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**Statement by Mr. Peter and Mr. Tola on 2021 External Sector Report
(Preliminary)
Executive Board Meeting 21/73
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The External Sector Report (ESR) is a key tool to guide the discussion on global imbalances within a multilaterally consistent framework. We thank staff for the 2021 ESR. This year's edition provides important insights on the impact of the crisis and of the global response on external developments as well as valuable inputs regarding the outlook.

Assessing current account balances within a multilateral framework, accounting for both domestic and foreign factors, remains essential. The fiscal response to the pandemic has had a significant impact on global imbalances and will continue to influence them over the medium term. The report underlines the role of fiscal policy as a driver of the widening global imbalances in 2020 and possibly in 2021/2022. In this context, we very much agree with the report's conclusion that current account balances cannot be analyzed from a domestic point of view only and that foreign factors and policies—especially those of major trading partners—can have a significant impact on other countries' current account balances.

External rebalancing should rely first and foremost on eliminating structural distortions and promoting sound macroeconomic policies. The fiscal consolidations required in many countries in the years ahead should lead to some degree of rebalancing, although with uncertainty on the path and timing, as shown in Chapter 2. In the medium term, however, fiscal policy is only one part of the story. The ESR should clearly mention that some current account surpluses and deficits are warranted and healthy, and that external rebalancing should thus target excessive imbalances that are driven by unwarranted or unsustainable policies. Clear communication on this issue is key.

The ESR could benefit from the adoption of a more holistic approach. We regret that the report continues to rely heavily on current account balances to draw important conclusions. A

more holistic approach would provide more nuanced and robust external sector assessments. We see two main issues with the focus on current account balances:

- First, current account balances are difficult to measure. For example, country-specific biases due to measurement issues can be substantial. Meanwhile, the COVID-19 crisis has made the 2020 headline numbers even more difficult to interpret. Staff estimates that two thirds of the current account balance movements for major economies in 2020 are due to COVID-specific factors. The impact of these factors varies significantly across countries in terms of both composition and magnitude. Even after adjusting for COVID-specific factors, model residuals remain high and for some countries differ significantly from the last year's residuals, suggesting that important shifts in countries' current account balances are not being picked up by the model. In our view, this uncertainty should be reflected in staff's assessment.
- Second, mechanically linking the current account gaps to exchange rate valuations is not straightforward for many countries. Indeed, greater reliance on exchange rate models could significantly improve staff's assessments, especially in cases where the current account balance is a poor indicator of the exchange rate. This is especially true given the relatively short time horizon considered in the ESR and because year-on-year fluctuations in the current account balance may have little to do with changes in fundamentals. In this context, we urge staff to take the opportunity of the upcoming review of the EBA methodology to improve the exchange rate models. The inclusion of the exchange rate models would provide a more complete assessment across countries and over time and should thus be given the same weight as the current account model. This would help balance the shortcomings of all three models and improve the robustness of results. In this context, let us note that a deeper discussion and a normative assessment of stock imbalances would also be welcome and helpful.

As a matter of fact, staff has already adopted a more holistic approach in the current report but, as it seems, only in the case of Switzerland. Switzerland has one of the most negative current account gaps and associated gap ranges, as shown in Figure 1.15. According to established practice, this would normally imply an external position that is weaker than the level implied by fundamentals and desirable policies. Yet, staff departs from their usual approach and, based on a broader range of indicators, assesses the Swiss external position as in line with fundamentals, while the Swiss franc continues to be assessed as overvalued. To ensure evenhandedness, such a broader, more holistic approach should be systematically applied across countries and over time.

As regards the individual economy assessment for Poland, we are of the view that the estimated scale of the REER misalignment is overestimated. There is significant uncertainty about the medium and long-run effects of the pandemic crisis, which implies substantial uncertainty in the decomposition of the key variables of interest into the medium-term trend and the cyclical component.