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Minutes of Executive Board Meeting 18/66-3

2:30 p.m., July 16, 2018

3. 2018 External Sector Report

Documents: SM/18/176 and Correction 1; and Correction 2 ; and Supplement 1; and Supplement 1, Correction 1; and Supplement 2, SM/18/177; and Correction 1; and Correction 2

Staff: Obstfeld, RES; Adler, RES. Cubeddu Merchan, RES; Kaufman, SPR

Length: 2 hours 9 minutes

Executive Board Attendance

D. Lipton, Acting Chair

Executive Directors	**Alternate Executive Directors**
	D. Mahlinza (AE)
	M. Raghani (AF)
A. Armas (AG)	
H. Jang (AP)	
	B. Saraiva (BR)
Z. Jin (CC)	
C. Hurtado (CE)	
N. Horsman (CO)	
M. Erbenova (EC)	
	A. Castets (FF)
S. Meyer (GR)	
S. Gokarn (IN)	
	F. Spadafora (IT), Temporary
M. Kaizuka (JA)	
J. Mojarrad (MD)	
H. Beblawi (MI)	
A. De Lannoy (NE)	
T. Ostros (NO)	
	L. Palei (RU)
H. Alogeel (SA)	
J. Agung (ST)	
	P. Inderbinen (SZ)
	V. White (UK)
	P. Pollard (US), Temporary

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

Also Present
Asia and Pacific Department: P. Cashin, K. Kang, X. Li, P. Morra, J. Ostry. Corporate Services and Facilities: N. Pambukhchyan. European Department: A. Cuevas Camarillo, M. Dao, J. Kozack. Legal Department: K. Christopherson Puh. Monetary and Capital Markets Department: D. Nyberg. Research Department: M. Obstfeld, G. Adler, L. Cubeddu Merchan, E. Durdu, S. Krogstrup. Strategy, Policy, and Review Department: V.

Chensavasdijai, M. Das, M. Kaufman, H. Lin, Y. Lu, M. Takebe. Executive Director: A. Tombini (BR). Alternate Executive Director: M. Siriwardana (IN), P. Sun (CC). Senior Advisors to Executive Directors: M. Choueiri (MI), H. Etkes (NE), N. Jost (NE), Y.Liu (CC), T. Nguema-Affane (AF), T. Ozaki (JA), G. Preston (AP). Advisors to Executive Directors: P. Braeuer (GR), X. Cai (CC), J. Garang (AE), J. Hanson (NE), R. Lopes Varela (AF), A. Olhaye (AF), A. Park (AP), B. Parkanyi (NE), P. Snisorenko (RU).

3. 2018 EXTERNAL SECTOR REPORT

Mr. Inderbinen and Mr. Waelti submitted the following statement:

We thank staff for the 2018 External Sector Report and welcome their continued efforts to further improve the External Balance Assessment (EBA) methodology and analytical tools.

We support the call in the External Sector Report for strengthening the open multilateral trading system and promoting trade in services. We underline that sound macroeconomic policies are key to reduce excessive global imbalances. In this respect, monetary policies should remain accommodative where warranted, i.e., where output gaps are negative and price stability is under threat. Meanwhile, fiscal buffers are currently insufficient in many economies, and they should be strengthened while favorable economic conditions last.

We would like to underscore once more that the estimates stemming from the EBA models should not be used in a mechanical way. Country-specific information as well as judgment by staff continue to be essential for the overall assessment of each country's external position. In this regard, consistency across countries and over time as well as transparency remain crucial.

The econometric analysis focuses narrowly on the current account model. Explaining current account balances across countries within a single model is a complex endeavor. In fact, the variation in the current account that is explained neither by model-based fundamentals nor by policy gaps remains quite large, notwithstanding significant methodological improvements over the years. In this regard, we would like to raise three points regarding the methodology:

First, staff should remain cautious when interpreting residuals and avoid automatically equating unexplained current account gaps with distortions. It should be recognized that fundamentals outside of the model can partly explain residuals. For example, the design of pension systems and its interaction with demographic factors could drive saving rates. We welcome the identification and analysis of additional factors as sources of current accounts gaps, such as distortions in product and labor markets. We call on staff to provide the estimates of the contributions of such structural factors for all countries. We also encourage staff to pursue their work in this area and to provide a more systematic analysis in future reports.

Second, in most cases, staff translates current account gaps into exchange rate gaps using trade elasticities. This approach requires caution. Directly linking exchange rate gaps and current account gaps may be unwarranted if current account gaps are not the result of exchange rate misalignments. In such cases, exchange rate adjustment might arguably not be effective in addressing current account imbalances and could even generate additional distortions. Also, the theoretical link between current account and exchange rate gaps is sometimes weak or absent in the data. In fact, the report mentions weak automatic adjustment mechanisms several times, the understanding of which would be beneficial in future analyses of the external sector.

Third, in light of these limitations, staff should avoid putting too much weight on the current account model alone, and additional indicators should complement the analysis of the external sector. The results of the exchange rate models should not be discarded. The analysis could further benefit from a deeper consideration of capital flows, international investment positions as well as the type of financing of current accounts deficits.

Providing multilaterally consistent external sector assessments remains a complex exercise. We appreciate staff's efforts in taking into account country-specific characteristics and providing a thorough country-level analysis of the external sector. Since staff judgment is an integral part of the analysis, the report requires a high degree of transparency. We encourage staff to continue providing comprehensive information on the factors underlying country-level assessments.

Finally, we appreciate staff's efforts to produce projections for both the evolution of current accounts and international investment positions across countries. In the end, it is the evolution of stocks that matters for external sustainability. The report states that global stock positions stabilized in 2017, mainly owing to valuation effects, showing that these should be taken into account in forecasting as well. Further study of valuation effects is warranted to provide more accurate forecasts of international investment positions.

Ms. White and Miss Chen submitted the following statement:

We thank staff for the 2018 External Sector Report (ESR). We take note that global imbalances have remained broadly unchanged and agree that the present level of imbalances are excessive. We believe the high level of imbalance remains a potential source of vulnerability which could be a source of risk to long-term sustainable growth. We reiterate our support for the EBA methodology, which we consider to be an important tool for the Fund to discharge its surveillance mandate. We note that for the first time the ESR will be released at a press conference, we welcome this step to increase the prominence of the ESR, and hope it will trigger a wider debate on global imbalances amongst policymakers through a multilateral lens.

Overall Conclusion

We note the tone of this year's report has shifted notably, with some clear warnings up front about risks from imbalances. While we welcome staff communicating a clearer view of the severity of the issues, we felt these warnings should be more fully backed up with robust – and highly valuable - explanations that would fully justify their strength. We wonder if such a shift in tone was intentional?

The lack of movement on the global level continues to suggest that automatic adjustments are insufficient, and implies policy action would be required from both surplus and deficit countries in order to bring global imbalances down. We reiterate the importance of incentivizing countries (especially surplus countries) to take actions via policy recommendations with direct and robustly - evidenced benefits for countries themselves.

Methodology

We welcome staff's work looking at the link between trade costs and current account balances. We are sympathetic to the data problems that staff faced and would encourage staff to return to this issue in the future when more data is available, so that they can more adequately ascertain the role played by trade policy costs, as opposed to non-policy costs. We note that to improve data availability, especially on services trade restrictiveness, staff would need to work closely with other international organisations, in particular the OECD to improve data.

We welcome the new complementary tools. We note that where staff found reducing domestic product and labour market regulations can help reduce a country's current account balance (box 3), this points to a connection between current accounts and services trade barriers, since domestic regulations are generally also service-sector ones. We would therefore like to see a close link between staff's work on structural factors, and on trade policy costs, particularly for services. We would also welcome further analysis on service sector rigidities to help make the case for policy actions to reduce them. Lastly, we would like to see further developed application of the regression results on the impact of multilateral rather than unilateral liberalization.

Presentation

In the EBA methodology discussion, staff made certain assurances with respect to improving the transparency of the report. We welcome the steps taken so far, but note there is still scope for further improvement, for example:

In the 2017 ESR, staff assessed one third of current account balances were excessive. However, in this year's ESR, that same metric has jumped to a half. The report does not discuss what drove this change, which is particularly notable given the overall size of current account deficits have not materially moved over the last year. We wonder if the change is driven by the new methodology? If so, while Box 2 prominently flagged the change in methodology, perhaps the impact of the methodological change needs to be woven through the document rather than focused in Box 2.

Similarly, in last year's report staff reported the overall global imbalance at about 1.9 percent of global GDP, yet this year the same figure is being reported as 3.25 percent - presumably the absolute sum of both surpluses and deficits. We feel an insertion of a simple footnote would avoid confusing the public.

