

SM/13/167  
Correction 1

July 9, 2013

To: Members of the Executive Board

From: The Secretary

Subject: **2013 Pilot External Sector Report**

The attached corrections to SM/13/167 (6/20/13) have been provided by the staff:

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

**Page 8, para. 7, line 1:** for "Real exchange rates have generally continued"  
read "In 2012, real exchange rates have generally continued" Correction to clarify the timing of appreciation particularly for commodity producers.

**Page 38, title:** for "Annex II. Central Bank Motivation for Reserve Accumulation"  
read "Annex II. Central Bank Motivation for Holding or Accumulating Reserves"

**Evident Ambiguity**

**Page 30, Figure 24, note, line 1:** for "Policy contributions are estimates from EBA of how"  
read "Policy contributions are estimates from EBA (see the EBA methodology paper)"  
Correction to clarify how the policy gaps are estimated.

**Page 30, Figure 24, additional sentence on the note:** Additional text after the last sentence read  
"'Unidentified policies and other' are not solely from EBA but represent all the other factors that affect the current account gap, including uncertainty over the size of the gap (see page 27 and Box 7)." This text has been included to clarify that "unidentified policies and other" does not come directly from the EBA methodology but also include other factors.

**Typographical Error**

**Page 24, Figure 18:** On Estimated Difference between Real Effective Exchange Rate and those Consistent with Fundamentals and Desirable Policies. The RHS Panel scale needs to be corrected so that it is identical to the LHS scale and goes from +15 to -20 instead of +15 -15.

Questions may be referred to Mr. Robinson, AFR (ext. 35691), Mr. Phillips, RES (ext. 37187), and Ms. Stuart, SPR (ext. 37897).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (4)

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Department Heads

## A. Current account divergences have narrowed and real exchange rates are adjusting

3. **Global current account divergences continued to narrow in 2012, reaching 2 percent of global GDP compared to a peak of 3 percent in 2006.** Much of the adjustment occurred at the onset of the global financial crisis—financial instability, a sudden stop of capital flows, and asset price collapses led to sharp external adjustments in both surplus and deficit economies (Figures 1 and 2, and Table 2). The largest contributors to closing the global divergences have been China, Japan, and the U.S. all seeing large reductions in their current account divergences whether measured relative to world GDP or national GDP. But most of the major country or country groupings have also contributed.

**Table 2. Change in Global Current Account Divergences**  
(2006–07 to 2012)

	(% of world GDP)	(% of own GDP)
Surplus		
China	-0.26	-6.83
Japan	-0.28	-3.41
Euro Area	-0.10	0.17
Germany	-0.08	0.12
Other	-0.04	-1.11
Oil	0.02	-3.05
Deficit		
United States	0.77	2.48
Euro Area	0.19	1.29
Other	-0.13	-0.69

Source: IMF, World Economic Outlook Database.

### Box 1. Key Concepts

This Report uses several terms to refer to the external sector.

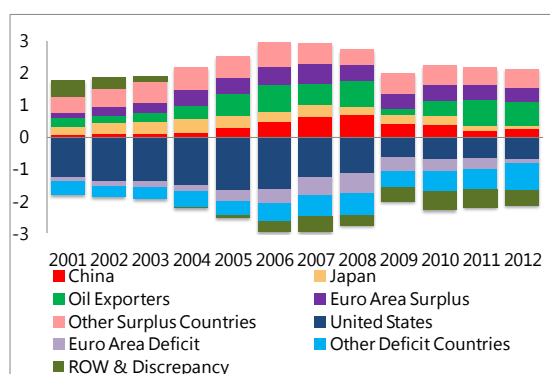
**Current account divergences** represent surpluses/deficits that differ across countries. They may be appropriate or inappropriate.

**External imbalances** represent the gap between actual current account balances and those estimated by staff to be consistent with fundamentals and desirable policies. They reflect distortions and other factors.

**External position** covers the overall assessment from the external indicators used in this Report, namely current account balances (and the counterpart capital and financial account balance), international investment positions and exchange rates (note: for an external position weaker (stronger) than expected the exchange rate is stronger (weaker)).

