

SM/13/168  
Correction 1

July 9, 2013

To: Members of the Executive Board

From: The Secretary

Subject: **2013 Pilot External Sector Report—Individual Economy Assessments**

The attached corrections to SM/13/168 (6/20/13) have been provided by the staff:

**Mischaracterization of the Views of the Authorities**

**Page 18, Korea, Current account, lines 3 and 4:** for “The authorities have committed to a zero CA balance in the context of the G-20 Mutual Assessment Process.” read “The authorities have forecasted in the context of the G-20 Mutual Assessment Process that the CA surplus would narrow.” Corrects a misrepresentation of the authorities’ views on their current account projections.

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

**Page 3, line 3:** for “...(Box 6 and Annex III of the Pilot Report describing the methodology).” read “...(Boxes 6, 7 and Annex III of the Pilot Report describe the methodology and the challenges.” Box 7 should have been mentioned in this context to provide a balanced description of the EBA model and potential challenges or shortcomings of such model-based methodologies.

**Page 5, Australia, Real exchange rate, line 1:** for “The real effective exchange rate is currently 30 percent above its 1990-2012 average. ” read “In 2012, the real effective exchange rate was 30 percent above its 1990-2012 average.” Correction to specify the timing of this assessment.

**Page 5, Australia Real exchange rate, lines 2 and 3:** for “.... the Australian dollar has remained high, in part related to recent capital inflows toward Australian government debt.” read “...the Australian dollar remained high in 2012, in part related to capital inflows toward Australian government debt.” Correction to specify the timing of this assessment.

**Page 5, Australia, Foreign asset and liability position, line 5:** for “Gross external liabilities of banks are large, with reliance on short-term wholesale funding.” read “Gross external liabilities of banks are large with reliance on wholesale funding.” Correction for the fact that Australia’s reliance on short-term wholesale funding has been reduced in recent years.

**Page 6, Belgium, Current Account, line 3:** for “The rapid recent decline in Belgium’s role as a financial center complicates the assessment...” read “Belgium’s role as a financial center complicates the assessment...” This was factually incorrect as it is Belgium’s role as a financial center rather than the recent decline which complicates the assessment of the current account.

**Page 6, Belgium, Real Exchange Rate, line 3:** for “Since 2011, Belgium has also fallen behind its main economic partners in terms of export performance.” read “In 2012, Belgium has also fallen behind its main economic partners in terms of export performance.” Export performance compared to close neighbors was better in 2011 and declined only in 2012.

**Page 9, China, Foreign exchange intervention and reserves, line 1:** for “Background: China continues to closely manage its exchange rate and conducts intervention on a regular basis....” read “China continues to closely manage its exchange rate and conducts intervention” The use of the term “regular basis” was incorrect as in 2012 the pace of intervention slowed and there was no intervention in the final months of 2012.

**Page 18, Korea, Capital and financial accounts flows and measures, line 9:** for “....continue to allow its exchange rates to fluctuate freely.” read “....continue to allow its exchange rates to move freely.” Correction to clarify that movements in the exchange rate could be around an appreciating or depreciating trend.

**Page 29, Switzerland, Real exchange rate, lines 2 and 3:** for “Since Sept 2011, the central bank has enforced a floor of 1.20 for the CHF/EUR rate and the Swiss franc has traded around that level.” read “Since Sept 2011, the central bank has enforced a floor of 1.20 for the CHF/EUR rate and the Swiss franc has traded above that level.” Correction to make clear that the SNB has not allowed the exchange rate to move below the floor.

**Page 29, Switzerland, Real exchange rate, lines 3 and 4:** for “The REER has depreciated by 13 percent since then, as a result of nominal appreciation...” read “The REER has depreciated by 7 percent between September 2011 and May 2013 as a result of nominal depreciation....” Correction for the size of the depreciation and to clarify the time period over which this occurred.

### Evident Ambiguity

**Page 9, China, Overall Assessment, lines 9–13** for “Given the systemic nature of the Chinese economy, these domestic imbalances pose risks over the medium-term for global economic and financial stability” read “Given the systemic nature of the Chinese economy, a reduction of these domestic imbalances over the medium-term would help foster global economic and financial stability. ” Correction for evident ambiguity between the staff appraisal (¶45) of the China Article IV report and the description in the 2013 Pilot External Sector Report.

**Page 18, Korea, Foreign asset and liability position, line 4:** for “About 7 percent of government bonds are held....” read “About 7 percent of listed government bonds outstanding are held...” Clarifies the specific type of government bonds held by foreign investors.

**Typographical Error**

**Page 6, Belgium, Foreign asset and liability position, lines 1 and 2:** for “The net international investment position has improved very sharply from 33 percent of GDP for 2002-07 to 65 percent at end 2011,” read “The net international investment position has improved very sharply from 32 percent of GDP for 2002-07 to 67 percent at end 2011,”

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

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# INDIVIDUAL ECONOMY ASSESSMENTS

## A. The External Sector Assessments

The external sector assessments use a wide range of methods, including the External Balance Assessment developed by the IMF's Research Department to estimate desired current account balances and real exchange rates (Boxes 6, 7 and Annex III of the Pilot Report describe the methodology and challenges). In all cases, the overall assessment is based on the judgment of IMF staff drawing on the inputs provided by these model estimates and other analysis and the estimates are subject to uncertainty. The assessments were initially based on the Spring 2013 WEO and an exchange rate reference period of the average of 2012. Potential policy responses are those which would work to reduce imbalances.

