

**EXECUTIVE
BOARD
MEETING**

SM/21/122

Correction 3

July 16, 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) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Pages 21, 22, 34

Questions: Mr. Leigh, RES (ext. 34747)
Mr. Rabanal, RES (ext. 36784)

Table 3.15. Korea: Economy Assessment

<p>Overall Assessment: <i>The external position in 2020 was broadly in line with the level implied by medium-term fundamentals and desirable policies.</i> 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.</p> <p>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.</p>							
<p>Foreign Asset and Liability Position and Trajectory</p>	<p>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 23 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.</p> <p>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.</p>						
2020 (% GDP)	NIIP: 28.4	Gross Assets: 119.8	Debt Assets: 31.0	Gross Liab.: 91.4	Debt Liab.: 30.8		
<p>Current Account</p>	<p>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.</p> <p>Assessment. The EBA model estimates the cyclically adjusted CA at 4.43 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.</p>						
2020 (% GDP)	CA: 4.6	Cycl. Adj. CA: 4.3	EBA Norm: 3.5	EBA Gap: 0.8	COVID-19 Adj.: -0.9	Other Adj.: 0.0	Staff Gap: -0.1
<p>Real Exchange Rate</p>	<p>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.</p> <p>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.</p>						
<p>Capital and Financial Accounts: Flows and Policy Measures</p>	<p>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.</p> <p>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.</p>						
<p>FX Intervention and Reserves Level</p>	<p>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.</p> <p>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.</p>						

Table 3.16. Malaysia: Economy Assessment

Overall Assessment: Malaysia's external position in 2020 was substantially stronger than the level implied by medium-term fundamentals and desirable policies due to the large pandemic-related fiscal expansions worldwide compared with Malaysia.							
Potential Policy Responses: Near-term policies should continue to support the recovery through targeted lifelines to households and businesses in the context of accommodative monetary and financial policies. Over the medium term, policies that could support external rebalancing and bring the CA balance closer to its norm include strengthening the social safety net in Malaysia and continuing to encourage private investment and productivity growth, as well as the unwinding of pandemic-related policy support worldwide.							
Foreign Asset and Liability Position and Trajectory	<p>Background. Since 2010 Malaysia's NIIP has averaged about 1 percent of GDP. The NIIP was 4.8 percent of GDP in 2020 (compared with -3 percent of GDP at the end of 2019), reflecting higher reserve assets, an increase in net other investment, and a decline in net portfolio investment. Direct investment and portfolio investment abroad contribute the most to assets, whereas direct investment and portfolio liabilities contribute the most to liabilities. Total external debt, measured in US dollars, was about 69 percent of GDP in 2020 (compared with 63.4 percent at the end of 2019), of which about two-thirds was in foreign currency and 38 percent in short-term debt, by original maturity.</p> <p>Assessment. Malaysia's NIIP is projected to rise over the medium term, reflecting projected CA surpluses. Malaysia's balance sheet strength, exchange rate flexibility, and increased domestic investor participation should continue to help withstand shocks (as they have in the context of the COVID-19 crisis).</p>						
2020 (% GDP)	NIIP: 4.8	Gross Assets: 134.6	Res. Assets: 30.6	Gross Liab.: 129.8	Debt Liab.: 28.1		