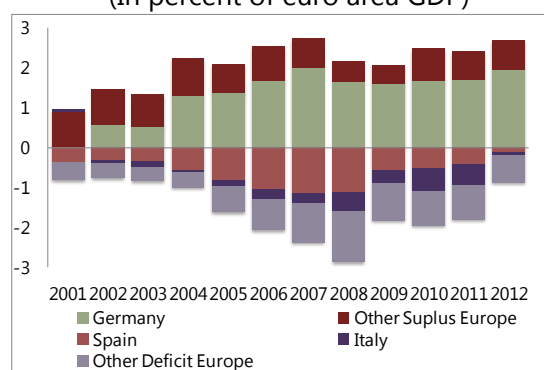
## 4. The further reduction in global

**Figure 1. Global Current Account, 2001–12**  
All Countries: Actual Current Account  
(In percent of world GDP)



Source: IMF, World Economic Outlook Database.

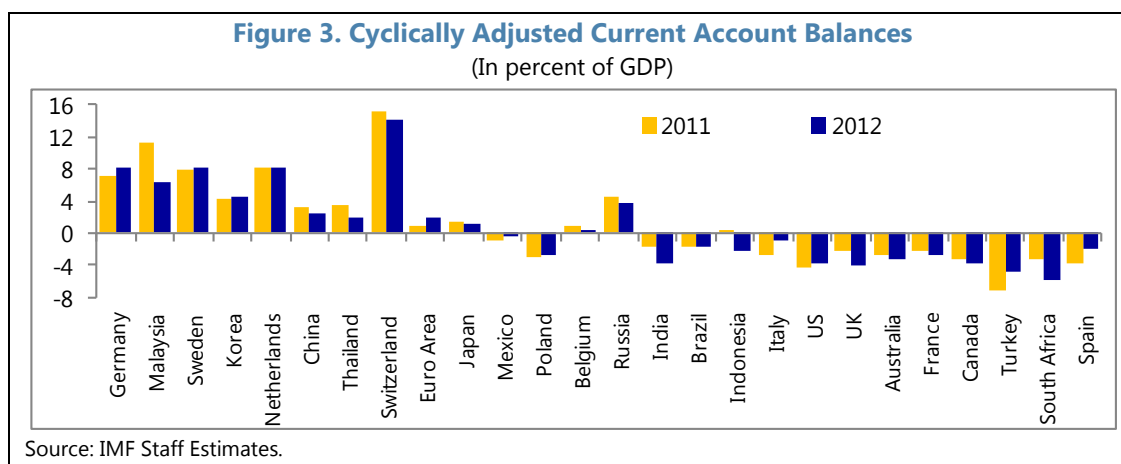
**Figure 2. Euro Area Current Account Balances, 2001–12**  
(In percent of euro area GDP)



Source: IMF, World Economic Outlook Database.

**imbalances in 2012 was concentrated in the surplus economies as well as the euro area deficit countries and the U.S.** Surpluses of oil exporting economies began to narrow from 2012 Q2 as oil prices started to fall and following an increase in fiscal spending. Emerging Asia swung into a small current account deficit, and there was a small increase in China's current account surplus (following a narrowing in 2011). Deficits in the euro area deficit countries narrowed by almost half, via export growth and further import compression—in crisis affected countries, imports are between 5 and 40 percent below pre-crisis levels. But surpluses increased in the euro area surplus countries such as Germany. Elsewhere current account deficits widened for India and South Africa, where growth has fallen below expectations.

5. **Cyclical factors have played a role, but cyclically adjusted balances provide a broadly similar picture suggesting some closing of underlying imbalances.** Cyclically adjusted current account balances—adjusted for both output gaps and the commodity price cycle—narrowed significantly in a number of countries in 2012 (Figure 3). The relative role of cyclical versus structural factors, and its likely evolution as the world economy strengthens, is taken up below (§29).



6. **Current account divergences have been persistent—the same countries have run surpluses or deficits for many years—contributing to a build up in asset or liability positions relative to the rest of the world.** While persistence in current account balances is to be expected—reflecting fundamental factors such as the stage of development of a country or demographics—the evolution of NIIPs (Table 3) and its composition can contribute to vulnerabilities.

