May 12, 2020
Approval: 5/19/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/61-1

10:00 a.m., July 10, 2019

1. 2019 External Sector Report

Documents: SM/19/181 and Correction 1; and Correction 2; and Correction 3; and Supplement 1

Staff: Gopinath, RES; Cubeddu Merchan, RES; Adler, RES; Kaufman, SPR

Length: 2 hours, 13 minutes

Executive Board Attendance

D. Lipton, Acting Chair

Executive Directors	Alternate Executive Directors
	O. Odonye (AE), Temporary
M. Raghani (AF)	
G. Lopetegui (AG)	
N. Ray (AP)	
	B. Saraiva (BR)
Z. Jin (CC)	
L. Villar (CE)	
L. Levonian (CO)	
R. Kaya (EC)	
H. de Villeroché (FF)	
S. Meyer (GR)	
S. Gokarn (IN)	
	F. Spadafora (IT), Temporary
M. Kaizuka (JA)	
	M. Daïri (MD)
	F. Al-Kohlany (MI), Temporary
	H. Etkes (NE), Temporary
T. Ostros (NO)	
A. Mozhin (RU)	
	R. Alkhareif (SA)
	K.Tan (ST)
P. Inderbinen (SZ)	
	D. Ronicle (UK)
M. Rosen (US)	

G. Tsibouris, Acting Secretary
O. Vongthieres, Summing Up Officer
B. Zhao / R. Smith Yee, Board Operations Officers
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
African Department: A. Coronel Andrade. Asia and Pacific Department: P. Cashin, M. Colacelli. Communications Department: R. Anspach. European Central Bank: A. Meyler. European Department: A. Cuevas Camarillo. Legal Department: C. DeLong, B. Steinki. Middle East and Central Asia Department: B. Joshi. Research Department: G. Gopinath, G. Adler, M. Casas Lozano, K. Chang, L. Cubeddu Merchan, D. Gautam, S. Hannan, L.

Juvenal, C. Kolerus, S. Meleshchuk, C. Osorio Buitron, P. Rabanal Minguella, C. Rebillard, J. Rodriguez Panqueva, Z. Wang. Strategy, Policy, and Review Department: T. Bayoumi, V. Chensavasdijai, S. Hassan, M. Kaufman, H. Lin, Y. Lu, B. McDonald, M. Muhleisen, N. Sheridan, E. Van Heuvelen. Statistics Department: C. Sanchez Munoz. Western Hemisphere Department: N. Chalk. Executive Director: A. Mahasandana (ST). Alternate Executive Director: S. Geadah (MI), A. Guerra (CE), N. Heo (AP), A. McKiernan (CO), H. Razafindramanana (AF), M. Siriwardana (IN), F. Sylla (AF). Senior Advisors to Executive Directors: W. Abdelati (MI), Z. Abenoja (ST), M. Alle (AF), A. Muslimin (ST), S. Evjen (NO), N. Jost (NE), Y.Liu (CC), M. Maidi (AE), G. Gasasira-Manzi (AE), R. Morales (AG), P. Pollard (US), S. Potapov (RU), J. Shin (AP), G. Vasishtha (CO), J.Weil (CO). Advisors to Executive Directors: M. Albert (FF), D. Andreicut (UK), L. Cerami (IT), D. Cools (NE), D. Crane (US), D. Fadhel (MI), U. Latu (ST), M. Merhi (MI), A. Park (AP), B. Parkanyi (NE), D. Susiandri (ST), S. Yoe (ST), K. Hennings (BR), K. Lok (CC), V. Lucas (GR), J. Montero (CE), A. Tola (SZ).

1. 2019 EXTERNAL SECTOR REPORT

Mr. Geadah and Mr. Al-Kohlany submitted the following statement:

Global current account imbalances narrowed moderately in 2018 and became more concentrated in a few large advanced economies. Current account surpluses in key advanced economies remained large and persistent, while larger current account surpluses in oil-exporting economies were matched by a narrowing in China's current account surplus. Meanwhile, current account deficits narrowed in some emerging markets and developing economies. This configuration of global imbalances was underpinned by several factors.

In surplus countries, there was tighter-than-desirable fiscal stances (Germany, Korea, Netherlands, Thailand) and generally insufficient health care spending (Korea, Malaysia, Russia, and Thailand). Countries with lower-than-warranted current account balances (Argentina, South Africa, Spain, United Kingdom, United States) had looser-than-desirable fiscal policy.

The report calls for a collective and concerted effort by the international community to avoid a disorderly adjustment. In this context, we echo staff's call on most economies with weaker-than-warranted external positions to adopt a gradual growth-friendly fiscal consolidation over the medium-term, while allowing monetary policy to be guided by inflation developments. We also agree that excess surplus economies with fiscal space should allow for greater fiscal stimulus to boost potential growth through infrastructure investments and greater support for innovation, and to reduce their reliance on accommodative monetary policies, when feasible.

Staff's analysis of the drivers of corporate savings is appreciated. The rise of net corporate savings has been noticeable in some surplus economies. Staff attributed this development to a combination of factors including increased concentration of wealth and firm ownership, reduced labor income share, higher income inequality, and lower domestic investment. We appreciate the information on these factors presented in Box 1.7. Staff point to the need to adopt reforms that encourage domestic business investment by relaxing product market regulations. We would look forward to work that clarifies the extent to which the rise in corporate saving reflects policy distortions, and the role technological progress and digitization play in weakening labor market institutions and labor compensation and in increasing net corporate savings.

We thank staff for the informative research chapter on exchange rates and external adjustments, and the chapter's focus on the influence of the currency of invoicing and of the global value chains on the potential role of exchange movements in external adjustment. Staff's analysis shows that the widespread use of US dollars in trade valuation and the level of integration into global value chains alter the response of trade flows to exchange rate movements, with a more muted effect of exchange rates on the trade flows in the short term, including because of the limited response of export volumes. However, over the medium term, the influence of the dominant currency is more muted, and exchange rate flexibility remains a key mechanism to facilitate durable external adjustment.

We note staff's finding that exchange rate flexibility needs to be supported by other structural policies to achieve the desired external adjustment. Structural policies are particularly helpful where economies' response to exchange rate movements is limited by capacity constraints, and policies to alleviate such capacity constraints would include improved access to credit and transportation infrastructure. We agree with staff that removing structural policy distortions remains important, together with a careful sequencing of structural reforms to achieve a sustained rebalancing in a growth-friendly fashion.

The findings strengthen the Fund's approach of not having an institutional preference toward a specific exchange rate regime, and for staff policy advice to continue to be based on country-specific factors in a rigorous, objective, and evenhanded manner. While we welcome the general policy implications set in the paper, we look forward to assessing the way they will translate into the Fund's surveillance and program work and, particularly, the way they will relate to the forthcoming Integrated Policy Framework.

Going forward, we note that the research only focused on manufacturing trade, and it is not clear how the result would change by including the impact of invoicing to commodity trade and services in the analysis. We look forward to future work that integrates the additional trade and financial features into the analysis. We also invite staff to evaluate the impact of currency pricing and global value chains on small open economies and on economies with fixed exchange rates, and to evaluate the impact of the findings on the External Balance Assessment (EBA) framework, and particularly on the EBA Real Exchange Rate Model which relies on the bilateral exchange rates. Is work planned in these areas?

Mr. Ronicle and Ms. Andreicut submitted the following statement:

We thank staff for the comprehensive and analytically rich papers, as well as the valuable outreach on chapter 2 of the report and earlier discussions on the G20 Global Imbalances note.

External openness brings benefits and risks. On the one hand, it raises consumer choice, and so welfare, and allows capital to flow to where it can be best employed, raising incomes. On the other, it can facilitate the emergence of imbalances, which it is the Fund's core purpose to identify, mitigate and support its member's in managing. In that context, the External Sector Report is an ambitious, multilaterally consistent, attempt to assess the health of this system.

Reaping the benefits of international openness

The report paints a mixed picture as to whether the most is being made of the opportunities of openness. While it suggests that capital is (just about) flowing "downhill", global trade growth has slowed markedly as tariffs have risen.

We are reassured to see a (small) net inflow of capital to emerging market and developing economies, driven by reduced reserve accumulation and sustained FDI inflows. Nevertheless, the global picture is difficult to judge: the report doesn't indicate the extent to which these flows are directed to where the return on capital is highest or where productivity is furthest from the frontier. In particular, it excludes a large share of the countries where investment needs are greatest. Could staff elaborate on the extent to which the "discrepancy" between net advanced economy outflows and net EMDE inflows reflects flows to countries outside the ESR sample?

In a world of limited policy space, we would have appreciated a deeper interpretation of this shift in the direction of capital flows. Should this be read as a fall in desired saving relative to desired investment, and if so, as a factor that might potentially push up on global equilibrium interest rates in coming years? How large might this effect be relative to other drivers of low equilibrium rates? Staff views would be welcome.

We share the report's assessment that barriers to trade reduce welfare without tackling underlying imbalances. In the short term, trade tensions appear to be weighing on trade, industrial production, confidence and investment, at the same time as distorting trade flows – risking an abrupt slowing in global growth. In the medium term, trade barriers reduce consumer choice and welfare. Countries should aim to resolve existing disputes and refrain from initiating new ones. The world has much to gain from further liberalisation, particularly in services; we note the the largest global deficits are concentrated in those countries with the greatest comparative advantage in services trade.

Identifying, mitigating and managing the risks

We interpret global imbalances to be small and contained. At 3 percent, the absolute global external balance is somewhat above levels observed in the 1990s, but is notably down on the mid-2000s peak, and has continued its recent downward trend. At the country level, we note that many balances have improved, and none have moved into the “substantial imbalance” category.

Where notable imbalances persist, like staff, we take comfort from the fact that these are predominantly concentrated in issuers of reserve currencies. These countries tend to have assets denominated in domestic currency coupled with floating exchange rates. As a consequence, markets are free to equilibrate imbalances, and we take note that such movements have helped maintain largely stable stock positions, despite persistent deficits and surpluses.

The UK’s floating exchange rate has been an important adjustment mechanism over the past 25 years; we welcome the analysis in chapter 2 that demonstrates that exchange rates remain an effective channel of external adjustment, even in the presence of dominant currency pricing and global value chains. In some senses, these results aren’t surprising: whatever the currency of invoicing, a significant portion of costs (notably wages) remain in domestic currency, even if that share has fallen over time as cross-border supply chains have deepened; and it has long been evident that adjustment takes time and can occur asymmetrically across imports and exports. Nevertheless, it is reassuring to see that the value of exchange rate flexibility holds in a robust assessment covering a broad cross-section of countries and reasonable time series. We would welcome further work on this topic, in particular examining the role of the exchange rate in adjusting to different types of shock, as well as broadening the scope of the analysis to cover other flows (capital, commodities, services) and the role of balance sheets (including their currency composition).

Looking ahead

Overall, the External Sector Report is an ambitious and potentially valuable report. We welcome the efforts made in recent years to raise its prominence, for example through a dedicated press conference, sharper policy messages and topical analytical content.

We support the EBA methodology, but think there is further to go analytically. We note that model residuals often play a very large role in determining current account gaps: 4.4 of 4.4 percentage points in the case of the United Kingdom. Could staff indicate how much of the overall variation in gaps is explained by the residual, rather than identified policy gaps? Areas that require more attention from our perspective include: non-current account drivers of stock positions; corporate surpluses; the role of barriers to trade in services.

We enjoyed the box on the net international investment position and external financing risks in emerging market and developing economies, and in particular the nascent identification of drivers (eg. the role of foreign currency debt) and policy advice (such as the importance of deep domestic financial markets). As evidenced in growing cross-border stock positions, global financial integration is deepening, a trend we expect to continue. We would like to see more analysis on these issues at the Fund, and see the Integrated Policy Framework as an excellent opportunity to deepen our understanding of the factors that lead to capital outflows ("push" factors), inflows ("pull") and the effect the international financial architecture has on flows more generally ("pipes").

Finally, we wonder whether the External Sector Report has yet to find a clearly defined role. Despite only modest imbalances being identified, policy recommendations are often wide-ranging, and occasionally aggregated imprecisely (for example, the seeming recommendation on page 2 that the UK further deregulate its labor market, despite already being one of the lightest regulated in the OECD – in fact, only the skills element of this advice was intended for the UK). That may reflect the fact that it sits somewhat uncomfortably apart from the other flagship publications and in between bilateral and multilateral modes of surveillance. Refining the modalities of the Fund's coverage of external sector issues seems like an important objective for the Comprehensive Surveillance Review.

Mr. De Lannoy, Mr. Etkes and Mr. Hanson submitted the following statement:

We welcome the 2019 External Sector Report (ESR). Assessing current account and stock imbalances is challenging and depends on the exact specifications of the underlying methodology and an element of judgment for country specific circumstances, as appropriate. We appreciate that the required element of judgement is presented in a transparent way. We note that the current account norms and policy conclusions presented in the 2019 ESR are broadly aligned with those of the European authorities.

We welcome staff's analysis on the size and composition of record-high stock positions as both affect the risk of a disorderly adjustment. These analyses should be more the focus of the ESR as mitigating disorderly adjustment is the aim of this report, as well as highlighting Current Account (CA) gaps. For instance, Belgium's "weaker than desirable" CA gap is less disturbing considering the strongly positive NIIP position. The composition of the stock position is important as well. For instance, equity financing allows for better shock absorption since risks are shared between creditors and debtors. Staff could extend future external sector analysis with an overview of the composition of NIIPs and the policy factors that promote more stable and shock absorbing sources of funding.

The external position of the euro area

We take note of the staff's assessment of the euro area's external position, indicating that in 2018 it was moderately stronger than the level implied by medium-term fundamentals and desirable policies. We note that the ESR suggests that the 2018 decline of the euro area balance was offset by a decline in the current account norm. The ESR's policy recommendations linked to EU external balances are broadly aligned with those of the European authorities. We agree with the justification for staff's adjustment to the euro area figures, which remained similar to the 2018 ESR.

We believe that research is needed to better understand country specific drivers of excess savings such as the causes of the high corporate savings, including the role of multinationals in surplus countries. Cross-border activities of multinationals affect the measurement and economic interpretation of current account balances. Their effect likely differs across countries. In case of The Netherlands, staff's analysis suggests that the high current account surplus is driven by high corporate savings which are dominated by a few multinationals, and that their corporate structures make it difficult to allocate retained earnings to ultimate shareholders around the world.[1] This may partly explain the high residual in the EBA model. We agree with staff that data collection efforts and more research are needed to better understand the effect of multinationals on the current account. This would help sharpen the analysis of policy distortions in the external sector assessment. Our authorities are working on this, and we would also encourage further work by staff on this issue.

At the same time, we note that the significant unexplained variance in the estimations of the EBA models results in uncertainty about policy implications, particularly for the smaller economies in the EBA sample. For instance, in the cases of the Netherlands and Belgium the “residual” is more than 4 times larger than the “identified” gaps. Moreover, according to these results the policy measures prescribed by staff, such as fiscal adjustment, are expected to have limited contribution for closing the CA gaps.

We agree with staff that while aggregate euro area imbalances are moderate at most, significant imbalances persist within the euro area, both in flow and stock terms. Addressing these imbalances requires further action by Member States as underlined in the ESR as well as in the Macroeconomic Imbalance Procedure. At the EU level, further integrating financial markets and the broader EU single market, in the context of the deepening of the Economic and Monetary Union, will also help reduce imbalances among Member States and shift the composition of stock positions towards more stable and shock-absorbing sources of funding.

Finally, we agree with staff’s assessment that the euro REER can be described as broadly in line with fundamentals, as the reported ‘REER gap’ remains limited and does not exceed 5 percentage points. The EU institutions consider the euro’s real effective exchange rate to be close to its equilibrium, bearing in mind the uncertainty underlying these estimates. We welcome the ESR’s deep analysis of the multiple factors that affect the relationship between exchange rates and current accounts. In this respect, we found the causal link between the rise in the euro area current account surplus and the euro depreciation rather simplistic (p.14). Prima facie, this interpretation does not seem consistent with the timing of the euro depreciation. In fact, the euro hardly depreciated during the height of the crisis that brought about the widening of the euro area current account (as is described in the ESR’s Box 1.3). The lasting depreciation only happened in 2014/2015, and reflected the policies that supported to end the crisis, reignite domestic demand, and put a halt to the surplus widening.

[1] Chen, Ruo (2019). “Corporate saving in The Netherlands”. Selected Issues Paper.

Methodological notes

We welcome staff's greater use of REER models in the current ESR following last year's summing up, which highlighted the importance of using the results from all EBA models. REER models often corroborate the results of the CA model, yet conflicting results of these classes of models call for staff's caution in devising policy advice, particularly when the residuals of the CA model are large. We encourage staff to give REER models the same weight as the CA model, provide more detailed information on the decomposition of the REER models like they did for the CA model (Table 1.6), and assess the REER-model-implied CA gap

Country specific adjustments should consider wide aspects affecting savings and investments. For instance, the long-term effects of ageing on the CA balance might differ from country to country and from current assumptions in the EBA model. A recent study on income and wealth by the Netherlands Bureau for Economic Policy Analysis shows no evidence of dissavings during retirement by elderly households in the Netherlands, and no evidence was found that bequest that motives influence consumption given that the findings hold for both households with and without children. This could be interpreted as a signal that the life-cycle assumptions behind the EBA model might not hold on a micro-level for all countries.

We welcome the increased focus on how invoicing and value chains affect the relationship between exchange rates, trade and current accounts. The analysis supports the ESR's stance to focus on broad macroeconomic policies, rather than just monetary instruments, in order to correct imbalances in major advanced economies with freely floating currencies. We note the specific implications for euro area Member States, with a common currency and significant value chains and trade integration, which could mitigate the impact of exchange rates, including vis-à-vis dominant currencies, on trade balances. We wonder whether following the findings on the effect of dominant currencies in the short run, it would be desirable to use in surveillance short term REER with large weight for dominant currencies, and the standard REER for medium analyses.

We agree with the staff's conclusions that nominal exchange rate flexibility could be important for helping the adjustment of the current account over the medium term. However, in the conclusion we would stress that the real exchange rate also plays a relevant role in reducing current account imbalances via changes in the relative internal prices of non-tradables vs. tradables. We believe that the interaction of exchange rate adjustments, including of dominant currencies, with external balance sheet vulnerabilities is another important area for future research.

Mr. Ostros and Mr. Evjen submitted the following statement:

We thank staff for the 2019 External Sector Report (ESR), which provides a comprehensive overview of the largest economies' external sector positions and related policies. We broadly agree with the main assessment and key takeaways in the report, including policy recommendations, and make the following reflections:

We agree that countries' abilities to run current account (CA) deficits and surpluses at different times are essential for absorbing country-specific shocks and facilitating a globally efficient allocation of capital. There can be a number of valid reasons for upholding a CA deficit or surplus, including investment needs in high-growth countries, deleveraging needs, financial center status and demographic developments. However, excess imbalances may signal risks or distortions, and could pose a threat to global stability.

Over time, particularly if global tensions intensify, stock imbalances could become too large for the world economy to support, with potential disruptive global adjustment as a result. We note that global CA deficits and surpluses have been broadly unchanged since 2013, at about 3 percent of world GDP in 2018. Some rebalancing has continued with excessive balances narrowing to 35-45 percent. A concentration of these higher- and lower-than-warranted balances in advanced economies decreases the risk of sudden external financing pressures but contribute to the worrying build-up of stock imbalances.

The US CA deficit continues to be the largest contributor to global imbalances particularly due to the large domestic fiscal gap. There are worryingly high CA deficits in some emerging economies. China's external rebalancing over the years has been a welcome development with the CA surplus gradually declining to 0.4 percent of GDP in 2018. However, this has coincided with a build-up of domestic fiscal and credit imbalances, which require attention together with longer-term structural challenges. Surpluses in large oil-exporting countries have increased recently, while the euro area and Japan have seen minor reductions to their surpluses on account of higher oil prices, and, especially in the case of the euro area, weaker external demand.

Global imbalances should be addressed in a growth-friendly manner with decisive and comprehensive policy action – strengthening conditions for investment in excessive surplus countries, and policies to boost savings and competitiveness in excess deficit countries. We agree that with most economies operating near potential, well-designed structural reforms should play a prominent role in policy mixes, not only to create improved prospects for long-run growth but also to address some of the distortions underlying excess external imbalances.

We stress the importance of enduring efforts to protect and strengthen the multilateral rules-based trading system while reviving liberalization and lowering barriers to trade. We deeply regret that trade tensions have intensified during 2018-19. Policies that distort trade should be avoided, as they pose severe risks to global growth, cross-border investment, and global supply chains. Increased trade tensions have already had a negative impact on firms' sentiment and led to a weaker development in global industrial production and world trade. A further escalation of tensions and an increase in the number of countries involved could also harm investment prospects and decrease productivity growth in the medium term.

As external imbalances are a result of differences between national savings and investments, trade policies play a role only to the extent they affect net national savings. Although trade policies may have limited effects on the external imbalances, spill-over effects will affect growth and development potential, especially for developing countries with large export exposure to impacted economies.

As trade in global value chains (GVC) has expanded over the past decades, their implications for trade prices and volumes have become increasingly important. We broadly agree with the key takeaways, notably that the expansion of production fragmentation can help explain a more muted response of trade volumes to movements in the exchange rate in the short and medium term. At the same time, exchange rate flexibility remains essential to address imbalances in combination with structural policies that boost productivity, lowers regulatory barriers and red tape.

Chapter 2 also looks at the overall effect of global value chains (GVC) on trade elasticities. According to the OECD, trade in GVCs seems to have slowed markedly – if not declined, since around 2011. Do staff find the same developments in their analysis? If so, what could be the reasons for such a development?

We agree that the increasing complexity of international trade requires more attention, particularly granular analyses of input-output linkages and the sources of final demand in trade. Improved international data collection efforts in this area, with timely releases, are of the essence. We concur with staff that continued efforts to account for complex cross-border flows and positions are required. The activities of multinational enterprises, digitalisation and the increasing role for services in trade necessitate enhanced data collection efforts and analyses.

We appreciate that staff assess the range of uncertainties related to the CA gap and the REER gap (Table 1.4). This helps to emphasize the inherent uncertainty attached to these numbers. Also, we strongly encourage staff to apply ranges when EBA results are used in e.g. Article IV etc., which is currently not the case. In addition, we suggest providing details on how staff arrives at the uncertainty bands, especially since there continue to be large discrepancies in the calculated ranges in relation to the semi-elasticities and estimated CA gaps.

Mr. Obiora and Mr. Odonye submitted the following statement:

We appreciate the opportunity to discuss the 2019 External Sector Report (ESR) and welcome the update of the methodology and staff's continued efforts to enhance the multilaterally-consistent assessment for the world's largest economies. We consider the report as timely and welcome the inclusion of the chapter on exchange rates and external adjustment as relevant to evolving international trade dynamics. In this respect, we broadly support staff's focus and judgement in ensuring transparency but underscore the need for continued incorporation of the peculiarities of different economies.

We remain concerned about the persistence of global imbalances, their concentration in key advanced economies, and the widening positions of both debtor and creditor countries in recent years. At near historic peaks, these imbalances continue to undermine global trade, growth and financial stability. Given their global effects, we believe that collective policy actions in both deficit and surplus economies would be essential to provide lasting solutions to this problem.

While short-term financing risks are mitigated by the concentration in reserve-currency-issuing advanced economies, intensified trade tensions or even, a disorderly Brexit outcome could adversely impact global growth and risk aversion. Ultimately, these spillovers may impact economies that are highly dependent on foreign demand and external financing, especially resource-intensive emerging market and developing economies (EMDEs) and frontier markets. Against this backdrop, we reiterate the need to prioritize focus on structural policies and investment trends within the non-financial private sector. Going forward, could staff consider presenting in the main report the analysis in Box 1.4, which shows more details on the EMDEs?

The disclosure that about 35-40 percent of global current account deficits and surpluses in 2018 reflected undesirable policy settings has amplified the urgency for policy recalibration. We therefore, recommend striking a balance between fiscal, monetary, and structural policies. In excess surplus countries, we encourage appropriate savings and investment policies and less emphasis on monetary policy, while priority should be attached to growth-friendly fiscal consolidation to narrow imbalances in excess deficit countries. Deficit countries should also improve labor market flexibility and competitiveness, including by strengthening the skills base of their workers. Further, structural policies remain critical to raise global growth potential and tackle external imbalances. At the same time, exchange rates should continue to adjust in line with the fundamentals, with interventions limited to smoothening disorderly market conditions. Compensatory policy actions remain important in countries with constraining and intermediate currency regimes. We note staff's recommendation of higher wage growth in key euro area creditor economies to help rebalancing. Given labor mobility in the common market, we wonder if staff could comment on the implications of wage increases for the euro area peer economies? How will such increases reflect on the relations between labor unions and the respective authorities in member states?

In addition to the significant risks posed by persistent trade tensions on global growth, we are concerned by several other key risks that warrant urgent attention. These include potential spillover effects on commodity prices, a disorderly Brexit, limited EMDEs' external debt servicing capacity, and the knock-on effects on both debtor and creditor economies that could amplify global economic vulnerabilities. Against this backdrop, we reiterate our support for the revival of liberalization efforts and strengthening of the rules-based multilateral trade system that supports amicable resolution of disputes without recourse to distortionary protectionist practices.

We welcome the timely reflection on exchange rates and external adjustment in the ESR and look forward to important policy takeaways. In particular, the focus on the currency of invoicing and global value chains is relevant to the wider membership of the Fund. That said, we underscore the need for caveats on country peculiarities relative to resource and non-resource countries; price-takers and price setters; small open economies and large open economies. Subject to data availability, we urge further work to cover other critical external sector elements that may exhibit different responses to exchange rate adjustments. Further, there is need to account for the composition of a country's balance of payments especially service trade, primary and secondary income, as well as financial and capital account flows. Policy recommendations, therefore, should be toned to reflect these practical considerations and the limitations of staff's analysis.

Regarding the overall assessment of South Africa, the only member country of this Constituency reflected in the ESR, our authorities argue that the report could have better reflected the current realities of their economic situation. To this end, our office is engaging with staff on the model used and would request some adjustments to reflect their actual position. In this context, we expect an update on South Africa in the table on foreign assets and liability position, capital and financial accounts as well as FX intervention and reserves level.

Mr. Ray, Mr. Shin and Ms. Park submitted the following statement:

We welcome the opportunity to discuss the 2019 External Sector Report (ESR). Rigorous, evenhanded and multilaterally consistent analysis of external positions can foster useful conversations about policy settings that would be supportive of addressing excess global imbalances. We see the policy implications drawn from this analysis as sound in broad terms, though we continue to stress that Fund advice needs to highlight the primary domestic benefits of policies also aimed at external rebalancing to gain traction. It is also important to be candid about the limitations of models and their conclusions and transparent about the use of judgement. We welcome the continued efforts to enhance the depth of analysis, but caution against drawing strong policy conclusions from ongoing work.

As an overarching point, it is important to recognize that current account deficits and surpluses may be beneficial from an individual country and global perspective. As noted in Box 1, there can be good reasons why individual countries' current account balances are not zero, and indeed can even be quite sizeable, without constituting imbalances or being a cause for concern. In an integrated global economy, some countries may benefit from running current account surpluses – for example, to lift the living standards of their people – while others may benefit from running current account deficits – for example, to import capital and meet investment needs more cheaply. The current account position reflects the net outcome of saving and investment decisions taken by households, businesses and government across the whole economy. If we are concerned that a current account position indicates the presence of imbalances, the focus should be on the domestic and/or external policies that are causing it.

We see the key policy messages from the analysis as including:

Protectionist policies that distort trade should be avoided. As highlighted in the 2018 ESR, protectionist measures undermine domestic and global growth without improving global rebalancing. We agree that imbalances are not a valid reason for protectionism, but rather a strong case for reviving the multilateral system.

Carefully calibrated policies are needed to achieve domestic objectives while contributing to external rebalancing. Structural reforms have a role to play in addressing external imbalances, but policy advice has most traction with policymakers when it is clearly centered on domestic objectives, as implementation challenges often stem from domestic political economy constraints. Recommendations regarding the macroeconomic policy mix should also take into account the cyclical context, including the case for rebuilding of buffers where output gaps have closed.

Policy recommendations need to be tailored to country circumstances. Chapter 2 shows that near-term effects of exchange rate movements on the current account balance can be muted due to dominant invoicing currency and global value chain integration. This highlights the importance of domestic policy changes in supporting external adjustment where traded goods prices are likely to be sticky in the short run in countries with a high manufacturing share. Commodity and services exporters may be in a very different position.

And while new work highlights some differences across countries and over time, exchange rate flexibility continues to have an important role in facilitating adjustment to shocks. This should not preclude the ability to respond to excessive volatility or disorderly movement in the FX market if there are potential adverse implications for economic and financial stability.

For the Fund's external sector analysis to be credible and persuasive, staff are encouraged to be candid about the limitations of models and their conclusions. Even with recent enhancements, residuals remain large and caution is needed in interpreting model results. It should not be assumed that residuals are imbalances that should be corrected rather than omitted fundamentals. We see value in looking at a range of evidence, including both current account and exchange rate-based models and complementary tools, and supplementing the EBA model's results with adjustments by country teams. Where judgement is used, there should be consistency and transparency in the exercise of that judgement. We encourage staff to continue to review and evaluate the effectiveness of their suite of tools, while seeking more relevant factors to explain the current account dynamics. Care must be taken to ensure that the Fund's valuable analysis is not misinterpreted or misused. Could staff share their views on the possibility that ESR assessment could be used to make the case for countervailing actions during a trade dispute?