Current Account	<p>Background. Between 2010 and 2019 Malaysia's CA surplus contracted by 7 percentage points, underpinned by lower national savings and robust domestic demand. In 2020 the CA surplus increased to 4.4₂ percent of GDP against a backdrop of transitory factors, including (1) the decline in travel income, given international travel restrictions; (2) the decline in the oil balance following the slump in fuel prices in 2020; (3) an increase in demand for pandemic-related exports, including rubber glove products and electronic and electrical equipment; (4) the decline in outward remittances as a result of the crisis; and (5) a one-off transaction in the third quarter of 2020, creating a surplus in the secondary income balance.</p> <p>Assessment. The EBA CA model estimates a cyclically adjusted CA of 4.6 percent of GDP and a CA norm at -0.6 percent of GDP for 2020. After factoring in the transitory effect on the CA of the net exports of pandemic-related medical goods, including rubber glove products (1 percent of GDP); the global household consumption composition shift (0.6 percent of GDP); a one-off transaction in the third quarter of 2020 (0.8 percent of GDP); lower net remittances (0.1 percent of GDP); the decline in receipts from travel services, including tourism (-1.2 percent); and the decline in the oil balance (-0.3 percent of GDP), the IMF staff estimate of the CA gap is about 4.1 percent of GDP (± 1 percent of GDP). Relative policy gaps explain 2.0 percentage points of the CA gap. Low public health care expenditures compared with the rest of the world contribute 0.7 percentage point to the CA gap, while the looser fiscal policies adopted in 2020 in the rest of the world relative to Malaysia contribute 1.2 percentage points to the excess surplus. Unidentified residuals are large and likely reflect structural impediments and country-specific factors not included in the model.</p>						
2020 (% GDP)	CA: 4.2	Cycl. Adj. CA: 4.6	EBA Norm: -0.6	EBA Gap: 5.2	COVID-19 Adj.: -0.2	Other Adj.: -0.8	Staff Gap: 4.1
Real Exchange Rate	<p>Background. In 2020 the REER depreciated by 3.6 percent relative to the 2019 average and was about 6 percent lower than in 2015. The depreciation in 2020 can be mainly explained by the impact of capital outflows and lower commodity prices on the NEER. As of end-May 2021, the REER had depreciated by 1.0 percent compared to the 2020 average.</p> <p>Assessment. The IMF staff CA gap implies a REER undervaluation of -9.0 percent in 2020, applying an estimated elasticity of 0.46. The EBA REER index and level models estimate Malaysia's REER to be undervalued by -32 percent and -42 percent, respectively. At the same time, considering the lack of underlying macroeconomic stresses, such as inflation or wage pressures, and the broad stability of FX reserves, the IMF staff assesses the REER to be undervalued in the range of -7.0 to -11.0 percent, with a midpoint of -9.0 percent, consistent with the IMF staff CA gap.</p>						
Capital and Financial Accounts: Flows and Policy Measures	<p>Background. Since the global financial crisis, Malaysia has experienced periods of significant capital flow volatility, largely driven by portfolio flows in and out of the local-currency-debt market, in response to both the change in global financial conditions and domestic factors. In 2020 Malaysia saw capital outflows during the March 2020 global risk-off episode, but capital flows stabilized afterward. Since late 2016 the Financial Markets Committee has implemented measures to develop the onshore FX market and increase hedging opportunities.¹</p> <p>Assessment. Continued exchange rate flexibility and macroeconomic policy adjustments are necessary to manage capital flow volatility. CFM measures should be gradually phased out, with due regard for market conditions.</p>						
FX Intervention and Reserves Level	<p>Background. The risk-off episode caused by the COVID-19 pandemic reduced reserves by about US\$1.9 billion by March 2020, to US\$101.7 billion. Reserve levels rose thereafter and stood at US\$107.6 billion as of December 2020 (compared with \$103.6 billion at the end of December 2019).</p> <p>Assessment. Under the IMF's composite ARA metric, reserves remain broadly adequate. Gross official reserves were about 118 percent of the ARA metric at the end of December 2020. FX interventions should continue to be limited to preventing disorderly market conditions. In case of an inflow surge, some reserve accumulation would be appropriate to increase the reserve coverage ratio, while still allowing the exchange rate to adjust as a first line of defense.</p>						

