International Monetary and Financial Committee

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April 16, 2005

Statement by Mr. Breton
French Minister of Economy, Finance and Industry

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AT THE ELEVENTH MEETING OF THE

INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE

April 16, 2005
Washington, D.C.

Dear colleagues:

The global economic environment has remained broadly favorable since our last meeting. Of course, risks are still present, notably the surge in oil prices and the persistent macroeconomic imbalances, which threaten growth and financial stability.

We know what needs to be done, however, and it is reassuring that the political authorities in our countries are able—that we are able—to take the necessary action, contrary to the common perception that governments no longer have any influence. I reject this defeatist ideology. If we act together, concerted political efforts can change the course of events. The International Monetary Fund has a decisive role to play in the quest for global prosperity, for the IMF is the beacon that sheds light on emerging vulnerabilities and promotes the necessary corrective measures.

I. CONCERTED EFFORTS TO MANAGE MACROECONOMIC RISKS AND FINANCIAL VULNERABILITIES.

A. Jointly manage the macroeconomic risks that hamper global growth.

Since the last meeting of the International Monetary and Financial Committee, the global economy has slowed, but growth has held firm and the outlook is still favorable.

The economic outlook described by the IMF, if confirmed, seems encouraging overall. In 2005, global activity is expected to hold steady in emerging countries and industrial countries, albeit slowing down from the record levels achieved in 2004. In particular, the emerging Asian economies are expected to record a particularly moderate slowdown, following in the wake of the Chinese economy. U.S. macroeconomic policies are likely to be even less conducive to growth, but rising wages and the sound financial health of businesses should ensure continued buoyancy for the U.S. economy. In the euro area and in Japan, domestic demand is expected to strengthen very gradually.

If we are to achieve strong and well-balanced global growth in the near future, however, we must work together to assess the risks we face.

First, consider the rising price of oil: while the effects of the oil shock are less severe now than they once were, they remain significant in industrial countries and arguably even more substantial in the nonoil emerging and developing countries. Second, consider the global macroeconomic imbalances which, in a worst case scenario, could lead to disorderly exchange rate fluctuations and an abrupt upturn in interest rates, which today are exceptionally low.

The members of the international community must take a cooperative approach toward managing these risks.

The major economic zones hold a special responsibility in this regard. The IMF's strategy for fiscal consolidation in the United States, structural reforms in Europe, and greater exchange regime flexibility in Asia are steps in the right direction. Reducing the U.S. current account deficit will first require boosting U.S. saving, both public and private. Government finance must be returned to a sustainable footing—any U.S. commitment in this regard is welcome—and furthermore, an increase in the household savings rate would be desirable. Ongoing monetary tightening would help to achieve this goal. Greater flexibility in the Asian currencies is also called for: if the chosen parity is not ideal, a fixed exchange rate may lead to price distortions, intensify protectionist pressures, and heighten the volatility of other currencies that float against the dollar. The euro area would have difficulty coping with such volatility.

Structural reforms are needed in Europe to enhance growth, and France is doing its part, as always. After the pension reforms in 2003, followed by the health care reforms last year, we are now pursuing labor market reforms designed to boost overall labor market participation, particularly by young people, the unskilled, and older people, through financial incentives to encourage individuals in these categories to work, and by easing payroll taxes on those earning the lowest wages. Furthermore, the reform of the product market—particularly the liberalization of France's network industries, which began in 2004—is ongoing. Finally, there is a new focus on supporting cutting-edge businesses and R&D. The French government is continuing its fiscal consolidation efforts and pressing ahead with government reform. Achieving these goals will require a high degree of expenditure control, a system of management by objectives, and improved productivity in government services.

However, as various economic studies have shown, structural reforms in the EU can only make a marginal contribution to overcoming global imbalances.

The euro area's external position is, in fact, nearly in balance. The low growth in Europe in recent years cannot be held responsible for the imbalances across the Atlantic. Of course this should not stop us from moving forward with our reforms to enhance growth potential in Europe; such reforms are essential if we are to derive maximum benefit from economic globalization and confront existing risks. Still, the solution to the macroeconomic disequilibria needs to come from domestic adjustments in the United States, in particular increases in public and private saving.

Regarding oil prices, oil-producing countries and oil-consuming countries need to work together in an environment in which high prices appear to reflect a long-term mismatch between supply and demand, and not just a reflection of short-term factors.