The assessments discuss a broad range of external indicators: the current account, the real effective exchange rate, capital and financial accounts flows and measures, FX intervention and reserves and the foreign asset or liability position.<sup>1, 2</sup> The individual economy assessments are discussed with the respective authorities as a part of bilateral surveillance.

## B. Selection of Economies Included in the Report

The 29 systemic economies analyzed in detail in this Pilot Report and included in the individual economy assessments are listed below. They were chosen on the basis of an equal weighting of each economy's global ranking in terms of purchasing power GDP, as used in the Fund's *World Economic Outlook*, and in terms of the level of nominal gross trade.

Australia	Indonesia	Singapore
Belgium	Italy	South Africa
Brazil	Japan	Spain
Canada	Korea	Sweden
China	Malaysia	Switzerland
Euro area	Mexico	Thailand
France	The Netherlands	Turkey
Germany	Poland	United Kingdom
Hong Kong SAR	Russia	United States
India	Saudi Arabia	

<sup>1</sup> In this report pertinent aspects of the capital and financial account are discussed for each country. In line with BPM 6 the capital account covers capital transfers and transactions in non-produced nonfinancial assets; and the financial account covers direct investment, portfolio investment, financial derivatives and employee stock options (other than reserves), other investment. Reserve assets which are also included in the financial account are discussed separately in the section on FX intervention and reserves.

<sup>2</sup> The IMF Emerging Market reserves metric included in these pages applies the full weight of M2. However, the presence of capital controls lowers the risk of capital flight, reducing the precautionary level of reserves needed against these possible outflows for countries with controls.

## C. Domestic and Foreign Policies and Imbalance Calculations: An Example

**The thought experiment.** A simplified example could help to clarify how policy distortions are analyzed in a multilateral setting and how the analysis can distinguish between domestic policy distortions where a country might need to take action to reduce its external imbalance and those that are generated abroad and where no action by the home country is needed (but where action by others would help reduce the external imbalance).

Take a stylized example of a two country world.

**Country A** has a large current account deficit, a large fiscal deficit and high debt.

**Country B** has a current account surplus (matching the deficit in Country A but it has no policy distortions).

**External imbalances.** The analysis would show that Country A has an external imbalance reflecting its large fiscal deficit. Country B would have an equal and opposite surplus imbalance. Country A's exchange rate would look overvalued and Country B's undervalued.

**Policy gaps.** The analysis of policy gaps would show that there is a domestic policy distortion in Country A that needs adjustment. However, the analysis for Country B would show that there were no domestic policy gaps—instead adjustment by Country A would automatically eliminate the imbalance in Country B.

**Individual economy write-ups.** While the estimates of the *overall external sector position*, needed *current account adjustment*, and associated *real exchange rate over/undervaluation* would be equal and opposite given there are only two economies in the world, the *individual economy assessments* would clearly identify the quite different issues and risks facing the two economies. In the case of Country A, the *capital flows* and *foreign asset and liability position* sections would note the vulnerabilities arising from international liabilities and the *potential policy response* section of the *overall assessment* would focus on the need to rein in the *fiscal deficit* and *limit asset price excesses*. For the Country B, however, if there were no domestic policy distortions the write up would find no fault with policies and would note that adjustment among other economies would help to reduce the imbalance.

**Implications.** At the current time, fiscal policy is the area where it is most important to distinguish between domestic and foreign policy gaps (as the contribution of foreign policy is most marked). As discussed later an elimination of the fiscal policy gap in deficit advanced economies could help reduce surplus imbalances in other economies by around 1 percent of GDP.