We found Box 2 helpful in showing the impact of the EBA methodology change. We note that the current account norms have changed quite significantly for several countries. More extensive country level discussion on which component of the new model is driving the movements seems warranted, and unfortunately missing in the individual economy assessments.

Mr. Ostros and Ms. Sand submitted the following statement:

We thank staff for the 2018 External Sector Report (ESR) which provides a comprehensive overview of the largest economies' external sector positions and related policies. We broadly agree with the assessment and key takeaways in the report, including policy recommendations.

We note that global current account (CA) deficits and surpluses have been largely unchanged since 2013, at about 3,25 percent of world GDP in 2017, and that these are increasingly concentrated in advanced economies. Over the past decade meaningful rebalancing has occurred; China's current account surplus has gradually declined, surpluses in large oil exporters have adjusted downward, and Euro-area debtor countries and emerging Europe have trimmed their past deficits. However, there are some persistent external imbalances in large advanced economies and a worrying rapid rise in current account deficits in some emerging economies.

In light of key policy actions contrary to stabilizing external positions since the end of 2017, we appreciate that section IV pays particular attention to the outlook and risks stemming from excess external imbalances. It is concerning that under baseline policies current account deficits are projected to widen further. Projections for United States' deficits, accumulatively 3,7 trillion dollars or 17 percent of GDP over the next five years, are worrying not only from their economic but also political sustainability perspectives.

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

Further, the overall differences in CA norms between advanced economies and emerging market and developing economies reflect that capital flows to regions with more growth potential – and we support the endeavour that detailed country-specific knowledge/judgement should be applied to assess these norms.

We emphasize that the EBA methodology should be used as input to the Fund's overall external balance assessment. However, the model has limitations, and we welcome staff's acknowledgement that analytically grounded and transparently presented staff judgement remains essential. We stress that there is still scope for improvement in areas of transparency and consistency especially regarding the translation of the CA gap into a REER gap using trade elasticities. Given estimation uncertainties, assessments should be presented in ranges. This is done for all ESR countries, but should be extended to all EBA countries.

Staff's analysis of the role of structural policies and impact of trade costs in external balances is appreciated. With corporate saving and investment decisions being increasingly important drivers of external sector accounts, in future ESRs staff could consider exploring the current account implications of global value chains, merchanting, internationally mobile intangible assets and growing market power of the world's largest firms.

Global imbalances should be addressed in a growth-friendly manner with decisive and comprehensive policy action – stimulating investment and consumption in excessive surplus countries, and policies to boost productivity and competitiveness in excess deficit countries. We agree that with negative output gaps closing or in some cases turning positive structural reforms should play a greater role in policy mixes, not only to create improved prospects for long-run growth but also to address some of the distortions underlying excess external imbalances.

The apparent weakness of automatic adjustment mechanisms creates additional pressure for policy actions. While not everything can be fixed with public sector policies, it is the responsibility of prudent policymakers to create supportive conditions for smooth and orderly changes in private sector behaviour and adjustment in prices. We would welcome staff's analysis of the reasons behind the weak automatic adjustment mechanisms and whether the weakness is expected to continue.

We regret that trade tensions have intensified in 2017-18 and strongly agree that protectionist trade policies should be avoided as they pose severe risks to global growth. We stress the importance of enduring efforts to protect and strengthen the multilateral trading system while reviving liberalization and lowering barriers to trade. Basically, external imbalances are results of differences between national saving and national investment. Trade policies play a role only to the extent they affect net national saving. Although trade policies may have limited effects on the external imbalances, spill-over effects will affect growth and development potential, especially of developing countries. The assessed impact of trade policies appears to depend on model specifics and estimation affected by measuring limitations. Further analysis of the relationship between trade policies and current account outcomes is warranted.

Specific comments on behalf of the Swedish authorities on the ESR Individual Economy Assessment for Sweden:

We broadly agree with the assessment of Sweden's external position as moderately stronger in 2017. The refinements made to the EBA model in this year's report reduces the tension between model-based and staff assessments for Sweden. This is a positive development which likely will entail that the EBA model can be more useful as a benchmark for assessing the Swedish external position in the future. However, given the uncertainty surrounding the model estimates it remains our view that these need to be supplemented by additional country-specific analysis, as has been the case in the past.

The staff-assessed CA norm decreased from around 3 percent in 2016 to 2 percent in 2017, which is in line with the decrease in the CA. The EBA model and staff assessments for 2017 are aligned, while there was a larger staff adjustment in 2016. On the other hand, this means that the revisions of the EBA model and staff assessments between 2016 and 2017 are quite different, roughly 3 percentage points and -1 percentage point respectively. We interpret this as giving substantially more weight to the EBA model (level) estimates in 2017 than previously, reflecting that the EBA estimate is now judged more reasonable. Is this a “coincidence” or should we expect that the assessment is more closely aligned with the EBA estimate also in the future? We further note that a staff adjustment to the EBA estimate similar to the one made in last year’s report for 2016 – adjustments largely due to merchanting trade - would have produced a higher CA norm and a correspondingly lower CA gap for Sweden in 2017.

Mr. Mkwezalamba and Mr. Sishi submitted the following statement:

We thank staff for the latest edition of the ESR, as well as the detailed supplements to the paper. Notwithstanding any differences in views and interpretations that we may have on its outputs, we, at the outset, reiterate our full support for the EBA process. In this regard, we broadly welcome the attempts by staff to improve the EBA model through the 2018 refinements. We also generally support maintaining a significant role for staff judgement, in consultation with the authorities and in a transparent manner, given the peculiarities in both the policy mix and structural features of different economies in the membership.

The persistence of global imbalances presents a significant challenge to the international monetary system, and has implications for the nature of Fund advice to individual countries. We note that imbalances are increasingly concentrated among advanced economies (AEs) and have risen within the Euro currency union, which underscores the ineffectiveness of automatic adjustment mechanisms. In addition, although there is a broad aggregate alignment between the REER and the CA balance in the 30 countries within the EBA, this link is uneven across countries and when global financial conditions change. For instance, a combination of large differences in the competitiveness of domestic markets and the presence of large capital flows has had a stronger relationship with changes in the real exchange rate in many emerging markets (EMs) than the pressure to correct an external sector imbalance. Given these dynamics, together with other chairs, we have supported a stronger focus on structural issues and investment trends within the non-financial private sector. In this regard, we welcome the analysis presented in Box 3, and would support the elevation of this level of detail to the main body of the report.

Staff have moved in the right direction to address the asymmetric bias that was present in previous reports, but more analysis of the features of excess surpluses is still warranted. We welcome the assessment presented in Box 7, and consider that, going forward, it should include recommendations to authorities during their bilateral engagements with the Fund on how they can influence the incentives present in the private sector. Moreover, the structural features should be presented more cogently, including the impact of labor and product market characteristics on the investment decisions of firms. The ESR would also benefit from a discussion on the impact of different pension systems and, in this regard, we would seek clarity on how staff have taken pension savings into account in the technical methodology, outside of the demographic component of the model. We also share the concern that has been raised by at least one chair in the past that the characterization of imbalances as "stronger" in some countries versus those that are "weaker" in other countries reinforces the impression that it is less important for surplus countries to reduce their imbalances than for deficit countries to do so.

Turning to the refinements in the model, as well as the case of South Africa, we were struck by the impact of changes in the demographics variable on the EBA CA norm across several countries. The use of a disentangled specification appears to have had the desired effect of closing the gap in the contribution of the variable among AEs with similar demographic characteristics. However, for EMs, the shifts are more difficult to interpret. Generally, the demographic contribution rises, implying that a higher savings rate is more appropriate, which on its face is understandable. However, in the case of South Africa, the 2 percent adjustment in the demographic variable is the biggest contributor to a CA norm that shifts from a deficit of 0.9 percent to a surplus of 0.7 percent. As discussed in detail in our gray for the 2017 ESR, the authorities estimated a more negative CA norm than staff, and considered the previous CA norm of a 0.9 percent deficit as inconsistent with an EM that is a net energy importer with significant import-intensive infrastructure needs.

In this regard, the new CA norm of a surplus of 0.7 percent may further erode confidence in the reliability of the model.

While we support the use of staff judgment in principle, we remain concerned about the lack of transparency around the way that staff apply such judgement. In respect of South Africa, the use of judgement results in a reversal of the EBA model's adjustments, due to "…special demographic factors relative to other countries in the regression sample…". Consequently, the CA norm returns to a deficit, this time of 0.4 percent of GDP. Staff comments on this would be appreciated.