7. **In 2012, real exchange rates generally continued to rise in surplus regions—China, oil exporters—and fall in deficit economies, with the exception of commodity producers such as Canada and Australia** (Figure 4). Since 2012 Q3, the yen which

**Table 3. Net International Investment Positions**

(In percent of GDP)

	2006	2012
Surplus economies		
Japan	33.5	57.4
Germany	29.3	41.0
China	23.6	21.1
Euro Area	-12.0	-7.7
Deficit economies		
Canada	-3.0	-15.9
France	1.1	-19.3
U.S.	-16.4	-28.2
U.K.	-30.9	-35.8

Sources: International Financial Statistics and Lane and Milesi-Ferretti, Updated and extended External Wealth of Nations database II.

Note: Measured in US dollars.

### Box 6. Use of the External Balance Assessment (EBA) Methodology in the ESR

**The EBA methodology was introduced in the 2012 Pilot External Sector Report.** The original model has been updated to reflect feedback received during outreach around last year's report as well as continued work on refining the model. The key innovations are summarized in Annex III, but the basic approach remains unchanged.

**The EBA analyzes current accounts and exchange rates based on both economic characteristics and, unlike CGER, the roles of policies—and of potential policy distortions.** Like CGER, the EBA methodology draws on panel regressions to derive values of current accounts and exchange rates that would be consistent with an economy's "fundamental" characteristics, such as demographic factors and the level of economic development. EBA also includes policies—fiscal, monetary, public health expenditure (which influences household saving), capital controls and foreign exchange intervention. For each of these policies, staff assessments of desirable policy settings offer a view on policy gaps. EBA also includes a third approach that focuses more narrowly on assessing the external sustainability of NFA positions and current account balances (this is the CGER's "ES" approach).

**The output of the EBA analysis is a set of estimated "Total Gaps" for both current accounts and real exchange rates.** These gaps are the sum of the estimated contributions of the various "policy gaps" – which in turn consist of separately-estimated contributions of domestic policy gaps and foreign (i.e., spillover) policy gaps – and a regression residual.

**The current account and exchange rate estimated gaps shown in the ESR reflect not only the EBA estimates but other information and judgment.** A judgment may need to be made on whether EBA residuals reflect only distortions not captured by the EBA regression model or instead reflect fundamentals missed by the model. For some countries, one of the EBA approaches may fit much better than the others, in which case this would become the basis for the ESR estimate. The separate EBA analyses of current accounts and exchange rates may not be equally reliable. In general, the current account approach, which takes full account of cross-country information, is likely to be more accurate since real exchange rate indices cannot be compared across countries, estimates of real exchange rate gaps are strongly influenced by past levels and are often sensitive to the sample period. However, where special difficulties may apply to the current account analysis, the exchange rate regression-based approach may be more reliable. Thus, the gaps reported by the ESR may differ somewhat from the EBA estimates, but there are very few cases in which the ESR gap assessments are in the opposite direction to the EBA estimates. Recognizing the uncertainty inherent in the EBA econometrics and in the interpretation of the policy gaps and regression residual, the ESR reports current account and exchange rate gaps as ranges.

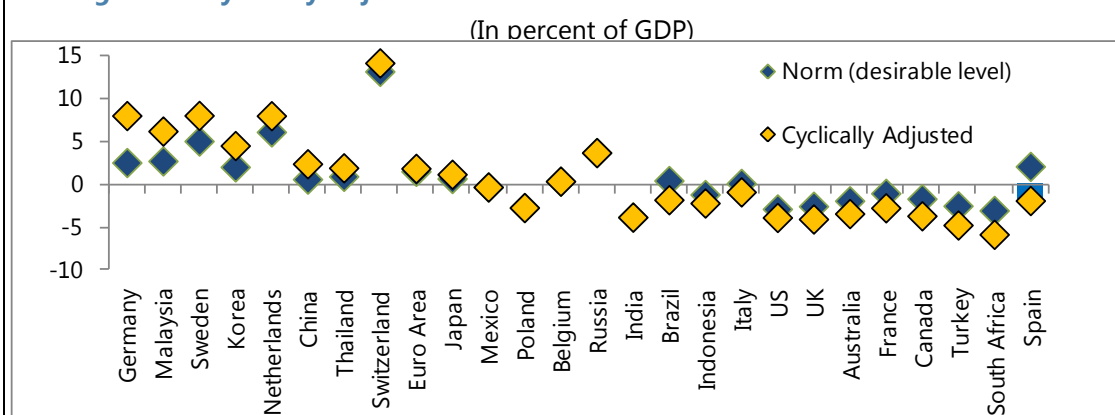
**An essential feature of the EBA methodology is its multilateral consistency; this is preserved in the set of ESR gaps.** That is, current account gaps "add up" in the sense that assessments of too-strong balances are matched by those of too-weak balances. The same holds for real exchange rates.