## D. Individual Economy Assessments - by Economy

	Australia	Overall assessment
<b>Current account</b>	<p><b>Background.</b> Australia's current account has been in deficit for most of the period since 1861 (with an average deficit of 4 percent since 1984). The deficit widened from 2.3 percent of GDP in 2011 to 3.7 percent of GDP in 2012 (3.5 percent of GDP cyclically adjusted), led by large increases in capital spending in the resources sector.</p> <p><b>Assessment.</b> A variety of econometric approaches suggest that the cyclically-adjusted current account is about 1 to 2 percent of GDP weaker than implied by medium-term fundamentals and desirable policy settings; some of this gap likely reflects mining-related investment imports.</p> <p>The current account deficit is expected to widen as investment in the resources sector is expected to peak sometime in 2013/14, and the terms of trade and interest rates on external borrowing normalize.</p>	<p>The external position appears weaker than the level consistent with medium-term fundamentals and desirable policy settings.</p> <p>The gap appears to be partly driven by cyclical influences, carry trades, and an investment boom which is projected to peak in the coming years. Model based estimates also suggest a real exchange rate overvaluation.</p> <p><b>Potential policy responses</b></p> <p>Part of the overvaluation is attributable to cyclical influences and carry trades (given central bank policy rates are higher than in most other advanced economies), and should dissipate naturally.</p> <p>The government's medium-term fiscal consolidation plan should help boost national saving. Additional steps to encourage higher private savings would be appropriate.</p>
<b>Real exchange rate</b>	<p><b>Background.</b> In 2012, the real effective exchange rate was 30 percent above its 1990–2012 average. Despite some declines in export commodity prices, the Australian dollar has remained high, in part related to recent capital inflows toward Australian government debt.</p> <p><b>Assessment.</b> Australia has experienced a structural savings/investment imbalance for some time in part related to a capital intensive mining sector resulting in a strong exchange rate. These structural factors aside, and after accounting for some depreciation since May, model results would suggest that the real exchange rate remains overvalued by 5-15 percent. Aside from these structural factors, there are a number of short-term factors contributing to the current overvaluation of the exchange rate, including the continued gap between domestic and foreign interest rates and increased portfolio inflows. The high exchange rate is accelerating structural change by increasing price competition for the non-commodity tradable sector.</p>	
<b>Capital and financial accounts: flows and measures</b>	<p><b>Background.</b> The investment boom has been funded predominantly from the profits generated by the resources companies. Net capital inflows into the resource sector have partially offset the decline in net capital inflows into the banking sector and have contribute to the increase in net FDI flows into Australia.</p> <p>Australia also received large inflows in recent years into bond markets given its sound fiscal position relative to other advanced economies, relatively high interest rates and buoyant growth prospects.</p> <p><b>Assessment.</b> The credible commitment to a floating exchange rate and strong fiscal position limit vulnerabilities from capital flows.</p>	
<b>FX intervention and reserves</b>	<p><b>Background.</b> A free-floater since 1983. The central bank did brief but large intervention in 2007–08 when the market for Australian dollars threatened to become illiquid (as bid-ask spreads widened) following banking sector disruptions in the United States. The authorities are strongly committed to a floating regime, which reduces the need for reserve holding.</p> <p><b>Assessment.</b> Although domestic banks' external liabilities are sizable, they are either in local currency or hedged with little or no counterparty risks, so reserve needs for prudential reasons are also limited.</p>	
<b>Foreign asset and liability position</b>	<p><b>Background.</b> Net foreign liabilities are high at 58 percent of GDP. Without a depreciation, liabilities would be projected increase to above 65 percent of GDP by 2018 by FDI and long-term debt inflows.</p> <p><b>Assessment.</b> Even in the highly unlikely event where domestic banks are seriously hit by external shocks and suffer a major loss, the government's low debt position allows it to offer credible support.</p> <p>Gross external liabilities of banks are large, with reliance on wholesale funding. Banks' external funding continues to pose a risk, although the maturity of funding has improved since the global financial crisis.</p>	

	Belgium	Overall assessment
<b>Current account</b>	<p><b>Background.</b> The current account had been in moderate surplus for two decades before the crisis, although on a secular decline—turning into a modest deficit in the crisis years as exports dropped.</p> <p>Belgium's role as a financial center complicates the assessment of the appropriate current account balance (the cyclically-adjusted current account surplus is estimated at 0.4 percent of GDP), but Belgium's export market share has declined steadily since 2000.</p> <p><b>Assessment.</b> The cyclically-adjusted current account appears broadly in line with medium-term fundamentals and desirable policies. As trading partner growth recovers, a return to a modest current account surplus of about 1¼ percent of GDP is expected. Such a surplus is consistent with medium-term fundamentals, including an aging population.</p>	<p>Trends in trade and unit labor cost point to an external position moderately weaker than suggested by medium-term fundamentals and desirable policy settings.</p> <p>The main vulnerability comes from market perceptions about the viability of the fiscal path and the cross-exposures of the sovereign and the banks.</p> <p><b>Potential policy responses</b></p> <p>Continued steady fiscal adjustment (based on structural targets) is needed to reduce vulnerabilities, and wage moderation and productivity enhancing structural reforms (in the labor and product markets) are needed to restore cost and non cost competitiveness.</p>
<b>Real exchange rate</b>	<p><b>Background.</b> In the last two years, unit labor costs have outpaced those in Belgium's three main trading partners (Germany, France, and the Netherlands), as wages have grown faster, pushed by sticky inflation and wage indexation. In 2012, Belgium has also fallen behind its main economic partners in terms of export performance.</p> <p><b>Assessment.</b> Models point to a real exchange rate moderately stronger by around 0 to 10 percent than the level consistent with medium-term fundamentals and desirable policy settings.</p>	
<b>Capital and financial accounts: flows and measures</b>	<p><b>Background.</b> Financial account outflows have predominantly taken the form of portfolio investments until the crisis. In 2008–12, temporary asset divestments (including those associated with Fortis, Dexia, and KBC) generated net inflows that exceeded substantial net outflows in loans and other investments. Once these effects wear off, a return to moderate net capital outflows of 1¼ percent of GDP is expected.</p> <p><b>Assessment.</b> Belgium is vulnerable to a drop in investor confidence owing notably to the large refinancing needs of the sovereign and banking sectors.</p>	
<b>FX intervention and reserves</b>	<p><b>Assessment.</b> The euro has the status of a global reserve currency. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</p>	
<b>Foreign asset and liability position</b>	<p><b>Background.</b> The net international investment position has improved very sharply from 32 percent of GDP for 2002–07 to 67 percent at end-2011, mostly reflecting valuation effects on FDI (positive valuation effects of FDI assets and negative valuation effects of FDI liabilities) Net international assets are expected to deteriorate slowly going forward, suggesting some weakening in the external position.</p> <p><b>Assessment.</b> Despite Belgium's decline as a financial center, gross foreign assets at end-2011 amounted to 505 percent of GDP. Belgium is vulnerable given the relatively large financing need of the government.</p>	