We welcome the continued efforts to enhance the depth of analysis, but caution against drawing strong policy conclusions from ongoing work. There is value in further work to understand high and rising levels of corporate savings and better measurement of the impact on the current account of the cross-border activities of multinationals and global value chains. In this regard, we again call on staff to encourage member countries to adhere to the international guideline set out in BPM6 as the basis for compiling sound and consistent BOP statistics, especially in the area of retained earnings, merchanting and processing trade data. The analysis in Chapter 2 provides valuable insights. We encourage more work on this topic, including in the context of the integrated policy framework. It will be important to think carefully about how to apply these findings beyond manufactured exports – resource export prices, for example, while invoiced in US dollars, can be set in highly flexible spot markets. Caution is also needed in the communication of these results, which should be seen as identifying situations where the impact of exchange rate movements may be muted in the short term, rather than the Fund stepping away from advice on the value of flexible exchange rates in mitigating shocks.

Mr. Tombini, Mr. Saraiva and Ms. Hennings submitted the following statement:

We thank staff for the detailed 2019 External Sector Report and for the previous presentation of Chapter 2 in an informal Board meeting.

General results of the overall global current account surpluses and deficits show that imbalances are trending slightly lower. Current account imbalances inched down to 3 percent of world GDP in 2018, while excessive imbalances declined from 40-50 percent to 35-45 percent of total deficits and surpluses. Despite this relatively favorable trend, the persistence over time of imbalances in key economies should encourage authorities to stay alert, especially in a global environment of increasing uncertainty and subject to costly disruptive adjustments.

We appreciate the report's longer-term view, which shows that excessive imbalances became concentrated in advanced economies (AEs), with progress in adjustment taking place mainly among emerging market and developing economies (EMDEs). From its peak immediately before the global financial crisis until 2013, substantial progress has been made bringing down current account imbalances from 6 to 3 ½ percent of global GDP. Thenceforth, imbalances have declined only modestly, while becoming more concentrated in a group of advanced economies – Japan and some euro area countries on the surplus side and the US on deficit. Persistence of flows imbalances over time has led to a historical peak in world's NIIP at 40 percent of GDP. While the accumulation of negative positions by countries that issue reserve currencies does not pose an immediate threat, large external liabilities could magnify shocks on global growth or risk aversion. Indeed, vulnerability is also associated to gross and net external liabilities, which result mainly from the financing of current account deficits over time – and do not require an imbalance to be deemed excessive. Furthermore, the composition of the liabilities is critical – differently from debt, a high stock of FDI in the country does not jeopardize stability.

Automatic adjustment mechanisms do not seem able to timely correct persistent imbalances in surplus economies. Urgency is always stronger in correcting current account deficits – particularly in EMDEs – than persistent surpluses. Market forces impinge more forcefully on deficit countries, while the international institutional framework has historically been set to promote the adjustment of deficit economies. Even though global imbalances are not causing an immediate economic problem, if surplus countries fail to adjust over time, deficit-centered correction will be costly in terms of global growth and may end up pushing our multilateral building to the brink. We welcome staff's effort to lay out the arguments to downsize excessive surplus, as well as to listing concrete measures, showing that adjustment could be made in a mutually advantageous way, and hence likely improving the traction of recommendations.

The focus on the underpinnings of excess corporate savings in advanced economies with large and persistent surpluses is welcome. Preliminary results show that this is an analytical avenue that deserves to be further explored. The fact that wealth and market concentration might be playing an important role here may make proper policy responses complex to devise and difficult to implement. Considering that in the US the aforementioned factors are prevalent but there are no excess corporate savings, are there lessons to be taken for other AEs?

The change in financial conditions in the beginning of 2019 has created a window of opportunity for countries to make progress in correcting policies and implementing structural reforms. Policy recommendations should not only address short-term adjustment but reflect each country's medium- and long-term structural reform needs. In this regard, we note that even for countries that are broadly in line with fundamentals and desirable policies there may be an important homework to do to ensure a durable balance. Moreover, countries with excess deficit should consider implementing growth friendly fiscal consolidation, improving labor market flexibility and enhancing competitiveness. While excess surplus countries should focus on discouraging excessive savings and boosting potential growth via public infrastructure investment and support to innovation and deregulation.

We concur that exchange rate flexibility remains key to supporting external adjustment and welcome the efforts to develop formal approaches that better resemble the range of realities on the ground. We appreciate the analysis of how the currency of invoicing and the integration into global value chains affect the impact of exchange rate movements on prices and trade volumes, especially in the short run. While the models in Chapter 2 assume that economies are trading manufactured products, the analytical toolkit should be extended to analyze economies with other characteristics, for instance, commodity exporters and importers. We welcome and incentivize staff's intensified use of other indicators, granular data and results from other flagship reports in addition to the regular EBA and REER models in the analysis.

Finally, we concur that protectionist trade policies are not effective in solving imbalances and should be avoided. We stress the importance of enduring efforts to foster free trade, as well as protect and strengthen the multilateral trading system. We missed a deeper analysis of potential impacts of an intensification of trade tensions, and of a no-deal Brexit. Could staff elaborate on the possible impacts of a disorderly Brexit scenario?

Mr. Lopetegui, Mr. Di Tata and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the well-written 2019 External Sector Report (ESR) and the on-line appendix. Chapter 2 of the report, which explores the role of dominant currency pricing and global value chains in shaping the working of exchange rates to induce external adjustment, is particularly interesting.

After narrowing sharply following the global financial crisis, overall current account surpluses and deficits declined marginally to 3 percent of world GDP in 2018 while rotating toward advanced economies in recent years, but further significant progress in reducing imbalances is necessary. Although there has been some progress in narrowing current account imbalances, the speed of adjustment has been slow, with underlying imbalances contributing to trade tensions. In addition to the role played by fiscal and monetary policies, reducing imbalances requires addressing structural rigidities that weaken the adjustment process, particularly within common currency arrangements where relative price adjustments are inherently constrained. In this regard, product and labor market reforms are particularly relevant. Capital account restrictions could also act as deterrents to the global adjustment process while stimulating faster labor mobility through migration flows. Staff notes that China's current account surplus narrowed further, although Box 1.2. recognizes that expansionary credit and fiscal policies have contributed to a buildup of leverage and vulnerabilities, and that achieving a lasting external rebalancing would require a gradual reigning in of these policies, accompanied by structural reforms. In view of the above, it is not clear to us whether the characterization of China's external position as being in line with fundamentals and desirable policies is fully consistent. We would appreciate staff's comments on this issue.

Net creditor and debtor positions have continued to increase at a fast pace, reaching historical peaks. Looking ahead, the projected fiscal policy in the United States is expected to widen the US current account deficit. At the same time, the report notes that the dynamics of stock imbalances will depend not only on the policy assumptions behind the current account projections but also on other factors, including the growth-interest rate differential. The latter constitutes another element justifying the need for prompt policy action in advanced economies. Could staff elaborate on the possible future implications of the growing stock imbalances for net income flows and the extent to which increases/declines in these flows are likely to be offset by compensating changes in trade balances? We would also like to emphasize that the composition of net international investment positions in terms of maturities is very important, as sudden reversals in short-term positions constitute an important vulnerability for some debtor countries. This issue, as well as the implications for global imbalances of a disorderly Brexit, could benefit from further analysis in future reports.

Regarding the role of exchange rates, we concur with staff that exchange rate flexibility remains key to facilitate external adjustment. As noted in Chapter 2, dominant currency invoicing and global value chain integration can alter external adjustment in the short term, but conventional exchange rate effects on trade flows seem to remain at play in the medium term. On a related matter, we wonder to what extent trade flows are influenced by perceptions about the permanency or temporariness of exchange rate movements. Trade flows responses may be limited, for instance, if exchange rate movements associated with unconventional monetary policies are perceived as only temporary. This would provide further justification for increased reliance on fiscal and structural policies to reduce external imbalances. We would appreciate staff's comments on this issue.

As a more general point, we agree with staff that a deeper analysis of the factors behind the choice of invoicing currencies and the associated price stickiness, as well as the intrinsic rigidities of global value chains, is key to the design of optimal policy responses. Staff also highlights in Chapter 2 of the report the role that other policies, such as access to credit and transportation infrastructure, may play in supporting exchange rate flexibility, as well as the importance of considering country-specific features, such as reliance on foreign currency debt, when designing the overall policy response. The distinct implications of currency of invoicing for small and large economies also deserve further analysis.

We welcome ongoing work to better understand the factors behind the high and rising levels of net corporate savings, which have been especially pronounced in certain advanced economies with large and persistent surpluses. It would be useful to analyze the drivers of this trend, which may be related to the increased concentration of wealth and to rising corporate market power. In this regard, we find very interesting the analysis in Box 1.7, which identifies some potential policy responses. The implications of large corporations and their location for global value chains could also be relevant topics. We strongly support more research on corporate savings and multinational activities in the future.

Lastly, we would like to emphasize the importance of avoiding policies that distort trade, which so far have had no discernible impact on external imbalances.

Mr. de Villeroché, Mr. Castets and Ms. Albert submitted the following statement:

The External Sector Report lies at the core of the Fund's multilateral surveillance mandate. The IMF is in a unique position to provide its members with a global view on external sector positions and global imbalances through BOP data collection from 190 countries, as well as its analysis and modeling capacity. This ESR once again shows the persistence of global imbalances while shifts in their composition appear limited compared to last year. Against this background, enhancing efforts to reduce excess current account surpluses as well as excess deficits is warranted, as an asymmetrical effort by deficit countries would imply a dampening of global demand and so of global growth, in a context where trade tensions already take a toll on global trade. On the analytical side, we thank staff for their intensive work to improve further the EBA methodology and look forward to seeing the results of ongoing research, especially regarding corporate savings, which seems to be a promising area of work.

Global assessment and NIIP

The reduction of the global imbalances appears to have paused over the recent years. The stock of imbalances reached a record level and, in the absence of corrective policies, it could continue to increase by 5 percentage points of global GDP by 2030. Global imbalances could even increase over that point if unfavorable evaluation effects which that are not tested in staff's estimation would materialize. Since this record level of global imbalances is a source of risks for external and financial stability, we encourage staff to work further on stock imbalances and disentangle the different contributions behind the NIIP trajectories to define optimal policies recommendations. Indeed, we would like to have a better view, beyond the accumulation of trade deficits and surpluses, of what is the internal dynamic of the NIIP (as valuation effects could be important, from (i) external assets influenced by the movements in financial markets and exchange rates and (ii) revenues from external assets recorded in the income balance which are not compensated elsewhere) and in which extent it could contribute to a more important NIIP divergence. Staff comments are welcome. Regarding some advanced economies, we note from the external sector assessments in Article IV reviews that staff derives evaluation of the external sector position from an estimation of the adequate level of NIIP (for Portugal and Spain for example). This implies that staff is able to determine an adequate NIIP position and the pace to reach this position. Could staff comment on whether there is a methodology to determine adequate NIIP? Regarding emerging and developing economies, we note that gross external liabilities position stands at a record 30 percent of GDP thanks notably to borrowing from non-bank sources, which underscores the necessity of an appropriate regulation in the non-banking sector.

Role of trade policy

The evolution of GVCs contributes to explain a part of the global trade slowdown and the fall in trade-to-income elasticity. Against this background, the reduction of the exchange rate elasticity of gross trade due to GVC does not come as a major surprise, but a better understanding of the role of GVC is important to design properly adequate policy recommendations to reduce global imbalances. We found interesting staff's finding which shows that a greater openness helps to increase trade balance elasticity, and offset the effects of more integrated GVCs. Moreover, the report highlights that the recently announced and envisaged tariff increases could reduce global GDP by an additional 0.3 percent in 2020, which shows the importance of promoting multilateral trade liberalization to boost growth.

Country assessments

China's position is now assessed as in line with fundamentals and desirable policies. This is an important and positive step in the evolution of global imbalances since the GFC. However, internal imbalances persist, and we encourage the authorities to pursue their efforts to reduce them by appropriately controlling credit evolution, supporting domestic demand though enhanced socials safety nets and pursuing the ongoing progress on financial sector reforms.

We note also the remarkable decrease of oil exporters current account surpluses and call for vigilance as they remain strongly exposed to oil prices volatility. Limiting the exposure to boom and bust through diversification and mobilization of non-oil revenues is of particular importance in LICs that are highly dependent on oil exports.

We regret the lack of progress in the United States as it still represents two-thirds of the global excess deficit. We see fiscal consolidation efforts and structural policies to increase human capital and improve competitiveness as the main measures to reduce the current account surplus, and we encourage staff to continue to work on the potential role of increase in corporate market power. Moreover, we note from the report p.16 that against conventional wisdom, cumulative current account deficit was accompanied by valuation losses thanks to dollar appreciation and higher equity prices. We would be interested to know more about the equity price effect, as potential overvaluation effect could play a role in a context of stretched equity prices.

Excessive current account surpluses remain concentrated in a few advanced economies, notably in the Euro Area. We note from the assessment that the adjustment has been asymmetric and more needs to be done to support internal demand in countries with excess CA surpluses, such as Germany and the Netherlands. We particularly support staff's recommendations for more proactive fiscal and structural measures to boost wages and investment, and so domestic demand. Taxation measures might also help to increase disposable income of households at the lower end of the distribution and so reduce inequalities while reducing significantly excessive current account surpluses.

We were somewhat surprised to read that some very high current account surpluses are deemed broadly in line with fundamentals and desirable policies. In those cases (Switzerland, Ireland) we wonder whether the existing significant measurement biases played a role in how staff came to the above assessment.

Ongoing work on EBA methodology

The ongoing work on corporate savings has started to provide very valuable insights to understand individual countries external positions. The box 1.7 is very informative, but we regret that there was not greater emphasis on this important issue in the core of the report. We are looking forward to country-specific analyses under the model of the SIP prepared for the last Article IV review for Germany, which usefully analyses the external sector position in the context of wealth distribution.

We understand that data collection is a key obstacle to better apprehending the role of MNE and profit shifting in some members, but we would like to have clarifications about the existing barriers and a precise roadmap on how to address persisting statistical issues. We would insist that given the centrality of this issue for the Fund's mandate more work is needed. A joint work by the Research Department, the Statistics Department and the European Department appears warranted in this regard. Could staff provide a summary of the existing obstacles, how to address them, and propose a calendar to ensure swift progress?

We thank staff for their work on dollar invoicing, which helps to better understand valuation effects on current accounts composition. The widespread use of the Dollar in international trade and finance markets is not something new. It is nonetheless helpful to better understand the impact of exchange rate variations on the short term to optimize policy recommendations in a context of adjustment. We note that, on the short run, a depreciation might have muted impact on exports, while it effectively dampens importations. On the longer run, exchange rate flexibility supports durable external adjustment. We look forward to discussing how those results might be integrated into the integrated policy framework. We note also from the presentation that China is among the countries with the most important share of imports and exports invoiced in dollar. In view of the conclusions mentioned above, this would imply that an increase of exports would be limited in case of a depreciation shock. Could staff indicate if the exchange rate pass-through for this economy is particularly low compared to other economies?

Ms. Mahasandana, Mr. Tan, Mr. Abenoja, Ms. Susiandri and Ms. Yoe submitted the following statement:

We thank staff for the well-written 2019 External Sector Report (ESR) and the helpful outreach to our office. We value staff’s updates on the assessment of global imbalances and the impact so far from the ongoing trade tensions globally. We find the discussion on the long-term evolution of external positions useful in providing a wider perspective of the evolving trends and how various macroeconomic policy drivers have helped shape the reconfiguration of current account balances. On the same note, the discussions on increasing financial integration of emerging and developing economies and the subsequent shifts in external balance sheets (Boxes 1.4 and 1.5) are interesting as they highlight the possible underlying vulnerabilities in gross positions that also merit closer scrutiny when discussing policy options for adjustment of external imbalances. We offer the following comments for consideration.

On the assessment of global external positions

We note that global imbalances have narrowed, with significant adjustments by emerging market and developing economies (EMDEs), albeit partly offset by larger imbalances in advanced economies (AEs). This is an encouraging step in the right direction. However, it is unclear if the rebalancing has been accompanied by associated trade gains and higher global output or lower global vulnerabilities and risks. Future work that goes beyond headline external positions would be particularly meaningful in assessing real progress as external rebalancing is not an end in itself.

With greater financial integration and widening stock imbalances, the Fund’s analysis, which focuses on current account and trade balances, runs the danger of providing an incomplete picture of external imbalances at the global level. Taking a holistic approach to assessing external positions, with closer monitoring of stock imbalances and capital flow dynamics, would convey a more accurate picture. In this regard, we welcome a closer look at the composition of gross external liabilities to better highlight vulnerabilities to external financing risks. Can staff comment on whether there are adequate and comprehensive data on external debt and foreign currency external debt for risk surveillance, including the granularity of data on non-financial corporate borrowings and the activities of less regulated nonbank financial sector? Are there efforts to enhance data collection in this area?

We appreciate the Fund's central role in supporting an open, rules-based multilateral trading system. However, we would caution that an over-emphasis on correcting global imbalances in isolation continues to run the risk of being misconstrued and inadvertently misused to legitimize protectionist measures. We encourage the Fund to shift away from a cursory narrative that global imbalances are automatically risky or undesirable. To steer global policy discussions in the right direction, the Fund should continue to conduct further analysis and heighten international attention on the adverse impact of trade tensions on global growth vis-à-vis the benefits of trade liberalization.

On the individual economy assessments

Limitations of the analytical framework remain significant, given large unexplained residuals of the EBA model and inherent uncertainties in the assessment. We support further refinements to the analytical framework to support bona fide interpretation of the residuals and well-tailored policy advice by the IMF. We reiterate the need for careful staff judgement to account for country-specific circumstances. Greater transparency around how judgement is applied remains important. For instance, it is unclear to what extent current account norms of economies with rapidly ageing population have been adjusted for demographics effects. It would be helpful if there is greater scope to reflect forward-looking trends in the external assessment, taking into account future expected external imbalances. For instance, the appropriate near-term policy response would differ for surplus countries that may be facing an ageing population in the medium term.

We appreciate staff's efforts in acknowledging the limitations upfront in this year's ESR. However, we wonder if labelling a country's external position and exchange rate valuation in a definitive and conclusive manner (i.e. substantially stronger/weaker, stronger/weaker and broadly in line, and REER are overvalued/undervalued) may distract the ESR audience from seeing the full context of the assessment and considering the important caveats that often underpin the assessment. Staff's comments are welcome. It may be more constructive to use the staff-assessed CA and REER gaps as a starting point to engage country authorities on the source and underlying factors behind the external position for each country, and the associated policy implications.

On the policy advice regarding external adjustment

We caution against equating external imbalances to misaligned exchange rate by default. There could be structural features for countries to run CA deficit or surplus (e.g. increase investments to narrow a wide infrastructure gap, accumulation of savings in anticipation of ageing population). Furthermore, we note that the Fund's understanding of the role of exchange rate movements in facilitating external adjustment is still evolving, as evident in the findings in Chapter 2. Hence, it may be presumptuous to draw conclusive policy advice on exchange rate adjustment for the membership at large.

We welcome the analysis in Chapter 2 as it adds greater nuance to the understanding of the role of exchange rate movements in facilitating external adjustment. We agree with staff that further work is needed to develop a fuller picture of the adjustment process. In particular, services trade (e.g. tourism, business process outsourcing receipts), investment incomes and remittance may be more significant than goods trade for some economies. Such country-specific structural feature could affect the workings of exchange rates on external adjustment. At the same time, exchange rate movements could exacerbate existing balance sheet vulnerabilities and pose financial stability risks. We welcome staff's comments on plans for further work in these areas. We would also like to know how the conclusions in Chapter 2 would be incorporated into the Fund's external assessment going forward. Furthermore, we also wonder if it is possible to reflect more clearly appropriate caveats in future ESRs and/or individual country reports on the evolving understanding and known limitations of the exchange rate mechanism, so that the public and financial markets can be more discerning when interpreting the results of the external assessments.

External rebalancing should be supported by a set of well-sequenced and calibrated macroeconomic and structural policies, instead of over-relying on the exchange rate channel. As borne out in the findings in Chapter 2, exchange rate flexibility needs to be supported by other complementary policies to facilitate external rebalancing. Countries in our constituency have long been advocating for the use of an expanded policy toolkit, including monetary policy, capital flow and macroprudential measures, and FX intervention aimed at disorderly market conditions, to deal with excessive capital flows while implementing structural reforms to address domestic imbalances and facilitate external adjustment. We look forward to the timely completion of integrated policy framework (IPF), and we welcome staff's comments on the current progress.

We support the stronger focus on structural reforms, which makes a more persuasive argument in favor of external rebalancing as a complementary outcome. In particular, policy advice on structural reforms tailored to reflect country-specific constraints on investment and savings behavior would better address the external imbalance and likely to gain more traction with country authorities.

On communication

We underscore the importance for the Fund to exercise greater caution and sensitivity when communicating the ESR findings and policy advice. The financial markets continue to perceive declining CA surplus or CA deficit as a sign of fundamental weakness for EMEs. As such, we urge the Fund to be cognizant of possible negative market sentiments when communicating the external positions of EMEs so as not to trigger any unintended market volatility. Similar to the above point on the link between exchange rate and external adjustments, the Fund should exercise greater caution with respect to communication on exchange rate direction.

Mr. Meyer and Ms. Lucas submitted the following statement:

We thank staff for an informative and concise report. Global current account balances continued to narrow, with a rotation toward advanced economies in recent years. We agree with staff that near-term financial risks from the current configuration of external imbalances are generally contained while in some cases policy actions are required to reduce risks from a further build-up in external leverage. As most economies are operating at or above potential, rebuilding policy space and implementing well-tailored structural reforms continue to deserve priority to support strong, sustainable and balanced growth. We support staff's call to avoid policies that distort trade and instead work toward reducing trade barriers and reiterate our view that sound domestic policies including sustainable fiscal policies and ambitious structural reforms in an environment of open markets and a rules-based, multilateral system represent the best response to concerns about global imbalances.

Notwithstanding the further reduction in deficits and surpluses, the report again underscores the need for deficit economies to adopt growth-friendly fiscal consolidation without further delay and for surplus economies to strengthen domestic sources of growth. Despite the still relatively favourable global growth environment, fiscal policies remain too loose, as it is reflected by staff's estimate for the global fiscal policy gap of 0.7 percent of GDP. This is worrisome as it reflects both emerging market economies with large domestic fiscal gaps and associated short-term risks as well as key major advanced economies maintaining large gaps and associated risks such as a lack of resilience to future shocks. In any case, we continue to see a need to put a strong focus on domestic policy gaps both in the main report and the individual economy assessments. Regarding surplus economies, we agree with staff that structural reforms that strengthen framework conditions for investment and support available incomes deserve consideration not least for domestic policy objectives. The appropriate policy mix will depend largely on country-specific considerations.

We thank staff for a pertinent and thought-provoking chapter 2 on exchange rates and external adjustment and mostly agree with the conclusions. As suggested by staff's analysis, certain features of international trade such as dominant currency pricing and integration through global value chains affect the composition and timing of an external adjustment process. For instance, a widespread use of the US dollar in trade pricing affects the short-term response of trade flows to exchange rate movements such that export volumes are more likely to respond only sluggishly to a currency depreciation while most of the adjustment would then take place through import compression. In our view, this would have implications also for Fund-supported programs that envisage an export-led recovery and external rebalancing inter alia through a depreciation of the REER. Thus, this calls for prudent assumptions regarding export growth at least in the short run (for those countries whose trade is mostly subject to dominant foreign currency pricing). Moreover, staff's findings highlight the inherent uncertainties regarding the estimation of trade elasticities with respect to real exchange rates which confirm our view to follow a cautious interpretation of exchange rate gaps implied by the EBA-current account model. Staff comments would be appreciated.

We acknowledge Germany's large current account surplus. In line with our statement for the Article IV consultation, we share staff's view that the CA surplus is expected to continue narrowing in the medium run. Continuously rising real wages as well as more people reaching retirement age should support lower external surpluses in the years to come. However, a large decrease in Germany's current account balance seems unlikely given a variety of fundamental factors such as a still aging population and high GDP-per-capita leading to net capital outflows, all else equal. That being said, we would like to highlight again our view that the current account surplus is mainly a result of private sector decisions in international trade and investment, and not of domestic policy choices.

We encourage staff to be careful in its judgement that the German position is “substantially stronger than justified by medium-term fundamentals and desirable policies”, as nearly all of Germany’s EBA gap is not explained by the model [4.0 percentage points of the 5.1 percent total gap]. Identified domestic policy gaps even decreased compared to last year. Among the domestic policy gaps identified, the most notable is again a fiscal balance higher than judged appropriate by staff. The fiscal policy gap contributes 1.2 percentage points to the total EBA gap, while only 0.5 percentage points are attributed to domestic fiscal policy. We reiterate our view, that this rather minor influence puts a premium on structural policies to facilitate investment in Germany instead of focusing the policy advice on an even more expansionary fiscal policy. The contribution of the credit gap decreased from 0.5 percentage points last year to only 0.1 percentage points also on the back of a lower domestic policy gap. However, we would be interested to learn why staff (again) deviates from the definition of the desired credit gap levels in the case of Germany which also raises some questions regarding cross-country consistency of the EBA exercise. As regards policy recommendations other than a more expansionary fiscal stance, we agree on the importance of structural reforms.[1]

Given the high model and estimation uncertainty, we would like to stress that a cautious interpretation of EBA “norms” is warranted. With regard to the REER estimates, we currently do not consider the REER as significantly undervalued, and instead assesses German price competitiveness to be neutral within reasonable error bounds.

With regard to the Euro Area, we agree with staff assessment that the euro REER can be described as broadly in line with fundamentals, as the reported REER gap remains limited and does not exceed 5 percentage points. In addition, we note that according to staff the increase in the overall euro area current account balance since 2007 “reflects in part the relative cyclical weakness of the euro area”, while the improved oil balance of the United States played an important role in preventing the US CA deficit to rise. In this context, we would like to draw attention to the growing empirical evidence that highlights the key contribution of the post-crisis collapse in commodity

[1] For a more comprehensive assessment of staff’s policy advice on Germany, we would refer to our statement for the Article IV consultation.

prices also for the Euro Area trade balance reversal. Against this background, it might have been interesting to also further decompose the Euro Area current account balance as displayed for the United States in Figure 1.5. Staff comments are welcome.

Ms. Levonian, Ms. McKiernan and Mr. Weil submitted the following statement:

We thank staff for a well-written External Sector Report (ESR), which continues to be one of the Fund's most valuable analytical products. Our key takeaway is that while the risks from the configuration of current account imbalances may be contained given their rotation towards advanced economies that hold reserve currencies, stock imbalances are a growing concern, particularly for emerging economies. We found that the topics in the analytical chapter were well chosen and, if anything, we would have welcomed more by way of policy advice for the membership. We continue to view the ESR as deserving greater profile, if not 'flagship status', given its consistently high quality and importance to the membership. It will be important to integrate the ESR's findings, including those from the analytical chapter, into bilateral and multilateral surveillance in a tailored way.

While the current configuration of global imbalances does not necessarily present an imminent threat, it may contribute to protectionist sentiment. The Fund's research has helpfully shown that tariffs do not help address a country's overall current account imbalance; rather, country-specific imbalances are simply diverted. However, the trade tensions created in the process reduce trade flows, create uncertainty, limit investment, lower productivity, and ultimately hurt global growth and prosperity. We encourage countries to avoid policies that distort trade and re-commit to the rules-based multilateral trading system. Persistent excess imbalances are best addressed through a rebalancing of savings and investment in deficit and surplus countries, taking into account cyclical and country context. A move towards greater liberalization of trade in services, both at and behind the border, will also support the process of external adjustment. Structural reforms are also key to addressing global imbalances and we encourage Research and Area Departments staff to collaborate in building a database that will enable the Fund to better understand the relationship between structural reforms and external imbalances.

Record high stock imbalances are a concern in the event of a shift in global risk sentiment. A decrease in net foreign currency-denominated external debt in emerging economies has been driven by increased foreign currency-denominated assets. This masks the fact that gross external debt and financing needs are at record highs, increasing external financing risks. We agree with staff that foreign currency-denominated debt levels need to be watched closely, especially where there is a mismatch between assets and liabilities. The trend towards increased foreign-currency borrowing, in particular from non-bank sources, underscores the importance of Fund research and advice on macro-prudential tools to manage the associated financial vulnerabilities. We encourage staff to leverage ESR research on these vulnerabilities in the context of the forthcoming FSAP review and expect that appropriately tailored advice will be integrated into relevant Article IV consultations.

Staff should seize the opportunity presented by the ESR to develop the policy implications of their research on the drivers of rising corporate savings. Staff presented a helpful summary of the drivers of rising net corporate savings and the correlation with aggregate saving trends. Given that rising corporate savings are a contributing factor to large and persistent surpluses, staff is encouraged to fully draw-out relevant policy recommendations. Previous work in this area stressed the importance of reducing behind-the-border barriers to entry in certain economic sectors to promote competition and unlock greater business investment. In the past staff has also signaled that a falling labor share could also imply a need to reform labor market institutions to rebalance worker bargaining power. Lastly, the trend away from paying dividends and towards retaining earning has previously led the Fund to suggest that authorities should focus on taxing economic rents where tax policy distorts profit distribution decisions. Staff should more fully develop such policy advice in ESR as the causal links for rising corporate savings become clearer. We also encourage the Fund to continue its work on the link between rising corporate savings and inequality.