Table 3.28. Turkey: Economy Assessment

<p>Overall Assessment: <i>The external position in 2020 was moderately weaker than the level implied by medium-term fundamentals and desirable policies.</i> Expansionary monetary policy and rapid provision of credit by state-owned banks put pressure on the lira last year through dollarization, import, and financial account channels, which led in turn to sales of foreign exchange reserves to support the lira. Despite the marked real exchange rate depreciation, the CA deficit resurfaced because of lower exports (including tourism) and robust imports (including gold). The monetary tightening beginning in late 2020 saw a return of capital inflows and modest reserves buildup, but outflows and reserves losses resumed in March 2021, amid rising policy uncertainty and lira depreciation. Policy uncertainty, large gross external financing needs, and relatively low reserves increase Turkey's vulnerability to shocks. Only over time will the REER undervaluation, with its usual lags, help move the current account back toward its norm, aided by less expansionary policies.</p> <p>Potential Policy Responses: Policies that could support Turkey's external rebalancing and bring the current account balance closer to its norm include (i) keeping credit growth at sustainable rates; (ii) maintaining a firm monetary policy stance, with additional measured tightening if inflation expectations increase further, to, at a minimum, keep the ex-ante real policy rate unchanged, which would also help ensure sustainable credit growth; (iii) enhancing the fiscal anchor with a credible commitment to future consolidation to bring debt down over time—which would also create greater space for meeting pandemic-related needs in 2021 and minimize scarring; and (iv) taking additional steps to build policy credibility, which would encourage capital inflows and support de-dollarization and a buildup of reserves.</p>							
Foreign Asset and Liability Position and Trajectory	<p>Background. In 2020, Turkey's NIIP declined from -46 to -56.4 percent of GDP, driven entirely by foreign liabilities, which rose from 79 to 90 percent of GDP.¹ External debt increased from 57 to 63 percent of GDP, driven by lower US dollar GDP. Over 70 percent of external debt is held by the private sector, and about one-third is short term (on a remaining maturity basis). Debt is expected to remain sustainable over the medium term, but debt servicing remains vulnerable to global and domestic financial conditions.</p> <p>Assessment. Turkey's NIIP has become more negative since the 2000s, with 2020 affected by one-off factors related to the pandemic. The size and composition of external liabilities, coupled with low reserves, increases Turkey's vulnerability to liquidity shocks, sudden shifts in investor sentiment, and a global upswing in interest rates. The FX exposure of nonfinancial companies, including short-term loans, is high, with the potential to affect bank asset quality. NIIP is projected to improve to about -45 percent of GDP in 2025, driven by a decline in liabilities, mainly loans.</p>						
2020 (% GDP)	NIIP: -56.4	Gross Assets: 33.6	Res. Assets: 13-4	Gross Liab.: 90.1	Debt Liab.: 62.8		
Current Account	<p>Background. After posting a surplus for the first time in nearly two decades in 2019, the CA registered a deficit of 5.1 percent of GDP in 2020, driven by weaker goods and services exports—including tourism—and robust imports. Credit-driven consumption and investment fueled imports, more than offsetting the lower oil import bill. Gold imports increased from 1½ percent 2019 to 3½ percent of GDP in 2020, driven by policy uncertainty, a weakening currency, and elevated inflation.</p> <p>Assessment. The EBA CA model estimated norm is -1.5 percent of GDP (with a standard error of ±1.8 percent of GDP). The CA deficit of 5.1 percent of GDP narrows to 4.7 percent of GDP after cyclical adjustment. Adjusting for temporary pandemic-related shocks (1.6, -0.3, and -0.2 percent of GDP for travel services, including tourism, the global shift from services to tradable goods, and oil prices, respectively) and the surge in gold imports (1 percent of GDP) yields an IMF staff CA gap of -1.2 percent of GDP relative to the CA norm. One-off shocks and the range surrounding the norm increase the uncertainty around this assessment.</p>						
2020 (% GDP)	CA: -5.1	Cycl. Adj. CA: -4.7	EBA Norm: -1.5	EBA Gap: -3.3	COVID-19 Adj.: 1.1	Other Adj.: 1.0	Staff Gap: -1.2
Real Exchange Rate	<p>Background. The average REER depreciated for a third consecutive year, with a depreciation of more than 10 percent in 2020. The nominal depreciation against the dollar in 2020 was 23.6 percent. As of end-May 2021, the REER had depreciated by 9.0 percent compared to the 2020 average.</p> <p>Assessment. The IMF staff CA gap implies a REER gap of 4.9 percent in 2020 (applying an estimated elasticity of 0.24). The EBA REER level and index approaches suggest that the REER was undervalued in 2020 by about 31 to 35 percent. Considering the recent sharp depreciation of the REER, which is expected to support a rise in Turkey's CA balance toward its norm over the coming years, the IMF staff gives more weight to the EBA REER approaches as the CA continues to adjust. The IMF staff assesses the REER to have been undervalued by about 15–25 percent, with a midpoint of 20 percent and large uncertainties surrounding these estimates.</p>						
Capital and Financial Accounts: Flows and Policy Measures	<p>Background. Net capital inflows increased only modestly in 2020, from US\$5.5 to US\$8.2 billion. Errors and omissions remained negative, likely reflecting unrecorded capital outflows. The modest increase in net inflows was driven by other investment (notably the increased bilateral currency swap agreement with Qatar), which more than offset larger net portfolio outflows and lower net FDI. Turkey introduced limits on bank swaps and other derivative transactions with foreign counterparties as well as export surrender/repatriation requirements (both CFMs) in August 2018. These were being unwound when new bouts of volatility resurfaced in late 2019. Limits on bank swaps and other derivative transactions with foreign counterparties were thus reintroduced and tightened in December 2019 and February–April 2020. These were relaxed in November 2020.</p> <p>Assessment. The quality of financing continued to worsen in 2020, with increased reliance on short-term financing and reserve drawdown. With annual gross external financing needs projected at about 24 percent of GDP on average in 2021–26 (29.4 percent of GDP in 2020), Turkey remains vulnerable to adverse shifts in global investor sentiment. Remaining CFMs should be phased out as conditions improve to increase market liquidity and support dedollarization.</p>						
FX Intervention and Reserves Level	<p>Background. The de jure exchange rate is classified as free floating. The central bank undertook significant FX sales in 2020 to contain pressure on the lira. Gross reserves declined from US\$105.7 billion at the end of 2019 to US\$93.53 billion by the end of December. Net international reserves dropped by US\$26.2 billion to US\$14.5 billion by the end of 2020.² The composition of reserves has also changed, with an increasing share of gold and non-SDR-basket currencies.</p> <p>Assessment. Gross reserves decreased from 84 to 74 percent of the IMF's ARA metric during 2020, falling further below the floor of the recommended 100–150 percent ARA adequacy range and covering only 54 percent of short-term external debt (at remaining maturity). Steady reserve accumulation over the medium term is needed given Turkey's large external liabilities, dependence on short-term and portfolio funding, and large domestic FX deposits.</p>						