	China	Overall assessment
<b>Current account</b>	<p><b>Background.</b> The current account surplus has fallen precipitously from its peak of over 10 percent of GDP in 2007 to 2¼ percent of GDP in 2012 (around 2½ percent of GDP cyclically adjusted) and exchange rate appreciation has been accompanied by very high investment, in turn driven by high levels of productivity in China, the cheap cost of capital and other factors of production, cyclical weakness in major advanced economies, and high oil and other commodity prices. There is less evidence, as yet, of a decisive shift toward consumption and lower national savings (as a percent of GDP).</p> <p><b>Assessment.</b> China's cyclically-adjusted current balance is some 1-3 percent of GDP stronger than implied by medium-term fundamentals and desirable policies.</p> <p>The desired current account balance—the level consistent with underlying fundamentals and desirable policies—is estimated to range from 0 to 2 percent of GDP. This reflects the need for a package of measures including better social protection, corporate and financial reform, higher costs for a range of factors of production, less reserve accumulation and a stronger currency.</p>	<p>The external position appears moderately stronger and the currency moderately undervalued compared with the level consistent with medium-term fundamentals and desirable policy settings.</p> <p>The post-financial crisis narrowing of the external imbalance has been accompanied by a rise in domestic imbalances, with investment approaching 50 percent of GDP. Given the systemic nature of the Chinese economy, a reduction of these domestic imbalances over the medium-term would help foster global economic and financial stability.</p> <p><b>Potential policy responses</b></p> <p>The transition to a more balanced and sustainable growth model requires implementing a comprehensive package of reforms that includes financial sector, fiscal, exchange rate, and structural measures. China has made progress on several fronts, including widening the exchange band, liberalizing interest rates, continuing to gradually open the capital account, and strengthening the social security system. However, more progress is needed. The priorities include improving financial intermediation to better allocate investment and boost household income; moving to a more market-based exchange rate; strengthening the fiscal framework to rationalize infrastructure spending and shift the tax burden away from regressive social contributions; improving resource pricing; and opening markets to more competition.</p> <p>China is committed to rebalancing toward a more-consumer based economy, and the new leadership announced plans to re-energize the reform effort. The objectives and directions of the reform agenda are consistent with rebalancing and forceful and timely implementation will be crucial for success</p>
<b>Real exchange rate</b>	<p><b>Background.</b> In real effective terms the currency appreciated by around 5 percent from end 2011 through April 2013 and some 35 percent since the mid-2005 exchange rate reform. Prior to the 2005 reform, the real effective exchange rate had been depreciating, so it is only 14 percent above the level reached a decade ago, which appears somewhat below the significant increases in China's productivity relative to trading partners over the past 10 years.</p> <p><b>Assessment.</b> Taking account of these developments and uncertainties in the model-based estimates, staff assesses the real exchange rate to be moderately undervalued by some 5-10 percent compared to medium-term fundamentals and desirable policies.</p>	
<b>Capital and financial accounts: flows and measures</b>	<p><b>Background.</b> Despite a number of steps in recent years to open up its capital account, China maintains a broad range of capital controls on both inflows and outflows covering the bulk of non-FDI portfolio flows and external borrowing. However, non-FDI capital flows are comparable in size to economies with more open capital accounts. Inflows are dominated by inward foreign direct investment (equal to US\$220 billion or 3 percent of GDP in 2011) limiting vulnerabilities; around one-half has gone into building manufacturing capacity. In 2012, China experienced net capital outflows of around US\$100 billion, a large turnaround from the net capital inflows of the previous years.</p> <p><b>Assessment.</b> Over the medium term a carefully planned and sequenced loosening of capital controls that supports and reinforces domestic financial liberalization would be appropriate. It is not clear what effect liberalization would have on the direction of capital flows, though recent staff research suggests that it could result in significant net capital outflows.</p>	
<b>Foreign exchange intervention and reserves</b>	<p><b>Background.</b> China continues to closely manage its exchange rate and conducts intervention which has the effect, in most cases, of controlling the pace of appreciation. The pace of reserve accumulation slowed significantly in 2012, due in temporary factors, and has picked-up again in the first part of 2013</p> <p><b>Assessment.</b> Reserves are somewhat above the IMF's composite metric (161 percent at end 2012), and further accumulation would be undesirable.</p>	
<b>Foreign asset and liability position</b>	<p><b>Background.</b> Net foreign assets amount to 30 percent of GDP and NFA has grown rapidly over the past several years. The NFA position reflects substantial and persistent current account surpluses and FDI inflows over the years while net balances on portfolio assets, trade finance, and banking are close to zero. The composition on the asset side is dominated by the accumulation of international reserves by the central bank (at end-2012 approximately 40 percent of GDP).</p> <p><b>Assessment.</b> With large foreign exchange reserves and liabilities largely composed of FDI, vulnerabilities are low.</p>	

