

SM/13/168
Correction 2

July 10, 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:

Evident Ambiguity

Page 32, United Kingdom, Overall assessment, lines 18–21: for “However, given that households banks and (to a lesser extent) firms are also attempting to save more than usual; the net drag can be self defeating.”
read “However, given that households banks and (to a lesser extent) firms are also attempting to save more than usual, the overall effect would weaken growth.” Corrects ambiguity about what is self defeating about fiscal consolidation.

Page 32, United Kingdom, Overall assessment, lines 21–25: for “A more gradual fiscal consolidation, within a medium-term framework, could help bridge to a more sustained pick-up in private demand, notably investment.”
read “Bringing forward infrastructure spending and other growth enhancing measures, within a medium-term fiscal framework, could help bridge to a more sustained pick-up in private demand, notably investment.” Corrects evident ambiguity between staff’s proposed policy advice and that contained in the staff appraisal of the Article IV report (para. 68).

Typographical Errors

Page 31, Turkey, Current account, line 1: for “5.9 percent of GDP” read “6.1 percent of GDP”;
for “5.8 percent of GDP” read “4.7 percent of GDP”

Page 31, Turkey, Foreign asset and liability position, line 1: for “–56 percent of GDP”
read “–53.2 percent of GDP”
line 2: for “11 percentage points”
read “ 8.4 percentage points”

Page 29 is also included to incorporate the corrected text detailed in SM/13/168, Cor. 1, which had been inadvertently omitted.

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: (3)

Other Distribution:
Department Heads

	Switzerland	Overall assessment
Current account	<p>Background. 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>Assessment. 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>Potential policy responses</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>
Real exchange rate	<p>Background. 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>Assessment. 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>	
Capital and financial accounts: flows and measures	<p>Background. 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>Assessment. 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>	
FX intervention and reserves	<p>Background. 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>Assessment. 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>	
Foreign asset and liability position	<p>Background. 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>Assessment. A healthy asset position, policy credibility and large reserves, mitigate the risks from large and liquid gross liabilities.</p>	

	Thailand	Overall assessment
Current account	<p>Background. 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>Assessment. 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>Potential policy responses</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>
Real exchange rate	<p>Background. Barring the global financial crisis, the Thai baht has been appreciating in real effective terms since 2005.</p> <p>Assessment. A number of methodologies suggest that the Thai baht is consistent with medium-term fundamentals and appropriate policies.</p>	
Capital and financial accounts: flows and measures	<p>Background. 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>Assessment. 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>	
FX intervention and reserves	<p>Background. 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>Assessment. 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>	
Foreign asset and liability position	<p>Background. 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>Assessment. 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>	

	Turkey	Overall assessment
Current account	<p>Background. The current account deficit adjusted to 6.1 percent of GDP in 2012 (4.7 percent of GDP on a cyclically adjusted basis), down from 9.7 percent in the previous year.</p> <p>Assessment. A substantial adjustment took place in 2012, driven by both cyclical and structural factors. However, model results suggest a cyclically-adjusted current account deficit that is 1.5-3 percent of GDP weaker than the level implied by medium-term fundamentals and desirable policy settings.</p>	<p>The external balance has improved vis-à-vis 2011, as have external buffers. However, the external position continues to be weaker than the level consistent with medium-term fundamentals and desirable policy settings. Turkey remains vulnerable to a large capital flows reversal.</p> <p>Potential policy responses</p> <p>Given the country's external imbalances, a tighter fiscal policy over the medium term and continued structural reforms to increase private savings (such as last year's changes to private sector contributions) are desirable.</p>
Real exchange rate	<p>Background. The Real exchange rate appreciated by 4 percent in 2012 largely due to higher inflation than in trading partners.</p> <p>Assessment. Model results point to a real effective exchange rate that is 10-20 percent stronger than the level that can be explained by medium-term fundamentals and policy deviations from desirable settings.</p>	
Capital and financial accounts: flows and measures	<p>Background. Turkey has received substantial capital inflows in recent years. In 2012 net inflows, including errors and omissions, amounted to some 10 percent of GDP, thereby over-financing the current account deficit and resulting in reserve accumulation. Despite improvements in the maturity composition of capital inflows, short-term debt remains the predominant financing instrument.</p> <p>Turkey has not resorted to capital controls on either inflows or outflows. Rather, it has used the reserve requirement ratio (RRR) and reserve option mechanism (ROM) as tools to manage liquidity.</p> <p>Assessment. Despite improvements in the current account deficit, short-term debt inflows expose Turkey's private sector to significant rollover risks. Gross external financing needs are estimated at a large 28 percent of GDP in 2013. In an environment of ample global liquidity, these risks have not thus far materialized, but continue to pose a major vulnerability.</p>	
FX intervention and reserves	<p>Background. The Central Bank has not intervened in the exchange rate since January 2012. The ROM has been the instrument of choice to accumulate reserves in the face of capital inflows, helping to alleviate pressure on the lira.</p> <p>Assessment. Turkey's gross reserves of \$119 billion at end-2012 increased from \$88 billion the year before. The 2012 reserves account for 115 percent of the IMF composite adequacy metric versus 99 percent in 2011. Reserves cover of short-term debt rose to 87 percent in 2012 compared with 71 percent in 2011. Reserve coverage is also adequate when using other traditional metrics. However, reserves accumulation is warranted for precautionary reasons given uncertainty in global liquidity flows.</p>	
Foreign asset and liability position	<p>Background. Turkey's net international investment position is about -53.2 percent of GDP, and it is comparable to peers. However, the NFA position has worsened by 8.4 percentage points of GDP since 2009 and the deterioration is projected to continue. The composition of NFA has also deteriorated in recent years, with short-term debt liabilities accounting for a growing fraction of total liabilities.</p> <p>Assessment. The current NFA level does not point to a solvency problem at this stage, but Turkey remains exposed to liquidity vulnerabilities.</p>	