It still is unclear in some instances how the determination of the calculated equilibrium REER and the appropriate level of international reserves is done. The South Africa authorities have noted that staff's assessment of a REER overvaluation of a range between 2 to 9 percent remains as unhelpful from a policy perspective as the 0 to 10 percent overvaluation range published for 2016. For the record, the authorities estimated an undervaluation of 9 percent for 2016. With respect to international reserves, we join Directors who have previously sought clarity on why the actual level of reserves is deemed to not be aligned to an "adequate" level in the context of a freely-floating exchange rate. Indeed, during the 2017 ESR discussion, we raised a concern about countries with a free-floating exchange rate and nearly six months of import cover in international reserves being assessed as falling below the IMF's composite adequacy metric. Notwithstanding these issues, the authorities have reaffirmed their commitment to use opportunities, such as FDI flows, to accumulate reserves.

In conclusion, we welcome a deeper discussion on structural issues in the consideration of external imbalances. We further note that recommendations for greater use of fiscal space may be correct, but insufficient, given that the most affected countries are at full employment. In this regard, there are several components of the analysis that require more work, as outlined above. We also welcome staff's attempts to address deficiencies through the 2018 refinements, but remain unconvinced that some of these refinements are fit-for-purpose. Finally, we call for more transparency in the approach that staff use to apply judgement.

Ms. Horsman, Ms. McKiernan and Ms. Zorn submitted the following statement:

We thank staff for a comprehensive External Sector Report (ESR) that evaluates external imbalances, their causes, and potential spillover effects, while also highlighting important global issues that are currently attracting heightened attention. The external assessment exercise continues to make a strong contribution to the Fund's surveillance process by identifying, for systemic economies, policy approaches which are inconsistent with foreign exchange regimes and current account positions, and resulting external imbalances which could pose risks for global stability. We broadly agree with the staff's assessment and related policy recommendations.

Despite the widespread pick-up in global economic growth over 2017 – supported by higher global trade and investment – the size of global external imbalances remains broadly unchanged. Moreover, about half of total global imbalances, as compared to one third in 2016, cannot be explained by fundamentals and desirable policies, and the trend of greater concentration of excessive current account imbalances in advanced economies has endured. Given that the overall size of global external imbalances has not changed significantly, can staff elaborate on the main reasons for the increase in the share that is not explained by fundamentals? While certain countries did make some headway in 2017 on reducing excess current account imbalances, northern European and advanced Asian economies generally continue to account for higher-than-desirable surpluses, while higher-than-desirable deficits have persisted in the United States.

In many countries, policy actions have fallen short of addressing needed adjustment, and in some cases policies may be aggravating external imbalances. In line with the prognosis in last year's ESR, the slow pace of improvement has indeed given rise to protectionism and global market volatility, and implies that a disruptive adjustment is much closer.

Adverse trade actions pose serious risks to global economic growth and will do little to reduce excess external imbalances. We welcome staff's work related to understanding the potential effects of trade frictions and policy barriers on external positions. The analysis reinforces that trade costs are not a key driver of current account imbalances, and protectionism will not have desirable outcomes. We are concerned that, in addition to retaliatory tariff increases, some countries also may consider managing the value of their currencies to offset the effects of tariffs on consumers. This would imply even wider global imbalances and adverse consequences for growth and stability. We fully support the message that resisting protectionism, reviving trade liberalization, and strengthening rules-based multilateral systems are essential for higher and sustainable economic growth.

It is incumbent upon all member countries to take responsive policy actions that support domestic stability and potential growth while also improving global external balances. The fiscal and monetary policy mix should be reassessed and realigned, where necessary, to promote sustainable demand and rebuild policy space. Flexible foreign exchange rates in most countries must continue to support adjustment, and exchange rates should not be targeted for competitive reasons. Structural reforms that are geared towards adapting to an evolving future world economy and increasing productivity will need to play a greater role. All members should contribute to enhancing the rigor of external sector analysis, including through the full and timely provision of data for surveillance purposes.

We appreciate the Fund's efforts to enhance the quantitative assessment of external imbalances and the presentation of results. We acknowledge the better fit overall resulting from the revised EBA methodology, although we also note that model residuals are still large for certain countries, and for some, the refinements have produced large shifts in model-estimated current account norms. Recognizing that models are imperfect, we appreciate the attempt to improve the rigor and transparency of staff judgement in individual assessments, but find that the model-induced differences in individual country results have not been sufficiently explained. Staff can go further in terms of the details provided.

It is important to keep elevating the level of awareness about the potential negative spillover effects of domestic policies and excessive imbalances, as well as the importance of multilateral considerations more generally. We note improvements to the readability of this report, including more neutral and less complex language. We also welcome the coverage of issues highlighted in earlier ESRs, such as the role of corporate savings and structural factors, as well as emerging issues that could affect global imbalances, such as the recent US tax reforms. Given the role of excess saving relative to investment in the non-financial and corporate sectors as driving forces of imbalances, we believe further analysis of the determinants of savings and investment in those sectors would help to support more tailored policy advice. More generally, the report could be further improved by providing more specific and compelling policy recommendations; for example, including an estimated numerical value on policy actions, likely impacts and timelines.

We maintain the view that there is scope to raise the profile of the ESR and better incorporate its findings into the flagship publications. The introduction of a press conference accompanying the ESR publication is an important step in this direction.

Mr. Raghani, Mr. Nguema-Affane and Mr. Bangrim Kibassim submitted the following statement:

We thank staff for a set of interesting papers on developments and assessments of the world largest economies' external sector positions and policies. As in previous meetings, we welcome the implementation of the refinements to EBA methodology, and of the presentational enhancements adopted a few months ago in the present external sector report (ESR). We recognize the difficult exercise to draw a comprehensive picture of the global external sector and clearly communicate on this. We broadly share the thrust of the staff policy recommendations and have a few comments for emphasis.

We note that the global external positions remained broadly unchanged in 2017, as excess external imbalances persist and their configuration little changed. As the report indicates, there is a continuation of current account deficits in debtor countries and current account surpluses in creditor countries. Notable developments seem to have occurred in China where trend reversals were observed on a few dimensions including reserve accumulation and capital flows. We take note that imbalances are concentrated in AEs, with notably the steady increase of commodities prices helping reduce external imbalances in some EMDEs. In this connection, it is not clear to which extent domestic policy actions may also have contributed to the reduction in external imbalances in some EMDEs. Staff comments are welcome.

We welcome the box on the implications of the revised EBA. Staff-assessed current account norms following assessments based on the revised EBA have little changed, with AEs having generally positive norms and EMDEs displaying negative norms. The complementary tools developed in the context of the revision of the EBA framework appeared to improve assessments of gaps, notably those triggered by structural factors, as policy gaps do not always explain excess external imbalances. That said, further methodological refinements to the model would be needed to better capture current account dynamics. In the meantime, could staff elaborate on the extent to which judgment has been exercised in this year's assessments compared to last year's, following the refinements brought to the models?

We draw from the report that policies appeared not to be in line with the objective of reducing excess external imbalances, that is there were "inappropriate or insufficient" as indicated in the staff report. The report also indicates that most major currencies had moved recently in a direction consistent with reducing excess external imbalances. Yet, current account imbalances are expected to widen and concentrate in AEs, absent changes in policy stance. We agree that inaction poses risks to the global economy and therefore support staff policy recommendations, notably the need to calibrate policies to achieve both internal and external objectives and to resist protectionism. The report could have delved more into the progress made on structural front, as structural reforms take longer to implement. Delays in this area suggest that excess external imbalances are likely to persist for a long time.

The persistence of the excess external imbalances over the past year begs a few questions about the prospects of their reduction. In particular, are there signs that a recalibration of domestic policies where needed is underway or in the works? More generally, we would appreciate staff assessment of the traction of their policy recommendations as well as the adequacy of policy collaboration/coordination between countries. Could staff indicate the main impediments to further progress in reducing excess external imbalances? Finally, comments on the impact of the persistence of these excess external imbalances on non EBA-countries will be welcome.

We welcome the section on trade costs and current accounts. We support the call by staff to address behind-the-border barriers and distortions. Given the ongoing trade tensions, we would appreciate a deeper insight of its adverse impact on the global economy as well as the advantages of open and fair trade as to persuade countries to refrain from imposing higher and additional tariffs. We also appreciate further efforts by the Fund to advocate for trade openness at the current juncture

Mr. Saraiva and Mr. Pinheiro de Melo submitted the following statement:

We thank staff for its continuing work to improve the External Sector Report (ESR). The ESR exercise is inherently complex and both assumptions and results must be taken with some caution. Nevertheless, the ESR remains the best tool available for trying to reasonably assess the controversial and sometimes contentious issue of global imbalances.