	Euro Area	Overall assessment
<b>Current account</b>	<p><b>Background.</b> The current account balance of the euro area improved moderately in 2012 to 1.2 percent of GDP, reflecting strengthened external positions of both surplus and deficit euro area economies. The cyclically-adjusted current account (after adjusting for the output gap and terms of trade shocks) is estimated to be a surplus of 1.3 percent of GDP.</p> <p><b>Assessment.</b> Building from a view of external positions in individual euro area economies as well as previous staff recommendations, the 2012 cyclically-adjusted current account is broadly in line with the estimated value from medium-term fundamentals and desirable policy settings.</p>	<p>The euro area external position is now broadly in line with its equilibrium level implied by medium-term fundamentals and desirable policies.</p> <p>Although only modest adjustment is needed for the euro area as a whole, more substantial adjustment is desirable for individual euro area economies on internal rebalancing and improving competitiveness.</p> <p><b>Potential policy responses</b></p> <p>Euro area economies need to improve their public and private debt positions, as appropriate. Improvements in competitiveness are particularly important for deficit economies, which need to lower costs and shift resources to tradable sectors. Increasing productivity in the non-tradable sector in the surplus countries could improve disposable incomes in these economies and lead to higher external demand. This would require strengthening the implementation of ongoing structural reforms, e.g., labor and product market reforms in deficit economies, and product market reforms in surplus ones. At the euro area level, a targeted implementation of the Services Directive would help reduce barriers to entry in protected professions, and improve productivity and living standards.</p>
<b>Real exchange rate</b>	<p><b>Background.</b> The euro REER has declined by 10-15 percent from its peak since end-2009 and it is currently close to the long-run average (from the inception of euro).</p> <p><b>Assessment.</b> Building from a view of external positions in individual euro area economies and staff estimates, the real exchange rate (in 2012 average) is close to equilibrium as suggested by medium-term fundamentals and desirable policy settings.</p> <p>Differences across euro area economies have remained roughly the same as in previous staff evaluations: real exchange rates seem moderately undervalued in surplus economies, while remain overvalued in most deficit economies. By early April 2013 the real effective exchange rate is estimated to have risen by about 2½ percent from its 2012 average.</p>	
<b>Capital and financial accounts: flows and measures</b>	<p><b>Background.</b> The current account surplus in 2012 was matched by financial outflows. In particular, the financial account deficit was largely driven by FDI and other-investment outflows, while mitigated by resumed portfolio inflows to the euro area.</p> <p><b>Assessment.</b> The path for financial flows depends crucially on the resolution of the euro area crisis including the long-term vision to complete the architecture of the EMU—failure to deliver previously agreed policy commitments will undermine market confidence and likely mean that “real money” flows will not readily return.</p>	
<b>FX intervention and reserves</b>	<p><b>Assessment.</b> The euro has the status of a global reserve currency. Reserves held by the Euro area are typically low relative to standard metrics, but the currency is free floating.</p>	
<b>Foreign asset and liability position</b>	<p><b>Background.</b> The net international investment position of the euro area has deteriorated through the crisis, to nearly -17 percent of GDP in 2008, but has since recovered to -7½ percent in 2012, reflecting both improved current account and valuation effects. Estimates of the cyclically-adjusted current account suggest that NFA position is likely to improve modestly going forward.</p> <p><b>Assessment.</b> External vulnerabilities largely come from the market perception of some deficit countries to service their debts, since financial market stress could easily re-intensify if expectations of strong policy implementation were disappointed.</p>	