	United Kingdom	Overall assessment
Current account	<p>Background. Prior to the crisis, the United Kingdom had a substantial current account deficit due to strong domestic demand. In the aftermath of the crisis the trade and current account balances had a transitory improvement, but have reverted back to the levels observed in 2007. The cyclically adjusted current account was - 3.8 percent of GDP in 2012.</p> <p>Assessment. Model estimates suggest that the cyclically-adjusted current account balance (after adjusting for the output gap and terms of trade) is some 1–2 percent of GDP weaker than the value implied by medium-term fundamentals and desirable policies.</p>	<p>The external position is moderately weaker than implied by medium-term fundamentals and desirable policy settings.</p> <p>From an accounting perspective, this reflects the position of public and private saving rates. More fundamentally, the external position is influenced by the lack of trade competitiveness.</p> <p>Potential policy responses</p> <p>Sustaining a strong and durable recovery in the UK requires a rebalancing away from public support toward private-sector led demand, along with a greater reliance on external demand.</p> <p>The authorities are pursuing fiscal consolidation, which, per se, would normally be expected to improve national savings. However, given that households banks and (to a lesser extent) firms are also attempting to save more than usual, the overall effect would weaken growth. Bringing forward infrastructure spending and other growth enhancing measures, within a medium-term fiscal framework, could help bridge to a more sustained pick-up in private demand, notably investment.</p> <p>The authorities have implemented some growth-friendly fiscal measures. More structural reforms (in improving infrastructure, skills, and banking competition) would help to improve competitiveness.</p>
Real exchange rate	<p>Background. The necessary fiscal consolidation and deleveraging of the private sector imply that the relative demand for non-tradables will be low over the medium term.</p> <p>Assessment. Various methodologies suggest a decline in the real effective exchange rate of the order of 5–10 percent may be appropriate given medium-term fundamentals and desirable policy settings, although, there is uncertainty regarding the precise magnitude of exchange rate misalignment. For instance, the recent depreciation of the real exchange rate has not propelled an improvement of net exports suggested by standard trade elasticities.</p>	
Capital and financial accounts: flows and measures	<p>Background. Given the UK's role as an international financial center, portfolio and bank flows are the key components of the financial account.</p> <p>Assessment. With safe haven inflows offset by debt outflows, and while the depth of the sterling market provide it with some cushion against idiosyncratic moves, the fickle nature of some flows into the UK is a potential vulnerability for sterling.</p>	
FX intervention and reserves	<p>Assessment. Reserves held by the UK are typically low relative to standard metrics, but the currency is free floating.</p>	
Foreign asset and liability position	<p>Background. The UK's net international investment position improved substantially during the crisis as the exchange rate depreciation yielded positive valuation effects. Current account deficits are worsening the net international investment position suggesting a weak external position, although net liabilities remain relatively low at about 35 percent of GDP at end-2012.</p> <p>Assessment. Gross liabilities exceed 500 percent of GDP, including a high proportion of short-term debt. These are offset by large holdings of equities. Large and highly liquid gross liabilities create vulnerabilities for the UK's large financial sector, despite continuing efforts to strengthen regulation and supervision.</p>	