Like the previous exercise, the 2018 ESR shows no significant changes in global imbalances. Global current account overall balances in 2017 have remained largely unchanged, slightly above three percent of the world's GDP. The analysis considers that roughly half of this figure would be classified as excessive, viz., not explained by fundamentals and desirable policies. Regarding the partition between surplus and deficit countries, there are also no marked changes. Surpluses are still concentrated in a few advanced economies – basically Germany, the Netherlands, and Japan – and China, although the latter has been markedly shrinking its current account surplus for the second year in a row. Deficits remain also highly concentrated, with the United States and the United Kingdom representing more than half of the global deficit measured as a ratio of world's GDP.

Overall the methodological refinements to the EBA model did not lead to significant shifts in the estimated norms distribution. We welcome the user-friendly approach used by staff to present the refinements in the Technical Supplement report. Changes and improvements are presented in a clear and informative way, allowing for the methodology to be better understood and scrutinized. In most cases the implications of the new specification and the new demographic data were in the direction of reducing the CA deficit or surplus estimated norm. We would like to know whether the new estimated norms resulted in less ad-hoc adjustments by staff, i.e., whether deviations from staff-assessed to estimated norms have been reduced on average.

Existing adjustment mechanisms are highly asymmetric and do not seem able to timely correct persistent imbalances in surplus economies. While markets tend to quickly punish current account deficits – specially so in the case of emerging economies – there are few market incentives for surplus economies to adjust. Figure 11 shows that since the beginning of the ESR exercise the set of countries classified as having imbalances "stronger than implied by fundamentals" has been overwhelmingly the same – status changes seem also less frequent and much less pronounced than for the set of countries with imbalances "weaker than implied by fundamentals". The dearth of efficient automatic stabilizers – an issue especially critical in the euro area where there is no currency fluctuation among members – calls for a more persuasive analysis. The ESR must become a better platform to present a convincing case of how excess surplus countries negatively affect the global economy and why adjustments could be made in a mutually advantageous way.

Although global imbalances have retreated from the record values verified just before the global financial crisis, they have since remained at consistently high levels. That may be not entirely unexpected, considering a world of increased trade, ubiquitous capital flows and unprecedented degree of interdependence among economies. However, the prevalent view is that decisive actions are needed to avoid that persistent imbalance of flows do not result in unsustainable stock positions in the future. Such reasoning again illustrates the need for sound analytical underpinnings and improved communication for the advice contained in the ESR to gain more traction – even considering that the ESR is a multilateral surveillance product, the Fund should strive to deliver more specific and practical advice. With international trade alone surging from roughly 40 to close to 60 percent of the world's GDP in little more than two decades, we wonder if wider current account imbalances and net international investment positions (NIIP) should not be a natural outcome.

We continue to see room for the econometric analysis in the ESR to be further complemented with more information and stylized facts about external sector developments. As expressed before, the annual ESR exercise would become more comprehensive – and probably increase its reach and traction – if more information were incorporated in the report. We immediately think about developments on accumulation and composition of international reserves, and instruments and framework for foreign exchange interventions. Moreover, while the current account position provides valuable information, a more granular assessment of how this position is reflected in the financial account would be welcome – volatile capital flows and swift changes in financial conditions are almost always high impact events, which may warrant more scrutiny over the financial account. While concurring that the Individual Economy Assessments brings more detailed data, addressing such themes would add value to the main report.

Finally, we appreciated the section on the impacts of trade costs on current accounts and support more engagement of the Fund on the subject. Nevertheless, the investigation is still in an early stage and needs further development before more substantive conclusions and positive advice can be established. Even concurring with the thrust of the preliminary conclusions and the need of more efforts to eliminate distortions in international trade practices, more evidence must be presented to support staff's conclusions.

Mr. Leipold and Mr. Di Lorenzo submitted the following statement:

We had two sets of expectations around the publication of the 2018 External Sector Report. First, we looked forward to ascertaining whether the methodological refinements recently introduced would lead to a more robust assessment of external positions. Second, we looked to the Report to deliver on the expectation that the Fund remained a strong voice in supporting the benefits of an open, fair and rules-based multilateral trade system. We thank staff for having produced a report that lives up to both these expectations, conveying a clear policy message, underpinned by a rigorous economic analysis, showing that persistent excess external imbalances – amid weak automatic adjustment mechanisms – are a source of serious risks to the global economy.

The lack of progress in reducing global imbalances is worrisome. Even worse, uncoordinated actions risk provoking a further widening of global imbalances. Staff's empirical analysis suggests that trade policy in the form of barriers to imports have no appreciable impact in reducing bilateral trade imbalances. Competition should remain fair also regarding tax regimes, while an adequate degree of redistribution is needed to ensure that efficiency gains from trade are fairly shared among the population. Uncertainties over trade rules also pose risks that exchange rates could become gradually misaligned from fundamentals. We therefore agree with the recommendation to resist protectionist policies and strengthen the multilateral trading system as essential pro-growth strategies.

Much progress has been achieved among net debtor countries in correcting their external imbalances, but large current account surpluses remain persistent in a set of creditor countries; fundamentally, the international monetary system lacks a mechanism to ensure a symmetric adjustment of global payments imbalances. In its absence, and as long as surplus countries resist – for whatever reason – to deploy their greater purchasing power, global adjustment remains asymmetric. What John Maynard Keynes defined as "the secular international problem" when shaping the post-war monetary system remains unresolved to this day. This is well-reflected in the Report, where it clearly states (paragraph 15) that the "persistence of external imbalances—especially on the surplus side—continues to be a feature of the global landscape." It goes on to note that "the same set of economies, especially on the side of positive excess imbalances, has displayed sizable excess external imbalances for much of the post-global financial crisis period… Meanwhile, on the side of negative excess imbalances, more reconfiguration has occurred in the past and remains under way." The noted issue of asymmetric adjustment is long-standing. The international community, with the IMF at the center, needs to continue to think of how to address it, if policy traction is to be fully evenhanded.

We take note of the staff's assessment of the euro area's external position, and agree that policy levers affecting the current account are mainly at the national level and that countries need to take steps in this regard. As the main drivers are excess savings relative to investment in the non-financial corporate and household sectors (although government balances also play a role), wide-ranging policies to enhance investment, productivity growth and labor supply to help offset the effects of population aging remain essential. In addition, area-wide initiatives will also help to reduce imbalances among Member States.

The methodological revisions seem to have yielded generally well-behaved empirical results for some countries. Overall, the refinement in the EBA estimation specification is welcome and presents an improvement in estimation fit and robustness. As nonlinear demographic effects are now taken into account more directly, without recourse to interaction terms that induced considerable year-to-year changes of current account norms, this should entail greater stability in the norms going forward. In this regard, a detailed analysis of the stability of the estimated norms is encouraged.

Transparency could be further enhanced relative to certain aspects of the report. For instance, it is unclear how the country-specific trade elasticities are computed. These elasticities have been marginally revised since last year's report; these adjustments are however not explained. Moreover, comparisons with previous assessments are not internally consistent and should be de-emphasized. For instance, we find that Figure 11 of the 2018 ESR, which compares assessments since 2012, is misleading; to be fully consistent, it should rather be based on the application of the revised methodology also to past years.

We agree with the assessment that the external position of Italy in 2017 was in line with fundamentals. As commented last year, we had appraised Italy's external position in 2016 as being broadly in line, suggesting a lack of external imbalances for several years now. We take note of the staff's suggestion that policies to further improve competitiveness are needed. However, it is worth noting that Italy's current account surplus last year (€47 bn) was the third-largest in the EU, whereas seven years ago Italy ran a deficit of the same magnitude in absolute terms. The shift represents an improvement of over 6 percentage points of GDP, with a 32 percent increase in the nominal value of exports of goods and services. In addition, we differ with staff in its assessment that weak bank balance sheets were the main determinant of the negative credit gap. Significant improvements have been accomplished so far and are still underway, as also acknowledged in the euro area FSSA. Our authorities consider that sluggish credit recovery is at the moment the byproduct of still subdued domestic demand, especially with respect to investment.

Mr. Agung, Mr. Sumawong and Ms. Ong submitted the following statement:

We thank staff for a rich and well-written 2018 External Sector Report (ESR), together with its Individual Country Assessment and Technical Supplement papers. We are pleased that the Fund's measures to raise the profile of the ESR are accompanied by continuing efforts to enhance the depth of analysis, clarity of presentation and relevance of policy discussions. Careful communication is paramount at the current juncture, and the semantic refinements in this year's edition of the ESR are appreciated. Despite these welcome efforts, we think a narrow focus on current account balances is of diminishing relevance in an environment where global financial conditions and the nature, volume and volatility of capital flows are increasingly important determinants of balance of payments pressures.

