as to ensure a proportional, non-discriminatory, predictable, transparent and accountable investment framework.

AML/CFT

22. EU countries remain committed to implement strong programs against money laundering and terrorist financing and place a high value on the contributions of the IMF and the World Bank to the global AML/CFT architecture. We call on the IMF and the World Bank to continue to closely cooperate with the FATF. We support the measures undertaken by the FATF to protect the international financial system from the risk of illicit finance including by ensuring enhanced scrutiny of transactions with countries with AML/CFT regimes' deficiencies, and issuing guidance on the implementation of relevant UNSCRs to counter the proliferation of weapons of mass destruction. As the past has shown the IMF can fulfil an important role in reaching out to members to support the implementation of the global standard. We encourage the IMF to continue to play this role.