Given that pressures on the oil market are expected to continue in the long term, short-term solutions, such as raising production within the limits of existing capacities or mobilizing stocks, will not be sufficient. Instead, we must look for ways of increasing the supply, which will require fresh investment in production and refining to prevent bottlenecks. Greater market transparency is also necessary, and progress has been made in this direction in recent months. However, these efforts will fall short unless we can gradually reduce the oil-intensive nature of economic growth. Many policies can help: introducing energy-saving technologies; developing renewable and alternative sources of energy; and adopting incentives for less extravagant consumption.

B. Collective efforts in support of greater financial transparency—a prerequisite for stability—must continue.

The international financial system has bounced back from numerous shocks; nonetheless we must remain vigilant.

This resilience is attributable to world economic growth, the recovery of the financial markets, and the improving financial situation of households, businesses, and financial institutions in many countries. With global growth that has held steady overall, financial stability is likely to go on improving.

The situation, then, is broadly favorable, but we should not relent in our efforts to identify the potential risks that may lie in store for us at some point in the future.

Some assets have increased substantially in value in recent years, rising to very high levels today. The surge in global liquidity that has underpinned growth in recent years has been accompanied by rising bond and real estate prices, and a sharp drop in risk premia. The improvement in fundamentals, and in the macroeconomic situation in particular, is a major reason for these changes. The fact remains, however, that certain market segments may have been overvalued as a result of easy credit. That is why we must remain vigilant.

Household exposure to financial risks has grown sharply, particularly in some countries. Increased indebtedness and higher financial saving theoretically enable households to smooth out their consumption throughout their life cycle, and allow monetary policy to act on the economy more readily. On the downside, the increased popularity of certain financial products may have strong procyclical effects, by making households highly vulnerable to stock market developments, and may trigger uncontrolled risk transfers—both by supervisory authorities and by transactors misinformed as to the risks they have incurred—with the danger that the recessionary effects of the shocks on rates would be dampened, given that households have less absorption capacity than financial institutions. Accordingly, high-risk financial products have come to account for a larger share of household savings, with the gradual disappearance of defined-benefit pension funds. In some countries, such as the

Netherlands, the United States, and the United Kingdom, pension saving represents over 60 percent of GDP, and over half is invested in equities through pension funds. The situation of French households is atypical and less worrisome, given their low rates of indebtedness and minimal savings invested in equities, even though real estate prices remain a concern. These changes reflect a growing transfer of risks toward households which, depending on the situation, could have a favorable impact on financial stability and growth, or otherwise result in harmful consequences.

The most recent meetings of the Financial Stability Forum and FATF have made headway in regard to the transparency of the international financial system.

The work on credit derivatives and the current research on transparency in reinsurance have contributed significantly to this progress. Other key issues are still on the agenda. In this respect, I welcome the IMF's work on hedge funds and agree with the Fund's conclusions concerning the need to set rules regarding disclosure of information.

I also applaud the significant progress made at the meeting of the Financial Stability Forum in Tokyo last month to strengthen the supervision of offshore centers and enhance international cooperation. The establishment of a group to look at the results achieved as well as any lingering deficiencies (or even backsliding), with the aim of keeping the public informed, is a major step forward. Our goal should be to avert potential systemic risks, to bolster savers' confidence, and to prevent some of these centers from being used as a channel for money laundering and terrorist financing. Naturally, the IMF has a key role to play in this surveillance of offshore centers. Further efforts should be made to identify relevant criteria for financial intermediaries.

The quest for heightened transparency also helps to prevent the use of the international financial system for criminal or terrorist purposes. As Chair of FATF, France is throwing its weight behind this endeavor. The adoption of a new FATF special recommendation on cross-border movements of cash in October 2004 is a major development in this respect. So is the initiation of China's membership process, as this will mean that a major new player can become involved in the development and application of standards. France is committed to ensuring that the cooperation between FATF and the IMF will continue. The assessment of national mechanisms is a vital tool in this respect. However, to be successful, this exercise must focus on determining the actual effectiveness of the mechanisms used, based on their results, particularly in terms of international cooperation. The IMF should lend its unqualified support to this endeavor. Furthermore, discussions must continue on safeguarding payment systems, with particular reference to the risks associated with the excessive use of cash and the inadequate supervision of companies engaged in funds transfers, electronic remittances, and check cashing.