We note that overall current account balances are projected to widen in the near-term and remain concentrated in advanced economies. The US will continue to be the main contributor to global current account deficits as its procyclical fiscal impulse widens imbalances. In the near-term, we are not unduly concerned about a sudden-stop in financing for the US deficit. However, higher US inflation and faster-than-expected interest rate rises may trigger a broader retrenchment of capital flows from emerging market and developing economies. In this regard, we have reservations about conclusion of Box 4 that recent financial market volatility has been idiosyncratic in nature. Some members of our constituency have seen substantial outflow pressures in spite of staff-assessed positive CA gaps and/or having further reinforced fundamentals since the taper tantrum. Staff's comments are welcome. On the surplus side, we have reservations about the narrative that imbalances are risky because they can be co-opted as a justification for protectionist measures, especially as recent tariff measures appear to be motivated by bilateral rather than multilateral trade balances. We wonder if this message, which is embedded across recent multilateral reports, could lend legitimacy to the imposition of inappropriate trade barriers.

We welcome that the discussion of policy implications has become more nuanced, with a stronger focus on structural reform. Conventional wisdom suggests that external imbalances warrant attention because they generally point to domestic distortions. But a current account balance consistent with the norm is by no means a clean bill of health, especially if it results from directionally-offsetting policy gaps. Staff appropriately acknowledge this in the 2018 ESR, and helpfully note that reducing external imbalances should not entail exacerbating domestic ones. We are also glad that staff's recommendations regarding the macroeconomic policy mix now account for the more favorable cyclical context, with priority attached to policy normalization and the rebuilding of buffers where output gaps have closed. Policy advice on reserve build-up should not be over-reliant on the ARA metric, which is backward looking and may not be an adequate guide as monetary policy normalization heightens capital flow volatility. The focus on addressing structural bottlenecks is a constructive one, though we remain unconvinced that the external position is an effective anchor for the domestic reform agenda. We encourage staff to continue to engage the authorities on structural reforms aimed at promoting sustainable and inclusive growth, regardless of the external balance. Again, we underscore that policy advice bears the most traction with policymakers if it is clearly centered on domestic objectives, particularly in the case of structural reforms where implementation challenges often stem from domestic political economy constraints.

With the adoption of the latest EBA refinements, the ESR needs to clearly distinguish between changes to norms and gaps that result from methodological changes, and those that stem from fundamentals and policy settings. In this connection, we thank staff for including Box 2 to highlight the implications of these changes. Box Figure 2.1 suggests that methodological refinements have led to significant changes in model outputs, in many cases moving EBA-estimated norms towards zero. Moreover, Box Figure 2.2 suggests that the change in staff-assessed CA norms from 2016 to 2017 was quite significant in some cases (e.g. Canada, Thailand, Netherlands). This is puzzling as EBA norms are anchored in the medium-term and should remain similar from year-to-year. We view the Fund to be at the cutting-edge of external sector analysis and fully support the work that staff have done and continue to do to refine their analytical frameworks. However, the instability in norms and gaps suggests that the EBA approach continues to be a work in progress, as recognized also by staff.

EBA methodological refinements do not diminish the need for caution and humility in interpreting model results. Our views on model limitations and the need for careful staff judgment in accounting for country-specific circumstances, as expressed in our grays on the 2017 External Sector Report (GRAY/17/2440) and the 2018 EBA methodological refinements (GRAY/18/999), remain broadly unchanged. We continue to caution against a simplistic treatment of the role of exchange rates in driving current account dynamics. Care must be taken to ensure that the Fund’s valuable analysis is not misinterpreted or misused.

We encourage the Fund to continue to examine the dangers of protectionism, as well as continue to advocate for enhanced international cooperation and liberalization. To this end, we appreciate staff's efforts on the challenging task of estimating trade costs and agree with the policy recommendation to lower trade costs while supporting for those that are dislocated by globalization. With trade tensions on the rise, it is essential to resist inward-looking policies and strengthen the multilateral trading system.

Mr. Meyer and Mr. Braeuer submitted the following statement:

We thank staff for an informative and concise report. As the global economy is operating at or above potential, rebuilding policy space and implementing well-tailored structural reforms should have priority to support strong, sustainable and balanced growth. We support staff's call to avoid protectionist policies and instead work toward reducing trade barriers. In our view, sound domestic policies including sustainable fiscal policies and ambitious structural reforms in an environment of open markets and a rules-based, multilateral system represent the best response to concerns about global imbalances.

We agree with staff, that implementing well-tailored structural reforms aimed at boosting domestic sources of growth in surplus countries, would help promoting external rebalancing. However, the report underscores the urgent need for deficit economies to consolidate their public finances without (further) delay. Last year, the Fund stressed that "excess deficit countries should move forward with fiscal consolidation without delay". However, despite the favourable global growth environment both in deficit and in surplus economies alike, fiscal policies remain too loose. According to staff, there is still a sizeable negative global fiscal gap. This is worrisome as several emerging market economies with large domestic fiscal gaps are facing sustainability concerns - requiring Fund support in some cases. Moreover, key major advanced economies maintain large gaps and have yet to make good on their commitment to put public debt on a sustainable path.

Given the inherent accommodation of the excessive fiscal deficit at the global level in the EBA model (given the specification of policy gaps, a worldwide increase in fiscal deficits does not lead to an extra total policy gap as the increase in the domestic gaps would be cancelled out by a simultaneous increase in the world gap), we see a need to put a strong focus on domestic policy gaps both in the main report and the country pages.

Euro Area

We take note of staff's assessment of the euro area's external position, indicating that in 2017 it was moderately stronger than the level implied by medium-term fundamentals and desirable policies. In 2018, the current account surplus is projected to shrink modestly as the region's economic recovery continues. We take note that only about a third of the EBA current account gap of the euro area identified according to the 2018 ESR can be explained by the model. Among the policy gaps identified, less than half can be attributed to domestic policy gaps, whereas a larger part is attributed to policy gaps outside the euro area.

We agree that the underlying determinants of savings and investment in the non-financial corporate and household sectors should be further analyzed to support more tailored policy advice. Government balances also play a role as highlighted by the Fund.

Further integrating financial markets and the broader EU single market, in the context of the deepening of the Economic and Monetary Union will help reduce imbalances among Member states. We agree that policy levers affecting the current account are, however, mainly at the national level.

Germany

We acknowledge Germany's large current account surplus. We note that staff projects "a modest narrowing in the medium run, supported by a gradual realignment of price competitiveness, and continued strong domestic demand". That being said, a large decrease in Germany's current account seems unlikely given a variety of fundamental factors such as the speed of aging and high GDP-per-capita leading to net capital outflows.

We do not share staff's judgement that the German position is "substantially stronger than justified by medium-term fundamentals and desirable policies". Despite the new refinement to the EBA model, nearly all of Germany's EBA gap is not explained by the model. The particularly bad fit for Germany is somewhat disappointing because it continues to limit the insights offered by EBA.

Among the domestic policy gaps identified, the most notable is a fiscal balance higher than judged appropriate by staff. The fiscal policy gap contributes 1 percentage point to the total EBA gap, while only 0.4 percentage points are attributed to domestic fiscal policy. In our view, this rather minor influence puts a premium on structural policies to facilitate investment in Germany instead of focusing the policy advice on a more expansionary fiscal policy. Moreover, staff's choice of the desirable fiscal balance seems not fully consistent with Germany's fiscal rules that are enshrined in the constitution. This raises questions about the likely traction of staff's policy advice.

A credit gap contributes another 0.4 percentage points. However, questions remain about the methodology used to estimate a large negative credit gap (- 9 percent of GDP) in the case of Germany. It seems that the results are not fully consistent with staff's refined methodology which yields a positive gap of 2 percent of GDP.

As regards policy recommendations other than a more expansionary fiscal stance, we note that staff recommends structural reforms to foster entrepreneurship, as well as pension reforms prolonging working lives that would reduce saving needs for retirement. In principle, we do see merit in well-designed structural reforms aimed at boosting domestic sources of growth in Germany. For a more comprehensive assessment of staff's policy advice, we would refer to our statement for the Article IV consultation.

We would like to stress that a cautious interpretation of EBA "norms" is warranted, given the high model and estimation uncertainty. With regard to the REER estimates, the Bundesbank currently does not consider the REER as significantly undervalued, and instead assesses German price competitiveness to be neutral within reasonable error bounds. Although we agree with staff that the REER level approach may be more reliable than the REER index approach, we do not share the argument that the REER index approach should be discarded because of a poor fit in one single country of a panel. According to model averages the German price competitiveness is much less favorable.

Remarks on EBA

We continue to view the External Balance Assessment (EBA) as a rather challenging quest to have a multilaterally consistent assessment of external positions. EBA can be a useful tool to assess the global state of economic imbalances in a transnationally uniform analytical framework. We appreciate that staff continuously strives to improve EBA. However, while the last methodological refinements may represent a step forward in delivering a more reliable assessment tool for some countries, they have also increased – and created new – difficulties to ensure consistency both across time and countries.

