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EXECUTIVE BOARD MEETING

SM/21/122
Correction 4

July 21, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **2021 External Sector Report—Chapter 3**

Board Action:	The attached corrections to SM/21/122 (7/1/21) and SM/21/122, Cor. 3 (7/16/21) have been provided by the staff:
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 10 and 21**
Questions:	Mr. Leigh, RES (ext. 34747) Mr. Rabanal, RES (ext. 36784)

Table 3.4. Brazil: Economy Assessment

Overall Assessment: *The external position in 2020 was broadly in line with the level implied by medium-term fundamentals and desirable policies.* In the wake of the COVID-19 shock, the CA deficit contracted due to the large currency depreciation and improvements in the service and income balances. The trend is expected to persist in 2021. **Potential Policy Responses:** Policies that would help keep the CA in line with its norm include desirable fiscal consolidation, accompanied by measures to support public and private investment, including structural reforms to improve efficiency and reduce the cost of doing business. FX intervention, including using derivatives, may be appropriate to alleviate disorderly market conditions in the FX market.	
Foreign Asset and Liability Position and Trajectory	**Background.** Brazil's NIIP was ~~−39~~−38 percent of GDP at the end of 2020, moderately stronger than at the end of 2019 (−42 percent of GDP) mainly due to valuation effects associated with the currency depreciation (assets are predominantly denominated in FX while liabilities are more concentrated in local currency). At the end of 2020 external debt declined by about 5 percent in nominal terms compared with 2019, accounting for about ~~45~~44 percent of GDP and 303 percent of exports, against a value of 36 percent of GDP and 299 percent of exports in 2019, with the large increase in the external-debt-to-GDP ratio in 2020 driven by the significant output contraction when measured in US dollars. **Assessment.** Brazil's NIIP has been negative since ~~2011~~2001. Short-term gross external financing needs are significant, at about 11 percent of projected 2021 GDP, with capital flows and the exchange rate particularly sensitive to global financing conditions.
2020 (% GDP)	NIIP: −38.5 | Gross Assets: 63.5 | Res. Assets: 24.8 | Gross Liab.: 102.0 | Debt Liab.: 44.6
Current Account	**Background.** The CA deficit contracted from −3.5 percent of GDP in 2019 to −1.7 in 2020 due to improvements in the trade, service, and income balances, supported, respectively, by the currency depreciation, the contraction in tourism and transportation service imports, and lower distribution of profits and dividends. In 2021 the trade balance is expected to continue to improve on the back of a recovery in economic activity in trading partners that would boost exports, more than offsetting the rebound in imports. Overall, the IMF staff projects a CA balance of about −0.4 percent of GDP for 2021. **Assessment.** In 2020 the cyclically adjusted CA balance was −1.6 percent of GDP. EBA estimates suggest a CA norm in 2020 of −2.4 percent of GDP. The IMF staff assesses a CA norm between −1.9 percent of GDP and −2.9 percent of GDP. Thus, after adjusting for the transitory impacts of the COVID-19 crisis on the oil; travel services, including tourism; and medical goods sectors (resulting in an impact on the CA balance of 0.3 percent, −0.3 percent, and 0.1 percent of GDP, respectively), the IMF staff CA gap is assessed at 0.9 percent of GDP. The medium-term outlook for the CA is still difficult to assess, given the unfolding COVID-19 crisis and related policy response.
2020 (% GDP)	CA: −1.7 | Cycl. Adj. CA: −1.6 | EBA Norm: −2.4 | EBA Gap: 0.8 | COVID-19 Adj.: 0.1 | Other Adj.: 0.0 | Staff Gap: 0.9
Real Exchange Rate	**Background.** After remaining broadly stable in 2019 (−1.9 percent), the REER depreciated sharply in 2020 (−20.6 percent), driven by large capital outflows in the first half of the year. Depreciation pressures have subsided since mid-May 2020. As of end-May 2021, the REER had depreciated by 3.5 percent compared with the 2020 average. **Assessment.** The IMF staff CA gap implies a REER gap of −7.1 percent in 2020 (applying an estimated elasticity of 0.13). The REER index (−36.6 percent) and level (−21.3 percent) methodologies point to some possible overshooting of the nominal exchange rate. Overall, the IMF staff assesses the REER gap at the end of 2020 to be closer to the REER gap implied by the IMF staff CA gap. Therefore, considering the CA norm standard error of 0.8 percent, the IMF staff assesses the REER gap to be in the range of −14.6 to 0.4 percent, with a midpoint of −7.1 percent (undervaluation).
Capital and Financial Accounts: Flows	**Background.** Net FDI has fully financed CA deficits since 2015 (averaging 3.2 percent of GDP during 2015–20, while CA deficits averaged −2.2 percent), despite net portfolio outflows (0.6 percent of GDP, on average, during 2015–20). In 2020 net FDI stood at 3.5 percent of GDP against a CA deficit of 1.7 percent. Net portfolio outflows accelerated sharply in the first half of the year before easing in the third quarter and then partly recovering in the fourth quarter, recording a balance of −0.9 percent of GDP over the year (−1 percent of GDP in 2019). Net FDI was stronger than in 2019 due to divestment abroad that more than compensated for lower FDI inflows. **Assessment**. The composition of capital flows is expected to remain favorable over the medium term, with positive net FDI inflows outweighing negative portfolio outflows that started in 2016 following the sovereign's downgrade to below investment grade. Nevertheless, the high degree of uncertainty about the scarring effects of COVID-19 on the global economy make it challenging to assess the medium-term prospects for capital flows. A renewed spike in international risk aversion, linked to a potential second wave of COVID-19, or a sudden tightening of global financing conditions could trigger a new bout of capital market volatility.
FX Intervention and Reserves Level	**Background.** Brazil has a floating exchange rate. In 2020 the central bank sold FX in the spot, repo, and FX swap markets in the amount of US$44.5 billion to dampen excess exchange rate volatility associated with the COVID-19 shock. Nevertheless, reserves remained high at US$356 billion at the end of 2020. **Assessment.** The flexible exchange rate has been an important shock absorber. Reserves are adequate relative to various criteria, including the IMF's reserve adequacy metric (161 percent as of the end of 2020) and serve as insurance against external shocks. The authorities should retain strong external buffers, with intervention limited to addressing disorderly market conditions.