	Japan	Overall assessment
<b>Current account</b>	<p><b>Background.</b> The current account surplus declined to 1 percent of GDP in 2012 (around 1¼ percent of GDP cyclically adjusted), reflecting sluggish external demand, an increase of energy imports (following the Great East Japan Earthquake) and a strong yen through most of the second half of 2012. Following the depreciation of the yen, our baseline forecast is that the current account will improve with a lag. Fiscal consolidation will help improve the current account over time but the higher costs of energy and intermediate-goods imports is likely to negatively affect the trade balance in 2013. The investment income account surplus (nearly 3 percent of GDP in 2012) is expected to remain sizable, supported by large net foreign assets and higher returns on assets than on liabilities.</p> <p><b>Assessment.</b> Before the recent sharp depreciation of the yen, the cyclically-adjusted current account was estimated to be about 2¼ percent of GDP weaker than the value implied by fundamentals and desirable policies. However this calculation pre-dates the adoption of new macroeconomic policies, which affect the norm through their impact on growth, inflation and the desirable policy mix. Taking into account the impact of higher energy imports in lowering the trade balance and the lagged impact of depreciation since mid 2012, the estimated current account gap ranges from 1 percent of GDP weaker to 2 percent of GDP stronger than implied by fundamentals and desirable policies.</p>	<p>The assessment of the external position is subject to an unusual degree of uncertainty in light of a major shift in the overall macroeconomic framework that has taken place since 2012. The external position appears moderately stronger than implied by fundamentals (and the exchange rate is moderately undervalued), due to the near-term effects of the monetary easing designed to secure an exit from deflation. Over the medium-term, if comprehensive fiscal and structural reforms are implemented in a credible manner, the external position would be expected to move to a position broadly consistent with fundamentals.</p> <p>As of mid-2013, the exchange rate and current account developments yield mixed signals about the external position. The new monetary framework and the reversal of safe haven effects have led to a sizable depreciation of the yen, while the current account has not, as yet, responded to the depreciation.</p> <p><b>Potential policy responses</b></p> <p>Policy gaps for Japan are more of an issue of internal rather than external sustainability. Fiscal consolidation to close the policy gap would raise national savings above our baseline forecast, more than offsetting the decline in private saving from aging, and raise the current account surplus. Ambitious structural reforms including liberalizing trade through the TPP could partially offset this by boosting productivity, domestic income, and imports.</p>
<b>Real exchange rate</b>	<p><b>Background.</b> The yen remained strong against major currencies through most of 2012, then began a steady depreciation in November 2012 reflecting several factors, including the new monetary framework, the reversal of safe haven effects—potentially contributing 5-10 percent to the depreciation since the fall of 2012—, and a structural weakening of the trade balance from higher energy imports. Since the last assessment in May 2012, the exchange rate has, by June 2013 depreciated by about 18-19 percent in real effective terms, reversing much of the appreciation since the global financial crisis.</p> <p><b>Assessment.</b> Relative to medium-term fundamentals and desirable policies, the sharp depreciation since 2012 implies moderate undervaluation, with estimates ranging from ranging from a 20 percent undervaluation to a 10 percent overvaluation as this assessment is subject to greater than usual uncertainty given market volatility. The exchange rate is expected to move in line with fundamentals over the medium-term assuming the implementation of comprehensive and credible fiscal and structural reforms.</p>	
<b>Capital and financial accounts: flows and measures</b>	<p><b>Background.</b> An important part of the capital flows in the 2000s was the yen carry trade and it's unwinding after the Lehman shock. The appreciation of the yen since the global financial crisis and the recent depreciation have not been associated with notable capital in- or outflows. Instead, the main driver of exchange rate movements appears to be the derivative position, reflecting hedging as well as speculative positions. The scale of the new monetary easing policy could result in some spillovers, notably a larger flow of capital to the region's other economies.</p> <p><b>Assessment.</b> Safe haven flows imply limited vulnerabilities to global financial instability.</p>	
<b>FX intervention and reserves</b>	<p><b>Assessment.</b> Reserves are higher than other reserve asset issuers (about 20 percent of GDP) on legacy accumulation. The level of the yen is market determined.</p> <p>Isolated fx interventions during safe haven periods appear to have reduced short-term exchange market volatility, while having ambiguous effects on the exchange rate level.</p>	
<b>Foreign asset and liability position</b>	<p><b>Background.</b> The net foreign asset position has risen from about 35 percent of GDP ten years ago to over 50 percent of GDP in 2012. Most assets and liabilities are portfolio equity and debt securities, rather than FDI.</p> <p><b>Assessment.</b> Vulnerabilities are limited as Japan's positive net position generates sizable investment income (that averaged about 3 percent of GDP over the past five years) and offset the goods trade deficit in 2012. Risks on assets and their returns are also diversified geographically and in terms of investment type.</p>	