We would like to outline some of these challenges in greater detail below.

Consistency Over Time

As outlined in the technical supplement that was presented to the Board on April 9, 2018, the refined EBA model would no longer include a financial center dummy but instead addresses measurement issues related to the statistical treatment of financial returns outside the EBA model through adjustments based on staff estimates of these specific forms of biases. We understood that the latter would include only those biases that arise from the statistical treatment of retained earnings and inflation distortions. Other issues (e.g. global value chains (GVCs), offshoring or merchanting) were also explored but staff deemed the conceptual basis for making adjustments outside the model for these factors unclear. However, this led to the fact that recent External Balance Assessments did not contain discretionary adjustments for merchanting trade even though last year's respective assessments made quite sizable adjustments related to merchanting trade that were justified on the grounds of the relevant academic literature (see, for instance, 2017 Article IV Consultation for Denmark and Switzerland). In our view, this could leave the impression that staff's discretionary adjustments to the EBA CA gap are somewhat arbitrary which would undermine the reputation and credibility of the EBA exercise. Staff comments would be appreciated.

More generally, according to our understanding, staff intends to label any adjustments outside the EBA-model that are related to measurement issues as "adjustments to the cyclically adjusted current account" that affect the staff-assessed CA gap. Other outside-the-model adjustments relate to factors directly affecting the EBA norm. However, these distinctions require a very careful and clear presentation when explaining the results of the staff-assessed CA gap. Sometimes even staff seems a bit confused by the rich terminology when stating in Box 2 that "changes in staff-assessed norms between 2016 and 2017 were largest in countries where there was some reassessment in the context of the refinements about […] factors affecting the underlying current account […] due to measurement".

As regards the refinements to the demographic specification that aim to better isolate the compositional demographic effect from the dynamic/longevity effect, we would like to reiterate that differences in demographic trajectories are key factors when explaining different current account positions (in particular persistent surpluses in rapidly ageing societies). Against this background, we were surprised to learn that in the case of Germany the overall contribution for this important – both empirically and theoretically well-established – explanation for the saving-investment balance has been reduced from 3 percent of GDP to less than one percent of GDP in just one year. Further elaborations by staff on the specific reasons behind this significant change are welcome.

Consistency Across Countries

It is not really clear to us how the adjustment for "measurement bias" has been applied consistently across countries. As mentioned above, our understanding of the new approach of dealing with measurement issues was that outside-the-model adjustments will only correct for biases that arise from the statistical treatment of retained earnings and inflation distortions. However, we take note that the new Technical Supplement now states that "staff will produce consistent and comparable country-specific estimates of (i) specific biases due to retained earnings and inflation distortions, and (ii) general biases related to the systematic and persistent differences between a country's financial account and changes in its IIP". Regarding the latter, we note that ad-hoc adjustments were applied for Hong Kong, even though granular estimates of inflation and retained earnings biases do not point in the same direction. In a similar vein, the respective adjustments applied to the UK were not based on granular estimates for the aforementioned biases and were much larger in magnitude than for instance for South Africa despite the fact that South Africa displays larger IIP valuation changes and a larger estimated inflation/retained earnings bias. In addition, in the case of UK, staff did not fully explain on which ground the adjustment of two percent of GDP was based upon. Furthermore, we would be interested to learn based on which criteria staff assesses IIP valuation issues to be large. In this context, we would like to reiterate that we are still not convinced that the correction of estimated measurement biases should only be considered for a subset of countries. A priori, one would expect that not least to safeguard multilateral consistency, it is important to apply such a correction across all countries consistently and in an evenhanded manner. The latter holds in particular true as adjustments to the underlying current account jeopardize multilateral consistency especially if applied to large countries such as UK. Staff comments would be welcome.

As regards the refinements related to the credit gaps, we wonder why staff deviates from its estimates in the EBA exercise for some countries (i.e. Indonesia, Spain, UK, Turkey, and Germany). In addition, neither for Spain nor for Germany, the definition of the desired credit gap levels is in line with the approach outlined in the Technical Supplement. Further explanation by staff is appreciated.

Finally, we see the need to enhance the transparency regarding the assumed elasticities used to calculate the REER gap that is implied by the staff-assessed CA gap. While we welcome that staff now seems to mention the assumed elasticities not only for countries covered by the ESR, it remains unclear how staff arrives at the respective estimates. Our understanding is that staff continues to base these estimates on a common elasticity assumption of 0.71 for exports and 0.92 for imports, adjusted by the size of exports and imports in GDP. At the same time, it is possible for staff to use different elasticities based on recent developments and country-specific circumstances. In these cases, such adjustments should be clearly explained. However, staff does usually not provide any explanation. Against this background –and also given the fact that the estimated "common elasticities" seem to date back to pre-1985 –we would ask staff to prepare a Working Paper that estimates the respective elasticities in a comprehensive and structured manner. Staff comments would be appreciated.

Consistency with Bilateral Surveillance and Policy Recommendations

Revisions to the estimation method of credit excesses have led to considerable changes in the estimated credit-to-GDP gaps for many countries. In particular, the sign of the credit gap switched for most of those countries which experienced fast credit growth in the run-up to the financial crisis and a deleveraging process thereafter. While we agree with staff that the de-trended credit gap measure better capture the turning points in the current account over different cycles, in some cases the methodology has led to a contradiction of the implications following from the EBA policy gaps and staff's general policy recommendations. For instance, in the case of Netherlands, staff recommends a repairing of household balance sheets while private credit-to-GDP is below what the filtering approach suggests resulting in a negative credit gap.

Finally, we take note that the estimated coefficient of the fiscal balance has decreased markedly in the refined model. Does staff have an explanation for this change in the coefficient?

Ms. Pollard submitted the following statement:

The IMF was founded to ensure stability of the international monetary system. Assessment of the external sector of member countries is at the core of the IMF's mandate. The United States has long pushed for a rigorous analysis of exchange rates and global imbalances and has strongly supported the EBA/ESR process. We have welcomed the evolution of the ESR from a pilot to mainstream status the move from an informal to formal Board discussion and now the roll out of the report with a press conference. We strongly support the elevation of the ESR to "flagship" status to raise the profile of its findings. As the status of the ESR has become entrenched we have pressed for enhancements to the methodology to improve the rigor and robustness of the results. Our goal has not been to pre-determine an outcome, but to promote consistent, evenhanded, and transparent reporting of external assessments across countries to increase the credibility of this important multilateral monitoring tool.

External Imbalances

We generally agree with the overall assessments in this year's ESR. The report rightly highlights the persistence of large global imbalances, especially among surplus economies.

Figure 6 illustrates this, showing that even after staff adjustments, current account gaps are not evenly distributed – the largest gaps are concentrated within a group of surplus countries.

We support staff's conclusion that these persistent imbalances pose risk to the global economy. We appreciated staff's discussion of policies countries should take to reduce external imbalances and the risks to the global economy from the failure to act. We also appreciated the recognition that policies need to be properly sequenced and calibrated to avoid increasing domestic imbalances while reducing external imbalances. Turning to individual counties, we fully agree that China needs to close the remaining policy gaps by improving its social safety net, reforming state-owned enterprises, opening more of its markets to foreign competition, and creating a more market-based financial sector. Sequencing of capital account liberalization is needed to avoid domestic financial instability. The persistence of high surpluses among some euro area countries makes adjustment for others more difficult. We agree that real exchange rate adjustment in euro area surplus economies would be helpful to support demand in other countries. We concur with the analysis in Box 5, that the Tax and Jobs Act will have limited effects on the overall current account balance.

Despite improvements in the model's ability to identify policy gaps and staff's work to identify gaps outside the model (e.g., structural factors), countries still insist that nothing can or should be done to reduce their own imbalances. Not only has there been little traction in policy advice, but in some countries policies are instead moving in the opposite direction. Staff does a better job addressing the need for reforms in the ESR, but there needs to be a better integration of this advice in bilateral surveillance. Too often the discussion of the external sector in Article IVs is limited to a sentence or two in the body of the report, with no analysis apart from the country page included as an annex.

We welcome the analysis of trade costs and current accounts in the ESR and the finding that effective export costs have a significant if moderate effect on current accounts. In our view the estimates are likely lower bounds as other non-measured costs would raise the estimates. As staff note, there is a need to look beyond tariffs to include other barriers to trade and distortions to the trading system. These include SOE subsidies and lack of protection of intellectual property rights. We encourage staff to continue working to better understand these effects.

Figure 9 indicates that intervention aimed at keeping the exchange rate undervalued continues to be a policy for a few countries. We urge staff to be more forceful in calling out countries for intervening beyond simply noting that “intervention should be limited to avoiding disorderly market conditions.”