The research on dominant currency pricing suggests a heightened risk of spillovers which emphasizes the need for further analysis and concrete policy advice to the membership. Staff’s findings suggest that shocks to the US economy can have significant spillover effects on world trade through the effects of US exchange rates used in non-US trade, especially in the short run. We would have welcomed an acknowledgement of this risk, and an assessment of the potential spillover impacts from US-specific shocks, such as bilateral trade conflicts and unanticipated US monetary policy changes. Further, staff’s findings tell us that devaluation alone cannot guarantee an external adjustment in the near term in a US dollar-dominated world. However, it is not clear what the corresponding policy message for the membership should be. Should small open economies peg their exchange rate to the US dollar? Should invoicing practices change? It will be important to frame a careful policy message for the membership, including the short and medium-term policy tradeoffs as this research agenda evolves. It will also be helpful to extend the analysis to services, and especially commodities, which behave quite differently from manufactured goods in response to changes in price. Staff's conclusions raise the question of what the right exchange rate metric is in a dominant currency invoicing world. This is an opportunity for the Fund to support the membership by developing more relevant measures of external competitiveness, such as a real effective exchange rate weighted towards dominant invoicing currencies. Staff's finding that larger exchange rate movements may be required to achieve near-term external adjustments should be considered and communicated carefully given the many associated internal and external tradeoffs. This finding also highlights the importance of the forthcoming Integrated Policy Framework.

We encourage staff to take a holistic view of the implications of global value chains (GVCs) for policy makers. Staff's finding that the trade balance has diminishing sensitivity to exchange rates as an economy is more integrated into GVCs is helpful for the membership, especially small open economies. The analysis should be complemented by a discussion on the external adjustment mechanism in other sectors such as services, which may have weaker cross-country linkages and less imported content than the manufacturing sector. Staff also made several important complementary findings that could warrant follow-on analysis. For instance, staff found that: (i) GVC integration has been limited since 2000; (ii) greater integration into GVCs is associated with higher trade openness; and (iii) GVCs are intrinsically rigid. These findings could have important implications for trade and industrial policy and should be explored further. Regarding findings (i) and (iii), we felt that Chapter 2 of the 2019 ESR contrasted somewhat with Chapter 4 of the April 2019 WEO. For instance, the WEO pointed to a significant increase in complex global value chain participation since the mid-1990s and illustrated how trade diversion in response to escalating tariffs can lead not only to sectoral reallocations across countries but to the actual repositioning of entire GVCs. Recognizing that there are definitional and measurement differences at play, it would be helpful for staff to pull together its valuable work to provide the membership with a holistic view of the policy implications of GVCs.

Mr. Daïri and Mr. Nadali submitted the following statement:

After remaining at about 3.5 percent of world GDP since 2013, global current account surpluses and deficits declined marginally to 3 percent in 2018, reflecting higher energy prices and continued external rebalancing in

China. The excess current account imbalances narrowed somewhat to about 1.2 percent but became even more concentrated in a few large advanced economies (AEs) running either persistently higher-or lower-than-warranted balances. Stock imbalances, however, have continued to widen, with the sum of net creditor and debtor positions reaching record levels at 40 percent of world GDP. While short-term financing risks appear contained, entrenched trade tensions and further divergence of external stock positions over time could trigger costly disruptive adjustments in key debtor economies with global spillovers. We agree on the need for a well-calibrated macroeconomic and structural policy mix to support rebalancing, concur with staff overall external assessment and associated policy recommendations, and wish to make the following points:

Deviating from a strict external balance is often desirable to absorb country-specific shocks and facilitate a globally efficient allocation of capital. AEs, with an aging population and weaker growth prospects, have positive current account norms, whereas most EMDCs, with younger population, greater investment opportunities, and higher growth potential have negative norms. Deviations from current account norms, dubbed excessive imbalances, reflect both domestic policy distortions and those that come from the rest of the world and should be eliminated, albeit gradually.

We note that even in countries where external positions are in line with fundamentals and there are no overall external gaps, offsetting policy distortions need to be addressed to prevent a resurgence of external imbalances.

The Fund should continue to strengthen its analysis of external imbalances, including by model-based estimates combined with analytically-grounded judgment, to arrive at evenhanded, transparent, and multilaterally-consistent external assessments, where positive and negative excess imbalances match each other. Given inherent uncertainties of the exercise, we see merit in presenting current account and REER norms in ranges.

Lags in the transmission of exchange rates to trade volumes and prices were cited as reasons behind discrepancies in three key emerging market economies between current account and REER assessments in 2018. Has this inconsistency been observed for these or other countries in previous years? Is the lag due to dominant currency invoicing and global value chain integration? How long does the lag typically last and what action, if any, has been taken to shorten it? Are there indications that the said discrepancies will disappear in 2019? Staff comments are appreciated.

Resorting to bilateral tariffs to target a specific bilateral balance should be avoided as it has proved both ineffective, because of trade diversion, and costly and disruptive to global trade, investment, and growth, because of negative effects on output, employment, and productivity. A modernized multilateral, rules-based trading system that captures the increasing importance of e-commerce and trade in services and ensures continued enforceability of WTO commitments should be promoted to help narrow imbalances and bolster domestic and global growth.

Gradual growth-friendly fiscal consolidation by excess deficit countries and greater fiscal stimulus by excess surplus economies should be pursued, complemented by well-sequenced and carefully-tailored structural reforms, along the lines suggested by staff, to address persistent external imbalances, boost potential growth, and achieve global rebalancing. High and rising levels of corporate saving in some AEs and increased gross external debt and financing needs by most EMDCs also warrant careful monitoring.

Compared with fiscal policy and the credit cycle, foreign exchange interventions have played a much more muted role in the narrowing and rotation toward AEs of aggregate surpluses and deficits. While some clarification on the basic assumption of price stickiness in this context would be helpful, we welcome staff analysis of the short-and medium-term impact of dominant currency invoicing and greater integration into global value chains on the responsiveness of gross flows to exchange rate movements. We note efforts to advance data collection and compilation on global value chains, and appreciate staff indication of progress made in this area since the formation of the relevant working group in 2017.

Understanding the full impact of exchange rate movements on external adjustment goes well beyond manufacturing trade and should take into account a country's other characteristics, including trade in services and external balance sheet vulnerabilities. While data limitations remain an obstacle at this stage, we find merit in empirical integration of these additional features as part of the future work agenda.

We agree that exchange rate flexibility remains key to facilitating durable external adjustment and can be strengthened with structural policies. However, exchange rate peg remains appropriate for several small open economies. It is also the case for many oil exporters where there is limited role for the exchange rate–reflecting the dominant share of hydrocarbons in exports and the high import content (including labor) of domestic production–to adjust the external imbalance, which could largely be due to the fiscal imbalance. Caution is therefore warranted to ensure a consistent message with flagship reports when communicating the findings in Chapter 2, which would only apply to manufacturing trade.

Mr. Inderbinen, Mr. Tola and Ms. Wicht submitted the following statement:

We thank staff for the 2019 External Sector Report and welcome the ongoing work on the underlying methodology and on topics related to the external sector. We regret the shortened circulation period. While we fully understand that the ESR is a complex and lengthy endeavor, this argues for more rather than less time between circulation and Board consideration.

The implementation of sound macroeconomic policies is key to reducing excess CA balances. The EBA CA model provides a rich framework to evaluate policies and their impact on CA balances. Looking at a single factor, namely the CA gap, is thus not sufficient. Staff needs to carefully consider the decomposition of policy gaps into policy variables and identify the impact of domestic and foreign components. In that sense, we welcome the emphasis on the sources of policy distortions and the transparency with which they are reported and discussed in the ESR. Identifying the drivers of CA gaps is essential to provide appropriate policy recommendations. In particular, if an excess CA gap is caused by a policy distortion rather than an exchange rate distortion, adjustment through the exchange rate would not be the right policy response.

We caution against linking unexplained CA gaps to policy distortions. Unexplained CA gaps remain high, calling for the need to explore the role of fundamentals or desired policies that are not taken into account in the empirical framework. In particular, the link between the CA, demographics, and pension systems deserves further consideration. This should build on existing work, including on aging and pensions systems. The institutional framework of pension systems is heterogeneous across countries and may not be properly captured by the institutional variable in the EBA CA model. The design of pension systems can affect savings, and thus CA balances. In addition, we would welcome further work on understanding the drivers of rising corporate savings.

We strongly support taking country-specific factors and biases linked to statistical standards into account when determining CA gaps. We note that the CA gaps of several countries have been adjusted for measurement issues. Systematic and persistent valuation changes over time could be indicative of measurement issues. Figure 1.8 shows a negative correlation between CA balances and NIIP valuation changes. What is staff's take on the underlying drivers of the relationship depicted in Figure 1.8? Are measurement issues one of those drivers?

We welcome staff's additional work on the link between trade balances and exchange rates. The chapter on exchange rates and external adjustment contains useful insights for policy. It offers some evidence that characteristics of international trade may mute the link between the exchange rate and the trade balance. Although these results may depend heavily on country-level characteristics, as well as the time horizon under consideration, they bring one aspect of the methodology underlying the ESR into question: In the EBA methodology, CA gaps are translated into exchange rate gaps using a country-specific CA elasticity. If features of international trade mute this relationship, CA elasticities could be lower than those used by staff. With low CA elasticities, closing CA gaps would require excessively large exchange rate adjustments, which are unrealistic both economically and for the purpose of policy recommendations. CA gaps should thus not be the sole basis for determining exchange rate gaps.

Emphasis should be placed on exchange rate models, rather than inferring exchange rate gaps from CA gaps. Exchange rate misalignments can be determined based on fundamentals and policies driving the exchange rate without relying on the empirically disputed link between the CA and the exchange rate. Further work on the two real exchange rate models of the EBA methodology is warranted.

While CA balances are the focus of the ESR, they are only one aspect of a country's external sector. It is important to complement the analysis of CA balances with the analysis of net and gross international investment positions (IIP). Indeed, these indicators contain information about different aspects of a country's external position: CA balances about the refinancing need of an economy; net IIP about the sustainability of a country's borrowing position; and gross IIP about the sources and potential build-up of risks. The ESR should therefore consider all indicators. For that purpose, we would welcome a more extensive discussion on net and gross IIP.

Finally, we support staff's call to avoid policies that distort trade. Even though CA balances have not significantly widened over the past year, risks from policies that disrupt free trade persist. In particular, we agree with staff that trade-distorting policies may weigh on global trade flows, investment and growth. In light of unresolved trade tensions, the Fund has an important role to play in promoting and communicating the benefits of a free and open multilateral trading system.

Mr. Mouminah, Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the focused 2019 External Sector Report and welcome the continued application of country-specific judgement in the assessment of external positions. This is important since uncertainties are inherent in model results, even after continued refinement efforts, because of data shortcomings and methodological limitations. Indeed, we note that the model still falls short of explaining some cases of large current account gaps in view of the presence of large residuals. In this connection, we take positive note of efforts to apply staff judgment evenhandedly and transparently. Here, we underline the importance of relying on area departments to better capture country-specific knowledge and help inform staff judgement.

Further reducing excess external imbalances in a manner supportive of global growth remains a priority for reinforcing global stability. While overall global current account surpluses and deficits narrowed sharply in the aftermath of the global financial crisis, they have declined only marginally since 2013. We also note that, in 2018, they narrowed somewhat, and that about 35-45 percent of overall current account surpluses and deficits were deemed excessive according to staff's assessment with continued trend of greater concentration of surpluses and deficits in a few large advanced economies. On the evolution of stock positions, we note that net international investment positions stabilized in 2018 and are projected to remain broadly unchanged, under baseline policies, over the medium term, but they continue to diverge among economies. Given large and persistent global imbalances and the need to rebalance the global economy, we echo staff's call for growth-friendly policy actions by both excess surplus and deficit countries.

A well-calibrated mix of macroeconomic and structural policies tailored to country-specific circumstances is essential to support rebalancing. In this connection, we broadly concur with the recommended fiscal and monetary policies for both excess deficit and surplus economies. In some cases, macroprudential policies may need to be tightened to help slow excessive credit growth. A greater role for well-sequenced structural reforms is also important in both excess surplus and deficit countries to address imbalances while boosting potential growth. Here, we agree that excessive surplus economies should prioritize reforms that encourage investment while excess deficit economies should focus on reforms that boost saving and competitiveness. In addition, we support the recommendation to revive trade liberalization efforts and modernize the multilateral rules-based trading system to boost global trade and growth for the benefit of all economies.

An improved understanding of the drivers of the rise in corporate saving especially in surplus advanced economies is important to the design of policy responses for addressing excess external imbalances. In this context, we welcome the staff work and note preliminary finding that tax and structural policies that encourage domestic demand and support higher labor compensation and disposable income of lower-income households may have a role to play. We would welcome an elaboration on staff's work plan on building on the current understanding of the underlying drivers of high and rising levels of corporate saving in some advanced economies and on identifying suitable policy options.

Finally, we welcome the analysis in Chapter 2 on the role of exchange rates in facilitating external adjustment, which will have implications for other areas of Fund work especially the design of Fund-supported programs. In particular, we take note of the features of international trade such as dominant currency pricing and international integration through global value chains, which suggest sluggish short-term export response to exchange rate flexibility. We encourage staff to continue their research in this area. We also see merit in exploring the impact of exchange rate adjustments on services trade and on exacerbating external balance sheet vulnerabilities.

Mr. Kaya, Mr. Just and Mr. Reininger submitted the following statement:

We thank staff for the comprehensive and insightful report.

We are encouraged that overall excess current account imbalances narrowed moderately in 2018, resulting from both smaller positive gaps in some countries, particularly in China and to a lesser extent also in Germany, and smaller negative gaps in several countries, including Turkey. While the remaining excess imbalances have become even more concentrated in a few large advanced economies, some larger emerging market economies also show substantially or moderately negative gaps, like Argentina, Indonesia and South Africa, or positive gaps, like Malaysia and Thailand. We note that under the baseline scenario, the current account surpluses of European countries, Japan and China are all projected to narrow gradually supported by appropriate policies, while the US fiscal easing is expected to lead to a larger negative gap in the US and higher current account balances elsewhere. We are concerned that not only unchanged current account imbalances at the present level but also the projected baseline current account balances would imply rising creditor and debtor stock positions. As this calls for enhanced efforts to implement tailored policies to rebalance, we share the thrust of staff's policy recommendations, including the warning against using tariffs to adjust bilateral trade balances or concluding managed trade agreements. As for the euro area, we note that staff's assessment of the unchanged, moderately strong, positive current account gap results from the lowering of the current account norm in parallel to the decline of the actual current account surplus. In this context, we would like to mention that the EBA current account regression has a special result for the euro area in that the sum of the contribution by identified policy gaps and the residual is considerably lower than the total positive gap. Staff comments are welcome. In policy terms, we concur with staff's recommendation that policy action for addressing the aggregate gap as well as the imbalances within the euro area, has to be taken both at the area level, deepening the economic and monetary union, and at the level of individual member states.

On a methodological note, we underscore that while identified policy gaps fall significantly short of explaining the total gap, there are a few countries with moderate excess imbalances, including the United States, Korea and Russia, where the identified policy gaps explain the major part of the total gap, suggesting more immediate reaping of the fruits of policy action. Concerning the residual of the EBA current account regression, we note the interpretation by staff that, apart from model misspecifications, the residual (partly) reflects structural distortions, with increased product market flexibility reducing and increased labor market flexibility raising the current account balance. We would like to suggest that for surplus countries this residual may not only comprise the effect of distortions but could also reflect the impact of specific strengths, like for instance the quality and branding of products or the export-related infrastructure, networks and financing.

Nevertheless, we concur with staff's main message that also countries with excess surplus have to implement policies to gradually achieve a more balanced position. Indeed, it is in these countries' own interest to increase public infrastructure investment and incentivize private investment in innovative activities to boost potential growth, and to foster wage growth particularly in the low- to medium-income brackets, underpinned by tax-relief for low-income households and tailored improvements, or in some cases particularly in Asia expansions, in the social safety net. While there is no doubt that the latter is important in all countries, in excess surplus countries, it has the beneficial side effect of helping reduce the external imbalance. For countries with excess deficit, we would like to limit our comments to highlighting that investment into education and training strengthens both competitiveness and the aggregate savings rate.

We appreciate the report's look into high net corporate saving and see merit in deepening the analysis with respect to determinants and impact of the main driving factors like declining labor shares, declining corporate investment and the increased concentration ratio of firms.

We welcome the increased focus on how invoicing and value chains affect the relationship between exchange rates, trade and current accounts. The analysis supports the focus on broad macroeconomic policies, rather than just monetary instruments, in order to correct imbalances in major advanced economies. At the same time, we fully share staff's point that exchange rate flexibility remains key to facilitate external adjustment over the medium term.

As for the asymmetric short-term effect of currency depreciation in achieving external adjustment under dominant currency (USD) invoicing, we support the recommended structural policy measure to promote export-related infrastructure, networks and financing, which we regard particularly important for low-income countries (LICs). However, we note that while under dominant USD invoicing export volumes are not enhanced via price-induced stronger foreign demand, still the export sector receives support from the currency depreciation, as the unchanged USD export prices imply higher export prices in local currency. This supply-side effect should help alleviate capacity constraints and possibly allow expanding to other markets – but this effect will have an impact on export volumes rather only in the medium-term.

For most small and open European economies outside the euro area, the euro area is their dominant trading partner and the euro the invoicing currency, i.e. destination currency pricing of exports, as opposed to producer currency pricing. Thus, the question arises whether for these economies such a feature of bilateral trade would lead to results (with respect to exchange rate pass-through and response of trade volumes and trade balance) that are comparable to dominant third-party currency pricing. Staff comments are welcome.

For a comprehensive view of the impact of USD invoicing on global trade, it would be important to combine the analysis on manufacturing trade in Chapter 2 with a corresponding study on commodity trade and, ideally, on the services sector.

For many small and open economies, the participation in global value chains (GVC), often coupled with dominant currency invoicing, constitutes some shield against currency volatility and acts as absorber of currency shocks. However, we emphasize that GVC could be hurt by the implementation of tariffs.

We welcome staff's plans to extend their analysis and research to cover the large and rising cross-border activities of multinational corporations (MNCs), a topic closely related to GVC, and we encourage staff to also actively outreach in this regard to UN organizations, particularly UNCTAD.

Finally, we encourage staff considering deeper analysis and research of illicit financial flows (IFF), which would correspond to the G20 commitment under the G20 Action Plan on the 2030 Agenda, reaffirmed by the G20 Leaders' Declaration in Osaka recently.

Mr. Kaizuka, Mr. Saito, Mr. Ozaki and Mr. Nagase submitted the following statement:

We thank staff for the 2019 External Sector Report (ESR).

Reducing excess current account (CA) imbalances remains a critical issue for the global economy. Global CA balances (the absolute sum of surpluses and deficits) have declined marginally since 2013 and have become increasingly concentrated in advanced economies (AEs). The 2019 ESR suggests that 35–45 percent of overall CA balances were excessive in 2018.

In this regard, under our G20 Presidency, the Japanese authorities took up global imbalances as its priority due to the importance of this issue. We thank the Fund for its significant contributions on this front including by issuing a report. Based on the discussion, G20 Finance Ministers and Central Bank Governors agreed on the following points: The importance of monitoring all components of CA, including service trade and income balances; Factors underlying excessive imbalances may include excess corporate savings, miscalibrated fiscal policies, and barriers to trade in goods and services and; Carefully calibrated macroeconomic and structural policies tailored to country-specific circumstances. Going forward, incorporating the takeaway of this year's G20 discussion, we expect the Fund to work on the global imbalances further, including their cause and counter measures to reduce them. Against this background, we highly appreciate the analysis in this ESR on possible impact on increasing corporate saving in AEs and the deepening of global value chain (GVC) on to the relationship between exchange rate and trade balances. In addition, we welcome staff's effort to conduct further analysis on the impact of exchange rate on the whole CA balances and its components, including services balances and income balances, and on the risk of expansion of stock imbalances.

At the same time, we reemphasize that the external assessment framework has rooms for further improvements. On this front, we would like to raise "exchange rate assessment" and "policy recommendation" by the Fund in the ESR.

Exchange Rate Assessment

The relationship between CA and exchange rate is not straightforward. The current assessment framework evaluates exchange rate by linking it with CA. However, the relationship depends on time frame; short-term or long-term, and structural factors, such as the compositions of CA and the participation in GVC.

Firstly, the impact of exchange rate on CA varies with time frame of assessment.

In the long run, all receipts in foreign currencies will be converted to a home currency. Therefore, CA, which represents the total amount of net receipts, will correspond to the total demand for a home currency. However, the ESR should focus on the short- and medium-term assessment, instead of the long-term one.

In the short and medium run, there are several factors complicating the relationship between CA and exchange rate.

As staff analyzes, the impact of exchange rate movements on CA is affected by the selection of invoicing currencies.

In addition, the impact also varies with currencies in which a country holds until its receipts are converted into its home currency. For instance, if residents in Japan keep holding their receipts in US dollars earned by exporting goods and services, such transactions would not affect exchange rates.

Moreover, large capital transactions significantly affect exchange rates. CA and capital account balances are matched by definition. However, for supply and demand of individual currencies, the net balance of currency transactions does not necessarily match with CA balances. Rather, in reality, capital transactions create currency positions which outsize several times of CA.

Secondly, adjustment mechanisms by exchange rates vary with structural factors, such as the compositions of CA and the expansion of GVC.

As long as depreciations of a home currency increase exports and/or decrease imports, and vice-versa, exchange rates can function as a tool to adjust trade balances.

However, the relationship between exchange rate and income balances is not simple. Several factors complicate the relationship. For example, while exchange rate movements affect investment decisions, we should be mindful that expectation of future exchange rate movements would also affect the decision. As we recognize that the increase of income balances plays a greater role in CA not only in exceptional countries but also in some AEs and developing countries, more careful discussions will be needed.

Furthermore, there are some structural changes that weaken the power of exchange rates adjustment on trade balances. One example is expansion and deepening of GVC. Bilateral exchange rate movements have less impacts on the transactions of goods and services in developed GVC. In addition, as pricing-to-market practices become more common, exchange rate movements lesser affect the transactions of goods and services.

Although we welcome the fact that the ESR began to turn its attention to time span and the structure of CA, we underscore that further analysis should be conducted with these points as staff mention above. We encourage staff to fully recognize the relationship between exchange rate and CA and conduct the analysis with such recognition. We suggest that staff reconsider how relevant it is to link CA gap to exchange rate assessment and develop more reliable tools to assess exchange rate in case of such assessment.

Policy Recommendations by the Fund in the ESR

The ESR aims to identify excess imbalances and their causes, thereby proposing macroeconomic and structural policies to address them.

Under the present framework of the ESR, if there are “large unexplained residuals of the EBA CA gap”, it is automatically recognized there are causes specific to the country or structural factors. However, staff do not give any proposal to address the problems in many cases. For example, while assessment of Japan suggests that there are still have “important bottlenecks to investment remain” in the ESR, the bottlenecks are not specifically identified. Without such identification, the messages are too abstract for the recommendation. We strongly encourage staff to improve the EBA model to enable to capture these unexplained residuals and propose more concrete policy recommendation to address the structural problems.

Regarding corporate savings, the ESR indicates that the increases in corporate savings could reflect declines in the labor share, decreases in corporate investment, and increases in retained earnings and share buybacks. In addition, it also shows that more wealth inequality and higher corporate market power could increase corporate savings and subsequently domestic savings. Excess savings in firms with higher market power reflect that under competition produces the situation of “winner takes most” and the profits of such firms are not taxed appropriately by the existing law. The latter could reduce tax revenues, and thereby induce more wealth inequality and smaller aggregated consumption. In this regard, the “two-pillar approach”, currently discussed in the international taxation; the review of the principle of international taxation and the introduction of the measures to cope with the profit shifting to the tax haven, is important. We will continue to discuss this matter in the G20 framework.

Mr. Rosen and Ms. Pollard submitted the following statement:

The 2019 External Sector Report (ESR) marks the eighth year of its publication. The report has strengthened over time as the Research team has made great strides in refining the External Balance Assessment (EBA) methodology that underpins the ESR analysis. In addition, there is greater transparency and a more systematic process for making staff adjustments to the results of the EBA models. Nevertheless, despite the improvements in the assessment of imbalances, less progress has been made in the reduction of excessive global imbalances and excessive surpluses have proven particularly persistent, highlighting the need for staff to continue to advocate for decisive policy actions in both its multilateral and bilateral surveillance.

External Imbalances

Figure 1.1 in the ESR indicates that global imbalances peaked in 2006 and fell sharply through 2009. Since then imbalances have narrowed more slowly, remaining above the 2.5 percent average for 1980–2000. Economic theory, however, does not provide a justification for current accounts to be balanced. Thus, while the decline in global imbalances may be welcome, the

ESR provides little information on what is the appropriate level for global imbalances based on economic fundamentals. For example, given the size of the United States in the global economy (accounting for nearly one-quarter of global nominal GDP in 2018), even if the U.S. current account deficit equaled its norm of 0.9 percent of domestic GDP in 2018, the U.S. current account balance as a share of global GDP would have been higher than any of the other "top 15 deficit economies" listed in Table 1.1.

The EBA models provide insight as to whether imbalances are driven by economic fundamentals or if they are cause for concern. Staff's assessment that 35 to 45 percent of global current account surpluses and deficits were excessive in 2018 down from 40 to 50 percent in 2017 provides a more relevant assessment of the importance of global imbalances than a simple sum of deficits and surpluses. Does staff have information on the historical trend in excessive imbalances?

We welcome developments that have led to the narrowing of excessive imbalances last year, notably a decline in intervention. We also appreciate the information in Table 1.3 on the publication of foreign exchange intervention. Publication of intervention data would help improve the accuracy of staff's intervention measurement in the EBA model as well as support greater transparency. We urge all countries to make this information available. We recognize that foreign exchange reserves can play a role in reducing the likelihood of an external crisis in emerging markets and developing economies but as Box 1.5 notes there are diminishing returns from accumulation. Staff note that the "uphill" flow of capital from poorer to richer nations in the 2000s was driven in part by reserve accumulation

We generally agree with categorization of external balances as shown in Figure 1.10. This figure points out the asymmetry in current account gaps, with four countries assessed to have current account surpluses substantially stronger than warranted by fundamentals while no countries have current account deficits substantially weaker than warranted by fundamentals. This implies that the global economy suffers more from an excess saving rather than an excess demand problem. We urge the IMF to press for a more symmetric adjustment.

The ESR also rightly highlights that even countries whose current account balances are considered broadly consistent with fundamentals need to be cognizant of underlying domestic imbalances that could give rise to external imbalances. In this regard, we welcome the decline in China's current account surplus but agree that saving remains unduly high and policies to improve the social safety net, reform SOEs, and open its markets are imperative.

We also welcome the evolution of Korea's external balance over the past few years while urging more progress. We agree with the policy recommendation to shift the accommodative stance from monetary to fiscal policy. We support staff's call for intervention to be limited to calming disorderly markets, but question how staff can conclude this has been the case for Korea. Korea's intervention figures are currently published semiannually while market condition data are available on a daily or more high frequency basis. Given this, can staff provide more information about their methodology for defining disorderly market conditions?

Singapore's recent decision to publish intervention data is a welcome development. We agree with the policy recommendations for Singapore listed in Table 1.8 and the individual country page but given the size and persistence of Singapore's excessive current account surplus, would have like to have seen more discussion in the text.

We appreciate the continued attention to intra-euro area imbalances which again highlights the asymmetric adjustment process. We urge the German and Dutch authorities to give due consideration to implement the recommended policies aimed at increasing domestic demand and welcome staff's continued efforts to better understand the drivers of the excessive surpluses in these two economies.

The ESR notes that "policies that distort trade should be avoided" but focuses only on tariffs and managed trade. We would have liked to have seen a broader assessment of policies that distort trade, including domestic subsidies, forced technology transfers, and non-tariff barriers.

EBA Methodology

We welcomed last year's substantial methodological changes and agree on the need to pause before undertaking any further revisions. Apart from these refinements, we strongly welcome the focus on better understanding "other gaps" as discussed in paragraph 13. The attention to structural factors outside the purview of the model, has shed light on the large size of the "other gaps" in some countries and has enhanced staff's policy advice to these countries. Better data will also be helpful to improve the fit of the model, particularly in small open economies with large financial sector transactions.

More attention to the other gaps and a more transparent accounting for staff judgement has decreased the size of staff's ad hoc adjustments the EBA model's current account gap. Moreover, most of staff's adjustments now appear to be based on rigorous and sensible analysis. This is true not only for the ESR countries but for most assessments of EBA countries in recent Article IV reports. That said, we still think it is important to consider the multilateral implications of making individual country adjustments.

Looking ahead, we repeat our call for a better understanding of the reserve currency variable in the EBA model. We are not convinced that the euro's role as a reserve currency has the same effect across all euro area countries. Relatedly, we welcome the reappearance of the chart showing the decomposition of current account norms (Figure 1.9) but preferred the greater detail provided in the 2017 ESR. For example, we do not understand why staff would combine the oil and reserve currency contributions to the norm into one category. We also encourage staff to do more analysis on the role of intervention on the exchange rate and current account balances. Some recent studies argue that intervention, even in the absence of capital controls, can affect the exchange rate.

Staff adjust the CA norm for Brazil, India, Poland, and Spain because of financing risk considerations related to the negative net international investment position (NIIP) of these countries. These adjustments seem arbitrary as the model already includes a variable to capture the negative effects of a NIIP below -60 percent of GDP. In addition, India's negative NIIP at 16 percent of GDP is much smaller than most of the other debtor economies listed in Table 1.2. Could staff provide an explanation of these adjustments?