## Assessments

27. **Overall imbalances are around ¾ percent of global GDP, slightly lower than last year.** With the exception of Japan, external sector imbalances are broadly similar to last year, but slightly lower for China and emerging Asia and the U.S. (Figures 17 and 18). The 2012 report noted that current account divergences and imbalances had narrowed with the cycle but remained around double those consistent with fundamentals and desirable policies. Staff's latest assessment is that

the range of dispersion of external sector gaps—measured both by looking at the current account and the real exchange rate—has narrowed a little, with the same economies as last year having excess surpluses or deficits and with the largest economies Germany, China, the euro area deficit economies and the U.S. accounting for around two thirds of the global external imbalance. Imbalances have narrowed for surplus economies such as China and emerging Asia and for deficit economies like the U.S. as well as other emerging economies. Elsewhere, imbalances are broadly the same as last year or have widened a little. For Japan, the assessment is complicated by the sharp depreciation of the yen since 2012Q3.

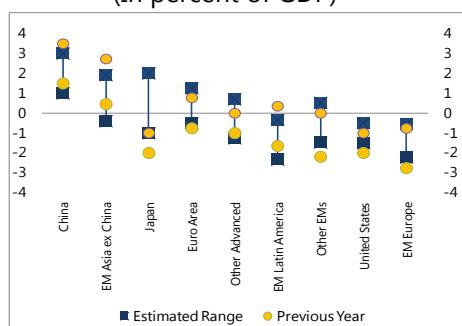
**Figure 17. Cyclically Adjusted Current Accounts and Current Account Norms 2012**



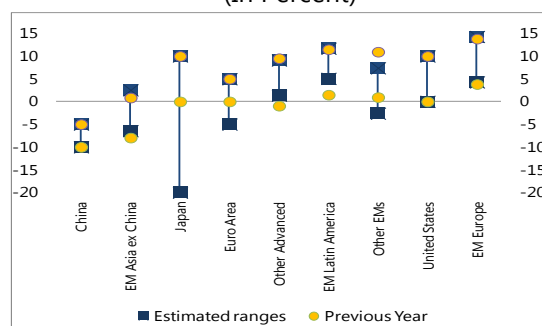
Source: IMF Staff calculations.

**Figure 18. Comparison of External Imbalances between the 2012 and the 2013 ESR**

Estimated Differences between Cyclically Adjusted Current accounts and those Consistent with Fundamentals and Desirable Policies (In percent of GDP)



Estimated Differences between Real Effective Exchange Rate and those Consistent with Fundamentals and Desirable Policies (In Percent)



Source: IMF Staff calculations.

Note: ESR estimates reflect a range of bilateral and multilateral inputs—drawing on models such as the EBA methodology and they also include desk judgment. Saudi Arabia is excluded due to extremely high uncertainty surrounding its estimates.

## 28. Five key features stand out:

- **External imbalances for China and emerging Asia have durably narrowed since 2008, with a further narrowing in 2012 reflecting a number of factors, some of which are permanent**

## POLICY CHANGES TO REDUCE EXTERNAL IMBALANCES

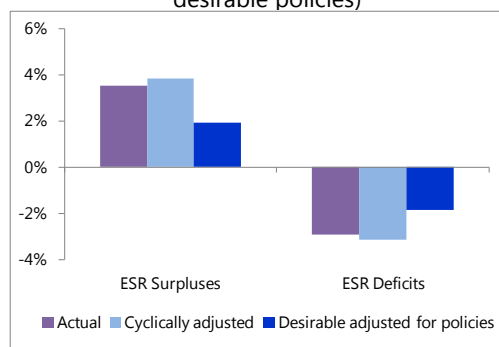
Many economies still need to take policy actions to reduce imbalances.

