

SM/13/168
Correction 3

July 31, 2013

To: Members of the Executive Board

From: The Acting 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. Page 5 is also included to incorporate the corrected text detailed in SM/13/168, Cor. 1, which had been inadvertently omitted.

Evident Ambiguity

Page 30, Thailand, foreign asset and liability position, lines 4–5: for “Net foreign assets are currently rising but would be expected to remain broadly stable as further liberalization of outflows raises foreign liabilities.” read “Net foreign assets are currently rising but would be expected to remain broadly stable, although further liberalization of outflows could raise both foreign assets and liabilities.”

The sentence was incorrect as capital outflows create foreign assets whereas liabilities could emerge from second round effects that were not explained.

Typographical Error

Page 18, Korea, foreign asset and liability position, line 4: for “7 percent” read “16 percent”

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

D. Individual Economy Assessments - by Economy

	Australia	Overall assessment
Current account	<p>Background. 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>Assessment. 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>Potential policy responses</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>
Real exchange rate	<p>Background. 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 remained high in 2012, in part related to capital inflows toward Australian government debt.</p> <p>Assessment. 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>	
Capital and financial accounts: flows and measures	<p>Background. 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>Assessment. The credible commitment to a floating exchange rate and strong fiscal position limit vulnerabilities from capital flows.</p>	
FX intervention and reserves	<p>Background. 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>Assessment. 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>	
Foreign asset and liability position	<p>Background. 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>Assessment. 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
Current account	<p>Background. 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>Assessment. 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>Potential policy responses</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>
Real exchange rate	<p>Background. 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>Assessment. 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>	
Capital and financial accounts: flows and measures	<p>Background. 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>Assessment. Belgium is vulnerable to a drop in investor confidence owing notably to the large refinancing needs of the sovereign and banking sectors.</p>	
FX intervention and reserves	<p>Assessment. 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>	
Foreign asset and liability position	<p>Background. 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>Assessment. 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>	

	Japan	Overall assessment
Current account	<p>Background. 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>Assessment. 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>Potential policy responses</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>
Real exchange rate	<p>Background. 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>Assessment. 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>	
Capital and financial accounts: flows and measures	<p>Background. 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>Assessment. Safe haven flows imply limited vulnerabilities to global financial instability.</p>	
FX intervention and reserves	<p>Assessment. 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>	
Foreign asset and liability position	<p>Background. 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>Assessment. 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
Current account	<p>Background. 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>Assessment. 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>Potential policy responses</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>
Real exchange rate	<p>Background. 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>Assessment. 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>	
Capital and financial accounts: flows and measures	<p>Background. 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>Assessment. 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 rate 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>	
FX intervention and reserves	<p>Background. Reserves grew by 1 percent of GDP (US\$ 21 billion) in 2012, broadly in line with external liabilities.</p> <p>Assessment. 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>	
Foreign asset and liability position	<p>Background. 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 7-16 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>Assessment. There are few risks to external debt sustainability.</p>	

	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 8¼ 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 8¼ 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, <u>although as</u> further liberalization of outflows <u>could</u> raises <u>both</u> foreign <u>assets and</u> 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>	