Exchange Rates and External Adjustment

Economists have long known that exchange rate passthrough is often incomplete at least in the short-run. Some studies have found asymmetric effects of passthrough related to the direction of the change in the exchange rate as well as the size of the exchange rate change. More recently studies have looked at the factors behind incomplete passthrough. Staff's analysis in Chapter 2 of the ESR adds to this literature by focusing on the effects of dollar invoicing and global value chains on the adjustment of merchandise trade balances. We welcome this work as a way to better understand the factors affecting the link between exchange rate movements and external adjustment. We encourage staff to undertake further work to explore how effects may differ across countries and to consider non-linearities in the link between exchange rates and external adjustments.

We think more emphasis should be placed on the conclusion that exchange rate flexibility remains key to facilitating external adjustment. We would also encourage staff to compare external adjustments for: countries in currency unions, countries with fixed exchange rates, and countries with flexible exchange rates, to further determine the role of exchange rate flexibility.

Mr. Raghani, Mr. Sylla and Mr. Alle submitted the following statement:

We thank staff for a very informative 2019 External Sector Report (ESR). The annual exercise of analyzing the external positions of the world's largest economies continues to add valuable inputs to the Fund's overall effort of providing a comprehensive view of developments in the global economy. This assessment is particularly relevant at this juncture when some member countries' legitimate objective of addressing their external imbalances is creating trade tensions that spillover to other economies.

We welcome the main findings of the report notably the marginal narrowing of global imbalances in 2018. The breakdown between the recent developments and a longer-term view of the external positions offers a comprehensive perspective on the dynamics of imbalances. We thus learned that while global current account balances declined sharply in the aftermath of the global financial crisis (GFC), global current account surpluses and deficits have narrowed since 2013 and are now concentrated in advanced economies. At the same time, besides the aggregate assessment, we took good note of the contrasts presented in individual country situations and regional disparities. The United States leads the subset of advanced economies which saw some increase in their current account deficit while others in the Euro area and Japan were rather seeing a rise in their surpluses.

We appreciate staff analysis of the factors driving the developments in external positions as a step for informed policy recommendations. The compression of private sector demand and deleveraging caused narrower deficits in advanced countries following the GFC while fiscal policy and market conditions contributed to outcomes in imbalances since 2003.

Against this backdrop, we share most of the policy challenges and related policy recommendations in the report and would emphasize the following points:

We call for an urgent, coordinated and multilateral solution to current trade tensions. It is regrettable that the first round of bilateral US-China tariff increases, and related uncertainties have led to a sharp slowdown in global trade. At the same time, we concur that bilateral trade imbalances and loopholes in the international trading system contribute to disputes and unilateral policy actions. It is therefore urgent that all players get involved and seek ways to revitalize and modernize the existing architecture for an improved multilateral rules-based trading system. Efforts should focus on further liberalization and capturing new forms of trade while addressing sources of disputes and enhancing the WTO dispute settlement system. An open, rules-based and well-functioning international system for trade is a public good.

We concur that a combination of carefully calibrated macroeconomic policies and structural reforms is needed to reduce excess external imbalances. Fiscal space in excess surplus countries could be used to boost potential growth, including through infrastructure investment and support to innovation, depending on country circumstances. Structural reforms should be explored in the areas of supporting private investment, R&D, and innovation, boosting competitiveness including through enhanced labor skills, and diversifying exports.

We take note of the call to address vulnerabilities associated with rising external liability positions. In the face of increasing gross external financing needs in most emerging market and developing economies, some of these countries have accumulated substantial foreign-currency-denominated debt. We agree that this situation should be closely monitored and, depending on country circumstances, macroprudential policies are warranted to address vulnerabilities and enhance domestic sources of financing going forward.

Staff should be acknowledged for providing a helpful technical background for the chapter 2 on exchange rates and external adjustment, with useful insights on the current debate about this issue. We tend to agree that the speed and composition of the external adjustment process can be affected in the short term, by certain characteristics of international trade such as currency of invoicing and the integration in global value chains. It is therefore important that policy recommendations on exchange rate flexibility continue to be tailored to country circumstances. We also share the view that exchange rate flexibility should be supported by additional policies which alleviate constraints in other sectors, including access to credit and transportation infrastructure. Such a holistic approach is better suited to ensure a greater effectiveness of the exchange rate as a tool to boost export volumes in some cases.

Finally, it is refreshing to note the continuous improvement of staff analytical toolkit on the ESR and we call for expanding the coverage. The approach of combining the EBA methodology with a series of external indicators and country-specific judgement should be maintained as it helps capture country specificities more accurately and enhances the relevance of the assessment. In the same vein, we continue to reiterate our call for a larger coverage of the ESR to African frontier markets. This will improve the analysis, including on external liability positions and developing financial conditions, many of these countries having tapped international capital markets over the past decade. We would like to hear from staff on what precludes such addition of frontier markets to the ESR sample.

Mr. Fanizza, Mr. Spadafora and Mr. Di Lorenzo submitted the following statement:

We thank staff for a comprehensive set of reports and appreciate the heightened focus on spillovers. We broadly share the staff's analysis and the main recommendations, notably on the euro area.

While global current account surpluses and deficits narrowed marginally in 2018, excess current account imbalances declined only moderately and became even more concentrated in a few large advanced economies. Aggregate euro area imbalances remain moderate at most, but significant imbalances persist within the euro area, both in flow and stock terms. Asymmetric intra-euro area adjustments since the Global Financial Crisis (GFC) are being perpetuated by excessive surpluses in Germany and the Netherlands that remain large and persistent, calling for policies to increase domestic absorption by supporting higher wage growth and boosting public and private investment.

Stock imbalances have continued to widen, with the world's net International Investment Position reaching a historical peak, primarily reflecting increased borrowing by corporates and sovereigns in EMDEs and by large corporate savings in some advanced economies. Staff assess short-term financial risks to be generally contained; we agree that policy actions are needed to avoid a further buildup of external leverage and attendant risks of disorderly adjustments.

The report brings further evidence of the detrimental consequences that trade tensions are inflicting to the global outlook. We thus strongly support the staff's call on resolving trade tensions to avoid further damage, particularly on investment and business confidence, as well documented by staff simulations in Section 1, paragraph 3.

We take positive note of the staff's assessment that the external position of Italy in 2018 was in line with fundamentals. Italy's current account balance has substantially improved comparing to the period immediately following the GFC. In addition, Italy's NIIP (-4 percent of GDP) is now close to balance.

Methodological Issues

We do not share the staff's analysis in Paragraph 13 (p. 21) about the source and impact of credit weaknesses, which in staff's view would be "masking underlying competitiveness problems". To begin with, subdued credit growth is usually a reflection of weak demand rather than supply constraints; besides, while a recovery in private credit demand in the medium term could lead to a deterioration of Italy's external position – due to an increase in investment – it is noteworthy that a boost in capital accumulation can also foster productivity growth, in turn improving Italy's competitiveness and CA balance. The mentioned downside risk to Italy's external outlook may, therefore, be more muted than stated. It is unclear why the contribution by the private credit gap to the CA gap is so high in Italy compared to Spain. Although the credit gap is very similar in both countries, the "desired" gap P* is 0.0 for Italy and -10.0 for Spain. Staff's comments are welcome.

In the staff's estimate of Italy's Current Account (CA) norm, a very large positive contribution stems from demographics; this holds true also in an international comparison. Although population ageing is indeed a concern for Italy, it is unclear why this trend is deemed to be so much worse than in other advanced economies, such as Germany. Staff's comments are welcome.

Chapter 2

We welcome the detailed analysis in Chapter 2 of the role that key features of international trade – such as dominant currency invoicing and global value chain (GVC) integration – might impact in the short term the traditional exchange rate channel in fostering external adjustment.

The sluggish short-term export response to exchange rate changes is not really surprising to us: the main channel through which real exchange rate depreciation fosters external rebalancing is through a reduction in domestic absorption, while also creating supply effects, especially higher mark-ups, which help shifting resources from the non-tradable to the tradable sector in the medium-term.

In general, the link between REER changes and the CA balance is complex and heterogeneous across countries. It is useful to recall that structural factors additional to the two analysed in Chapter 2 may affect the REER-export link. The composition in terms of exporting firm size and the weight of multi-product exporting firms in a given economy also matters for external adjustment. As documented by the recent literature on firm heterogeneity and trade[2], larger, more productive firms tend to absorb exchange rate changes by varying their mark-up, which leads to a weaker reaction of their export volumes. Multi-product firms are also less sensitive to REER movements: in response to negative exchange rate shocks, they pull out their least productive products from the export markets and concentrate on their more productive goods.

With specific reference to Italy, several structural factors may impact the REER-export link. As highlighted by recent research at the Bank of Italy[3], the higher the share of small enterprises, the higher the sensitivity of export dynamics to REER movements. Given that in Italy this share is relatively large, its export elasticity to the REER is higher than, for example, Germany's and France's elasticities, all other things equal.

Mr. Villar, Mr. Guerra and Mr. Montero submitted the following statement:

We welcome the 2019 External Sector Report (ESR) for providing a sound and theoretically grounded assessment of external positions from a multilateral perspective for a group of systemic advanced and emerging economies. This year's ESR has fully benefited from the methodological improvements introduced in 2018 which have had a clear positive impact on the quality of overall assessments. This notwithstanding, analytically-grounded staff's judgement remained essential to fine-tune some challenging external assessments, which we positively acknowledge.

[2] Giordano C. and P. Lopez-Garcia (2019), Firm Heterogeneity and Trade in EU Countries: A Cross-Country Analysis, ECB Occasional Paper No. 225.

[3] Bugamelli M., S. Fabiani, S. Federico, A. Felettigh, C. Giordano and A. Linarello (2018), Back on track? A macro-micro narrative of Italian exports, Italian Economic Journal (2018), Vol. 4 (1), pp. 1-31.

We note that global current account surpluses and deficits narrowed marginally in 2018, with some reconfiguration largely reflecting higher surpluses in oil-exporting economies matched by a sharp narrowing in China's external balance. Moreover, currency movements were generally supportive of observed current account dynamics, although in a context of more volatile exchange rates in key emerging and developing countries driven by changes in US monetary policy and rising trade tensions. From a longer-term perspective, global current account surpluses and deficits have declined marginally over the last few years, becoming increasingly concentrated in key Advanced Economies, as economic policies in many of these economies are generally inadequate to address these imbalances in terms of both direction and intensity, and in some cases tend to aggravate them. Under baseline policies, these imbalances are expected to gradually narrow, though with some degree of uncertainty.

We appreciate the discussion on the harmful effects on trade and investment of protectionist measures, which at the same time proved to be useless to tackle external imbalances—suggesting a strong and very rapid trade diversion—as evidenced in several IMF reports. The estimated impact on global growth could be non-negligible, depending on offsetting policy responses and deterioration of confidence. Thus, we call for a more open, stable, transparent and rules-based international trade system.

Relatedly, stock imbalances have continued to widen, reaching record levels at 40 percent of world GDP. Gross external liability positions of EMs and developing economies are also at historic peaks, driven by a rise in corporate and sovereign borrowing, which makes them vulnerable to external financing risks—which have increased importantly over the last few quarters. This notwithstanding, we continue to believe that the treatment of stock imbalances would deserve a deeper analysis. We miss more details about the contribution of valuation changes, cumulative current accounts and growth effects on NIIPs, and the adequateness of countries' NFA positions.

Regarding the global allocation of capital, we are encouraged by the recent reversal in the direction of capital flows, which are increasingly flowing downhill, especially in the form of direct investment. We are concerned, however, by the fact that according to staff these flows have done little to support income convergence over the past decades. We support staff's view that this fact requires additional investigation. Could staff provide a preliminary assessment of why this has been the case?

Like the evolution of global current account balances, the normative assessment of external positions shows that overall excess deficits and surpluses narrowed somewhat in 2018, becoming even more concentrated in a few large AEs. Additionally, we found very interesting the analysis in Box 1.2 on the decline of China's external surplus, which is one of the Report's main highlights. Given its systemic relevance, we welcome the substantial correction of its external imbalances, which has improved the composition of the Chinese growth model. However, we are concerned about the quality of this adjustment, as support from domestic policies has come at the expense of some internal imbalances, mostly in terms of excess leverage. We concur with staff that to achieve a more sustainable adjustment it would be desirable to improve social safety nets, reform SOEs and step up the opening of markets.

We welcome staff's analysis in Box 1.3 on the intra-euro area asymmetries. The rise in the euro area current account surplus since the GFC reflects progress achieved among net debtor countries in correcting their external imbalances—supported by a large internal devaluation in most cases—and persistent large surpluses in creditor countries. Sustainable rebalancing within the euro area will require measures that foster savings and competitiveness in debtor countries and parallel efforts in large surplus countries to support domestic demand, boost potential growth, and strengthen the conditions to boost wage growth.

We share staff's view that there is a need to better understand and address high and rising levels of corporate saving in several AEs. We thus commend staff for its analysis in Box 1.7 and encourage it to dig deeper into this topic. Regarding the role of the distribution of profits among dividends, retained earnings and share buybacks, we note that staff focuses exclusively on the consumption channel—through differences in marginal propensities to consume across agents. However, we would like to highlight that the investment channel may also be relevant. For instance, the allocation of corporate profits towards dividends and stock buybacks instead of retained earnings can be detrimental for investment.

From a methodological point of view, the EBA analysis does not provide a formal, multilaterally-consistent model-based derivation of a target value for NIIP positions. This limitation has important implications for the computation of the CA norm in those cases where NFA are excessively large, either negatively or positively so. Moreover, since the model-derived CA norm is only adjusted ad hoc in countries with a large debtor, this also raises the issue of evenhandedness. We thus believe that a more formal approach to this matter might be a desirable medium-term objective for IMF's analyses.

Indeed, an optimal stock of NFA could also be used as an input for EBA regressions to avoid ad hoc corrections and treat in a more balanced way debtor and creditor countries.

We welcome the analysis in Chapter 2 on exchange rates and external adjustment, which we believe provides relevant insights that deserve consideration in future assessments of external positions.

In the case of the US-China Trade tensions, strong and very rapid trade diversion was observed, towards Mexico in the case of US imports and towards Vietnam in the case of China's imports, which suggests that GVC production lines display more flexibility than that suggested in the chapter. This evidence makes it difficult to reconcile the swift and rapid diversion in trade flows with the idea that exchange rate elasticities are low. Is this a by-product of the US dollar dominance as a currency of invoicing? Staff's comments are welcome.

Empirical evidence confirms the dominance of the US dollar as a currency of invoicing, implying important asymmetries on exchange rate pass-through from a depreciation of any currency against the US dollar and against third-party currencies. We wonder whether the evolution of the dollar dominance during this period changed with the emergence of the Euro and more recently with the Renminbi.

Chapter 2 rightly stresses that any policy recommendation on exchange rate policy and external adjustment cannot be based only on the analysis of trade in manufacturing goods—which is the focus of this chapter. Services trade, financial flows and balance sheet effects are key elements to extract any policy conclusion. From the point of view of econometric exercises, we understand that the estimated FX elasticities combine the "traditional" relative-price effects and the financial-type channel from balance sheet effects —which tends to have a dampening impact on the FX elasticity. We wonder if this fact contributes to the low elasticities found in those exercises, in addition to the dominance of the US dollar as a currency of invoicing and to the impact of GVC. Staff's comments are welcome. In this vein, we call on staff to be careful in conveying the empirical results in this chapter to avoid misinterpretations regarding the case for exchange rate flexibility, which remains a key mechanism to facilitate durable external adjustment. Furthermore, exchange rate flexibility has an important role to play in avoiding currency mismatches and thus helping in securing financial stability.

As a concluding reflection, we note that the US dollar dominance as a currency of invoicing has important implications in terms of asymmetries between the impact of the US monetary policy and that of other countries, even advanced economies, a point illustrated in Box 2.1 on US dollar spillovers. As stressed in recent literature, the US dollar has been described as enjoying an 'exorbitant privilege' owing to its reserve currency status in asset markets. In view of Chapter 2's results, one could argue that the dollar also enjoys a 'privileged insularity' regarding inflation, owing to its invoicing currency status in world trade. This may be a new argument in favor of the development of a truly international and multilateral currency, as could be the SDR. This is just a very long-term goal to think about. In any case, the implications of the US dollar dominance as a reserve currency for the international monetary system would deserve careful consideration by staff.

Mr. Mozhin, Mr. Palei and Mr. Potapov submitted the following statement:

We thank staff for the 2019 External Sector Report (ESR). We continue to view the ESR as a largely technical exercise, which can support comprehensive multilateral and bilateral surveillance conducted through other means and presented in other Fund products. We support the call in the report to refrain from using tariffs and protectionist measures to target bilateral trade balances, as they have a negative impact on global trade, investment, and growth.

The key findings and recommendations in the 2019 ESR remain broadly unchanged from the past reports. Global current account surpluses and deficits have gradually narrowed to around 3 percent of world GDP over the recent years. Excess imbalances have become increasingly concentrated in advanced economies, with lower than desirable current account balances centered in the United Kingdom and the United States and higher than desirable balances centered in the euro area (Germany, the Netherlands) and other advanced economies (Korea, Singapore, Sweden). At the same time, stock imbalances have reached record levels, at 40 percent of world GDP. Against the background of procyclical fiscal easing in the United States, external flow and stock imbalances could widen over the medium term.

We agree that both surplus and deficit countries need to implement additional measures to address persistent excess external imbalances and mitigate risks to the global economy. In the United States, a credible medium-term fiscal consolidation plan is needed to facilitate rebalancing and address the unsustainable trajectory of public debt over the medium term. Efforts to further strengthen fiscal, banking, and capital market integration in the euro area would help support investment and address distortions that can lead to internal and external imbalances. Further work is needed to analyze the role of wage moderation policies in some countries with excessive current account surplus, as well as high and rising levels of corporate savings and their impact on wealth distribution. The rapid rise of public and private external debt in emerging market and developing economies warrants, in our view, the buildup of additional international reserves, as well as careful monitoring of currency and maturity mismatches. In light of the incomplete reforms of the GFSN, for this group of countries we may need to revisit the benchmarks on adequacy of reserves and reevaluate the definitions of weaknesses and strengths in the external sector.

Despite the recent refinements to the EBA methodology, high uncertainty of the estimates requires caution and humility in interpreting the outcomes of model-based assessments. We note that the refined EBA methodology still falls short of explaining some large current account gaps, as the presence of large residuals remains in place. The estimated current account norms continue to be subject to revisions over time for many countries, undermining the robustness of the models to alternative specifications and to measurement challenges. As highlighted in the report, the EBA models do not capture all relevant country characteristics and potential policy distortions. The 2019 ESR sheds light on how the dominant role of the US dollar in trading prices and the growing importance of global value chains affect the composition and timing of external rebalancing, thus complicating the assessment of countries' external positions. We agree that further efforts are needed to strengthen the analysis of multinationals' cross-border activities and the blurring boundaries between residents and nonresidents, which have an impact on the corresponding attribution of income across countries.

In this context, we encourage staff to continue paying attention to country-specific factors and offer additional insights in their assessment of economies' external positions. As highlighted in the report, many important determinants of savings and investment balances at the country level require further analysis to support more tailored policy advice. Thus, we favor an in-depth analysis as the basis for recommendations on optimal policy design, while avoiding excessive reliance on the results of regressions.

Methodological improvements in the EBA methodology should remain an ongoing and continuous process. In this context, we broadly welcome the analysis in Chapter 2 of the report on the role of exchange rate in facilitating external adjustment against the background of the widespread use of the US dollar in trading prices and the growing importance of global value chains. Staff's work suggests the diminishing effects of the conventional expenditure-switching mechanism, at least, in the short term, while most of the adjustment takes place through import volumes with the limited response of export volumes. These findings may imply additional considerations for the Fund's policy advice on how to implement near-term external adjustment and on how to support it with specific structural reforms. Moreover, this work points to the importance of close monitoring of the key drivers behind the US dollar movements. Could staff elaborate on further research in this area and on how additional trade and financial features will be integrated in the Fund's policy advice and in the EBA methodology?

Turning to the timing and format of the 2019 ESR, we would express our concern about the shortened circulation period. We understand that this reflects the need to ensure full consistency with the key Article IV consultations and the forthcoming WEO update. At the same time, we believe that the Board's discussion of the report can be moved to a less bunching period in the Board's calendar. Staff's comments would be appreciated. We also noticed some changes in the format of the report with the inclusion of Chapter 2, which has a broadly theoretical nature. The presentation of this preliminary and still debatable work in the ESR may create additional uncertainty about the economies' external assessments. In our view, departmental working papers and/or WEO chapters may have been a better tool to conduct and present the study of the exchange rates' role in facilitating external adjustment. We would appreciate staff's additional elaboration on the ESR format change.

Finally, the 2019 ESR remains silent about the U.S. Department of Commerce's plans to impose countervailing duties if it judges that currencies are undervalued in some trading partners. Could staff elaborate on the risks of conflicting opinions between the Department of Commerce and the U.S. Treasury, as well as the Fund's work reflected in the External Sector Report?

Mr. Gokarn submitted the following statement:

We thank staff for an excellent External Sector Report, which is based on a rich set of analytical exercises. The EBA methodology is evolving over time, taking into account a larger range of variables that are likely to impact the external transactions profile of individual countries. As model specifications pay more attention to country characteristics, their use in normative assessments can be made with greater confidence. Nevertheless, the report takes care to point out that, even with greater customization, models are intrinsically limited by their inability to adequately consider the entire range of policy, structural and external factors that play a role, which then leaves room for judgement. We broadly endorse the path that the methodology for this very important annual exercise is taking, while recognizing that authorities may still have good reasons to challenge staff assessments about individual countries. We would like to make the following specific remarks.

In making country assessments, staff points out that a judgment of "broadly in line with fundamentals" does not necessarily mean that the country's policies are entirely appropriate. Such a situation could arise when two sets of distortionary policies neutralize each other with respect to their impact on external transactions. These two scenarios have significantly different implications for global balance and stability. In the latter, a policy correction by a country to address domestic distortions could actually lead to greater instability. Could staff comment? While this kind of judgement can emerge in the individual country assessments, it may not always do so, for reasons staff refers to in the paper - data limitations, modeling complexity, etc. Notwithstanding these, it might be useful for countries to be classified on the basis of this additional attribute. Could staff comment?

Chapter 2 presents a very interesting exercise, which relates structural and institutional changes in trading practices to the role of bilateral exchange rates. Messaging needs to be carefully handled, though. It should not create the impression that exchange rates have ceased to matter in determining trade flows. From an efficiency perspective, both third currency invoicing and global value chains obviously contribute to enterprise profitability; consequently, companies will use these mechanisms whenever an opportunity presents itself. The chapter is making the important point that this may come at a macroeconomic cost in terms of the weakening of the shock-absorbing and stabilizing effects of a flexible currency. For individual countries, the implication is that larger average benefits from trade derived from these mechanisms could be accompanied by greater vulnerability to global shocks to specific sectors. From an analytical perspective, identifying the share and sectoral composition of a country's trade that uses these mechanisms is necessary to quantify the exchange rate effects. Is there a plan to expand the set of countries for which such data are generated?

On the India country table (Table 3.11on Pg 84) we have the following suggestions prior to publication:

The text in the assessment paragraph may be modified as follows:

The external sector position in 2018 was broadly in line with the level implied by fundamentals and desirable policies. India's low per capita income, favorable growth prospects, demographic trends, and development needs justify running CA deficits. External vulnerabilities remain, as highlighted by bouts of turbulence in 2018. India's economic risks stem from volatility in global financial conditions and an oil price surge. Progress has been made on FDI liberalization, whereas portfolio flows remain controlled, though limits are increased periodically as per the medium-term framework for investment by foreign portfolio investors in government securities.

In response to the policy recommendation "Gradual liberalization of portfolio flows should be considered, while monitoring risks of portfolio flows' reversals", we would like to state that, apart from the increase in limits for investment by foreign portfolio investors in Government Securities under the medium-term framework, other measures have also been undertaken to attract portfolio capital flows. In March 2019, a separate channel, called the 'Voluntary Retention Route' was introduced to enable FPIs to invest in debt markets in India. Broadly, investments through this Route are free of the macro-prudential and other regulatory norms applicable to FPI investments in debt markets, provided FPIs voluntarily commit to retain a required minimum percentage of their investments in India for a period. Participation through this Route is entirely voluntary.

Mr. Jin and Ms. Liu submitted the following statement:

We thank staff for the comprehensive and well-balanced External Sector Report (ESR), which provides a holistic view of the external imbalances from a multilateral perspective. In 2018, the overall global current account surpluses and deficits declined marginally while rotating toward Advanced Economies (AEs). Against the backdrop of escalating trade tensions, we concur with staff that greater urgency is needed in tackling persistent excess imbalances and support the call in the ESR for avoiding policies that distort trade, especially refraining from the use of tariffs to target bilateral trade balances. We stress that reducing imbalances requires a joint global effort while strengthening the rules-based multilateral trade system. We broadly agree with staff's assessment and would like to make the following comments for emphasis.

Raising tariffs would not solve bilateral trade imbalances. At the same time, it weighs on global trade, investment and growth. A country's external imbalances are driven by a combination of factors. For example, a tighter-than-expected fiscal stance, rising corporate saving, and insufficient health care spending tend to contribute to an increase of a country's current account (CA) surplus, while looser-than expected fiscal policy, a lower-than-normal savings rate, and a less efficient health care system would likely result in the widening of a country's CA deficit, both contributing to global imbalances. Trying to address CA deficits through bilateral tariff measures will very likely generate little impact on a country's overall trade balances due to trade diversion. In this regard, we fully share staff's view and call on relevant parties to make efforts to revive and strengthen the rules-based multilateral trade system. In addition, given the pronounced increase of net corporate savings in some AEs, we encourage staff to conduct a more in-depth analysis on possible causes, including the effect of market power of some giant companies.

Addressing external imbalances in a constructive, sustainable manner requires a carefully calibrated macroeconomic and structural policy mix. Major drivers of external imbalances are primarily macroeconomic and structural in nature, mainly reflecting the specific savings and investment pattern of economies and domestic policies. Staff pointed out in the ESR that excess surplus economies should make use of available fiscal space to boost potential demand, including through infrastructure investments. We understand that increasing spending is only one of the options, while reducing taxes could be another one. We therefore concur with staff that further tax relief for low-income households could boost disposable income and contribute to domestic demand. We also echo staff's advice that countries with excess deficit should adopt growth-friendly fiscal consolidation while allowing monetary policy to be guided by inflation developments and expectations. Structural reforms play an important role in effectively tackling both domestic and external imbalances and eliminating policy distortions. It is necessary for countries with excess deficit to protect the vulnerable, boost household savings, enhance education and training, and make the health care system less expensive and more efficient, while countries with excess surplus should encourage more R&D spending, conduct tax cuts, improve social safety nets, implement pension reforms, and promote infrastructure investment.

We welcome staff's analysis on exchange rate and its role in facilitating external adjustment. We thank staff for the interesting technical briefing on the subject. We concur with staff's view that exchange rate flexibility remains key in facilitating durable external adjustment, despite muted short-term effects of exchange rates on trade flows through the currency of invoicing and global value chain channels. Against the backdrop of escalating trade tensions, further attention needs to be paid to the role of exchange rate changes in facilitating external adjustment. Meanwhile, exchange rate flexibility could be supported by other macroeconomic and structural policies that alleviate capacity constraints. In China's case, trade tensions have placed the RMB exchange rate and cross-border capital flows under pressure. China will continue to promote market-based reform on the formation mechanism of exchange rate and enable the market to play a more decisive role.

China's external position improved with continued rebalancing efforts and was assessed as being broadly in line with medium-term fundamentals and desirable policies in 2018. We agree with this assessment. China's current account surplus has narrowed from 1.4 percent to 0.4 percent of GDP, which is within the estimated reasonable range. For 2019, we expect a current account surplus and its share of GDP to continue to be within the reasonable range. Staff pointed out that China still needs to continue rebalancing to avoid a return of excessive CA surplus. Our view is that while attention should be paid to the risks of a return to excessive surplus, risks of excessive deficit may also warrant attention. In particular, one should prevent larger-than-warranted deficits caused by the overvaluation of exchange rates, which could eventually result in a passive depreciation to achieve a necessary correction. Staff's comments are welcome.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their Report and Assessments.

We thank Staff for their substantial 2019 External Sector Report (ESR). Recognizing that assessing current account and stock imbalances is challenging and depends on the exact specifications of the underlying methodology as well as the appropriate application of an element of judgment, we appreciate that the element of judgement applied by Staff is presented in a transparent way in the Report. We note that the current account norms and policy conclusions presented in the 2019 ESR are broadly aligned with ours and those of the European Commission.

We take note of Staff's assessment of the euro area's external position, indicating that in 2018 it was moderately stronger than the level implied by medium-term fundamentals and desirable policies. We note that the ESR suggests that the 2018 decline of the euro area balance was offset by a decline in the current account norm. The ESR's policy recommendations linked to EU external balances are broadly aligned with those of the Commission. We agree with the justification for Staff adjustment to the euro area figures, that remained similar to the 2018 ESR.