29. **While cyclical factors have played a role in narrowing global imbalances, addressing remaining policy gaps will be key to closing imbalances.** Actual current account gaps are smaller than the cyclically adjusted in most countries and country groupings but the cyclical factor is less than 0.5 percent of GDP (Figure 23). Policy gaps, on the other hand, are much larger and need to be addressed in order to close global imbalances. Needed actions differ by country (Figure 24).

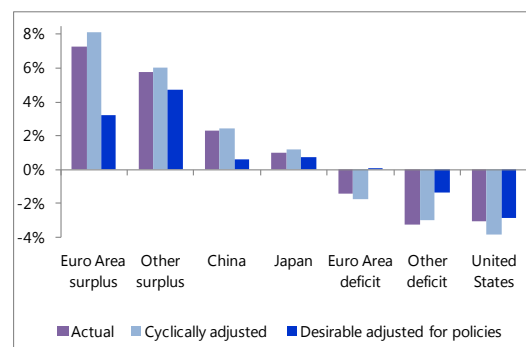
**Figure 23. Estimated Impact of Cyclical Factors and Policies on Current Accounts 2012**

(In Percent of economies' regional GDP based on mid points of staff estimates)

Stronger/Weaker External Positions  
(than consistent with medium-term fundamentals and desirable policies)



Regional Groupings

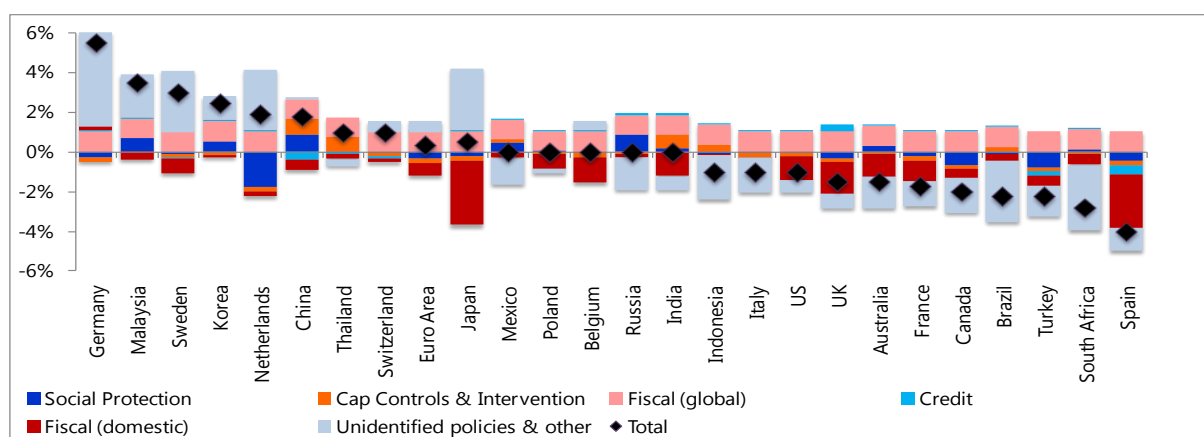


Source: IMF Staff Calculations.

30. **For AEs, some progress has been made in bringing down general government deficits as a percent of GDP.** The Fiscal Monitor notes that fiscal deficits narrowed on average by some  $\frac{3}{4}$  percent of GDP in cyclically adjusted terms and the average pace of consolidation is expected to pick up to  $1\frac{1}{4}$  percent of GDP this year. Yet, global fiscal imbalances remain a significant contributor to external sector imbalances—adding around 1 percent of GDP to the current accounts of other economies (see Figure 24).