	Korea	Overall assessment
<b>Current account</b>	<p><b>Background.</b> The current account (CA) surplus widened to 3.8 percent of GDP in 2012 (from 2.3 percent in 2011), but remained at 4½ percent in cyclically-adjusted terms. It is projected to narrow as domestic demand strengthens over the medium term. The authorities have forecasted in the context of the G-20 Mutual Assessment Process that the CA surplus would narrow.</p> <p><b>Assessment.</b> In line with last year's assessment, the cyclically-adjusted CA balance is assessed to be some 1-4 percent of GDP above the value suggested by fundamentals and desirable policies. This reflects the need for fiscal adjustment in many advanced economies and higher public spending, in particular social spending, in Korea.</p>	<p>The external sector position appears stronger than that implied by medium-term fundamentals and desirable policies (including in partner countries).</p> <p>The real exchange rate is assessed to be moderately undervalued.</p> <p><b>Potential policy responses</b></p> <p>The current account gap would further narrow with fiscal rebalancing in advanced economies as well as higher public spending, in part due to higher social spending in Korea. Policies have already been put in place to enhance social protection (e.g. subsidies for child care) and further measures are envisaged.</p> <p>The exchange rate should continue to be market determined with intervention limited to smoothing excessive volatility. In the event of a capital flow surge, existing macroprudential measures can be further tightened as a supplement to macroeconomic policy adjustments, particularly the exchange rate and monetary policies.</p> <p>Reserves are in line with the IMF's composite metric. There is no precautionary need to increase reserves, although a slow increase in line with rising liabilities would be reasonable.</p>
<b>Real exchange rate</b>	<p><b>Background.</b> During the 2012 ESR, the real effective exchange rate (REER) was assessed to be moderately undervalued, in the range of around 0-10 percent. Since then, it appreciated by 7 percent in 2012, followed by depreciation of around 1 ½ percent between end-2012 and April 2013.</p> <p><b>Assessment.</b> The REER is assessed to be around 2-8 percent below the level that is consistent with medium-term fundamentals and desirable policies, i.e. moderately undervalued, though less than during the last ESR round.</p>	
<b>Capital and financial accounts: flows and measures</b>	<p><b>Background.</b> Capital flows remained volatile in 2012, in particular equity and other flows with no significant net capital inflows overall. This reflects a combination of Korea-specific factors—e.g., North Korea risks and macro prudential measures on the negative side; and strong policy fundamentals as well as appreciation expectations on the positive side—and global push factors, particularly higher risk appetite. After the global financial crisis, Korea introduced an array of macroprudential measures aimed at containing banks' FX funding risks. It also reinstituted the withholding tax on bond investments. In 2012, some of these measures were tightened.</p> <p><b>Assessment.</b> While Korea faces the risk of volatile capital flows, its financial system has become more robust. There is also no evidence of unsustainably large capital inflows. It should therefore remain open to capital flows and continue to allow its exchange rates to move freely; it can further strengthen existing macroprudential measures if faced with a surge in capital inflows. Macroprudential measures should continue to be targeted at mitigating financial stability concerns and reducing excessive volatility rather than affecting the level of the exchange rate. Official communication should be clear on these intentions.</p>	
<b>FX intervention and reserves</b>	<p><b>Background.</b> Reserves grew by 1 percent of GDP (US\$ 21 billion) in 2012, broadly in line with external liabilities.</p> <p><b>Assessment.</b> Reserves are adequate at 180 percent of short-term external debt and 130 percent of the IMF's composite metric, within the 100–150 percent recommended range. Including forward positions, the reserve coverage looks more comfortable. Therefore, there is no need for further reserve accumulation for precautionary purposes although going forward, a slow increase in line with rising liabilities would be reasonable. Continued nominal exchange rate flexibility would be desirable with intervention limited to smoothing volatility.</p>	
<b>Foreign asset and liability position</b>	<p><b>Background.</b> At -9 percent of GDP, Korea's net international investment position is modest and improving, given CA surpluses. Net debt, which is relatively small (16 percent of GDP), is more than covered by reserve assets (28 percent of GDP). Korea's short-term external debt is largely held by banks, which are bound by prudent net open position limits. About 7 percent of listed government bonds outstanding are held by foreign investors, exposing the government to some interest rate and rollover risk, however, little exchange rate risk as most of the debt is in local currency.</p> <p><b>Assessment.</b> There are few risks to external debt sustainability.</p>	

	Switzerland	Overall assessment
<b>Current account</b>	<p><b>Background.</b> Switzerland has a large current account surplus (13½ percent of GDP in 2012 according to preliminary estimates or about 14 percent in cyclically-adjusted terms) dominated by service exports and net investment income. The latter is very volatile and preliminary estimates of current account are subject to large revisions. In addition, correcting for the foreign ownership of FDI retained earnings and domestic ownership of the retained earnings of foreign multinationals could reduce the balance by 2-5 percentage points (SNB estimates for 2009-11), while accounting for cross-border shopping would further increase imports.</p> <p><b>Assessment.</b> The cyclically-adjusted current account surplus in 2012 is some 0-5 percent of GDP above the level implied by medium-term fundamentals and desirable policy settings, mostly reflecting a large preliminary estimate of net investment income, particularly FDI income. Given the preliminary nature of the data and other factors discussed above, there are considerable uncertainties around this assessment.</p>	<p>The underlying external position is moderately stronger than the level consistent with medium-term fundamentals and desirable policy settings, but this assessment is complicated by measurement and other issues and is subject to unusual uncertainty. The real exchange rate is moderately overvalued because of safe-haven capital inflows, but the overvaluation is eroding over time given negative inflation differentials with trading partners.</p> <p>As a rapid real appreciation threatened to destabilize the economy with deflationary pressures, Switzerland successfully imposed a floor on the franc-Euro rate, curbing further appreciation. The introduction of the floor was appropriate in light of the risk of economic contraction and deflation.</p> <p>In the authorities view the exchange rate is significantly overvalued.</p> <p><b>Potential policy responses</b></p> <p>Introducing negative interest rates on bank excess reserves at the SNB might discourage inflows if exchange rate pressures return.</p> <p>Once growth recovers and inflation returns to comfortable levels, the credibility of the ceiling may be called into question and the central bank should return to floating the currency to avoid stoking inflation.</p>
<b>Real exchange rate</b>	<p><b>Background.</b> The Swiss franc appreciated by more than 30 percent in real effective terms from mid-2007 to August 2011. Since Sept 2011, the central bank has enforced a floor of 1.20 for the CHF/EUR rate and the Swiss franc has traded above that level. The REER has depreciated by 7 percent between September 2011 and May 2013 as a result of nominal depreciation and negative inflation differentials.</p> <p><b>Assessment.</b> Model-based estimates suggest that the real effective exchange rate is overvalued by 5-10 percent relative to its medium-term fundamentals and desirable policy settings.</p>	
<b>Capital and financial accounts: flows and measures</b>	<p><b>Background.</b> The large current account surpluses have led to accumulation of foreign exchange reserves and increases in the net foreign direct investment position (in large part via reinvestment of retained earnings).</p> <p><b>Assessment.</b> Switzerland continues to face the risk of safe-haven capital inflows and/or reduced outflows if a tail event occurs in the Euro area or problems in the euro periphery persist.</p>	
<b>FX intervention and reserves</b>	<p><b>Background.</b> The SNB has accumulated massive foreign exchange reserves during 2009–12 following several rounds of intervention. As a result of interventions in the spring and summer of 2012 reserves increased by 175 billion (29 percent of GDP).</p> <p><b>Assessment.</b> The introduction of the floor was appropriate in light of the risk of economic contraction and deflation. The credible exchange rate arrangement mitigated the need for reserve accumulation initially, but reserves are on the rise again with a large scale intervention from the SNB as a result of the intensification of the European crisis and, to a lesser extent, a continued increase in global liquidity. The central bank has access to dollar swap lines with the US Federal Reserve.</p>	
<b>Foreign asset and liability position</b>	<p><b>Background.</b> Switzerland is a financial center and has a positive IIP position of 150 percent of GDP, and large gross foreign asset/liability positions. Valuation changes due to exchange rate movements have also had a significant effect on the IIP position.</p> <p><b>Assessment.</b> A healthy asset position, policy credibility and large reserves, mitigate the risks from large and liquid gross liabilities.</p>	