We agree that policy levers affecting the current account are mainly at the national level and that countries need to take steps in this regard. The main drivers are excess savings relative to investment in the non-financial corporate and household sectors, although government balances also play a role, as highlighted by Staff. Analysis of underlying determinants of savings and investment in the non-financial corporate and household sectors should be furthered to support more tailored policy advice. At the same time, we note that the significant unexplained variance in the results of the EBA models results in uncertainty about policy implications. We agree with Staff that while aggregate euro area imbalances are moderate at most, significant imbalances persist within the euro area, both in flow and stock terms. Addressing these imbalances requires further action by Member States as underlined in the ESR as well as in the Macroeconomic Imbalance Procedure. At the EU level, further integrating financial markets and the broader EU single market, in the context of the deepening of the Economic and Monetary Union, will also help to reduce imbalances among Member States and shift the composition of stock positions towards more stable and shock-absorbing sources of funding.

While some progress has been achieved among net debtor countries in correcting their external imbalances, large current account surpluses persist. The net foreign liabilities of the most indebted Member States have been improving, albeit at a slow pace. Sustained rebalancing efforts are still needed to address vulnerabilities stemming from large stocks of public or private debt. At the same time, we agree with Staff that parallel efforts are needed in large surplus countries to support domestic demand, boost potential growth, and strengthen the conditions that support higher wage growth. These policies will also facilitate the rebalancing of the euro area.

We agree with staff assessment that the euro REER can be described as broadly in line with fundamentals, as the reported ‘REER gap’ remains limited and does not exceed 5 percentage points. We (and the EU Commission) consider the euro’s real effective exchange rate to be close to its equilibrium, being aware of the uncertainty underlying these estimates. We welcome the ESRs deep analysis of the multiple factors that affect the relationship between exchange rates and current accounts. In this respect, we found the causal link established between the rise in the euro area current account surplus and the euro depreciation as lacking nuance and being rather unconvincing (p.14). Prima facie, the causal link does not seem consistent with the timing of the euro depreciation. In fact, the euro hardly depreciated during the height of the crisis that brought about the widening of the euro area current account (as is described in the ESR's Box 1.3). The lasting depreciation only happened in 2014/2015, and reflected the policies that have helped to end the crisis, reignite domestic demand, and put a halt to the surplus widening.

Conceptually, we believe that it would be useful to analyze the potential relevance of a possible distortion introduced in Staff's assessment of the euro due to the treatment as the euro exchange rate as a weighted average of individual Member States' currencies. While the treatment of the current account as the sum of individual Member States' current accounts is valid, the same is generally not true for a similar aggregation of real exchange rates, as the real effective exchange rate of the euro is neither the sum nor any other linear combination of the euro area countries' real effective exchange rates. The basic reason is that intra-euro area misalignments, rather than "cancelling each other out" as in the case of the current account, affect the estimated misalignment for the euro. This aggregation issue also underscores the importance of careful communication of the exchange rate assessment.

We welcome the increased focus on how invoicing and value chains affect the relationship between exchange rates, trade and current accounts. The analysis supports the ESR's stance to focus on broad macroeconomic policies, rather than just monetary instruments, in order to correct imbalances in major advanced economies with freely floating currencies. We note the specific implications for euro area Member States, with a common currency and significant value chains and trade integration, which should mitigate the impact of exchange rates on trade balances. We agree with Staff's conclusions that nominal exchange rate flexibility could be important for helping the adjustment of the current account over the medium term. However, in the conclusion we would stress that the real exchange rate also plays a relevant role in reducing current account imbalances via changes in the relative internal prices of non-tradable vs. tradable.

We note that the estimated EBA current account norm for the euro area has changed noticeably, to 1.1 percent of GDP, compared to 1.5 percent in the 2018 ESR. This seems mainly due to 'multilateral consistency' adjustments to ensure the netting out of external positions within the euro area.

The Acting Chair (Mr. Lipton) made the following statement:

Reflecting on Directors' gray statements, I thought I would start by saying a few words about the External Sector Review (ESR) and the role that it plays here.

The analysis of external imbalances is inherently complex. This has been a challenging exercise since its inception. Our models are work in progress. We have made changes in recent years. We will continue efforts to incorporate insights, including those that come from Board discussions of this subject, lessons from our discussions with authorities. But even as we keep refining the model, external assessments will at times be contentious, and there will be some disagreements about assessments and about the root causes of the imbalances that we are analyzing. The fact that this can be a contentious exercise should not stop us from exercising an important core mandate and one that our membership has assigned to us. We have to recognize that the legitimacy of the exercise requires that certain principles are preserved, ensuring analytical rigor, and the multilateral nature of the exercise is key to this.

At its heart, the objective of the ESR—and this is after a few years of piloting and adjustment, this is now the eighth year—is to inform our membership about the potential risks from external imbalances and to highlight the shared responsibility that the membership has—both excess deficit and excess surplus countries—and the need to address these responsibilities without compromising global stability or global growth.

I look forward to a candid and open discussion. As in past years, what happens in this discussion helps us refine our efforts and adjust our views, so let us have a good discussion of this year's report.

The Director of the Research Department (Ms. Gopinath) made the following statement:[4]

I thank Directors for the input via the gray statements, and I thought I would respond briefly to some of the comments that came up about the external assessment methodology and about the policy lessons that can be drawn from the analytical chapter, which is Chapter 2.

[4] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

On the external assessment methodology, we view our work on current accounts and real exchange rates, or the model that we use, as providing useful numerical inputs for assessing external positions. That said, like all models, there is uncertainty surrounding it, which is why we always complement our numerical work with analytically grounded and country-specific insights and judgment, which is essential to policymaking.

Coming from academia, I am fully aware of the challenges of modeling equilibrium current accounts and exchange rates, and there is clearly a lot to be done on that front. I do believe that the Fund has moved in the right direction of taking a holistic approach and not focusing on any one particular metric, like exchange rates, but focusing on many aspects of it and coming up with a broader judgment on this issue. We also do believe that analytical work must continue on this front. There is much more to do done, as was brought up in many of Directors' comments. The work that we are doing on the link between exchange rates and external adjustment is one useful input going forward. It gives us information about what measures of exchange rate to focus on, and what do we use as elasticities of trade balances to exchange rates, so that is useful for us. At the same time, we also have ongoing work on stock imbalances and trying to understand the composition and to more systematically incorporate risks associated with stock imbalances in our external assessments.

We also agree that there is more work to be done on linking structural policies to imbalances. There are measurement challenges, especially in a world where there is so much cross-border multinational activity. We will continue working on all those fronts. In some cases, we will be constrained by data availability, and we may not be able to do it all, but we have our plate full at this point.

On the analytical chapter, which is Chapter 2, linking exchange rates and external adjustment, we believe this is core to the work that we do at the Fund, both on our bilateral and multilateral surveillance. Therefore, we are excited to make this a part of the ESR because that gets us broader readership. We are able to have careful discussions with Directors on this, and so that is one of the reasons why it is in the ESR.

In response to the questions that were asked about the breadth of the analysis and the policy implications, I will just mention two things. First, we look quite closely at two specific issues—the currency of invoicing and global value chains. But there are other aspects to how the external adjustment takes place, and there are other considerations, like balance sheet considerations. We will continue to work on those.

What we have learned from the exercise we have done so far is that if you look at the empirical link between exchange rates and the trade balance, and especially between exchange rates and exports, there is a muted effect in the short-term. Regardless of what you think is driving this, the truth is that empirically there is the case that in the short-term the impact of exchange rates on export volumes can be weak. It does increase over time. In the medium term you can get more of a response to it.

We have now tried to explain some of that by using our theories of currency of invoicing in global value chains, but it can also be tied to balance sheet effects, and we will continue working on that.

Then the question is what does that imply then for policy? One thing it does tell you is that at least in the short run, if you are trying to adjust to shocks, the exchange rate mechanism alone may not give you that much insulation, and other cyclical policy tools may be needed. Of course, this will be country specific and dependent upon country-specific details and features.

The other aspect is that to go from what we find in terms of the impact of exchange rates to normative conclusions about the benefits of exchange rate flexibility, one has to take into account many other aspects of a country and how it works. For instance, if a conclusion is that you need bigger exchange rate movements, then that will be problematic for countries that have currency mismatches on their balance sheets. I will not go into any of those details here, but we completely recognize and take on board Directors' comments that when we start thinking about policy, we are going to have to think about country-specific issues. Countries are going to differ on their exposure to trade. They are going to differ on how much they use commodities versus non-commodities, how open their financial markets are, balance sheets mismatch and so on. All of this is part of the work we are doing on the Integrated Policy Framework (IPF), and I look forward to briefing you on that in the future.

Lastly, I just want to end with one comment, which is that something that has come up more recently about how similar or dissimilar are tariffs and exchange rate pass-through. There is a good reason to think that tariffs and exchange rates do not work the same way in the data. I will talk about this a little more on Friday when I present the World Economic Outlook (WEO) update, and I look forward to hearing Directors' views on that.

Mr. Ostros made the following statement:

I thank the staff for an excellent product. It has its limitations, but it is also fundamental economics that could be used in universities when studying international economics because one gets a grip of the basic flows and stocks.

The first time I took part of an ESR discussion was four years ago, and I asked the question at that time, how much do we actually know about how long it takes before an economy adjusts? Since then, we have understood much more about these adjustment processes. I had an example four years ago on the Swedish economy that during the 1970s and 1980s constantly struggled with current account deficits but now has enjoyed 25 years of current account surpluses. On balance, we are in balance, so to say, but that is quite a long time period. But we have understood more on the role of demographics. We have understood more on the role of inequality with contributions now and other fundamental issues, and maybe some of these fundamental issues gives rise to the thought that it takes a bit more time than we believed to adjust.

External imbalances are still a source of vulnerability to the global economy, and there is a risk that intensified global trade tensions could trigger a potential global adjustment that would be disruptive, and that is a big and important message that is in the report, to warn toward that.

On a positive note, there has been a small reduction in global excessive imbalances. China is an example of a slow-moving trend that now is reaching more or less a balance that is interesting to see. The United States has a current account deficit that is unchanged, a bit of a surprise, but the underlying trend of the United States is not very good. Lower oil imports have masked the negative impact of the current account from the fiscal easing, but it seems like in the medium term the pressure would be toward increasing current account deficits in the United States and thereby stimulating more surpluses in other countries and thereby increasing global imbalances.

Policies that distort trade should be avoided. That is a very clear message in the report. It is not effective in reducing overall trade balances for a country, and it can have significant negative spillover effects.

I welcomed the analysis in Box 1.7 that uneven distribution of wealth may play a part and may delink corporate savings and the private savings if we have a high degree of inequality in the economy. This is a contribution that makes it—in the German case as an example—very interesting to discuss possible policy recommendations in the future, but I guess we have to go deeper into this issue to fully understand how these links work.

It is an interesting analysis of the role of the dominant currency trade pricing and global value chains, another contribution that shows why it can take a bit longer time than expected to get these rebalancing effects. We have taken another step forward in a product that is a global public good. I believe it is needed in the global debate.

Finally, I would like to assess what I always do in these discussions. When it comes to individual country matters, it is important to continue to have staff's own assessment being lively in the debate so that we do not use the External Balance Assessment (EBA) model mechanically but really have staff's and country teams' assessment as a big part of the individual country assessment.

Mr. de Villeroché made the following statement:

Like Mr. Ostros, we like this report. It is a part of a core mandate of the Fund to issue such a report, and year after year we are building upon a product which is increasingly relevant. What are our takes of this year? Global imbalances are persistent, and we continue to see their reduction as a priority when looking at the risks they are posing.

We are concerned by the stock imbalances and the historical peak in terms of net international investment position (NIIP). We believe it increases uncertainty on the global outlook, and it creates the risk of disruptive adjustment.

The EBA model remains a useful guiding tool. We take note of staff's analysis, but rebalancing has been asymmetric so far with many deficit countries making progress in reducing their current account deficit with one exception or one concern on the U.S. economy, and we see a link between the fiscal deficits and the current account deficit in the U.S. economy. While excess surpluses countries remain concentrated in a few advanced economies for a very long time now, we believe that it calls for domestic adjustment policies, boosting domestic demand through public demand where there is fiscal space, and support for investment and working on wage dynamics. For the United States, we see the reduction of the fiscal deficit as the main tool going forward.

Like Mr. Ostros, we believe that trade policies are not effective to reduce imbalances, even bilateral trade imbalances. They should not be used for that purpose. We see trade tensions as a risk posed by imbalances but certainly not as a solution.

Third, we consider the chapter related to dominant invoicing as a relevant matter regarding the short-term impact of exchange rate valuations. We also agree with the results that indicate that the currency invoicing becomes less relevant with time.

In terms of work going forward, we have three priorities. We fully support the work on corporate savings, as it can explain more than half of the divergence in overall current account balances between surplus and deficit countries. We liked Box 1.7 dedicated to that, and like Mr. Ostros, I would like to add the reference to inequalities and the discussion we had yesterday on Germany.

We also see a better understanding on the international investment position (IIP) as essential. The IIP position size on currency composition could play a significant role in the potential realization of a sudden shock or an external crisis. Thus, we believe it is important to have a more in-depth analysis to understand better the risk associated and what optimal policies could be implemented to mitigate this risk.

Lastly, we see data transparency as a key issue to understand better the evolution of current account gaps in some offshore financial centers. The role of profit shifting is still a source of data gaps, and more work needs to be done in this area to fully understand the external position of financial centers. We are looking forward to seeing the results from the initiatives promoted by the Statistics Department (STA) and the IMF Committee on the Balance of Payments Statistics, so we look forward to further work on this important issue.

Mr. Kaizuka made the following statement:

Before getting into the substance of the ESR, I would like to extend my sincere gratitude to the whole Fund team for making a huge contribution to the G20 on the global imbalances issue, because with this dedicated work, the communiqué successfully included the importance of monitoring all components of the current account, including services, trade, and income balances, and also identified that some of the factors underlying excessive imbalance might include excess corporate savings, miscalculated fiscal policies, and barriers to trade in goods and services, and also affirmed that the carefully calibrated macroeconomic and structural policies tailored to country-specific circumstances are necessary to address excessive imbalances. This is a very good basis for our discussion on how to deal with the global imbalances. I thank the staff for this huge contribution.

Back to the ESR, we would like to appreciate again the inclusive work done by the Research Department (RES), the Strategy, Policy, and Review Department (SPR), and also area departments, and my Japan team. I thank all for the dedicated work done on this important product. There are several improvements which may include, as Mr. Ostros and Mr. de Villeroché mentioned, substantive analysis of the excessive corporate savings in advanced economies, which is summarized in Box 1.7. I would like to reiterate my point in the gray statement that corporate taxation has something to do with the excessive savings and also to the current account imbalances. I look forward to engaging with further work on that. On the implications of the deepening and expansion of the global value chains and to the link between the exchange rate and the trade account, we encourage staff to do further work on how relevant the exchange rate could be in adjusting each component of the current account balances.

As Ms. Gopinath mentioned, the risks emerging from the expanding stock imbalances are quite important. I have a few comments to make. One is assessing exchange rate norm. We are not comfortable seeing that the way to assess the exchange rate norm is extracted by the current account norm, while we understand the real effective exchange rate (REER) model has some difficulties and limitations. There should be a granular study of how to incorporate the proper deepening of global value chains in the future model, and also there should be some granular study on the link between the exchange rate and the income account, which is different from the case of a trade account.

Secondly, there is room to improve how to handle the unexplained portion of the current account gap, which is now interpreted as reflecting country-specific factors and some structural factors, for example, investment bottlenecks. I here encourage staff to define more concretely the investment bottlenecks and provide granular policy recommendations to absorb such imbalances. In this context, we look forward to the granular policy discussion in the next round of the Article IV consultation on Japan.

Finally, on the countervailing duty, Ms. Gopinath mentioned that there will be a substantive discussion on Friday, so I defer my comments to Friday, but the written answer to the technical question raised by Mr. Ray reflected the situation well. I fully agree with that. I will come back to that point on Friday again.

Mr. Ronicle made the following statement:

Let me add my voice to those speakers who said that this is a very good product. I also thought that the briefings staff did on the G20 imbalances link in Chapter 2 ahead of this session were particularly helpful given the limited circulation period we had with the paper.

We came to the report looking to learn two things. First, are cross-border flows serving their intended purpose, by which I mean, are they raising welfare and incomes by supporting consumer choice and an efficient allocation of capital? Second, are the risks that arise from openness contained?

On the first of those questions, are we making the most of the benefits, we read the report as offering both good news and bad news. The good news is that capital is flowing downhill from advanced economies to emerging ones, suggesting an improved allocation of capital. We would have liked a deeper assessment of that in the report itself, including any implications for equilibrium interest rates, but we found the staff’s answers here and the written responses very helpful and look forward to seeing future work in this space.

In particular, we would be keen to see more coverage of valuation gains, stock positions, and the drivers of capital flows. On capital flows, we are interested in a deeper understanding of issues that relate to both sending and receiving countries, as well as any effects that derive from the global financial architecture. Work in this area will be valuable support for the IPF.

The bad news is on trade. In the near-term, raising tariffs risks jeopardizing the global expansion through reduced confidence and financial volatility. In the medium term, it reduces consumer choice and impedes the efficient allocation of resources. It worsens imbalances rather than improving them. We fully support the calls to deescalate trade tensions and to hold back from broadening trade disputes. We also make from the report that the largest deficits are concentrated in the countries where services exports are a comparative advantage. Rather than trying to address imbalances through trade barriers, this chair would advocate greater liberalization of trade in services.

What about our second question on whether risks are contained? I should say that we see external imbalances first and foremost as a potential warning sign of other issues. As Ms. Mahasandana and colleagues put it in their gray statement, external rebalancing is not an end in itself. As such, we are encouraged that global imbalances are on a downward trend and increasingly concentrated in advanced economies. With market-determined exchange rates, liabilities denominated in domestic currency, and robust macro frameworks, these economies are generally well placed to manage such imbalances. Our reading of Chapter 2 reinforces that view. Our take was that it largely vindicated the status quo, that flexible exchange rates can have an important role to play in managing external imbalances. We believe the United Kingdom has been well served by 25 years of floating exchange rates, and so we are pleased to see that this holds across a broad sample and time series, despite the prevalence of dominant currency pricing and the rise of global value chains.

Finally, let me pose a question about the report itself. We wonder whether the balance is right between the bilateral elements of the report and the multilateral ones. To us, it seems that the bilateral elements of the report are best covered through Article IV consultations. Many country cases are difficult. The revised EBA model is a good baseline, but judgment is frequently needed to come to a robust view. Those detailed discussions and the policy recommendations that follow are better suited to the in-depth focus offered by an Article IV consultation, like the discussion we had on Germany earlier this week. That would allow this report to focus on the global narrative and issues, and for us the addition of analytical chapters is already a valuable step in this direction. It seems that the precise role of the ESR is a question we should cover as part of the Comprehensive Surveillance Review (CSR).

Mr. Meyer made the following statement:

I thank the staff for the informative and concise report, and this chair fully supports this report. It is a very important element, and it is going to the core of our mandate.

As the report clearly outlines, global current account balances continue to narrow moderately with a rotation toward advanced economies in recent years. We agree with staff that the near-term financial risks from the current configuration of external imbalances are generally contained. Having said that, we support those who indicated that more work on stocks but also on drivers of capital flows could be helpful going forward.

On substance, let me discuss three or four main elements. First and foremost, like many other chairs, I support staff's call to avoid policies that distort trade and instead work toward reducing trade barriers. We also reiterate our view that sound domestic policies in an environment of open markets and a rules-based multilateral system represent the best response to concerns about global imbalances.

A second point, the report again underscores the need for deficit economies to adopt growth-friendly fiscal consolidation. It remains somewhat worrisome that even after a relatively long period of solid growth, fiscal policies in a number of countries remain too loose, as it is reflected by staff's estimate for the global fiscal policy gap of 0.7 percent of GDP.

Third, we also agree with the importance for surplus economies to strengthen domestic sources of growth.

Fourth, I would like to emphasize that open trade is not a zero-sum game. For that reason, we welcome the focus on improving the competitiveness in deficit countries. For example, if country A has a surplus with very innovative companies that are in the tradeable sector. Country B does not have that. It is not a zero-sum game if country B becomes more innovative on the tradeable sector. This will incentivize country A to be more innovative, be even more competitive in a positive way. This overall leads to higher welfare, and this is an element that we did not have in the report in the past. It is highlighted more now, and going forward that could be an element to further examine in terms of how that would impact imbalances.

Let me acknowledge Germany's large current account surplus. However, I would encourage staff to be careful in its judgment, as in many countries the gap is only to a very limited extent explained by the model. In the case of Germany, just one point of the 5.1 total gap is explained. Mr. Ronicle put it very well in his gray statement. We need to do an even better job to explain residuals before jumping to conclusions. In the German case, the Article IV had a very good discussion on corporate savings. We need to follow up on that, but that was a very good discussion.

I would also agree with moving the ESR a bit more to the multilateral side, a bit away from the bilateral policy recommendations, as those do not take into account the uncertainty around those large unexplained gaps.

We mostly agree with the conclusions in the thought-provoking Chapter 2 on exchange rates and external adjustment. I just wanted to make the point that this also, especially on the exchange rate, has important implications for Fund-supported programs that envisage an export-led recovery and external rebalancing through depreciation of the REER. It puts a premium on being cautious in that regard.

I welcome the adjusted language in the report. Box 1.1 is now excellent in letting the reader understand what we are doing in this report. However, I was really thrilled after the first part. Then in the latter part, we are using this term “excess imbalances” again five times in this report. It was used 22 times in the last report, and you just have to delete the word “excess.” Very interestingly, Mr. Chairman, you and Ms. Gopinath, you are speaking about the topic. You did not use the term “excess imbalances.” You are always talking about imbalances, because it is understood that this has a negative connotation. Going forward, maybe in this report you could delete the word excess five times.

Mr. Odonye made the following statement:

I thank the Acting Chair for the context elaborately presented at the beginning of this session and also with further elaboration by Ms. Gopinath. Clearly the insights are well understood.

First, we would like to underscore a deep satisfaction with the attention that this report continues to receive from staff and from management, as well as the Board. Even though it is not treated as one of our flagship reports, we believe it is critical to our work in the Fund and our deliberations and decisions on the multilateral system, fair trade, and evenhandedness.

In this respect, we therefore welcome the discussion of the 2019 ESR and the refinement of the methodology to continue enhancing the multilaterally consistent assessment for the world’s largest economies. We find the inclusion of the chapter on exchange rates and external adjustment timely and relevant to international trade dynamics, and we particularly appreciate the staff’s focus and judgment in this assessment, which seamlessly incorporates several countries’ peculiarities.

Overall, we agree that the global current account surpluses and deficits narrowed moderately in 2018 and are more concentrated in a few large advanced economies. Therefore, policy actions should aim to reduce external imbalances through well-calibrated macroeconomic policies and well-sequenced structural reforms that are tailored to country circumstances. We would also reiterate strengthening the rules-based multilateral trading system, reducing barriers to trade and other trade distortions, and revamping trade liberalization.

The persistence of global imbalances with concentration in key advanced economies and the widening position of both debtor and creditor companies remains a critical concern that needs to be resolved with some urgency since its continuation would undermine global trade, growth, and financial stability. We strongly reiterate our earlier call for collective policy actions in both deficit and surplus economies to provide lasting solutions to this problem.

Regarding the elaboration of emerging market and developing economy issues in the main report, we welcome the staff's feedback that the project is on course to build a comprehensive data set to provide details on the currency composition of the main components of the IIP for these economies. We appreciate the staff's work and look forward to the regular updates on this project.

Mr. Lopetegui made the following statement:

I commend the staff for continuous improvement in the analysis of global imbalances and a very good report.

Let me first welcome the Acting Chair's opening remarks, which we fully support. Picking up on the shared responsibility comment that he made, as has been noted many times, including by Mr. Tombini in his gray statement, arguments for external adjustment in excess current account deficit countries carry a stronger sense of urgency compared with excess surplus countries, but it is appropriate to highlight again that if excess surplus countries fail to adjust over time, global prospects would remain subdued, which at this juncture is of particular concern.

In addition to the role played by fiscal and monetary policies, reducing imbalances requires addressing the structural rigidities that weaken the adjustment process, particularly within common currency arrangements and pegs where relative price adjustment is inherently constrained. In this regard, product and labor market reforms remain particularly relevant for rebalancing. Capital account restrictions, particularly on FDI, could also act as deterrents of the global adjustment process.

Net creditor and debtor positions have continued to increase at a fast pace reaching historical peaks. We would like to emphasize, and we are aware that the staff keeps an eye on this, that more attention should be paid to the composition of gross stocks of the IIP, both in terms of components, be they in portfolio debt equity or deposits and loans, and maturities as sudden reversals in short-term liability positions of debt and also on deposits may constitute important vulnerabilities for some countries.

Regarding the role of exchange rates, flexibility remains key to facilitate external adjustment. As noted in Chapter 2, dominant currency invoicing and global value chain integration can alter external adjustment in the short-term, but conventional exchange rate effects on trade flows remain at play in the medium term.

We would like to agree with Mr. Ray and his colleagues that caution is needed in the communication of the results, which should not imply that the Fund is stepping away from the advice on the value of exchange rate flexibility. As Mr. Ray also noted and is well-known, this should not preclude the ability to respond to excessive volatility or disorderly movement of foreign exchange markets when there are potential adverse implications for economic and financial stability.

We welcome ongoing work to better understand the factors behind the high and rising levels of net corporate savings, which have been especially pronounced in certain advanced economies with large and persistent surpluses. It would be useful to further analyze the drivers of this trend, which may be related to increased concentration of wealth and to market power. The implications of large corporations and their location for global value chains could also be relevant topics.

Finally, we agree that protectionist policies are not effective in solving imbalances and should be avoided. On the contrary, stimulating and further liberalizing global trade under clear and agreed rules remains critical to enhance global prospects, which would in turn support inclusive growth..

Ms. Levonian made the following statement:

I thank Ms. Gopinath and colleagues for truly a great piece of work. We continue to see the ESR as deserving flagship status. At a minimum, we would encourage RES to engage with the Communications Department (COM) to see what can be done to increase the reach of this publication, especially with a summer release. In an environment of escalating trade tensions, our authorities look to the ESR to keep the debate over imbalances grounded in facts.

First, on the model aspect, all models have their limitations, as the Acting Chair and others have said. Trying to be evenhanded as possible limits the necessary country specificity and tailoring, and we appreciate that. It is therefore important to keep these limitations in mind when providing policy advice.

Second, without dismissing the importance of persistent excess imbalances—or maybe I should just say imbalances—we are inclined to agree with staff that the current configuration of imbalances is less worrisome than record-high stock imbalances. On that topic, it would be interesting if further research could look at the risks posed by the composition of the IIP by investment type, like portfolio flows, FDI, as well as the overall level and currency.

We appreciate that the ESR builds on issues identified in previous editions, such as the role of corporate savings, while also tackling emerging issues such as those treated in Chapter 2, and there is a nice balance there. That balance helps keep the ESR relevant for the membership and helps the credibility of the Fund's recommendations.

Third, given recent doubts expressed about the role of exchange rates in the adjustment process, we commend the Fund for reaffirming the importance of exchange rate flexibility in its assessment of the role of dominant invoicing currencies and global value chains. We encourage staff to extend their research on these issues to commodities and services, which behave quite differently than manufactured goods.

Finally, with this excellent edition of the ESR in hand, it is now up to the membership to address persistent excess deficit and surplus positions in a way that protects inclusive growth, boosts economic potential, and supports stability.

Mr. Inderbinen made the following statement:

We join others in thanking staff for this report and also for their continued work on the underlying methodology and other topics related to the external sector, and this is core to the Fund's mandate.

I would like to reiterate some of the points we made in our gray statement and then offer some additional remarks. First, the main focus of the ESR remains on current account balances, as in the past, and this seems straightforward, but it is worth recalling that the current account is only one aspect of a country's external sector. Further analysis of stock imbalances and valuation effects would be valuable, as they do contain information on different aspects of the external sector.

Second, we welcome the insights into the link between exchange rates and external adjustments offered in Chapter 2. We agree that exchange rate flexibility does remain essential to address imbalances, but we would like to stress that adjustments with the exchange rate may not always be the right policy response, especially if excess current account balances are driven by other policy distortions, and sound macroeconomic policies would, in any case, seem to be key to reducing global imbalances.

Further, we echo Mr. Kaizuka's point that the link between the current account and the exchange rate is not straightforward. Rather than mechanically applying trade elasticities to infer exchange rate gaps from current account gaps, staff should utilize real exchange rate models. In that sense, we agree with Mr. De Lannoy's statement that REER models should be given the same rate as the current account model.

Furthermore, country-specific information and staff judgment remain essential for external sector assessment, as Ms. Gopinath reiterated in her opening remarks. In view of the large unexplained residual, staff should continue to exercise caution when interpreting current account gaps.

Finally, transparency in Fund documentation when reporting EBA results is important. Similar to Mr. Ostros, we consider that transparency is essential whenever EBA results are used, including in Article IV reports. We would argue that transparency should extend from the decomposition of current account and real exchange rate gaps into policy gaps and into domestic and foreign contributions to such gaps.

Mr. Spadafora made the following statement:

I would like to congratulate staff on an excellent report. We note the crosscutting theme of risks from escalating trade tensions. In this regard, we also support the staff's view that in a scenario where stock imbalances are increasing, trade tensions can be entrenched. Let me just recall the staff's main conclusion in the report—that under an unchanged current account scenario, creditor and debtor position would expand by an additional 5 percentage points of world GDP by 2030. We share the staff's concern about such a scenario where trade tensions can become even more worrisome and a threat to the global stability.

We welcome Chapter 2, which is a nice contribution to the debate. However, I remember during my undergraduate studies 30 years ago, and in International Economics101 there was this reference to the J curve. In a way, I struggle to understand what is new in the findings of Chapter 2.