**Figure 24. Individual Economies: Contribution of Policies to Current Account Gaps (2012)**

(In percent of GDP, based on midpoint of staff estimates)

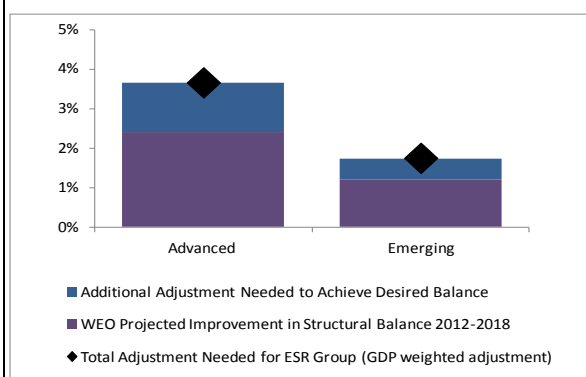


Source: IMF staff calculations from EBA, incorporates desk judgment.

Note: Policy contributions are estimates from EBA (see EBA methodology paper) of how much deviations from desirable policies contribute to the gap between the cyclically adjusted current account and that consistent with medium-term fundamentals and desirable policies. Deviations are measured for each economy relative to a global benchmark. For fiscal policy, the gaps are shown separately as a domestic policy contribution and a global fiscal contribution which illustrates how medium-term fiscal consolidation in the large advanced economies impacts the current accounts of others. The global fiscal policy gap is around 3 percent of GDP which has an effect on current account gaps of around 1 percent of GDP. "Unidentified policies and other" are not solely from EBA but represent all the other factors that affect the current account gap, including uncertainty over the size of the gap (see page 27 and Box 7).

31. **Thus, further progress on the fiscal front for the largest economies would have an important impact on reducing imbalances elsewhere—but the pace of adjustment should be carefully calibrated.** According to WEO projections, around two-thirds of the adjustment will have taken place by 2018 but further adjustment would be needed beyond that horizon. But in the short-term, the pace of fiscal consolidation in the larger AEs, such as the U.S., should not be too aggressive in order to avoid an adverse impact on global growth. Comprehensive reforms are needed in Japan if the monetary easing and the other two arrows of the strategy—medium term fiscal consolidation and structural reforms—are to succeed in ending deflation and achieving self sustaining growth.

32. **Within the euro area, external sector imbalances remain very high and policy actions are needed by both surplus and deficit economies to boost demand.** Large fiscal consolidations are already underway in the economies worst hit by the crisis but they have also faced a steep loss

**Figure 25. Fiscal Adjustment Required to Reach the Medium-Term Desired Structural Fiscal Position**

Source: IMF International Financial Statistics and IMF Staff Calculations.

Note: The desired structural fiscal position is from EBA and is based on desks' judgement on the structural fiscal position that would be desirable in the medium-term.



**Table A.3. Regression Results***(Dummy=1, if year=2008-2011)*

VARIABLES	Dep. Var.: Capital Inflows (excl. FDI)						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Growth Differential (lag)	0.30** (0.15)	0.35** (0.16)	0.35* (0.18)	0.34* (0.18)	0.34* (0.18)	0.31* (0.16)	0.35** (0.17)
Inflation (lag)	-0.01 (0.05)	-0.00 (0.05)	-0.01 (0.05)	-0.01 (0.05)	-0.01 (0.05)	0.01 (0.05)	0.02 (0.05)
Interest Rate Differential (lag)	-0.01 (0.04)	0.03 (0.05)	-0.02 (0.05)	-0.01 (0.05)	-0.01 (0.05)	-0.08 (0.06)	-0.08 (0.07)
Government Debt	-0.09*** (0.03)	-0.08*** (0.02)	-0.10*** (0.03)	-0.11*** (0.03)	-0.11*** (0.03)	-0.11*** (0.03)	-0.12*** (0.03)
Market Capitalization	0.02*** (0.01)	0.02*** (0.01)	0.02*** (0.01)	0.02*** (0.01)	0.02** (0.01)	0.02** (0.01)	0.02** (0.01)
ICRG Composite (Risk)	-0.12 (0.12)	-0.07 (0.12)	-0.15 (0.12)	-0.17 (0.12)	-0.17 (0.12)	-0.18 (0.12)	-0.19 (0.12)
VIX	-4.27*** (1.08)		-2.11* (1.12)	-1.95* (1.10)	-1.90* (1.10)	-1.91* (1.11)	-0.58 (1.17)
Euro Spread	-0.24 (0.18)	-0.627*** (0.23)	0.09 (0.17)	0.04 (0.16)	0.05 (0.16)	-0.02 (0.15)	-0.31** (0.15)
Industrial Materials Index		0.06*** (0.02)					
Dummy * Growth Differential (lag)			-0.10 (0.16)	-0.09 (0.16)	-0.10 (0.16)	-0.07 (0.16)	-0.08 (0.16)
Dummy * Government Debt				0.07** (0.03)	0.07** (0.03)	0.06* (0.03)	0.06* (0.03)
Dummy * Market Capitalization					0.01 (0.01)	0.01 (0.01)	0.01 (0.01)
Dummy * Interest Rate Diff (lag)						0.24* (0.13)	0.23* (0.13)
Dummy * VIX							-6.14** (2.76)
Dummy			-2.07* (1.10)	-4.64** (1.84)	-4.82** (2.10)	-5.04** (2.12)	15.19* (8.61)
Constant	26.30*** (8.93)	8.68 (7.59)	22.43*** (8.59)	23.93*** (8.41)	23.68*** (8.41)	25.03*** (8.41)	22.03*** (8.30)
Observations	353	353	353	353	353	353	353
R-squared	0.13	0.11	0.14	0.17	0.16	0.17	0.18
Number of Countries	41	41	41	41	41	41	41