EBA Refinements

At the April informal Board meeting to discuss the refinements to EBA methodology we noted that staff have proposed changes in the ingredients for preparing the soufflé and while the changes appeared to be improvements, the test would be in the baking. With the soufflé before us we can affirm that while it comes out of the oven lighter and fluffier, the chef’s creation is at times deflated before serving by staff’s thumbprint, as we discuss in the next section.

For example, we supported the revisions to the demographic variables and the country level results appear reasonable, noting that the Fountain of Youth has indeed not been located in Sweden, as we wondered last year. The results based on the more comprehensive institutional variable and the credit gap also seem reasonable. We note, however, that cross-country comparisons of determinants of the current account norms was much clearer in the 2017 report, with the inclusion of Figure 7, than it is by looking at Table 7 in the technical supplement to the 2018 report. We strongly urge staff to include the equivalent to Figure 7 in future reports. We also encourage staff to provide the underlying data to the Board along with the staff documents.

We welcome the refinements to the proxy for foreign exchange intervention. The shift to a more rigorous approach to desirable policies (i.e., setting P* at zero for most countries) is a major conceptual improvement over previous practice. However, we agree with staff that the accuracy of the results could be vastly improved through the inclusion of actual intervention data. We urge all member countries to make these data available to staff.

Looking forward, we encourage staff to do further work on better understanding the role of corporate sector saving in current account surpluses, including policies giving rise to higher corporate saving as well as lower labor income shares. We urge staff to reconsider the use of net foreign assets as an explanatory variable within the model – while it may improve model fit, the policy implications of its inclusion are counter-intuitive, as it implies that countries with large net assets should have higher saving rather than lower, thus reinforcing stock imbalances. We also encourage staff to continue to examine how best to model reserve currency status.

Finally, we support staff's focus on the current account model in the ESR and country assessments. The REER models and External Sustainability (ES) metric can be seen as a useful supplement in a few cases for the EBA countries. The ES metric is a useful input for many low-income countries and should remain a key part of the EBA-Lite methodology. Given the better fit of the REER-level model over the REER-index model, has staff considered eliminating the latter for EBA countries?

Staff Adjustments

Even with the methodological refinements, staff adjustments may be necessary to account for relevant factors that are not captured by the model. These adjustments need to be well-supported by economic theory, transparent, and evenhanded. Some progress has been made in achieving these goals, but adjustments are still too often made to minimize imbalances. Staff adjustments tend to be more transparent but we still struggle to understand how staff determine the extent of the adjustment. We are often surprised that while staff will stress the uncertainty around the estimated EBA current account norm, their adjustments to the norm are determined with precision.

Evenhandedness tends to be lacking across adjustments. Why, for example, is Australia's current account norm reduced by 0.9 percentage points because its size and population density mean it has higher investment needs than captured by the model, whereas Canada, a far larger country measured by geographic size, with a similar low population density, is not deemed to have a higher-than-modeled investment need? Canada's norm is lowered because its population projections differ from the UN projections. Have staff compared national estimates of population projections with the UN projections for other countries? For the second year, Thailand's current account surplus was reduced by close to 4 percentage points because of political uncertainty. Has staff considered an adjustment for the UK because of uncertainty related to Brexit? We also note that no idiosyncratic factors seem to raise a country's current account gap, which seems remarkable.

We do support some adjustments, as in the case of unrecorded retained earnings and inflation distortions. But, even with these, we would like to see the supporting analysis behind the adjustments.

Finally, we commend staff for the steps taken in recent years to increase the transparency of the EBA process and staff adjustments. Along those lines, we would like to see greater transparency in how desired policy settings are determined.

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

General

We congratulate staff for the comprehensive and well drafted External Sector Report (ESR). The report neatly analyses the evolvement of actual CA surpluses and deficits, as well as "excessive" CA gaps in systemic economies. The ESR also provides a limited and cautious analysis of REER gaps. This is the first ESR that draws on the refined EBA methodology, of which we broadly support the changes.

External sector assessment is subject to uncertainty as reflected in the expected moderate overall fit of the model. This uncertainty could be better reflected in the report by presenting all the results as ranges, even if some parts of the uncertainty, such as staff judgement, are not quantifiable. Uncertainty may also warrant interpreting the residuals and gaps between actual CA/REER and "norm" values as a mixture of imbalances and uncertainty, rather than pure imbalances. Uncertainty could be reduced by using multiple approaches particularly for estimating REER rather than drawing mainly on the CA model (more details in the methodological comments below). Finally, the uncertainty embedded in the formal model highlights the importance of country team judgment and of tailored policy advice particularly regarding local institutions affecting the saving-investment gap. Evidently, staff judgement should not undermine the transparency of the analysis by clearly distinguishing between model outcomes and staff judgements.

We fully agree with staff that protectionism is neither the right nor an effective policy response to global imbalances. Staff is correct to underline the negative consequences of protectionist policies including undermining confidence, which serve as a negative supply shock. Trade barriers increase producer prices and serve as an implicit tax if no substitutes are readily available, thereby increasing prices and lowering output. Therefore, protectionist policies have on aggregate negative consequences, especially in today's world of global value chains and strongly progressed globalization. Moreover, staff rightfully demonstrates that protectionist policies have no effect on the current account balance. We also agree with staff that the fiscal easing underway in the US is leading to a larger US current account imbalance. However, we call on staff to be careful not to qualify imbalances as stoking protectionism. and thereby validating irrational trade policies. We believe that excessive external imbalances should be addressed using macroeconomic and structural policies rather than protectionism.

The ESR covers 26 systemic economies while its underlying EBA analysis is based on a sample of 49 economies. This leaves a group of 23 "other" economies in the awkward position where the results are partially reported as point estimates (only) in the technical supplement without historical perspective or country specific adjustments. We encourage staff to include more data on adjusted ranges of the gaps of the "other" 23 countries at least in a statistical supplement to enhance transparent and even-handed treatment of all countries included in the EBA sample.

We take note of staff's assessment of the euro area's external position, indicating that in 2017 it was moderately stronger than the level implied by medium-term fundamentals and desirable policies. In 2018, the current account surplus is projected to shrink modestly as the region's economic recovery continues. We agree that further integration of EU financial markets and the broader EU single market, in the context of the deepening of the Economic and Monetary Union, will also help to reduce imbalances among Member States. We note that less than half of the current account gap of 1.3 percent GDP of the euro area identified according to the 2018 ESR can be attributed to domestic policy gaps, whereas a larger part is attributed to policy gaps outside the euro area.

The advice on the appropriate policy response for countries with stronger than warranted external positions seems not always appropriate and a result from the analysis. With regards to the Netherlands for example, it is remarkable that staff is advising an expansionary fiscal policy, yet the savings surplus is almost entirely attainable to the corporate sector. In general, it is not easy for policy makers to address this excess corporate savings. In the Netherlands the authorities have repeatedly called for wage increases but they cannot enforce this on employers and employees. Also, the call for stronger credit growth in this context should be dealt with carefully in the context of already elevated private debt levels in some sectors. We therefore welcome the box on understanding the drivers of the increase of corporate savings and we agree with staff that more research is needed to understand the role policies could play in this area.

Methodological Aspects

The methodological revisions seem to have yielded well-behaved empirical results for some countries, yet residuals increased for other countries. Some questions remain, including why life-expectancy data for some emerging/developing countries is adjusted for the regression, rather than performing such adjustments ex post via staff adjustment. Similarly, adjustments for "measurement biases" were applied for some countries, but it is unclear why such adjustments were not applied in other cases. Further clarification by staff would be appreciated.

We welcome the transparent presentation of staff adjustments and believe that area and country teams should be given appropriate room for adjusting the model to fit the specific country characteristics. We also support that Article IV assessments reflect both old and new ESR figures where relevant. The significant changes in CA gaps of some countries (e.g. the Netherlands and Switzerland call for explicit discussion of the impact changes in such case in the main report). Staff has removed the financial sector dummy from the EBA model and has instead chosen to make adjustments to account for financial sector biases (staff-adjusted CA-gaps). However, these adjustments need further clarification. The Netherlands has for example not seen an adjustment, while the financial center status of the Netherlands entails a concentration of corporations with high savings which staff cannot yet explain.

We note and welcome the limited and cautious nature of the analysis of the REER gaps in the current ESR. Unlike staff, we argue that CA models should not receive greater weight in estimation of REER gaps in comparison to REER models for few reasons. Exchange rates reflect current conditions and expectations, while CA models are “backward looking”. In addition, updated exchange rate data are readily available, while CA data are available with lags and subject to revisions. Finally, CA models include additional uncertainty regarding REER gaps because of the uncertain elasticity. Indeed, in some cases the CA and the REER models point to gaps in opposite directions. Therefore, we encourage staff to apply a humble approach which is based on multiple models in future general and country reports. Moreover, we believe that country teams should apply judgement, which is not biased by an institutional preference for a specific model.