A few points on Italy, the ESR makes a reference to undesirable credit weaknesses that are hindering or holding back investment. We believe this statement is overly generic and is not substantiated by data, so we would appreciate if it either is removed or disqualified, and we would like to know what this assessment is based on. Our concern is that it can fuel further misconceptions on the role of credit in Italy. Until a few years ago, there was great attention on Italy's NPLs, which are now completely off the radar screen. There was some exaggeration about the role of NPLs, and we would like to avoid repeating the same exaggeration for the relationship between the supply of credit and investment.

I have a few methodological points also. There seems to be a mild disconnect between the staff-assessed current account gap range and the corresponding REER gap range. The REER gap, consistent with the current account gap, is 0.4. On the contrary, the two REER model-based estimates lie in the range of 0 to 10 and are closer to the upper limit. It is not clear to us why staff is giving more emphasis or more importance to the one model rather than the other, and this is a bit puzzling because staff seems to be thinking that the current account-based models were superior to real exchange rate-based models, also because the first one has been going through important methodological innovations. We agree that there should be a comprehensive approach taking into account several models in assessing external imbalances. At the same time, we would like to join others in calling for further methodological improvements on the real exchange rate-based models.

Finally, with reference to Figure 1.14 on page 23, because in 2018 the EBA methodology has been revised, it is a bit misleading to compare the evolution of external imbalances since 2012 because it does not take into account this methodological breakdown.

Mr. Daïri made the following statement:

We reiterate our appreciation for the excellent work done by staff in the ESR and the supplement, and for the answers to Directors' questions. In our gray statement, we broadly agreed with the staff's conclusions and main recommendations. In addition to the points made in our gray statement, I wish to associate myself with the concerns and views expressed by several Directors on the staff's assessment of the strength of external positions and EBA methodology.

I agree with Directors' views on the need for caution in the staff's assessment in view of the limitations in the methodology and the potential adverse impact on member countries if staff's assessment and advice are not the outcome of a robust and balanced approach that takes fully into account country characteristics. In this regard, I agree on the importance of using all approaches instead of excessively relying on the current account approach.

I also support Directors' call for presenting the results in ranges, which is not always the case. Strong attention should also be given to the size of residuals, which often exceed the policy gaps. Furthermore, we agree on the need to look into potential structural issues that may explain the residual, but the residual may also be due in part to the specifications of the model or to data shortcomings.

Conclusions in this area, including on structural issues, should be well justified. More generally, the approach would gain credibility and legitimacy by increased transparency and interaction with the authorities, including on staff judgment. I hope that staff's further work on the EBA would help address at least some of these issues.

Mr. Tan made the following statement:

We would like to echo Directors' appreciation of the extensive work done on the report. The assessment has provided valuable perspectives on global external developments and on implications for individual countries and global stability. We welcome the analysis on exchange rates and external adjustment, which raises good questions related to certain features of international trade. We also support the study to identify underlying factors behind savings and investment trends, which would better inform Fund advice. Further to our gray statement, we would like to offer some additional comments under two broad themes.

First, like Mr. Meyer, the membership would be well served if the report and the wider Fund effort to reduce global imbalances avoided the perception that external balances are a zero-sum game. The reasons are threefold. One, such a perception overshadows legitimate reasons for countries to run current account gaps based on their economic structure and developmental states. Two, it overemphasizes unexplained residuals that may not be attributable to policy distortion. Three, the narrative centers on negative spillover effects, and asymmetric adjustment risks inducing an unhealthy mindset.

In practical terms, this calls for staff to keep up the available efforts to drill down to country-specifics and avoid generalization, to put a premium on getting the methodology right, even though it will not be an exact science, and to make a more robust case against a race to the bottom as evidenced in ongoing trade tensions.

On the theme of non-zero-sum game, the Fund's policy advice to the global community is to do no harm. We will end by asking the Fund in the report to make a more emphatic call for the membership to not just do no harm, but to do good as part of the shared responsibility, and to continue to shine light on mutually beneficial externalities of well-tailored policies to support sustainable growth in the domestic context, while contributing to the rebalancing of global external positions.

Second, further progress will benefit from focusing more on the forest than the trees and recognizing that external balancing is not the be all and end all. To do so, we encourage staff to continue to approach this annual exercise and country engagement with three things in mind. One, with greater appreciation of the broader premise of policy priorities that also considers internal balance and fundamentals rather than addressing external rebalancing in isolation, as Fund policy advice bears the most traction if it keeps domestic objectives firmly in mind, and external rebalancing is most enduring if it does not come at the expense of domestic balance.

Two, with greater realism in policy discussions that is not predicated on a simplistic link between exchange rate adjustment and external rebalancing. Staff has made an encouraging start with the conclusions in Chapter 2 on the complementary role of structural policies, the weakening link of global value chains as global value chain integration deepens, and the potential impact of services trade balance and balance-sheet vulnerabilities in the adjustment process. In this regard, we appreciate Ms. Gopinath's opening remarks on the holistic approach and taking country-specific issues into account.

Three, with a greater, broader focus beyond current account balance given its diminishing relevance in providing a full understanding of domestic policy gaps, vis-à-vis. We agree with other Directors that this remains a work in progress given the model-related limitations, gaps, and inconsistent results, and we welcome and encourage staff to continue the good work such as the analysis of drivers of investment savings gaps.

In conclusion, we would like to echo some comments from Directors. Like Mr. Ray and Mr. Geadah, we look forward to the forthcoming IPF, including understanding how Chapter 2's findings will be incorporated, as mentioned by Mr. Kaizuka and others, and on a stronger multilateral focus for the report, as suggested by Mr. Ronicle.

We also join Directors in supporting an open, multilateral, rules-based trading system and emphasizing the importance of reviving trade liberalization and lowering barriers to trade.

Mr. Kaya made the following statement:

We appreciate the comprehensive assessment of current account imbalances and the transparent presentation of the methodology and of the judgment applied. As other Directors pointed out and as noted in the opening remarks, we positively note the enhanced focus on stock imbalances and on the size and composition of IIPs. We applaud staff for the special feature on how the invoicing currency and global value chains affect the influence of exchange rate chains on trade volumes and external adjustment. In addition to our gray statement, we would like to emphasize the following.

First, we note that stock imbalances will rise further even under modest reductions of flow imbalances. Thus, we highly welcome the recent decline of excess surpluses in some countries, particularly in China, and to a lesser extent, also in Germany, and of excess deficits in several countries, including Turkey. This would require further policy efforts at the domestic level to address the underlying causes within a country. We would like to emphasize that such policy actions tend to be in the long-term interest of those countries.

Second, we conclude from the special feature of one invoiced currency and global value chains that it is essential to focus on a broad set of macroeconomic policies to achieve correction of excess imbalances. At the same time, we fully share the belief that exchange rate flexibility, including

REER differences in relative prices, remains key to facilitate the external adjustment over the medium term.

Having said that, we support a cautious approach when assessing an exchange rate level considering the significant uncertainty surrounding any estimation result within the 5 percent range, which is rightly deemed as broadly in line with fundamentals, and this should also be communicated in a careful manner.

Third, we emphasize that for most small and open European economies outside the euro area, some of these countries belonging to our constituency, the euro area is the dominant trading partner and the euro is the main invoicing currency, particularly in manufacturing trade. Thus, in these countries, we have destination currency pricing for exports. We thank staff for confirming in response to our gray that in this case, bilateral exchange rate movements will lead to results that are quite comparable to those of dominant third-party, namely U.S. dollar currency pricing. We encourage staff to provide a more systematic plan to look into this issue.

Mr. Ray made the following statement:

I thank staff for a very valuable report. I just wanted to add a few points to our gray statement and also to pick up on a few points made by Directors this morning.

First, the Fund has a particularly important role to play in promoting an open rules-based multilateral trading system. Given ongoing trade tensions, we do need to be careful about how the results of the Fund's external sector analysis are communicated. As Ms. Mahasandana said in her gray statement, emphasis on correcting global imbalances runs the risk of being used to legitimize protectionist measures, and care should be taken to ensure that the Fund's valuable analysis is not misinterpreted or misused. In this regard, we welcome the staff's answer to our technical question, and as staff highlighted, we would be concerned if the Fund's ESR analysis was used in subsidy investigations, and we share staff's concerns that this could be both divisive and ineffective.

Second, as we discussed last week, the continued efforts to enhance the depth of analysis are most welcome, and they strengthen the Fund's ability to provide advice that is well tailored to individual country circumstances. As I said last week, the analysis on the impact of currency invoicing and global value chains on external adjustment is both interesting and welcome. The key policy implications are that in a country with a high manufacturing share, exchange rate flexibility may well need to be supported by domestic policies in the short term, as Ms. Gopinath noted.

That said, as Ms. Levonian stressed, different conclusions might be drawn for services and commodity exporters, and it is important that the analysis in this document is not communicated in a way that detracts from the Fund's advice on the value of exchange rate flexibility in facilitating adjustment to shocks, which for commodity exporters is particularly important.

As usual when you come to the Board, we sometimes give you homework, and I wanted to support Mr. Kaizuka's call for staff to consider the link between the exchange rate and the income account, which is not straightforward at all, and income accounts are becoming much more important in current account balances. I do wonder whether partly that is a demographic issue, and I would be interested if staff could think a bit more about how demographics in the future might drive external balances globally.

Lastly, I could not agree more with Mr. Ronicle's call for further liberalization of services. In that regard, I wonder whether staff could get ahead of the curve to think about how that would affect the external balances and how we should think about exchange rates. In Australia's experience, services exports are highly sensitive to exchange rate movements.

Mr. Raghani made the following statement:

I too would like to join other Directors in thanking staff for their set of informative papers, which give a comprehensive view of the external position of the world's largest economies. I also thank the Acting Chair and Ms. Gopinath for their introductory comments. We issued a gray statement, and I would like to emphasize a few points.

We welcome the recent developments in global imbalances with the current account surpluses and deficit continually narrowing and being now more concentrated in a few advanced economies. At the same time, we learned that the aggregate assessments hides a great deal of heterogeneity among countries. In that regard, we appreciate the granular analysis provided by staff on individual country situations which form the basis for well-targeted policy advice.

That said, we share the main recommendations of the report to address external imbalances. Like most Directors, we concur with staff that surplus countries should use their fiscal space to boost potential growth, including through fostering investment and support for innovation. While gradual growth-friendly fiscal consolidation is warranted in excessive deficit countries, we also share the view that macroeconomic policies need to be complemented with structural reforms to reduce external imbalances. Besides the specific policy recommendation to individual countries or country groupings, we would like to reiterate our call for a coordinated and multilateral solution to current trade tensions. Like many Directors in their gray statements, we are of the view that the revival of liberalization efforts and strengthening of the rules-based multilateral trade system through concerted effort are better suited to address disputes in a win-win fashion and preserve global trade as public good.

Finally, we thank staff for the continuous improvement of their methodology and the ESR as a result. We particularly appreciated staff shedding light on policy challenges and vulnerabilities associated with the rising external liabilities position, including for emerging markets and developing economies. We encourage further analysis in the coming ESR on issues of this kind, which are relevant to more and more frontier market economies in our African constituencies.

Mr. Saraiva made the following statement:

I thank Ms. Gopinath and the Acting Chair for their initial remarks. This is an excellent report, as many others have highlighted. I appreciate the Acting Chair's comments emphasizing that this is a continuously evolving, challenging enterprise, but I would dare say the specific 2019 ESR is a well-balanced report. It goes into more granularity when analyzing the main issues, the drivers of imbalances. It provides a timely long-term view on how imbalances evolved since the global financial crisis and also good coverage of broader analytical issues.

I also thank the staff for the answers to the technical questions. They are of very good quality. They gave good attention to that. I would just mention the answer to question 11. I would like to memorize this concise and insightful definition of disorderly market conditions and the situations in which the exchange rate can stop working as a normal shock absorber and start playing a disruptive shock-amplifying role. It gives an idea that this is work that has been engaging staff in a very productive way.

That being said, let me focus on the issue of stock imbalances, as Ms. Gopinath has mentioned. As we said in our gray statement, stock imbalances are not created necessarily by excess imbalances but by the persistent and regular surpluses and deficits over time. In this regard, I would like to highlight, like Ms. Levonian, the importance of focusing on the composition of IIPs. I will open a brief parentheses here because Mr. Ronicle raised an important question that needs to be thought through regarding the balance between multilateral and bilateral assessment in the report.

My first take is that while I like the one-pagers of the other countries, I do not like mine. We always think that in our case it loses granularity. I would mention what Mr. Spadafora brought to the discussion here as well, and Brazil and Italy were mentioned together in one of the answers to the technical questions.

In the case of Brazil, it is mentioned in our one-pager that the rise in debt is a source of risk, and I would emphasize that most of this debt that grew since the global financial crisis was in the form of intercompany loans, which is not necessarily a very threatening kind of debt. A big chunk of it will be paid by exports that are being financed by those flows from other companies..

Mr. Rosen made the following statement:

Let me start by supporting the comments of other chairs and reiterating our strong support for the ESR and the work of RES and SPR to better understand the causes of global imbalances. This is an excellent piece of work, and as noted by Mr. de Villeroché and Mr. Meyer, the ESR is at the core of the Fund’s multilateral surveillance mandate.

We share the views of Mr. Lopetegui, Mr. Ray, Mr. Ronicle, and Mr. Tombini in stressing the importance of market-determined exchange rates in facilitating the adjustment process and as Ms. Gopinath also pointed out today. We agree with Ms. Mahasandana that exchange rate intervention may have a role to play to address disorderly market conditions but note that there is no clarity on what constitutes disorderly markets, and this has been used in the past by countries to maintain undervalued exchange rates, and so we would be cautious on using this as a frequent reason for intervention.

Mr. Ostros called for addressing global imbalances in a growth-friendly manner with decisive and comprehensive policy action, and we agree. But as pointed out by Mr. Tombini and Mr. de Villeroché, adjustment is too often asymmetric with market forces compelling adjustment in deficit countries but not surplus countries. Thus, it is not surprising that the persistence of excessive imbalances has largely been on the surplus side. Asymmetric adjustment has the effect of reducing global demand, as Mr. Lopetegui pointed out. This makes it vital for the Fund to continue to press for policies to bring about a more symmetric adjustment.

A number of chairs referred to their concerns with trade tensions and specifically with respect to the United States, and we understand these concerns, but we believe they do not take into account that the actions taken by the United States are as a response to our attempts over many years to work within and reform the World Trade Organization (WTO) system, which have so far not been successful and did not resolve these serious trade issues, particularly relating to technology transfer. In our view, these issues could not have been addressed by changes in U.S. macroeconomic policy, as some chairs have suggested. It is the strong desire of the United States to move toward freer and fairer trade, and that is why we are in negotiations with China and other countries and regions to this end. In the case of China, if the outcome of the trade talks is successful, many other countries aside from the United States and China will benefit from this agreement, and we believe we will end up with a significant reduction in global imbalances.

Mr. Alkhareif made the following statement:

I would like to echo the remarks just made by Mr. Rosen, that this work is the core mandate of the Fund, and we welcome staff's emphasis on this area. In this context, I appreciate the Acting Chair's and Ms. Gopinath's remarks that the Fund will continue exploring the role of exchange rates in the external adjustment.

I am reassured by your remarks that the IPF will take into account country specificity. Mr. Ostros, Mr. Inderbinen, and Ms. Levonian raised a good point that we encourage staff to continue their efforts to apply judgment in an evenhanded and transparent manner. Reducing excessive external imbalances is a priority to ensure sustainable global growth. In this context, we agree with staff's recommendation that a well-calibrated mix of macroeconomic policies and structural reforms tailored to country-specific circumstances is essential for the rebalancing. In addition, we support the recommendation to revive trade liberalization efforts and modernize the multilateral rules-based trading system to boost global growth for the benefit of all countries.

We welcome staff's analysis in Chapter 2 on the role of exchange rates in facilitating external adjustment. Mr. Meyer raised a good point on the role of this analysis for countries and programs, as the adjustment will take time in the medium term compared to the impact on the short term. We fully agree that the exchange rate flexibility remains key to facilitate durable external adjustment, but like Mr. Inderbinen, we believe the exchange rate itself is not always the only tool to address external imbalances, and hence incorporating other structural reforms on policies is needed.

Mr. Daïri and Mr. Nadali and Mr. Lopetegui raised an important question about the role of pegged exchange rates and the communication around that. In many countries, including Saudi Arabia, where oil exports dominate the external side, it is important to keep in mind the country specificity to address external developments. Here Ms. Levonian and others emphasized the role of communication, proper communication, around the exchange rate policies.

Finally, we have heard many comments about the models. Let me be clear that I fully support the Fund's work on models. I particularly welcome that Ms. Gopinath came from an academic background. I attended some of her courses, and I personally appreciate the excellent work. I have felt that her spin and her expertise has been reflected in this report, and I welcome this analysis. I look forward to further analysis and understanding the role of exchange rate in the adjustment. However, it is extremely important to translate this analysis into capacity development. There is a big role for capacity development to distill this analysis into more constructive dialogue with the authorities. For many countries, our analysis remains a black box, and we need to do more in terms of translating our excellent work to further benefit of the membership.

Mr. Gokarn made the following statement:

We join others in thanking staff for an excellent report and also Ms. Gopinath for setting the context. We issued a gray statement, but I would like to emphasize a few points that we made.

There is a tendency to view imbalances as imbalances—all imbalances are the same, excess or otherwise, however we characterize it. One of the themes that I have picked up in the report was that a country could be doing the wrong things and still not have an excess imbalance. The policy implications that flow from this analysis depend quite significantly on what the source of the imbalance is. If we say that a country's external position is broadly in line with fundamentals, it will be a good thing if those fundamentals are basically on the right track, but it would not necessarily be a good thing if those fundamentals were not on the right track. Some distinction needs to be made as this work proceeds on what the precise nature of those fundamentals is. For example, if a country is using trade restrictions to achieve moderate imbalances, and it does something which the Fund would recommend in terms trade liberalization, trade reform, that could worsen the overall imbalance picture, and there may be other positive consequences from it. A nuancing of what the sources of the imbalances are is important, and I am not yet getting that sense from the analysis.

The second issue is the very important and interesting chapter on currency of invoicing and global value chains. It does introduce a wrinkle, and I think the messaging in the G20 paper was not adequately qualified. It gave the impression that exchange rate variability is no longer as important as it used to be. But this report qualifies it very well. It lays down specific conditions under which the impact of floating exchange rates or variable exchange rates may be muted, may be dampened by these institutional arrangements. It is important for us to understand what is driving these institutional arrangements, what is causing them to, if not regress, certainly slow down in terms of development over the past few years.

The tradeoff is very significant, the tradeoff between micro motivations, efficiency considerations, risk management, and macro considerations, which essentially is the flexibility that exchange rates provide to shock absorption and to stabilization. To the extent that these are conflicting potentially, a deeper understanding of what is driving each side of this equation is important. If you are saying that global value chains are eroding or slowing down, growth is slowing down, does it mean a broadening of production capacity so that firms no longer see the need to lock into suppliers in a particular country, and these are questions which are quite important in the context of the structural drivers of external sector transaction. It is worth looking into them.

Mr. Jin made the following statement:

I would like to join my colleagues in thanking staff for their efforts in preparing this year’s ESR. I have already issued my gray and would like to make some additional comments. We commend the staff for their innovative analysis by introducing dominant currency and a global value chain approach. We also notice the insight associated with the analysis on corporate saving. We believe that a multilateral approach is more urgently needed in tackling persistent excess imbalances in the wake of escalating trade tensions. We need to emphasize that under the framework of the WTO, some policies that may distort trade are, unfortunately, legal, while many others are both distortive and illegal. What we can do as a first step is to ensure that our policies are WTO-consistent, and then we can work together to reform and improve the rules of the WTO to reduce those legal but distortive policies across all member countries. We support the call in the ESR for refraining from the use of tariffs to target both bilateral and overall trade balances. We encourage staff to continue to actively engage members in constructive policy dialogues on structural reforms to address excessive imbalances.

On China's imbalances, the decline of China's current account surplus has shown a clear trend in the past decade. It has mainly reflected its structural adjustments and changes and the large appreciation of China's REER rather than the easing of macroeconomic policies. At the current level of current account surplus of only less than 1 percent of GDP, we cannot exclude the possibility of a current account turning into a deficit, although both staff and some officials in China sound quite confident about the continuous surplus. In the past one year, we further reduced our tariff rate on many products and liberalized market entry in many sectors. Our effective tariff rates are even lower than our nominal rates, actually among the lowest in all emerging market countries and very close to advanced economies.

Last but not least, the current ESR mainly focused on current account analyses. A comprehensive balance of payments analysis will require examination of both the current account and capital account. In financial markets, my observation is that the interest rate parity approach seems to be more widely applied in practice, so I wonder if the Fund should also introduce more interest parity-related approaches. Staff's comments are welcome.

Mr. Villar made the following statement:

We congratulate staff for a very interesting ESR that has benefited from important improvements. We issued a gray statement, so I just want to emphasize three issues.

First, we want to highlight that the flow imbalances have narrowed, but stock imbalances have continued to widen. This leads us to believe that the stock imbalances would deserve deeper analysis, including details about the contribution of valuation changes, composition, and adequateness of countries' net financial asset positions. This has also important implications on the income account, as highlighted by Mr. Kaizuka and other Directors.

Second, I want to highlight the need to adjust not only countries with excessive deficits but also countries with excessive surpluses. Only if judgment is undertaken in a simultaneous and coordinated way, can the measurement bias be averted.

Finally, I would like to highlight the importance of foreign exchange flexibility as a mechanism of adjustment even if some characteristics of the international pricing system and the global value chains make adjustment in goods trade relatively large.

Mr. Etkes made the following statement:

I thank the staff for a very good report and the answers to Directors' questions. In fact, the report has a lot of good inside, and it deserves, as intended initially, four weeks of digesting and understanding what is going on there. We understand that there were some problems and causes of delay in the circulation, perhaps next year it is better to set the date of the Board report not after July 4 weekend, but before, so we will have at least two weeks to digest this good report.

Assessing current account and stock imbalances is very challenging, and the methodology is clear, and there are various models, and we understand there are benefits for different models, and this highlights the importance of using different models, as some colleagues already highlighted, to analyze the situation. This is particularly true regarding the need to develop models on stock imbalances. If we know the adequate stock level, the current account analysis could get a different interpretation. Perhaps going faster than expected by the model convergence into stock level is desired in the final conclusion if we think that stock exchange, or stock levels, are the main risks for disorderly adjustment.

We welcome staff analysis of the drivers of corporate savings, as other Directors already mentioned. They are the main drivers of the current account in a number of countries, including the Netherlands. Better understanding and better research of the contributions of multinationals to the current account will help to avoid a policy distortion. The authorities for our constituency are working on this, and they are obviously happy to share their work with staff and get comments.

Finally, we encourage staff to continue exploring the impact of dominant currencies in global value chains on external sector assessment. We agree with staff that understanding the policy implications depends on the reasons for these distortions, and we were surprised that global value chains are negatively correlated with invoicing in U.S. dollars. We expected it to be the other way around. It is not positively correlated even when we take out Euro countries, which are both integrated and not invoicing mainly in dollars. Understanding the real reasons are critical for devising sound policy advice on this issue. We thank staff for the very good report and for the interaction during the period after the circulation.

Mr. Mozhin made the following statement:

Let me join everybody else in recognizing the high-quality of the report and welcoming it. It is very important for us to better understand the reasons behind the dynamics in these global imbalances and at least those parts of the report which I have read, I was impressed by the progress staff have been making in their analysis. However, our long-held view is that the analysis of the global imbalances would make an excellent chapter in the WEO report. We continue to have doubts that this report needs to be a standalone report, and we keep holding this view, which is a long-held view by this chair.

Listening to colleagues, my conclusion could be that it is very difficult to solve the problem when the problem does not exist. This would be my conclusion.

The Director of the Research Department (Ms. Gopinath), in response to further questions and comments from Executive Directors, made the following additional statement:

I thank Directors for their thoughtful comments and appreciative words. Before I hand over to my colleagues, I wanted to respond to a few points. One point that came up often was that to do a full assessment of external positions, stock imbalances and understanding them, their composition is critical, and we share that view fully. When I got here and talked to my colleagues about the ESR, I said, well, besides the current account and the flows, we need to look at the stock positions and how sensitive countries are, depending upon the composition of those stocks. We plan to do more work on that. The points that several Directors raised about the services sector and the sensitivity to exchange rates, commodities, we are doing work on that, and it is the case that from preliminary work, the services exports seem to be more sensitive to exchange rates than manufacturing. But these are the ingredients that will guide our thinking about the IPF because it is going to be country-specific.

I will just end with the question that came up about the J curve, and you said we knew this 30 years ago, so what is new, so I thought I would just clarify that. If you remember your J curve from 30 years ago, it would say that when your currency depreciates, your trade balance deteriorates in the short run, and that is because in the short run, neither exports change nor imports change. The only thing that happens is that it makes the price of your imports go up relative to the price of your exports, so that is what drives the trade balance, and that is what worsens it. If you look in the data, the contrary imports actually do decline, and the relative price of your imports relative to your exports actually do not change. In fact, empirically what we do find is you do have an improvement on your trade balance. It just happens to be a smaller improvement. My take on this is that the J curve does not have a very good reputation at this point from the empirical point of view.

Secondly, what is new about what we are doing is, unlike the J curve, which is all about bilateral exchange rates, an important implication is that what might matter for some countries is much more their exchange rate relative to the dollar or the euro, depending on which is the currency they tend to invoice in, so there is a big difference between bilateral and dollar exchange rate passthrough.

Lastly, that has implications of the following kind, which is that a stronger dollar can weaken the rest of the world trade, again something that was never a part of the J curve thinking.

The staff representative from the Research Department (Mr. Cubeddu), in response to questions and comments from Executive Directors, made the following statement:

I would like to start by expressing my gratitude to Directors for their thoughtful feedback, as well as the many questions that were raised in the gray statements. I also would like to apologize for the short circulation period and the burden it presented to some.

Let me respond by reflecting on some of the issues that you raised in today’s discussion. I will organize my remarks broadly as follows: I will say a few words about the role of the ESR. I will then clarify our views on the risks from the current configuration of flow imbalances and stock imbalances. I will end by touching upon some of the ongoing work that is taking place to better understand the model residuals, including the drivers of high and rising corporate saving.

I will start off with the ESR. It is now in its eighth year. It is important to highlight that it has moved from a pilot to standard report. We had previously informal-to-engage meetings. Now we have formal Board meetings, and we have made efforts to increase the profile of the report, and much like last year, we will hold a press conference a week from today on this issue. Equally important, we have moved the report in the direction of improving the presentation, the transparency, the language (even though we still have five mentions of "excess" imbalances) in the report as well as the analysis underpinning the assessments. Many of these changes benefited from your feedback.

Since 2017, and also encouraged by your feedback, we have tried to give the report a bit more of a thematic flavor, also understanding that excess surpluses and excess deficits do not vary much year over year. We thought it was important to include this analysis to improve our understanding of external sector trends and issues. As a reminder, in 2017 when we started doing this, we did some work on the persistence of current account surpluses, when do these surpluses reverse, and what were the conditions that led to those reversals. In 2018, we did some work looking at the issue of how imbalances are affected by the asymmetric reduction in trade costs between goods and services, and this was in some ways encouraged by the work of our colleagues at the Bank of England conducted on the role of services trade liberalization and the extent to which that could reduce imbalances.

This year we featured work looking at the role of exchange rates in facilitating the external adjustment process. We see these analytical pieces as important in improving our understanding of imbalances and also of policies to correct them. We will give more thought to whether we need to shift the balance further and give the report much more of a multilateral flavor. We will also try to make sure that it is made clear in the report that the reduction in external imbalances is not an end in itself. In that regard, we will continue to work toward ensuring that our policy advice is properly communicated since the objective should be to reduce domestic imbalances while reducing external imbalances.

Let me turn to the issue of risks from the current configuration of imbalances. As we said in the report, we do not see the risks from the current configuration as in imminent danger from the point of view of global stability. However, we do see that in the event of heightened trade, technology, and geopolitical tensions this would have knock-on effects on global growth and global risk aversion. This could negatively impact some economies, especially those reliant on foreign demand and foreign financing who could face a sudden stop in capital flows similar to that observed in mid-2018. Again, near-term risks from global imbalances are contained, but there could be spillovers if some of these trade, technology, and geopolitical tensions are to surface. I do think, and the report tries to make the point, that over the medium term, in the absence of corrective actions or adoption of policies that exacerbate imbalances, we could see a further widening of stock positions, and this could raise the likelihood of disruptive currency and asset price adjustments down the road in debtor countries with losses corresponding in creditor countries.

As many Directors have said, the risk of a further buildup of sovereign and corporate debt in some economies, particularly if associated with the continued easing in financing conditions and the slower pace of monetary policy normalization, would amplify this effect. We agree that we need to increase our surveillance of this particular risk, do further research as well, and increase our data collection efforts. We are doing work on this dimensions. In addition, we need to think further about policies that could help reduce maturity and foreign currency mismatches. In this regard, we see that foreign exchange flexibility, as in fact helping to reduce one-sided bets and reduce risk-taking.

Continuing on risks, I would like to make the point about the persistence of current account imbalances, which we see as a risk in itself, is leading rightly or wrongly, to protectionist sentiments in many deficit economies. This escalation of protectionist policies will come at the expense of domestic and global growth. We would like to emphasize that we do not see imbalances as an excuse for protectionism, and that there are alternative ways to address these excess deficits and surpluses. In this regard, the report highlights that there is a strong case for reviving liberalization efforts and strengthening the multilateral trading system.