Panel data, random effects estimation over 2003-2011. T=9, n=41. Robust standard errors in parentheses.

\*\*\* p&lt;0.01, \*\* p&lt;0.05, \* p&lt;0.1.

## Annex II. Central Bank Motivation for Holding or Accumulating Reserves

### Advanced economies

**Australia.** Assistant Governor Guy Debelle, Reserve Bank of Australia, 2013: “The primary motivation is to provide the capacity for the Bank to intervene in the foreign exchange market when necessary ..... in 2008–2009, the Bank was able to deploy its reserves to inject liquidity into the market .... to ensure the depreciation was orderly, without excessive price gapping that is, avoiding the exchange rate moving by large amounts from one transaction to the next, which only tends to exacerbate market dysfunction.”

**New Zealand.** Governor Graeme Wheeler, Reserve Bank of New Zealand, May 30, 2013: “investors seem undeterred by the fact that our exchange rate is over-valued, the current account deficit is sizeable and private sector external indebtedness is high. For the current exchange rate to be sustainable in the long term, sizeable increases in the terms of trade and/or productivity would be needed. Investors also appear to downplay the liquidity risks inherent in a small market like New Zealand. This is reflected in our past exchange rate cycles that have exhibited substantial overshooting followed by sharp and rapid exchange rate depreciation. The Reserve Bank has been responding to the rising exchange rate through two avenues: in maintaining the Official Cash Rate (OCR) at an historically low level; and through a degree of currency intervention. The downward pressure on inflation exerted by the high exchange rate means that the OCR can be set at a lower level than would otherwise be the case. In recent months we have undertaken foreign exchange transactions to try and dampen some of the spikes in the exchange rate. But we are also realistic. We can only hope to smooth the peaks off the exchange rate and diminish investor perceptions that the New Zealand dollar is a one-way bet, rather than attempt to influence the trend level of the Kiwi. ”

**Switzerland.** Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, 26 April 2013: “It is the SNB’s statutory mandate to ensure price stability, while taking economic developments into account. With money market interest rates already close to zero and conventional monetary policy options exhausted, we would have no longer been able to fulfill this mandate without the introduction of a minimum exchange rate.” .... “An appreciation of the Swiss franc would have caused an inappropriate tightening in monetary conditions, which in turn would have compromised price stability and had serious consequences for the economy.”

### Emerging markets

**Brazil,** Governor Alexandre Tombini, 2012: “The policy of accumulation of international reserves has not been relinquished. ... If market conditions permit, we will resume the accumulation of reserves.” [Governor Tombini’s statement to FT during the BRICS summit in South Africa, 2013: “The purpose of [this] swap is..... [that it] is sufficiently large to guarantee normal trade operations.”]