II. THE PIVOTAL ROLE OF THE IMF IN THE INTERNATIONAL FINANCIAL SYSTEM AND VIS-À-VIS DEVELOPING COUNTRIES MUST BE REAFFIRMED.

A. Strengthening the institution.

First of all, governance and management.

Strengthening the institution's political legitimacy, which ultimately rests with the member country governments, is a vital concern. That is why the Articles of Agreement envisaged a Council comprised of ministers, which was to give advice to the Board. The establishment of the IMFC was a step forward, but it lacks the authority intended by the Articles of Agreement. This reform needs to be carried through to its conclusion. Achieving this enhanced legitimacy will also require management procedures to generate better information for the Board and IMFC and ensure accountability for Management. In this regard, internal controls need to be strengthened and a Board audit committee should be set up.

Furthermore, the question of ensuring fair representation for each member needs to be resolved. Low-income countries have an insufficient voice, both because voting rights are calculated strictly on the basis of each member's Fund quota and because they do not have enough seats on the Board. Solutions might include a limited and proportionate increase in the number of Board seats (two, for example) as well as greater basic voting rights. Action must be taken to address the problems facing the emerging countries, whose share of the global economy has increased, without an adequate, corresponding shift in the Fund's structure. The necessary reforms could be considered once agreement is reached on a fairer and more transparent quota calculation formula and a general increase reflecting trends in the world economy.

Surveillance and crisis prevention instruments must also be strengthened.

Considerable headway has been made in the area of surveillance, with the development of regional surveillance procedures, the launching of the so-called balance sheet approach, which should help pinpoint the vulnerabilities in our economies, financial system surveillance, and the development of a new framework for debt sustainability analysis for poor countries.

Nonetheless, we should consider three areas where there is room for improvement. First, there is the matter of how surveillance is organized, and the need for independent views—views that come from outside the area departments. We need to strike the right balance, possibly through an increased role for the Policy Development and Review Department, as well as more direct information for the Executive Board on the different staff analyses. Second, there is the question of the scope of surveillance. Progress in focusing on exchange rate issues—long ignored, despite their centrality to the Fund's mandate—is welcome but must be strengthened. Furthermore, the Fund's jurisdiction should be broadened to encompass capital account issues, so as to facilitate orderly capital account liberalization. Last but not least, the question of the Fund's insurance function can no longer be overlooked. We favor the establishment of a precautionary facility,[1] intended to send signals regarding the caliber of chosen policies and to provide massive and immediate support in the event of a crisis in order to keep it from spreading. Some, I know, fear that such an instrument will put excessive strain on the IMF's resources and increase its already high credit concentration.

[1] Such an instrument did exist, but it was poorly designed, had no takers, and was discontinued in November 2003 (Contingent Credit Line).

Indeed we must be attentive to this, and answers must be provided in the context of crisis resolution efforts.

The work on crisis resolution should not be allowed to languish; recent experience shows that the IMF lacks the necessary tools to discharge its responsibilities within its own particular environment.

The IMF's exposure could be better managed if we could better define its crisis resolution procedures. Progress has been made with the adoption in 2003 of a framework providing "exceptional access" to Fund resources. Moreover, the collective action clauses that are increasingly common in sovereign bond issues should ultimately lead to a more orderly debt restructuring process. Lastly, the Principles for sovereign debt restructuring developed last year by a number of emerging countries and the main investor associations have been welcomed by the G-20.

However, numerous questions remain. We know that collective action clauses are inherently limited, as they do not address claim aggregation and creditor coordination difficulties or the stock of debt existing prior to their use. The Principles only partly answer this question because they do not address the central question of the IMF's role. A review of debt sustainability and an assessment of the good faith criterion—key factors in the implementation of the IMF's lending into arrears policy—is the IMF's responsibility: what would happen if a restructuring agreed between a country and its creditors were incompatible with the debt sustainability review and resulting macroeconomic framework in the IMF program? Furthermore, the assessment of the good faith criterion has given rise to objections that justify having the Fund reconsider its design and implementation. When we talk about the role of the Fund, what we are really talking about is the institution that ensures that the ground rules of the international financial system are followed. Take that away, and you've undermined one of the lynchpins of the system—namely, mutual confidence between creditors and debtors as reflected in contract compliance.