Let me now move on to my final point, which is associated with model residuals and the work that we are doing to better understand them. We acknowledge that the unidentified portion of the current account gap is often large and explains a large bulk of the imbalance. This is one of the reasons why we also present our assessments in ranges to reflect that uncertainty. We have also developed complementary tools to ascertain the extent to which structural policies can help explain part of these residuals, and we see that the country teams are increasingly using these structural complementary tools in their own assessments.

In parallel, over the past years, we have been doing quite a bit of work on better understanding the link between corporate saving and current account imbalances. This started two years ago in the 2017 ESR. We highlighted the key role played by net corporate saving in accounting for current account differentials between surplus and deficit countries. In last year's ESR, we provided additional analysis by decomposing the sources and uses of gross corporate savings in these economies. In this edition of the ESR, we dug deeper into better understanding the composition of corporate net savings into its sources and comparing the factors that explain the divergence. We found that corporates in surplus advanced economies, especially those in northern Europe and parts of Asia, tend to have lower labor compensation, lower dividend payments, lower domestic investment; and importantly, households in these economies have not been offsetting the rise in corporate saving.

The next step, which I personally admit is probably the most challenging and complex one, will be to identify policy options. This will require assessing the extent to which the rise in corporate savings reflects fundamentals or policy distortions. We are going to have to do work in new areas, including the taxation of property and inheritance, corporate governance, also understanding wage bargaining frameworks and the extent to which this may be reducing labor compensation. As you have pointed out, we will continue to work on issues of wealth and income inequality as well as market power. We also agree that this will require collaborating with country teams and looking much more at firm- and household-level data. As many Directors have highlighted, the work conducted by the Germany team this year on the links between corporate saving and wealth inequality is a good example in how we should move forward.

The staff representative from the Research Department (Mr. Adler), in response to questions and comments from Executive Directors, made the following statement:

Let me address some of your comments in the gray statements and your interventions related to Chapter 2. One of them relates to the focus on manufacturing goods, and a number of Directors mentioned that the chapter had a narrow focus on trade in manufacturing goods, leaving aside trade in services, commodities, and also aspects of the income balance that may be relevant when we think about all of the elements of the current account.

There are two reasons why we focus on manufacturing in this particular chapter. The first one, for some economies, other aspects of the current account may be very relevant. For example, in economies that have large either net or gross stock positions, the income balance may be quite relevant both on the debit and credit side. But when we think from a systemic point of view, trade in goods remains a dominant element of the current account transactions. In fact, at an aggregate level, about 70 percent of transactions in the current account relate to trade in goods and the other 30 percent broadly divided into services and income components.

The second reason for focusing on manufacturing is a methodological one that relates to data reliability. For manufacturing goods, there are granular data that allow us to disentangle the effects of exchange rates both on prices and quantities, and this is a key element to understand the process of external adjustment, which may not be available for other elements of the current account.

Having said that, as Gita pointed out, there are ongoing efforts to explore some of these other aspects. There is a research agenda looking into services trade starting by collecting more granular data. As I said before, part of the challenge is that there are not comprehensive data on deflators for services in many cases, which makes it difficult to disentangle prices and quantities and understand the process of adjustment and, hopefully, we can make some progress on this.

There is also ongoing work related to the income balance of the current account and its connection to the stock positions and how potentially exchange rates may affect the income balance. This is part of a broader agenda of trying to understand the return on foreign assets and liabilities, and we have done some work on this in terms of both understanding the investment income component, which goes into the current account, but also the valuation changes of the IIP, both of which are part of the return on foreign assets and liabilities. This is key to understand the dynamics of the NIIP.

In this regard, as Mr. Ray rightly said, every time we come to the Board we get more work to do, and that is perfectly fine. Let me return the favor, if I may. Here we need help from country authorities to make progress on data collection in many respects. For example, on the composition of the IIP, we have tried to make progress in trying to get a better picture on the currency composition and we are conducting some surveys for your country authorities. We would welcome your support in getting good data. Similarly, in order to have a good understanding of the role of valuation changes in the IIP, we need what we call stock-flow reconciliation data, basically reconciling how changes in the NIIP relate to the current account accumulated flows, as well as other aspects, like valuation changes but also statistical revisions. Even though this is basic information for our analysis, in some cases the data are quite limited, and we are trying to make progress in getting a better picture, and your support would be very welcome.

I would just add one more point about communication of the findings of the analytical chapter. Some Directors stressed the need for cautious communications on the findings of the chapter and especially on the implications of the benefits of exchange rate flexibility, and Ms. Gopinath already elaborated on the policy implications of our work and their connections to the ongoing work on the IPF. Let me just say that we agree on the need for nuanced messages and cautious communication. In broad terms, our message is that exchange rates still have an important role to play in facilitating durable medium-term external adjustment even in the presence of dominant invoicing currencies and high integration into global value chains but also that exchange rates may not do all the work, especially in the short term. We are of the view that the report strikes the right balance in terms of the message and the nuances without foreshadowing the analysis that will come in the IPF, and we intend to strike the same balance in other related outlets and communications to the broader public.

Mr. Spadafora remarked that in qualitative terms, the Fund's models were completely identical to the J curve, and he recommended mentioning the similarity in a footnote.

The Acting Chair (Mr. Lipton) made the following statement:

I wanted to say one word in response. Our Dean, as he often does, made a provocative comment, and I did not hear a question mark at the end of it, and I did want to respond to the point. It is inherent to this exercise that there will be times when the imbalances are problematic and times when they are not. We might want to remind ourselves of the history of the subject, the asymmetrical nature of the fact that sometimes deficit countries really must adjust, but surplus countries under our system have less compunction to adjust, can be problematic when deficit countries are choosing to make those adjustments or are forced to make those adjustments, and their absorption decreases if there is not a corresponding adjustment in absorption in the surplus countries. Instead of getting less problematic adjustment, you can have the equilibration come through a slowdown in the global economy. We have to remind ourselves that the deficits always equal the surpluses. The question is how you get there, and when deficits are declining, you want to make sure that the path does not involve an undesirable path for the global economy.

I think it is right, and perhaps this was part of the implication of his point, and I think we say in this report that that is not where we are at this moment. The big deficit countries are not in the process of adjusting, but we are recommending such adjustments in certain cases, and so it is important, and the point that the paper makes is that there may be circumstances in which these imbalances and where there in some are cases excessive imbalances, and the fact that those may grow over time could lead to vulnerable moments in the future in the event that adjustment is needed. As we do this year in and year out, we have to acknowledge that there may be moments where there are less immediate implications from the imbalances that we have identified, but that does not mean that we should not be on the case and trying to find ways to adjust to excessive imbalances in order not to have problems at points where it becomes germane to the path of real activity in the global economy.

The following summing up was issued:

Executive Directors generally agreed with the findings of the 2019 External Sector Report and its policy recommendations. They noted that, while global imbalances had declined considerably since the global financial crisis, progress has been more limited in recent years, with increased concentration in advanced economies. Directors also observed that the persistence of current account surpluses and deficits have led to a continued widening of stock imbalances, reaching record levels. Moreover, recent trade measures are weighing on global trade, with negative implications for investment and growth.

Directors shared the view that, in the near term, financial risks from the current configuration of global imbalances are generally contained. Nevertheless, an intensification of trade tensions and a disorderly Brexit, with knock-on effects on global growth and risk aversion, could adversely affect economies highly dependent on foreign demand and external financing. Over the medium term, Directors cautioned that, absent corrective policies, trade tensions could become entrenched, and further divergence of external stock positions could trigger costly disruptive adjustments in key debtor economies that could spill over to the rest of the world.

Directors agreed that carefully-calibrated macroeconomic policies, tailored to country-specific circumstances, would be necessary not only to achieve domestic objectives but also to support external rebalancing. Excess deficit economies should give priority to adopting or continuing with growth-friendly fiscal consolidation, and to deploying macroprudential policies where credit growth or foreign-currency borrowing may be excessive. Excess surplus economies should deploy available fiscal space to boost potential growth, including through public infrastructure investment, while avoiding overreliance on monetary policy, where applicable. Directors highlighted that, even in some economies where external positions are assessed to be broadly in line with fundamentals, policy actions are necessary to address domestic vulnerabilities and prevent a resurgence of external imbalances. Meanwhile, rising external debt liabilities in a number of economies require careful monitoring, especially of maturity and currency mismatches.

Directors underlined the key role of carefully-sequenced and designed structural policies to tackle persistent external imbalances. Reforms that enhance competitiveness and productivity of the tradable sector are central for rebalancing in excess deficit economies. In excess surplus economies, reforms should aim to encourage investment—including through innovation support and deregulation of certain sectors—and discourage excessive savings by households and corporations. Noting that excess surpluses tend to be associated with rising corporate saving and the resultant wealth inequality, Directors encouraged staff to conduct further analysis on its drivers, including at the country level, to arrive at more concrete policy implications.

Directors agreed that exchange rate flexibility remains key to facilitate external adjustment and welcomed the analysis on how evolving features of international trade, such as dominant currency invoicing and global value chain integration, can affect the external adjustment process. They noted that, while exchange rates may have relatively muted effects in the short term as a result of some of these features, standard exchange rate effects on trade flows remain at play in the medium term. Directors saw the benefits of policies that ease capacity constraints, through improved access to credit and transportation infrastructure, in helping strengthen exchange rate mechanisms. They looked forward to further analysis on the mechanisms of external adjustment, including through balance sheet channels and trade in services, to distill policy lessons in an integrated framework that takes other important country-specific characteristics into account.

Directors stressed the importance of a collective effort by the international community to avoid policies that distort trade, including trade barriers and subsidies. They observed that recent trade barriers had done little thus far to address underlying external imbalances while reducing welfare. They encouraged countries to work toward reviving liberalization efforts, including in areas like e-commerce and services trade, and strengthening the rules-based multilateral trading system.

Directors highlighted the valuable public good aspect of the Fund's multilaterally-consistent external sector assessments. They appreciated ongoing efforts by staff to strengthen the analysis and transparency of the External Sector Report, especially in the use of judgment, while acknowledging inherent uncertainties in the conduct of external assessments. Directors called for continued efforts to improve the External Balance Assessment (EBA) methodologies, including to better understand the risks posed by external stock positions and their composition, as well as strengthen data collection efforts to account for the rising cross-border activities of multinational corporations. Directors reiterated that, given large unexplained residuals, caution would continue to be needed in interpreting model results and drawing policy recommendations. In this context, they encouraged staff to continue using all EBA models and complementary tools in the conduct of external assessments.

Directors stressed that rigorous and evenhanded analysis of external positions is necessary to promote growth-friendly policy actions by both surplus and deficit countries to rebalance the global economy in a durable and symmetric way. They looked forward to further integration of external sector assessments into surveillance at both the bilateral and multilateral levels.

APPROVAL: May 19, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Chapter 1: Overview Paper

General Comments

1. ***Turning to the timing and format of the 2019 ESR, we would express our concern about the shortened circulation period. We understand that this reflects the need to ensure full consistency with the key Article IV consultations and the forthcoming WEO update. At the same time, we believe that the Board's discussion of the report can be moved to a less bunching period in the Board's calendar. Staff's comments would be appreciated.***

- Staff apologizes for the short (2 week) circulation period. There was indeed a narrow window to hold this year's ESR Board discussion, given the need to ensure full consistency with the July WEO update (as in the past) and Article IV consultations of key economies. Given these constraints, Staff will reassess the precise timing of the ESR Board Meeting going forward to ensure meeting the agreed 3-week minimum.
- It is worth mentioning that Staff has continued to make efforts to engage with the Board on these important issues: (i) in late-May, a meeting was held to discuss a background note on Global Imbalances prepared for the G20; and (ii) on July 1, an informal Board briefing was held to discuss the findings of this year's ESR analytical chapter.

2. ***We wonder if labelling a country's external position and exchange rate valuation in a definitive and conclusive manner (i.e. substantially stronger/weaker, stronger/weaker and broadly in line, and REER are overvalued/undervalued) may distract the ESR audience from seeing the full context of the assessment and considering the important caveats that often underpin the assessment. Staff's comments are welcome.***

- Staff takes a holistic approach to external sector assessments that balances numerical inputs with well-justified judgement; and focuses on assessing the "overall" external position instead of a single component like the exchange rate, which is generally far more volatile.
- Given the uncertainties inherent, assessments are generally presented in ranges rather than point estimates, with *qualitative* labels corresponding to specific ranges. In Staff's view, these qualitative labels help in communicating the extent to which a country's external position may deviate from levels consistent with fundamentals and

desired policies, although it also recognizes potential stigma issues associated with the labeling. Staff plans to revisit this issue in the context of the next External Sector Report.

3. ***We look forward to the timely completion of integrated policy framework (IPF), and we welcome staff's comments on the current progress.***

- *An interdepartmental working group has been created and work is ongoing to advance our understanding of the policy interactions and tradeoffs for countries dealing with external shocks and capital flow volatility. Staff plans to bring an update to the Board later in the fiscal year.*

4. ***Care must be taken to ensure that the Fund's valuable analysis is not misinterpreted or misused. Could staff share their views on the possibility that ESR assessment could be used to make the case for countervailing actions during a trade dispute? Could staff elaborate on the risks of conflicting opinions between the Department of Commerce and the U.S. Treasury, as well as the Fund's work reflected in the External Sector Report***

- The question refers to the potential that the ESR assessment might be used by a domestic investigating authority to determine whether a foreign currency is undervalued in a way that constitutes a countervailable subsidy under domestic law. Like other countervailing duties (CVDs), such a determination could be disputed by the government of the exporting country under WTO dispute settlement with respect to its consistency with the WTO Agreement on Subsidies and Countervailing Measures and other relevant WTO agreements.
- Many countries carry out such investigations of foreign subsidies and impose CVDs; however, staff's understanding is that no country currently considers currency undervaluation as a subsidy for the purpose of CVD investigations. There are good reasons for this, as making such undervaluation into a potential subsidy would raise serious concerns. Exchange rates reflect many factors, including domestic and foreign macroeconomic policies, which are often an appropriate response to economic conditions. This is why staff analysis of external conditions focuses on medium-term, which abstracts from the economic cycle, and emphasizes the uncertainties involved in any evaluation.
- The use of the ESR by domestic authorities in carrying out subsidy investigations that may result in trade measures could interfere in the ESR process and the Fund's external surveillance more generally. The Fund has made significant progress in recent years in providing more reliable, timely, candid, and transparent external sector assessments. The introduction of measures of undervaluation into CVD investigations could hinder this progress and prove divisive and ineffective.

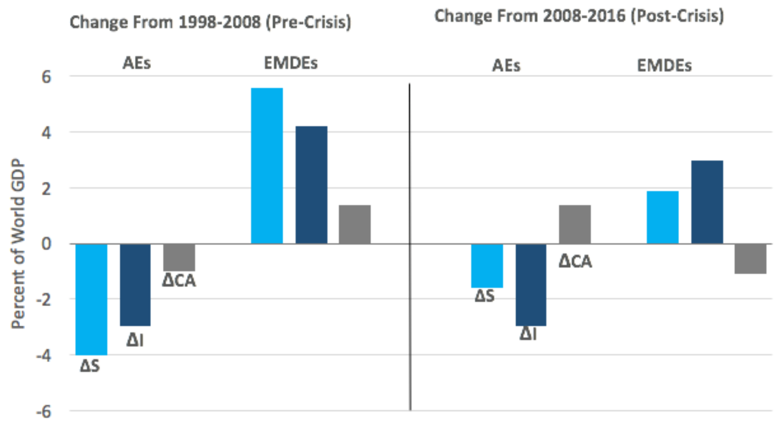
Recent Developments, and Longer-Term View

5. ***Regarding the global allocation of capital, we are encouraged by the recent reversal in the direction of capital flows, which are increasingly flowing downhill, especially in the form of direct investment. We are concerned, however, by the fact that according to staff these flows have done little to support income convergence over the past decades. We support staff's view that this fact requires additional investigation. Could staff provide a preliminary assessment of why this has been the case?***

In a world of limited policy space, we would have appreciated a deeper interpretation of this shift in the direction of capital flows. Should this be read as a fall in desired saving relative to desired investment, and if so, as a factor that might potentially push up on global equilibrium interest rates in coming years? How large might this effect be relative to other drivers of low equilibrium rates? Staff views would be welcome.

- In the years preceding the global financial crisis, AEs as a group received persistent and sizable net capital inflows. These inflows were mirrored by large and growing outflows from EMDEs—and particularly China, the largest among them, which was integrating into the global economy—and exporters of raw materials, which benefited from the boom in commodity prices. Outflows from developing economies during this period were dominated by accumulation of official foreign exchange reserves.
- Our preliminary analysis suggest that the pre-crisis uphill flows mostly reflected saving-related factors and did not prevent rising investment in EMDEs in relation to world GDP. In fact, investment grew strongly in EMDEs despite the intensification of capital outflows, as saving growth outpaced investment growth. This sharp rise in saving in EMDEs reflected consumption smoothing of the commodity boom and the intensive export orientation (at the expense of consumption) of some EMDEs.
- Following the crisis, current account balances in EMDEs fell, as investment growth, despite slowing sharply from its pre-crisis rate, outpaced growth saving. In contrast, current account balances in AEs increased as investment lagged, even despite monetary easing. Therefore, one could argue that the recent net flow of global saving has been in the direction of supporting higher investment (and therefore income convergence) in EMDEs (see chart below).
- Staff plans to look into saving and investment drivers of overall capital flow trends, including to help draw policy implications. Clearly, reaping the benefits of capital inflows will remain a central challenge for EMDEs. In general, this will require further strengthening policy frameworks to lower the risk of potential capital-flow reversals, as well as having in place well-functioning (domestic and international) financial markets to efficiently channel saving into productive investment.

Change in CA Balance: Role of Saving and Investment



6. ***Could staff elaborate on the extent to which the "discrepancy" between net advanced economy outflows and net EMDE inflows reflects flows to countries outside the ESR sample?***

- Reported current account surpluses and deficits do not always match at the global level. This statistical discrepancy, however, is relatively small and stands at about 0.4 percent of global GDP. It is worth clarifying that the estimated statistical discrepancy (in Figure 1.7 and Table 1.1) considers all economies and does reflect more narrow country coverage.

7. ***Going forward, could staff consider presenting in the main report the analysis in Box 1.4, which shows more details on the EMDEs?***

- Staff is currently working on a project to build a comprehensive dataset which will detail the currency composition of the main components of the IIP for the countries which are part of the EBA/ESR. Staff expects that this project will be completed in the fall of 2019. Going forward, this dataset will be for surveillance and Staff plans to use it in future ESRs.

8. ***Figure 1.8 shows a negative correlation between CA balances and NIIP valuation changes. What is staff's take on the underlying drivers of the relationship depicted in Figure 1.8? Are measurement issues one of those drivers?***

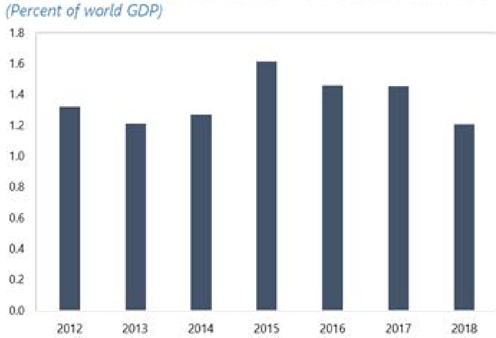
- In some cases, measurement issues related to the treatment of certain elements of investment income are part of the pattern of offsetting NIIP valuation changes. However, those patterns depicted in figure 1.8 seems to be broader and relate to actual economic forces at play. For example, in most advanced economies external liabilities are denominated in local currency. In such cases, appreciation pressures stemming from positive and sustained current account surpluses entail negative NIIP valuation changes as appreciating currencies increase the value of external liabilities (in relation to the value of external assets). See related work in "The Stabilizing Role of Net Foreign Asset Returns" IMF Working Paper 18/79.

External Sector Assessments and Methodologies

9. ***The EBA models provide insight as to whether imbalances are driven by economic fundamentals or if they are cause for concern. Staff's assessment that 35 to 45 percent of global current account surpluses and deficits were excessive in 2018 down from 40 to 50 percent in 2017 provides a more relevant assessment of the importance of global imbalances than a simple sum of deficits and surpluses. Does staff have information on the historical trend in excessive imbalances?***

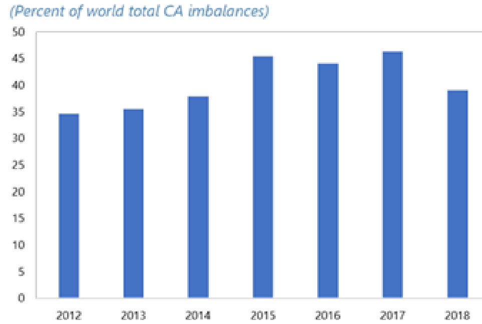
- The estimates of excess imbalances start in 2012, which is the year when the ESR was introduced. Excess imbalances (as percent of world GDP, and as percent of global imbalances) have been relatively stable, although they increased through 2015 and have been gradually declining since. It is important to remark that even though these charts reflect *staff-assessed* CA imbalances, these figures may not be strictly comparable overtime, given methodological changes in 2015 and 2018 to the EBA models.

ESR Economies: Evolution of Excess Current Account Imbalances 1/
(Percent of world GDP)



Sources: IMF, *World Economic Outlook*; IMF, *External Sector Report*; and IMF staff calculations.
1/ Excess CA imbalance is calculated using staff-assessed CA gaps in ESR.

ESR Economies: Evolution of Excess Current Account Imbalances 1/
(Percent of world total CA imbalances)



Sources: IMF, *World Economic Outlook*; IMF, *External Sector Report*; and IMF staff calculations.
1/ Excess CA imbalance is calculated using staff-assessed CA gaps in ESR.

10. ***We note that model residuals often play a very large role in determining current account gaps: 4.4 of 4.4 percentage points in the case of the United Kingdom. Could staff indicate how much of the overall variation in gaps is explained by the residual, rather than identified policy gaps?***

- For 2018, about two-thirds of the overall variation in gaps is due to the residual, while about one-third is due to identified policy gaps. Efforts have been made in recent years to help country teams shed light on model residuals, including through the development of complementary tools that assess the role of structural factors and gaps.

11. ***Can staff provide more information about their methodology for defining disorderly market conditions?***

- Staff consider disorderly market conditions as situations in which the exchange rate can stop working as a normal shock absorber and start playing a disruptive shock-amplifying role. In these circumstances, markets stop operating normally, they become one-sided and illiquid, normal market-clearing breaks up and price signals may not be informative, and conditions may be prone to herd-like dynamics.
- Devising quantifiable and objective empirical indicators remains a challenge, notably because policy responses to such episodes may mask their manifestations in exchange rates. Staff hence relies of a suite of indicators, including sudden stops or reversals of capital flows, prices, volatility and illiquidity conditions in debt, equity, and FX markets, and indicators of credit crunch, as well as discussions with market participants and the authorities.

12. ***Could staff comment on whether there is a methodology to determine adequate NIIP?***

- The External Sustainability (ES) Approach usefully complements estimates from the current account, REER-Index and REER-Level models, by focusing on sustainability considerations for debtor economies, which are central to external sector assessments in some cases. The ES approach seeks to determine the current account-to-GDP ratio that would stabilize the NFA-to-GDP over the medium term at a benchmark or desired level.
- Staff's ongoing work is aimed at understanding the adequacy of NIIP levels across countries, taking into consideration factors such as the composition of the IIP (including the role of foreign currency external debt, which as Box 1.5 shows has a positive association with external crises).

13. ***Staff adjust the CA norm for Brazil, India, Poland, and Spain because of financing risk considerations related to the negative net international investment position (NIIP) of these countries. These adjustments seem arbitrary as the model already includes a variable to capture the negative effects of a NIIP below -60 percent of GDP. In addition, India's negative NIIP at 16 percent of GDP is much smaller than most of the other debtor economies listed in Table 1.2. Could staff provide an explanation of these adjustments?***

- Often, the level of NIIP (which the ES approach relies on) does not provide sufficient information on external sector risks, since financing risks often depend more on the composition of liabilities, and especially the extent of maturity and currency mismatches.

- For some of these countries, their large debtor positions suggest that higher current account balances are needed to lower external liabilities to levels that are considered safe. Some emerging markets, despite low levels of net external debt, seem to have difficulty financing CA deficits beyond a certain level when global risk aversion increases (e.g. India during the "Taper tantrum"), and therefore an adjustment to the CA norm is needed.

14. ***Lags in the transmission of exchange rates to trade volumes and prices were cited as reasons behind discrepancies in three key emerging market economies between current account and REER assessments in 2018. Has this inconsistency been observed for these or other countries in previous years? Is the lag due to dominant currency invoicing and global value chain integration? How long does the lag typically last and what action, if any, has been taken to shorten it? Are there indications that the said discrepancies will disappear in 2019? Staff comments are appreciated.***

- In the 2018 ESR, this inconsistency was identified for Turkey, since sharp lira depreciation in 2017 was not yet reflected in a lower current account deficit (although the deficit narrowed in 2018). In the 2017 ESR, this inconsistency was identified in Mexico due to a sharp peso depreciation.
- As explained in Chapter 2, exchange rates affect trade flows over the medium term, although the short-term response may be muted due to short-run nominal and real rigidities. Other considerations may be relevant when predicting the response of the current account to large exchange rate movements, including country -specific characteristics (e.g. balance sheets), the policy response, and the nature of the shock (i.e. permanent vs. transitory). Therefore, time lags are generally very case-specific.

15. ***In the same vein, we continue to reiterate our call for a larger coverage of the ESR to African frontier markets. This will improve the analysis, including on external liability positions and developing financial conditions, many of these countries having tapped international capital markets over the past decade. We would like to hear from staff on what precludes such addition of frontier markets to the ESR sample.***

- The set of economies covered in EBA is guided by balancing the need to capture a large share of the global economy with the need to ensure an appropriate model fit (which can be compromised by sample heterogeneity). The current sample of 49 countries in the EBA model, which compromise about 90 percent of global GDP), was selected to ensure a proper mix of geographically-diverse advanced and emerging economies with access to global capital markets and data of sufficient good quality and availability.

- In the context of future refinements, Staff is exploring the possibility of expanding the list of countries to reflect the growing importance and market access of some EMDEs, although data limitations may be a constraint. It is also important to keep in mind that the EBA-lite methodology is generally intended for the conduct of external assessment of all other economies not included in EBA or the ESR.

Outlook, Risks, and Policy Responses

16. ***We missed a deeper analysis of potential impacts of an intensification of trade tensions, and of a no-deal Brexit. Could staff elaborate on the possible impacts of a disorderly Brexit scenario?***

- Staff's views on the impact of tariff increases and risks related to a further escalation of trade tensions and a disorderly Brexit scenario were discussed in the recent G-20 Surveillance Note (June 2019). Related to trade tensions, staff found that the recently announced and envisaged tariffs in May between the United States and China could reduce the level of global GDP by 0.3 percent in 2020. These effects would be in addition to the impact of tariffs already imposed in 2018. Related to Brexit, the European Union has extended Britain's exit deadline until October 2019. Nonetheless, prolonged uncertainty regarding the ultimate agreement, the exit process, and conditions post-Brexit could worsen confidence and stress financial markets.

17. ***Could staff elaborate on the possible future implications of the growing stock imbalances for net income flows and the extent to which increases/declines in these flows are likely to be offset by compensating changes in trade balances?***

- Gross income flows have been rising over time, as percent of world GDP, alongside financial integration and growing stock imbalances (with affect investment income) and migration (which affect other primary income, and secondary income). At the same time, trade still holds a predominant role at the country and global level. Indeed, the relative importance of trade and income has been generally unchanged, as trade openness has also risen, and interest rates have fallen to historic lows (see Staff G20 Background Note on Global Imbalances, June 2019).
- While the current account summarizes, on aggregate, a country's intertemporal saving and investment decisions, the relative importance of its main components (trade balance, income balance) varies depending of fundamentals and policies (past and present). The primary income balance tends to be more positive in richer, faster aging economies that have accumulated net external assets to provide for consumption at old age. The opposite is true for younger and faster growing economies who must pay

returns on their stock of foreign borrowing. At the cross-country level, there is a negative relationship between trade and income balances, as countries may need to run trade surpluses to meet external debt service obligations, while others run trade deficits as they start dissaving and put to use the income on assets held abroad.

- It is also worth noting that the distinction between trade and income is becoming less relevant and increasingly blurred with the growing complexity of multinational operations. For example, offshoring decisions and/or tax optimization strategies may imply a decrease in effective or registered exports, together with an equivalent increase in income receipts.

18. ***Indeed, we would like to have a better view, beyond the accumulation of trade deficits and surpluses, of what is the internal dynamic of the NIIP (as valuation effects could be important, from (i) external assets influenced by the movements in financial markets and exchange rates and (ii) revenues from external assets recorded in the income balance which are not compensated elsewhere) and in which extent it could contribute to a more important NIIP divergence. Staff comments are welcome.***

- The simulation in Figure 1.15 is meant to be illustrative, showing the evolution of the NIIP under three different scenarios. As such, no valuation effects are assumed in the projections, since this would require also making assumptions about their underlying drivers (including exchanges rates, equity prices, and bond prices). In addition, the simulation use CA projections from the WEO and staff-assessed norms for 2018 and avoids an integrated analysis about the evolution of the different CA components (i.e. the goods and services balances, and primary and secondary income balances).