Table 3.15. Korea: Economy Assessment

<table>
<tr><td colspan="8">Overall Assessment: The external position in 2020 was broadly in line with the level implied by medium-term fundamentals and desirable policies. The CA surplus widened from the 2019 level on account of a recovery in exports, lower oil prices, and narrowing of the service sector deficit and is projected to narrow slightly over the medium term as domestic demand recovers and transitory factors related to the COVID-19 shock recede.

Potential Policy Responses: To support activity following the COVID-19 outbreak, the authorities have deployed fiscal and monetary stimulus, of which a substantial part is expected to be temporary. Ensuring that the external position remains in line with medium-term fundamentals will require continued accommodative fiscal and monetary policies as well as structural policies to stimulate investment and facilitate rebalancing of the economy toward services and other new growth drivers. Desirable reforms include reducing barriers to firm entry and investment, deregulating the nonmanufacturing sector, and strengthening the social safety net to lessen the need for precautionary saving across sectors. Reforms in some of these areas are contained in the authorities' Korean New Deal, to be implemented over the next five years. The exchange rate should remain market determined, with intervention limited to preventing disorderly market conditions.</td></tr>
<tr><td>Foreign Asset and Liability Position and Trajectory</td><td colspan="7">Background. The NIIP has been positive since 2014. Data for 2020 imply that, in 2020, Korea's NIIP was 28.4 percent of GDP, with gross liabilities at 91.4 percent of GDP, of which about one-third was gross external debt. The NIIP declined by about 3 percent of GDP from the 2019 level, largely reflecting valuation effects resulting from a sharp rally in domestic equity prices in the second half of 2020. The NIIP is projected to rise to about 50 percent of GDP in the medium term on the back of CA surpluses and search-for-yield activity by financial institutions driven by asset accumulation for old-age consumption.

Assessment. The positive NIIP is a source of external sustainability. Foreign asset holdings are diversified, with about 36 percent held in equity or debt securities. About 60 percent of foreign assets are denominated in US dollars, implying that depreciation of the won could have positive valuation effects. The structure of liabilities limits vulnerabilities, with equity and direct investment accounting for about 60 percent of total liabilities.</td></tr>
<tr><td>2020 (% GDP)</td><td>NIIP: 28.4</td><td>Gross Assets: 119.8</td><td>Debt Assets: 31.0</td><td>Gross Liab.: 91.4</td><td colspan="3">Debt Liab.: 30.8</td></tr>
<tr><td>Current Account</td><td colspan="7">Background. The CA surplus in 2020 widened to 4.6 percent of GDP from 3.6 percent in 2019, driven by a rebound in exports since the third quarter of 2020 and a narrowing of the services deficit due to COVID-19 travel restrictions. The CA surplus has been trending down from the peak of 7.2 percent of GDP in 2015, reflecting a fall in savings, particularly for the household sector, and an increase in the investment-to-GDP ratio. Over the medium term, the CA surplus is projected to narrow slightly to 4.3 percent of GDP as export demand and the service sector balance normalize.