The Fund's role in crisis resolution implies that its structure and financial leadership must be strengthened. In light of the steadily increasing risks and risk concentration, France has voiced its support for a number of additional policies: strengthened risk management, in order to gauge the likely impact of default in the event of exceptional access, while further strengthening the IMF's reserves; increasing IMF resources; and ensuring that debtors show due regard for the IMF's preferred creditor status. For these same reasons, France is opposed to measures that might weaken the financial position of the Fund, such as gold sales to finance debt forgiveness or any waiver of claims not based on objective debt sustainability criteria, except as a last resort after all other solutions and contributions have been attempted, and if financed by bilateral contributions in order to neutralize the cost to the IMF.

B. Strengthening the Fund's financial instruments for poor countries is now a top priority.

The Fund's role in poor countries has been one of the most controversial topics in recent times.

While there is broad consensus that policy advice and institution-building through technical assistance are IMF missions, a debate has begun regarding the Fund's financial assistance function in poor countries. This reflects a number of concerns: namely, that some countries might be forced to borrow when they are merely seeking a seal of approval for their economic policy, insofar as they do not have balance of payments problems. Over-borrowing in such cases would lead to unsustainable debt levels. Two main conclusions have been drawn from this assessment: we should avoid prolonged use of Fund resources by giving developing countries alternatives that involve signaling instruments; and grants and/or debt relief should be provided.

My view is that, if we focus once again on the IMF's principles, we will see that the Fund has a duty to engage financially with developing countries.

It is precisely because the IMF is a universal institution, and because its only resources are those which Fund members place at its disposal, that it needs to have instruments and policies that are suited to its entire membership. Consequently, we must ensure that the IMF has appropriate tools for responding to the specific needs of low-income countries.

Under these circumstances, we must first ask ourselves whether the Poverty Reduction and Growth Facility (PRGF) is a suitable tool and whether resources are sufficient to meet future needs. The answer to the first question is certainly yes. The answer to the second question at the present time is definitely no.

France does not share the view that the high degree of structural conditionality or the length and repetition of PRGF programs indicate that the Fund is going beyond its mandate. Of course, some features can be improved, but that is not the essential thing. What is essential is for the PRGF to meet needs associated with the specific characteristics of developing economies, characterized by ongoing and structural balance of payments requirements. But as the IMF has shown, these needs are not always associated with large current account deficits, as the latter are artificially compressed by external financing constraints. Account must also be taken of the link between macroeconomic stability and structural and institutional issues, which are particularly important for low-income countries. It is these two factors that provide the fundamental rationale for the PRGF.

Besides, developing countries need a concessional facility like the PRGF, perhaps even a facility that is more concessional, both because their repayment capacity may at times be limited and in order to protect social and growth-oriented spending.

Because I consider the PRGF to be essential, I must voice serious concern about the financial impasse that will soon befall this instrument. As matters currently stand, only SDR 660 million will be available as of 2006, even though SDR 1 billion will be required. It is

therefore imperative that the IMF and its members make the necessary decisions to ensure continuity of financing for the PRGF at this level.

Furthermore, developing countries are particularly vulnerable to shocks, as shown by the current situation of the African cotton-producing countries. The IMF itself has determined that specific financial assistance is necessary. The PRGF is not right for all situations—if a country is not covered by a program under the PRGF at the time the shock hits, there is not enough time at that point to negotiate and implement a program; hence the need for a new instrument.

III. ENSURING DEVELOPMENT FINANCING, PARTICULARLY IN AFRICA, IS THE THIRD REQUIREMENT CALLING FOR COLLECTIVE ACTION BY THE INTERNATIONAL COMMUNITY.

A. Ensuring debt sustainability for developing countries in the context of a financing policy tailored to each country.

The top priority is to ensure full implementation of the Heavily Indebted Poor Countries (HIPC) Initiative.

France applauds the sizable increase in the number of countries benefiting from the HIPC Initiative which reached the completion point in 2004. France also welcomes the two-year extension of the HIPC Initiative decided on last year. However, there are challenges that must still be addressed. For the HIPC Initiative to be fully beneficial, additional debt relief at the completion point should be presumed necessary when debt ratios exceed the targets set by the Initiative. In particular, additional financing must be found in order to provide the resources needed to handle overdue obligations to multilateral institutions owed by countries that have not yet reached the decision point, namely Sudan, Liberia, and Somalia.