19. ***The fact that wealth and market concentration might be playing an important role here may make proper policy responses complex to devise and difficult to implement. Considering that in the US the aforementioned factors are prevalent but there are no excess corporate savings, are there lessons to be taken for other AEs?***

- The rise in net corporate saving (i.e., saving minus investment of the corporate sector) between 1995 and 2017 has been moderate in the United States (about 1 percent of GDP increase), in line with other deficit advanced economies, and far smaller than in surplus advanced economies (increase of 4 percent of GDP). While some of the trends behind the rise in net corporate saving, such as increased wealth and market concentration, can also be observed in the US, the US differs from surplus advanced economies through (i) higher corporate investment and (ii) higher dividend payments. Consequently, Staff sees a case for adopting reforms in surplus economies to encourage business investment (e.g. through deregulation of key sectors) and to consider changes in dividend policy (especially through tax and corporate governance reforms).

- In addition, it is worth noting that fiscal policy has largely offset the rise in net corporate saving in the US, yet it has contributed to the surplus in other advanced economies. This highlights the role of fiscal policy to reduce excess external imbalances in both surplus and deficit economies.

20. ***We would welcome an elaboration on staff's work plan on building on the current understanding of the underlying drivers of high and rising levels of corporate saving in some advanced economies and on identifying suitable policy options.***

- Staff has been working into better understanding the link between corporate saving and current account balances for the past two years. The 2017 ESR highlighted the key role played by net corporate saving in accounting for current account differentials between surplus and deficit countries. The 2018 ESR provided additional analysis by decomposing the sources and uses of gross corporate saving in surplus economies. The 2018 refinements also introduced complementary tools to assess the role of structural (product and labor markets) distortions, which are correlated with corporate net saving.
- This edition of the ESR digs deeper into the decomposition of corporate net saving into its sources and compares the key factors of divergence across surplus and deficit economies. Box 1.7 finds that what distinguishes the two groups of economies includes the diverging impact of: (i) labor compensation, (ii) investment, and (iii) dividend payments. Going forward, identifying suitable policy options will require assessing the extent to which these trends reflect changes in fundamentals or policy distortions, potentially leading to improvements over time of the structural complementary tool and (as data coverage of structural variables is enhanced) the EBA model itself.
- In the short term, Staff plans to conduct further work on structural reforms (and their link to corporate saving), including on wage bargaining frameworks. Preliminary Staff work shows that so-called "pattern" wage bargaining (where a leading sector, generally manufacturing, sets wage benchmarks and other sectors follow) is associated with significantly higher net corporate saving and current account balances. However, further work is needed to better understand the underlying economic mechanisms, especially whether and how wage bargaining frameworks affect the speed of current account adjustment towards equilibrium.
- Staff work on corporate saving will continue to be multifaceted—drawing not only on work by the ESR team, but also related issues tackled in WEO analytical chapters (e.g., falling labor shares, corporate market power), and insights from country teams (e.g. *Selected Issues Papers* on corporate saving for the Netherlands, Malaysia, and Germany).

21. ***Our view is that while attention should be paid to the risks of a return to excessive surplus, risks of excessive deficit may also warrant attention. In particular, one should prevent larger-than-warranted deficits caused by the overvaluation of exchange rates, which could eventually result in a passive depreciation to achieve a necessary correction. Staff's comments are welcome.***

- Staff agrees on the need to highlight the risks from the reemergence of both excess surpluses and excess deficits. In this regard, the ESR discusses the cases of Brazil and Italy, where avoiding a reemergence of an excess deficit requires reforms that tackle weak competitiveness and increase public saving (see Para. 13, last bullet point).

Data Issues

22. ***We note efforts to advance data collection and compilation on global value chains, and appreciate staff indication of progress made in this area since the formation of the relevant working group in 2017.***

- There are several initiatives that are being promoted by STA and the IMF Committee on Balance of Payments Statistics (BOPCOM):
- In 2017 BOPCOM set up a Working Group on GVCs jointly led by the OECD and the IMF to identify the role of multinational enterprises in the current account. The preliminary report was finalized in October, which identified components and statistics in the current balance of payments framework that are relevant for developing indicators on GVCs.
- Currently, the WGGVC is: (i) developing a reporting template on GVCs; (ii) conducting a stocktaking survey of current GVC data availability and potential feasibility; (iii) identifying the role of multinationals in the current account transactions, including through further enhancements to the linkages between trade and business registers, to develop trade by enterprise characteristics for both goods and services; and (iv) developing additional guidance that can help to identify merchanters and factoryless producers, building on existing efforts in this area. The final report of the WGGVCs will be presented to BOPCOM in October 2019.

23. ***We understand that data collection is a key obstacle to better apprehending the role of MNE and profit shifting in some members, but we would like to have clarifications about the existing barriers and a precise roadmap on how to address persisting statistical issues. We would insist that given the centrality of this issue for the Fund's mandate more work is needed. A joint work by the Research Department, the Statistics Department and the European Department appears warranted in this regard. Could staff provide a summary of the existing obstacles, how to address them, and propose a calendar to ensure swift progress?***

- See answer above. Given the level of granularity of the data that is involved to ensure the proper measurement and assessment of external positions, national statistics agencies need to strengthen their data collection and collaboration efforts (see the 2019 European Commission report which finds large bilateral statistical discrepancies on income and service balances).

24. ***Can staff comment on whether there are adequate and comprehensive data on external debt and foreign currency external debt for risk surveillance, including the granularity of data on non-financial corporate borrowings and the activities of less regulated nonbank financial sector? Are there efforts to enhance data collection in this area?***

- Staff (in collaboration with staff at the ECB) is currently constructing a comprehensive dataset which will detail the currency composition of the main components of the IIP for the countries which are part of the EBA/ESR. One of its main items is *Portfolio Debt Liabilities*. Actual data on currency composition is only available for recent years and for a subset of countries which responded to the survey sent to authorities or report to the ECB. Staff relies on estimation methods based on BIS international issuance statistics (available by reporting country and by currency) to fill data gaps. Using these three sources, staff will be able to produce a time series of portfolio debt liabilities for most of the economies included in the EBA model. The foreign currency breakdown includes USD, euro, sterling, yen and renminbi, and other currencies. Unfortunately, sector-specific data are not generally available. Due to confidentiality reasons, data on portfolio debt liabilities for "each" foreign currency cannot be published (as a result only aggregate data on foreign currency exposure will be made available).

Chapter 2: Exchange Rates and External Adjustment

25. ***Going forward, we note that the research only focused on manufacturing trade, and it is not clear how the result would change by including the impact of invoicing to commodity trade and services in the analysis. We look forward to future work that integrates the additional trade and financial features into the analysis.***

We encourage staff to take a holistic view of the implications of global value chains (GVCs) for policy makers. Staff's finding that the trade balance has diminishing sensitivity to exchange rates as an economy is more integrated into GVCs is helpful for the membership, especially small open economies. The analysis should be complemented by a discussion on the external adjustment mechanism in other sectors such as services, which may have weaker cross-country linkages and less imported content than the manufacturing sector.

- Work is under way to explore the effect of exchange rate movements on services trade flows, starting from the collection of comprehensive data on services trade. A challenge in this area of analysis relates to the lack of price indicators for services, which hinder staff's ability to disentangle price and quantity effects, as done in Chapter 2 for manufacturing services trade.

26. ***We also invite staff to evaluate the impact of currency pricing and global value chains on small open economies and on economies with fixed exchange rates, and to evaluate the impact of the findings on the External Balance Assessment (EBA) framework, and particularly on the EBA Real Exchange Rate Model which relies on the bilateral exchange rates. Is work planned in these areas?***

- While the results presented in Chapter 2 reflect the evidence from weighted regressions—which give relatively more importance to trade patterns prevailing in large economies—results hold also, and tend to be more pronounced, in the unweighted regressions—which give more importance to small economies. Moreover, as the empirical evidence in the chapter shows, US dollar invoicing and integration into GVCs tend to be more pronounced in many small open economies. Thus, the overall results apply to small open economies.
- For countries with exchange rates that are pegged to the US dollar, the analysis suggests that trade flows would behave like those of the US. In the short term, imports volumes would not respond much to exchange rate movements, while export volumes would. See a fuller discussion on this in Box 2.1.
- Regarding the implications of the findings for the EBA framework: the analysis indicates that the currency of invoicing is a relevant dimension to assess short-term effects and, thus, existing REER metrics could be usefully complemented with similar measures that take invoicing currencies into account. Work to collect invoicing currency data more comprehensively is under way. At the same time, the results indicate that the currency of invoicing becomes less relevant with time, pointing to the continued usefulness of existing REER metrics from the perspective of medium-term analysis and the EBA analysis (although they could be refined to better capture aspects of global value chain integration).

27. ***Chapter 2 also looks at the overall effect of global value chains (GVC) on trade elasticities. According to the OECD, trade in GVCs seems to have slowed markedly – if not declined, since around 2011. Do staff find the same developments in their analysis? If so, what could be the reasons for such a development?***

- Measures on GVC participation constructed for the analysis of Chapter 2 also reflect a slowdown in the general process of integration since 2011. While the underlying drivers of the process of GVC integration are beyond the scope of Chapter 2, work by the WTO relates the slowdown to a shift towards production of intermediate inputs domestically in emerging markets and a return of manufacturing jobs due to technological innovation in some developed countries.

28. ***On a related matter, we wonder to what extent trade flows are influenced by perceptions about the permanency or temporariness of exchange rate movements. Trade flows responses may be limited, for instance, if exchange rate movements associated with unconventional monetary policies are perceived as only temporary. This would provide further justification for increased reliance on fiscal and structural policies to reduce external imbalances. We would appreciate staff's comments on this issue.***

- Indeed, changes in exchange rates that are perceived to be temporary are likely to have more muted effects on trade flows in relation to exchange rate changes that are perceived as permanent, since economic agents tend to react more to permanent shocks. This suggests that temporary exchange rate changes, which may be necessary for short-term rebalancing, may need to be larger (than required from a medium-term perspective) or complemented with other polices tools. Achieving durable (medium-term) rebalancing requires permanent exchange rate changes, however, which are also likely to have more meaningful effects on trade flows.

29. ***We note also from the presentation that China is among the countries with the most important share of imports and exports invoiced in dollar. In view of the conclusions mentioned above, this would imply that an increase of exports would be limited in case of a depreciation shock. Could staff indicate if the exchange rate pass-through for this economy is particularly low compared to other economies?***

- The analysis indeed suggests that, for countries with a higher share of trade invoiced in USD, export volume elasticities are lower in the *near term*. Over the medium term, however, export volumes respond to exchange rate movements regardless of the share of trade invoiced in USD. In China, data and ADB reports suggest that a high share of trade is invoiced in US dollars. Based on trade invoicing considerations alone, China's exchange rate pass-through would be *higher* in the near-term, compared to other economies with less US dollar invoicing.

30. ***In the case of the US-China Trade tensions, strong and very rapid trade diversion was observed, towards Mexico in the case of US imports and towards Vietnam in the case of China's imports, which suggests that GVC production lines display more flexibility than that suggested in the chapter. This evidence makes it difficult to reconcile the swift and rapid diversion in trade flows with the idea that exchange rate elasticities are low. Is this a byproduct of the US dollar dominance as a currency of invoicing? Staff's comments are welcome.***

- While some trade patterns following US-China bilateral trade actions point to possible trade diversion and raise valid questions about the degree of flexibility of global value chains, there are some key distinctions between the results of Chapter 2 and the such recent patterns of trade. In particular:
    - The analysis in the chapter reflects broad patterns of trade for a large set of countries and sample period; while the recent events are specific to some countries and products. In this regard, there are many goods for which it is easy to substitute the location of supply both within and outside global value chains—like unspecialized or commoditized goods (such as steel and aluminum) or final goods (such as washing machines)—while for others changing the location may be more difficult. The general evidence in the chapter points to the aggregate importance of the latter; while many of the products affected by bilateral US-China trade actions appear to be of the first kind.
    - The chapter relates more to the effect of exchange rates on trade flows, but less to the effect of tariffs, which may have a different impact (as found in previous studies).

31. ***Staff also made several important complementary findings that could warrant follow-on analysis. For instance, staff found that: (i) GVC integration has been limited since 2000; (ii) greater integration into GVCs is associated with higher trade openness; and (iii) GVCs are intrinsically rigid. These findings could have important implications for trade and industrial policy and should be explored further. Regarding findings (i) and (iii), we felt that Chapter 2 of the 2019 ESR contrasted somewhat with Chapter 4 of the April 2019 WEO. For instance, the WEO pointed to a significant increase in complex global value chain participation since the mid-1990s and illustrated how trade diversion in response to escalating tariffs can lead not only to sectoral reallocations across countries but to the actual repositioning of entire GVCs. Recognizing that there are definitional and measurement differences at play, it would be helpful for staff to pull together its valuable work to provide the membership with a holistic view of the policy implications of GVCs.***

- On i) While the measure of GVC integration used in the WEO chapter is different from the measures built for the special feature, they both capture broadly similar concepts (GVC trade that crosses borders more than once). Indeed, different GVC measures point to a rapid process of integration in the 1990s. However, since the early 2000s (period of focus of Chapter 2) the increase in GVC participation has been more limited. This is visible in measures reported by WEO and the ESR.
- On iii): There are many goods for which it is easy to substitute the location of supply both within and outside global value chains—like unspecialized or commoditized goods (such as steel and aluminum) or final goods (such as washing machines)—while for others changing the location may be more difficult. The results of Chapter 2 suggest that the latter group is important. For these products, reallocation across

countries may still happen in response to tariffs, especially if the shock is large and perceived to be persistent.

32. ***We welcome the analysis in Chapter 2 as it adds greater nuance to the understanding of the role of exchange rate movements in facilitating external adjustment. We agree with staff that further work is needed to develop a fuller picture of the adjustment process. In particular, services trade (e.g. tourism, business process outsourcing receipts), investment incomes and remittance may be more significant than goods trade for some economies. Such country-specific structural feature could affect the workings of exchange rates on external adjustment. At the same time, exchange rate movements could exacerbate existing balance sheet vulnerabilities and pose financial stability risks. We welcome staff's comments on plans for further work in these areas.***

- As Chapter 2 discusses, the analysis conducted focuses on the process of external adjustment through trade in manufacturing goods, leaving aside possible other aspects related services trade, investment income or remittances. The latter elements—which may be particularly relevant for some economies—may display different patterns of external adjustment, which requires further analysis. Work is under way to study the role of services trade in external adjustment, given its growing importance. That said, while some of these elements are particularly important for some economies, in general, current account transactions remain dominated by trade in goods.
- The discussion in Chapter 2 acknowledges that balance sheet (as well as inflation pass-through) considerations are important aspects in designing appropriate policy responses. Thus, adequately tailored advice requires an analysis of policy trade-offs that take into account aspects not covered in the chapter. This is part of the ongoing work on an Integrated Policy Framework.

33. ***We would also like to know how the conclusions in Chapter 2 would be incorporated into the Fund's external assessment going forward. Furthermore, we also wonder if it is possible to reflect more clearly appropriate caveats in future ESRs and/or individual country reports on the evolving understanding and known limitations of the exchange rate mechanism, so that the public and financial markets can be more discerning when interpreting the results of the external assessments.***

- The conclusions in Chapter 2 point to the continued relevance of exchange rate flexibility as a mechanism to facilitate external adjustment over the medium term. This is consistent with the current EBA/ESR framework. That said, the analysis recognizes that REER metrics could be refined to take into account aspects of invoicing currencies (relevant in short term) and global value chain participation (more generally).

- Regarding caveats: the analysis of Chapter 2 will help inform, along other ongoing work on an Integrated Policy Framework, future ESR discussions on appropriate policy responses. While properly nuancing and reflecting caveats will be key, it is important to stress that the findings of the chapter lend support to the notion that exchange rates still have an important role to play to facilitate durable external adjustment.

34. ***Moreover, staff's findings highlight the inherent uncertainties regarding the estimation of trade elasticities with respect to real exchange rates which confirm our view to follow a cautious interpretation of exchange rate gaps implied by the EBA-current account model. Staff comments would be appreciated.***

- The analysis of Chapter 2 focuses only on two aspects of international trade that can affect the elasticities of manufacturing trade: trade invoicing and GVC integration. Because of its relatively narrow focus, the analysis should be regarded as a building block to a fuller view on the process external adjustment.

- With further enrichments, the econometric framework developed in the chapter may be used to refine EBA/ESR estimates of exchange rate elasticities. Like estimates on any other macroeconomic variables, there is a certain degree of uncertainty regarding exchange rate elasticities, and staff assessments are presented in ranges to reflect this.

35. ***For most small and open European economies outside the euro area, the euro area is their dominant trading partner and the euro the invoicing currency, i.e. destination currency pricing of exports, as opposed to producer currency pricing. Thus, the question arises whether for these economies such a feature of bilateral trade would lead to results (with respect to exchange rate pass-through and response of trade volumes and trade balance) that are comparable to dominant third-party currency pricing. Staff comments are welcome.***

- Data on euro invoicing indicates that the euro tends to be used for intra-EA trade, and in many cases for trade with a euro member. The share of euro invoicing among small open European economies outside the Euro Area ranges between 30 and 70 percent, while the share of USD invoicing for these economies ranges between 10 and 60 percent. Because the share of trade invoiced in USD is significant in some of these countries, the implications of dominant third-country currency pricing hold. On the other hand, where euro invoicing is high, there would be "destination currency pricing" for exports. In these cases, bilateral exchange rate movements would lead to a muted export volume response and high pass-through into exporter-currency prices (compared to imports) in the short term.

36. ***From the point of view of econometric exercises, we understand that the estimated FX elasticities combine the "traditional" relative-price effects and the financial-type channel from balance sheet effects —which tends to have a dampening impact on the FX elasticity. We wonder if this fact contributes to the low elasticities found in those exercises, in addition to the dominance of the US dollar as a currency of invoicing and to the impact of GVC. Staff's comments are welcome.***

- The analysis in Chapter 2 does not distinguish between the relative price and the financial-type channels. While the latter can indeed affect elasticity estimates (as financial shocks could jointly impact exchange rates and trade-flows), whether the underlying balance sheet effects would tend to increase or reduce the estimated elasticities is unclear: if domestic agents are short in foreign currency, a depreciation would reduce their net-wealth, and lower domestic demand and imports. By contrast, if domestic agents are long in foreign currency, a depreciation would increase their wealth, boosting domestic demand and imports. These effects could be compounded by balance sheet effects in the corporate sector, where movements in the exchange rate may affect the value of firms' collateral and so their ability to borrow to produce.

37. ***We also noticed some changes in the format of the report with the inclusion of Chapter 2, which has a broadly theoretical nature. The presentation of this preliminary and still debatable work in the ESR may create additional uncertainty about the economies' external assessments. In our view, departmental working papers and/or WEO chapters may have been a better tool to conduct and present the study of the exchange rates' role in facilitating external adjustment.We would appreciate staff's additional elaboration on the ESR format change.***

- Starting in 2017, and partly in response to feedback from the Executive Board, the ESR has gradually moved to being more thematic by including an analytical feature/chapter that went deeper into specific aspects of relevance to external sector assessments. For example, in 2017 we studied the persistence and reversal of current account surpluses, while in 2018 we studied the impact of the asymmetric reduction in trade costs on imbalances. These analytical features are intended to shed light and encourage a discussion on key aspects of external sector assessment and associated policies.
- This year's chapter on exchange rate and external adjustment contributed to the ongoing debate about the role of global value chains and invoicing currencies in altering the workings of exchange rates. We see this issue as central to external sector surveillance, helping also to inform our view on future methodological refinements.

Chapter 3: Country-Specific Questions

China

38. ***Staff notes that China's current account surplus narrowed further, although Box 1.2. recognizes that expansionary credit and fiscal policies have contributed to a buildup of leverage and vulnerabilities, and that achieving a lasting external rebalancing would require a gradual reigning in of these policies, accompanied by structural reforms. In view of the above, it is not clear to us whether the characterization of China's external position as being in line with fundamentals and desirable policies is fully consistent. We would appreciate staff's comments on this issue.***

- Using the EBA methodology, China's 2018 current account gap—the difference between the2018 cyclically-adjusted current account balance and the 2018 current account norm (the current account level consistent with medium term fundamentals and desirable policies—is deemed to be broadly in line with fundamentals. Hence, Staff's assessment is that China's external position is broadly in line with fundamentals.
- One of the distinctive features of EBA methodology is that it allows a discussion beyond the current account gap and offers insights into what is driving these gaps. In most cases, the policy gaps—difference between current policies and desired medium-term policies—suggest potential policy responses that are needed to close the current account gap. In some cases, closing policy gaps could widen the current account gap. The report makes it clear that while China's position is assessed to be in line with fundamentals, there are indeed policy distortions with offsetting effects on the current account that need to be tackled together to avoid a reemergence of excessive surpluses.
- For China, the national savings rate has declined from its peak in 2008 but remains higher than the global average and other countries with similar income levels. From the policy front, since 2008, China's structural fiscal balance has deteriorated, and private credit has expanded. While this helped in reducing the current account, it has also led to build up of domestic vulnerabilities.

Euro Area

39. ***We note staff's recommendation of higher wage growth in key euro area creditor economies to help rebalancing. Given labor mobility in the common market, we wonder if staff could comment on the implications of wage increases for the euro area peer economies? How will such increases reflect on the relations between labor unions and the respective authorities in member states?***

- Even though faster wage growth in key euro area creditor economies could attract labor inflows from other EU countries, these flows should only be marginal. Existing wage gaps between EU countries are already very large—an order of magnitude larger than the changes rebalancing may cause within a country—and yet labor mobility remains limited. Moreover, the main EU source countries of migrants are outside the euro area. Therefore, intra-EA migration is unlikely to meaningfully affect labor relations in euro area countries. To the extent such migration happened, it could increase wage pressures in source countries, but would also reduce unemployment.
    - Labor mobility has been limited within the EU (compared to across US states). Intra-EU migration remains low with 0.4 percent of the population moving each year. For comparison, migration rates between US states are about 5 times larger, despite their declining trend. This is mainly due to language barriers, but also to structural hurdles such as incomplete implementation of the Services Directive for the Single Market.
    - Therefore, higher wage growth in euro area (EA) creditor countries will likely induce labor inflows from other EA or EU countries at the margin. In fact, non-EA EU countries are more likely to experience emigration than EA peers. In any case, the magnitude would be small – the wage level gap between core EA countries and non-EA EU countries is already very large, so it is not clear that cyclical wage growth in creditor economies would attract significant labor inflows.
- Regarding implications for peer economies, wage increases in the tradables sector in large euro area creditor economies – if not matched by increases in productivity – could render these sectors relatively less competitive compared with euro area peer economies which do not experience similar wage growth.
- The institutional structures of labor unions across the euro area are diverse, with the main strongholds in manufacturing and transportation. Recent data, however, show a broad-based increase in wages across various sectors, hinting at no specific role of unions behind this trend.

40. ***While the treatment of the current account as the sum of individual Member States' current accounts is valid, the same is generally not true for a similar aggregation of real exchange rates, as the real effective exchange rate of the euro is neither the sum nor any other linear combination of the euro area countries' real effective exchange rates. The basic reason is that intra-euro area misalignments, rather than "cancelling each other out" as in the case of the current account, affect the estimated misalignment for the euro. This aggregation issue also underscores the importance of careful communication of the exchange rate assessment.***

- Staff strongly agrees that any aggregation of REER results needs to be treated with caution. Aware of large uncertainties, the reported, staff-assessed REER gap is informed by various components, one of which is the REER gap derived from the EBA current account model (which is -3.2 percent).

41. ***As for the euro area, we note that staff's assessment of the unchanged, moderately strong, positive current account gap results from the lowering of the current account norm in parallel to the decline of the actual current account surplus. In this context, we would like to mention that the EBA current account regression has a special result for the euro area in that the sum of the contribution by identified policy gaps and the residual is considerably lower than the total positive gap. Staff comments are welcome.***

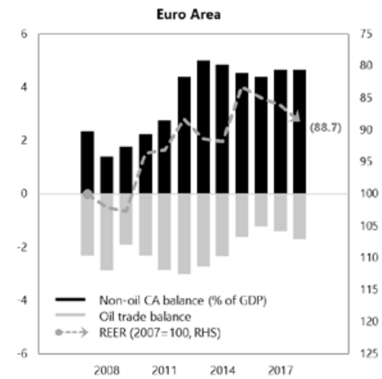
- The identified policy gaps and the residual add up to the EBA gap, also for the euro area. There was a typo in Table 1.6. in the version sent to the Board, and corrections will be issued.

42. ***We note that the estimated EBA current account norm for the euro area has changed noticeably, to 1.1 percent of GDP, compared to 1.5 percent in the 2018 ESR. This seems mainly due to 'multilateral consistency' adjustments to ensure the netting out of external positions within the euro area.***

- The decline in the euro area current account surplus between 2017 and 2018 partly reflected cyclical factors, namely changes in output gaps, and a deterioration in terms of trade deterioration (in line with higher oil prices). These factors contributed close to 0.2 percent of GDP of the CA surplus decline.
- The decline in the euro area EBA current account norm (from 1.5 to 1.1 percent of GDP) between 2017 and 2018, results from several ad-hoc factors that may unwind going forward, including: (i) *multilateral consistency considerations* (0.2 percent of GDP), which applies to everyone and relates to the fact that the EBA sample excludes large oil exporters; (ii) the *rise in the intra-EA statistical discrepancy* (0.1 percent of GDP); and (iii) *changes in desirable policies* in some member countries, namely France, Greece and Ireland (0.1 percent of GDP).

43. ***Against this background, it might have been interesting to also further decompose the Euro Area current account balance as displayed for the United States in Figure 1.5. Staff comments are welcome.***

- The report did not include that decomposition for the Euro Area because staff wanted to highlight the decline in the US oil balance deficit, which has been a key driver in its current account balance, as highlighted in last year's ESR. The importance of the terms-of-trade effects on other oil importers is discussed in Para 5, and while the oil balance deficit has narrowed somewhat in recent years in the Euro Area, most of the increase in the surplus is due to the non-oil current account balance (see chart).



Germany

44. ***The contribution of the credit gap decreased from 0.5 percentage points last year to only 0.1 percentage points also on the back of a lower domestic policy gap. However, we would be interested to learn why staff (again) deviates from the definition of the desired credit gap levels in the case of Germany which also raises some questions regarding cross-country consistency of the EBA exercise.***

- Unlike other policy variables such as the fiscal balance or health spending, the credit gap is a proxy for financial excesses that needs to be estimated. The starting point to estimate these excesses is the BIS-type filter for the credit-to-GDP ratio described in Cubeddu and others (2019) and the Technical Supplement to the 2018 ESR. Staff may apply judgement when the estimate coming from the filter does not reflect financial conditions in a given country. Consistent with last year's practice, for the specific case of Germany, the credit-to-GDP ratio is near its lowest level in decades which is what informed staff's decision to make a downward adjustment to the filter estimates and to the desired level of credit.

Italy

45. ***It is unclear why the contribution by the private credit gap to the CA gap is so high in Italy compared to Spain. Although the credit gap is very similar in both countries, the "desired" gap P* is 0.0 for Italy and -10.0 for Spain. Staff's comments are welcome.***

- Unlike other policy variables such as the fiscal balance or health spending, the credit gap is a proxy for financial excesses that needs to be estimated. The starting point to estimate these excesses is the BIS-type filter for the credit-to-GDP ratio described in Cubeddu and others (2019) and the Technical Supplement to the 2018 ESR. Staff may apply judgement when the estimate coming from the filter does not reflect financial conditions in a given country. Staff uses the estimate from the filter for the case of Italy. For the case of Spain, an adjustment for the credit gap is done since the filter estimate (close to -50 percent) is deemed to be too large. Moreover, in Staff's view, the level of credit in Spain is expected to remain below pre-crisis levels over the medium term, and this informs the assumed negative P*.

46. ***In the staff's estimate of Italy's Current Account (CA) norm, a very large positive contribution stems from demographics; this holds true also in an international comparison. Although population ageing is indeed a concern for Italy, it is unclear why this trend is deemed to be so much worse than in other advanced economies, such as Germany. Staff's comments are welcome.***

- In the new EBA CA model, demographic variables try to capture two effects on the current account. The first block of variables estimates the effects related to a country's population structure (countries whose populations are older or younger tend to dissave, while countries with a high share of prime aged savers tend to save). This combined effect contributes to Germany's norm by 0.3 percentage points and to Italy's norm by 0.4 percentage points. The second block of variables measure longevity risk in a non-linear way. Longevity risk contributes to Germany's norm by 0.5 percentage points, while it contributes 1.5 percentage points to Italy's. Therefore, higher life expectancy and the need to save more after retirement appear to be the most important effect for Italy.

Switzerland

47. ***We were somewhat surprised to read that some very high current account surpluses are deemed broadly in line with fundamentals and desirable policies. In those cases (Switzerland, Ireland) we wonder whether the existing significant measurement biases played a role in how staff came to the above assessment.***

- As discussed in the individual country assessments and in detail in the Technical Appendix of the 2018 ESR, measurement biases can be very important in economies with large gross external stock positions, as the statistical treatment of certain elements of the associated income balance (e.g., retained earnings on portfolio equity, and interest income) can lead to large and systematic NIIP valuation changes. In these cases, among which Switzerland and Ireland are included, standard statistical measures of the current account do not necessarily reflect with accuracy the real accumulation of external wealth by domestic residents. Thus, external sector assessments include adjustments for the estimated magnitude of these statistical biases.