Assessment. The EBA model estimates the cyclically adjusted CA at ~~3~~4.3 percent of GDP. The CA norm is estimated at 3.5 percent of GDP, with a standard error of 0.9 percent of GDP. After accounting for transitory factors arising from the COVID-19 shock (mainly in the travel services—including tourism—and oil sectors), the IMF staff estimates the 2020 CA gap midpoint at −0.1 percent of GDP. The relative policy gap contribution is estimated at 1.5 percent of GDP; however, this is driven mainly by large exceptional fiscal stimulus in the rest of the world relative to Korea and is not expected to persist over the medium term.</td></tr>
<tr><td>2020 (% GDP)</td><td>CA: 4.6</td><td>Cycl. Adj. CA: 4.3</td><td>EBA Norm: 3.5</td><td>EBA Gap: 0.8</td><td>COVID-19 Adj.: −0.9</td><td>Other Adj.: 0.0</td><td>Staff Gap: −0.1</td></tr>
<tr><td>Real Exchange Rate</td><td colspan="7">Background. Following sustained appreciation during 2015–18, the REER depreciated in 2019 by about 4.5 percent, returning to its 2015 level. The REER depreciated further in the first half of 2020 before recovering somewhat more recently. Overall, the average REER for 2020 depreciated by about 2 percent relative to the 2019 average. As of end-May 2021, the REER had appreciated by 0.8 percent compared to the 2020 average.

Assessment. The IMF staff CA gap implies a REER gap of 0.2 percent (applying an estimated elasticity of 0.36). The EBA REER index model estimates a REER undervaluation of 3.7 percent, while the REER level model estimates a 12 percent undervaluation. The IMF staff uses the estimated CA gap for its assessment, given the better fit of the EBA CA model. Consistent with the IMF staff CA gap, the IMF staff assesses the REER gap to be in the range of −2.3 to 2.7 percent, with a midpoint of 0.2 percent.</td></tr>
<tr><td>Capital and Financial Accounts: Flows and Policy Measures</td><td colspan="7">Background. Net FDI and portfolio outflows have declined since 2017, when outflows peaked at 4.6 percent of GDP. Portfolio outflows were 3.6 percent of GDP in 2020, reflecting further portfolio diversification and institutional investors' continued search for yield. Net FDI and portfolio outflows comprised the bulk of the 2020 financial account (1.4 and 2.5 percent of GDP, respectively), whereas other investments (net) recorded inflows (0.6 percent of GDP). Despite nonresident equity outflows in the first half of the year, overall capital flows have remained relatively stable in 2020, supported by portfolio debt inflows and a slowdown in outward FDI.

Assessment. The present configuration of net and gross capital flows appears sustainable over the medium term. In recent years, including in the context of the COVID-19 shock, Korea has demonstrated ample capacity to absorb short-term capital flow volatility.</td></tr>
<tr><td>FX Intervention and Reserves Level</td><td colspan="7">Background. Korea has a floating exchange rate. As of the end of 2020, reserves stood at 27 percent of GDP, largely reflecting legacy accumulation. FX intervention data released by the Bank of Korea show net purchases of US$5.3 billion (0.3 percent of GDP) in 2020, with net sales of US$5.9 billion in the first quarter to dampen excess FX volatility amid the COVID-19 shock and net purchases of US$11.5 billion in the fourth quarter, when the won appreciated sharply in nominal effective terms. With valuation gains from non–US dollar-denominated assets, gross reserves rose by US$34.3 billion (2.1 percent of GDP) in 2020. During March–May 2020 the Bank of Korea temporarily drew US$20 billion from the US$60 billion swap line established with the Federal Reserve.

Assessment. Intervention has continued to be two-sided and appears to have been limited to preventing disorderly market conditions. As of the end of 2020, FX reserves were about 99 percent of the IMF's composite reserve adequacy metric, which, together with access to the Federal Reserve swap facility, provides an adequate buffer against a wide range of possible external shocks.</td></tr>
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