Suitable mechanisms should also be established to ensure the debt sustainability of countries that are not yet eligible for the HIPC Initiative, and of countries for which the Initiative has proven insufficient.

For non-HIPC countries, there is today—thanks to the Evian Approach of the Paris Club—a framework for dealing with the debt of non-HIPC countries facing unsustainable indebtedness. This approach allows Paris Club creditors to craft carefully tailored responses to the needs of each eligible country potentially facing an unsustainable debt burden.

Under certain conditions, ensuring debt sustainability may argue in favor of relief for debt owed to multilateral financial institutions.

For countries that have benefited from the HIPC Initiative, some of which remain vulnerable to exogenous shocks and whose multilateral debt is still significant, consideration should be given to an assistance mechanism that does not exist in the current framework. That is why France is ready to consider additional relief for HIPC country debt to IDA and the African Development Fund. Conversely, reducing HIPC countries' debt to the IMF is not a priority,

given that such claims form only a small part of the total debt and the need to focus on finding the additional resources necessary to ensure full implementation of the HIPC Initiative by the Fund.

Regarding the arrangements for new multilateral debt relief, France shares the view expressed by the multilateral institutions regarding key principles in the event of additional multilateral debt cancellation: equity, additionality, viability of IFIs, and aid effectiveness. In common with the IMF and World Bank, France further believes that debt sustainability should be considered in the context of the new analysis framework developed by these two institutions. France urges the Fund and the Bank to implement this framework rapidly. By working together with other donors, it will be possible to set a manageable ceiling, country by country, on loan-based financing and to determine the appropriate level of grants, taking account of the financing needs associated with the Millennium Development Goals (MDGs). The approach that we should take can be summed up as follows: as many loans as possible, as many grants as necessary to ensure genuine sustainability. This approach will help strengthen coordination within the donor community, including multilateral donors. Last but not least, it is necessary to distinguish the question of debt sustainability for poor countries from the broader issue of development financing, precisely because the restoration of debt sustainability is a prerequisite—albeit not the only prerequisite—for achieving the MDGs.

B. Mobilizing additional resources.

But beyond debt, the real problem is one of mobilizing additional resources for development.

Debt relief—not sufficient in and of itself—must be supplemented by the mobilization of additional development resources. The resources freed up by debt relief fall far short of needs: on average, the debt service for HIPC countries is 2 percent of GDP, while the additional resources needed to finance the MDGs amount to 20 percent. It is thus clear that once debt is brought down to a sustainable level, the MDGs can be achieved only by mobilizing additional resources, particularly through the use of innovative mechanisms.

Much work remains to be done to ensure financing for the MDGs and global public goods, because the resources mobilized at this stage are insufficient, notwithstanding the results that have been achieved.

The needs estimated by the World Bank and UN for reaching the MDGs—an additional $50 billion per year—are substantial. We are almost one-third of the way to 2015 and we are already falling behind, especially in Africa. Of all of the continents, Africa is still farthest from achieving the Millennium Development Goals.

Under these conditions, we not only need more resources, we need new kinds of resources.

We believe that the lack of stability and predictability in aid and financing is a major obstacle in the fight against poverty. That is why we must come up with new and innovative

mechanisms. An International Finance Facility (IFF) or global taxes are not merely theoretical tools; rather, they are practical, complementary ways of raising additional resources.

There are several options for possible taxes, with their respective advantages and disadvantages. These need to be studied in detail. Possible approaches include an aviation tax, implemented at the national level but coordinated at the international level. This sector pays few taxes, as aviation fuel is exempt from excise taxes and is not covered by the Kyoto Protocol, even though it contributes significantly to global warming. The aviation sector is facing a number of short-term difficulties, but its growth outlook is strong.

The joint IMF/World Bank report on innovative financing mechanisms prepared for these meetings has shown that these various issues, including the tax options, deserve closer attention. Last February, France and Germany made a joint proposal at the meeting of the G7 Finance Ministers, with a view to implementing a pilot project for tax aviation. France is determined, together with its partners, to build consensus on these issues, particularly at the G7 summit in June 2005 and at the UN General Assembly in September 2005.