	Thailand	Overall assessment
<b>Current account</b>	<p><b>Background.</b> Thailand's current account has been quite volatile over the last decade, ranging from a 4¼ percent deficit to 8¾ percent surplus, against the backdrop of a relatively stable trend real appreciation, and volatile economic fundamentals. The current account surplus came down sharply from its peak in 2009 at 8¾ percent of GDP to 0.7 percent in 2012 (2 percent cyclically adjusted) and is expected to remain close to balance over the medium term, as large investment projects raise imports and the baht continues to appreciate in real terms.</p> <p><b>Assessment.</b> Thailand's cyclically adjusted current account is close to its norm; model-based and other estimates suggest a cyclically adjusted current account that is about 0-2 percentage points, of GDP stronger than the value consistent with medium-term fundamentals and desirable policies.</p>	<p>The external position is consistent with medium-term fundamentals and desirable policy settings.</p> <p>Thailand's current account is likely to remain close to its norm and the exchange rate is assessed to be fairly valued. To the extent that higher infrastructure investment adds to the productive capacity of the economy its equilibrium real effective exchange rate is likely to appreciate.</p> <p><b>Potential policy responses</b></p> <p>A medium-term infrastructure investment policy is key to unlocking growth by boosting private investment, which would reduce existing current account surpluses.</p> <p>The authorities should allow the nominal effective exchange rate to follow fundamentals. The more-than-adequate reserves can support two-way flexibility of the baht while still providing some scope for intervention to prevent exchange rate overshooting and smoothing excessive volatility.</p> <p>To deal with the impact of strong capital inflows, macroprudential policies should also be considered.</p>
<b>Real exchange rate</b>	<p><b>Background.</b> Barring the global financial crisis, the Thai baht has been appreciating in real effective terms since 2005.</p> <p><b>Assessment.</b> A number of methodologies suggest that the Thai baht is consistent with medium-term fundamentals and appropriate policies.</p>	
<b>Capital and financial accounts: flows and measures</b>	<p><b>Background.</b> While equity flows were mostly flat over 2012, bond inflows have been very large and volatile, reaching historic peaks at times, and reversing during periods of heightened domestic or external uncertainty.</p> <p><b>Assessment.</b> While capital flows to banks reflect mostly hedging activities of the trade sector and therefore follow the trade balance, portfolio flows are driven by global push factors as well as the relatively better fundamentals of the Thai economy compared to advanced economies.</p> <p>Portfolio inflows are expected to continue, although they will increasingly be offset by outward investment as the authorities push forward with their financial account liberalization plans.</p>	
<b>FX intervention and reserves</b>	<p><b>Background.</b> Foreign currency reserves are about 50 percent of GDP, over four times short-term debt, and at 297 percent of the IMF's composite metric. Thailand's net forward FX position (7 percent of GDP in 2012), has been increasing since mid-2012.</p> <p><b>Assessment.</b> Thailand's gross reserves are more than adequate and there is no need to build up reserves for precautionary purposes.</p> <p>Intervention has smoothed volatility but sterilization costs have increased and there is room for more two-way exchange rate flexibility.</p>	
<b>Foreign asset and liability position</b>	<p><b>Background.</b> Net foreign assets had been rising steadily as a percentage of GDP from the large deficit they hit following the Asian crisis until 2011, when large inflows of direct and portfolio investment raised foreign liabilities and lowered the net investment position to -9 percent of GDP.</p> <p>Net foreign assets are currently rising but would be expected to remain broadly stable as further liberalization of outflows raises foreign liabilities.</p> <p><b>Assessment.</b> There are limited risks to external debt sustainability because Thailand's external debt is projected to remain low and net foreign assets (as a percent of GDP) are expected to stabilize.</p>	