We encourage staff to explore the implications of the growing literature on the Dominant Currency Paradigm for EBA evaluation of exchange rates. This paradigm suggests that trade between two countries is affected by the exchange rates of their national currencies vis-à-vis the USD even when none of these countries peg to the USD or use it as a national currency. To the extent this phenomenon is ascribed to international value chains of production (rather than price stickiness), the weight of the USD may be higher in the REER calculations in the medium and perhaps even the long run and may have implications for the EBA analysis. It seems that estimating models with REER weighted by the share of currencies in invoices is a possible step towards understanding the implications of this emerging paradigm. Staff comments are welcome.

Last but not least, the definition of the objectives of the ESR mentions that “eventual elimination of such gaps is desirable” (Box 1). We believe that explanation of the objectives of the report should state briefly the reasons for the desire to eliminate these gaps and the dangers arising from excessive gaps, together with some references to relevant research literature.

Mr. Beblawi, Mr. Mojarrad, and Mr. Al-Kohlany submitted the following joint statement:

Global current account imbalances were broadly unchanged in 2017, with minor shifts, building on reconfiguration that started in 2013. Current account surpluses in key advanced economies widened, while the narrowing of deficits in emerging markets, key oil exporters, and developing economies was more than offset by higher negative gaps in other key advanced economies. This reconfiguration of global imbalances was underpinned by several factors, including the gradual tightening of financing conditions, the sharp decline in commodity prices—which recovered somewhat after bottoming out in 2016— the uneven demand recovery in systemic economies, and the related policy differences. Imbalances in key economies are expected to persist and possibly widen, reflecting sustained tight fiscal policy in some economies and loosening fiscal policy in others.

The report warns that the persistent excess external imbalances represent significant risks to the global economy by aggravating trade tensions, and could result in a faster tightening of global financial conditions. The report also calls for a collective and concerted effort by the international community to avoid a disorderly adjustment. In this context, we echo staff's call on most economies with weaker than-warranted external positions to move forward with fiscal consolidation over the medium-term, while gradually normalizing monetary policy. We also agree that excess surplus economies with fiscal space should allow for greater fiscal stimulus and reduce their reliance on easy monetary policy, when feasible.

Increased concentration of external deficits in a few economies has given rise to protectionist policies with potential negative consequences for the global economy. Staff provided a useful summary assessment of the impact of protectionist trade policies on external balances and showed that tariff and nontariff trade barriers have a limited impact on current account outcomes and do not appear to be a key drive of imbalances, reaffirming conventional economic theory. We look forward to staff analysis of this important topic in the upcoming working paper.

We thank staff for the summary discussion (Box 7) of the drivers of corporate savings and their contributions to current account surpluses. Can staff elaborate on the way the refined model captures the impact of corporate savings? We call on staff to expand further on this discussion, with a focus on the underlying motives and structural factors for the high nonfinancial corporate net saving rates, to help better formulate policy advice. More attention should also be given to the treatment of cross-generational savings by oil exporting countries, to include an intergenerational equity perspective given that hydrocarbon wealth is exhaustible. These savings also constitute buffers to avoid sharp fiscal adjustments and mitigate the impact on output and prices when oil prices drop, as was evident during the 2014-16 oil price decline.

We welcome the refinements made to the EBA model, which we commented on extensively at the informal Board discussion on the topic in April. The refinements improved the model's conceptual framework and its overall statistical fit and should also enhance confidence in the methodology and its policy implications. We welcome the complementary tools developed to shed light on the role of structural policies in explaining part of the model's residual. We agree with staff that no model can fully capture the complex dynamics of the external balance, and call on them to continue their effort to improve the model and supplementary tools in order to better inform policy making.

Staff reported that the refinements to the EBA current account model were also incorporated in the REER index and REER level models, and generally did not change the models' fit compared with the previous version. We are noticing a trend of greater emphasis on the EBA current account model, disregarding the results of the other two models (i.e., the Czech Article IV discussions). We reiterate our call on staff to continue to present the results of all the EBA models, and not to dismiss one as inferior without explicit and compelling justification. In cases where the models' outcomes are inconclusive, we suggest that staff present their assessments as a range, rather than point estimates.

With regards to transparency and communicating external sector assessments, we welcome the normalized language in the report, and look forward to the publication of the forthcoming comprehensive working paper on the refinements and the related data set. We also encourage staff to consider including common language in staff surveillance reports on the limitations of EBA calculations and findings. Informing country authorities about these adjustments would be helpful, including by hosting workshops during Article IV missions. For countries where staff judgment substantially alters the EBA norm, greater focus in the staff outreach should be on the adjustment processes and their assumptions.

Mr. Alogeel and Mr. Keshava submitted the following statement:

We thank staff for the 2018 External Sector Report and welcome the refinements to the External Balance Assessment (EBA) methodology as part of a continuous effort to improve key tools for external sector assessments. We also encourage in these assessments the continued reliance on area department's country-specific knowledge and insights gained during the Article IV consultation process as well as staff judgement. This is essential since uncertainties are inherent in EBA model results, even after continued refinement efforts, because of methodological limitations and data shortcomings. Indeed, we note that the refined model still falls short of explaining some cases of large current account gaps as presence of large residuals remains an issue.

We note that, in 2017, overall global current account surpluses and deficits were broadly unchanged, with minor shifts and continued trend of greater concentration of surpluses and deficits in advanced economies (AEs), and that about half of global current account balances were deemed excessive. We also note that current account surpluses and deficits, under baseline policies, are projected to further widen and concentrate in AEs. On the evolution of stock positions, net international investment positions stabilized in 2017, but are projected to expand over the medium term assuming no valuation changes, as sustained current account surpluses are expected to remain in the largest creditor economies, and deficits in debtor economies.

As we have underscored earlier, it is important in external sector assessments to have a broader focus beyond current account imbalances, including on the overall external balance sheet, to convey an accurate picture of risks and vulnerabilities. We note in Box 1 that the overall assessment of a country's external position takes into consideration indicators beyond the current account and the REER, including the financial account balance, the international investment position, reserve adequacy, and other competitiveness measures. We would appreciate staff comments on whether the overall assessment of any country was changed based on other indicators from what was determined from the current account gap?

Given weak automatic adjustment mechanisms, we agree that both surplus and deficit countries need to undertake policy measures to address persistent excess external imbalances and mitigate risks to the global economy. In this connection, we broadly concur with the recommended fiscal and monetary policies outlined in the report. A greater role for structural reforms going forward is also essential with both surplus and deficit countries needing to rebuild policy buffers. In this regard, we see merit in staff recommendation that addressing product- and labor-market distortions is desirable in all countries, but product market reforms that remove unnecessary burdens from starting a business in high current account surplus countries and labor market reforms that reduce labor costs in high current account deficit countries would be especially beneficial.

Finally, we welcome the analysis in Section V on the linkages between trade policies and current account balances. Against the backdrop of rising trade tensions, we would like to reiterate the importance of resolving the current disagreements among major trading partners in a cooperative manner to mitigate growing risks to the favorable global growth outlook.

Mr. Jang, Ms. Preston and Mr. Shin submitted the following statement:

We thank staff for the 2018 External Sector Report (ESR). The ESR is a key tool to assessing the impact of both domestic and global influences on an economy's current account and exchange rate. Given the increasing prominence of the ESR since its inception, and the calls from some Directors to elevate it to flagship status, it is critical that the key messages from the report are clear and framed to maximize the Fund's traction. In this year's report, we consider that the key messages are diluted within the dissection of global imbalances and their movements.

In our view the ESR's most important contributions at the current juncture are 1) lowering trade costs – not increasing them – is essential for addressing the inefficiencies that affect national saving and investment. Protectionist policies should be avoided as they will have a limited impact on external balances. Instead, the focus should be on reducing both barriers to trade in services and the trade impeding effects of natural factors. 2) Foreign exchange intervention played a limited role in driving excess external imbalances. The IMF should use this as a platform to continue to articulate the benefits of flexible exchange rate regimes in facilitating adjustment 3) Domestic policies can play a more prominent role in tackling excess global imbalances.

We note staff's view that current account surplus and deficit are sometimes inevitable and can be beneficial from both an individual-country and global perspective. As noted in Box 1, countries have their own legitimate reasons to bear either current account surpluses or deficits based on their country-specific circumstances. Nonzero external imbalances can be desirable from both the individual country and global stand points. Further in the integrated global economy, the savings from current account surpluses in one country could ultimately flow into the other countries as a form of capital flow such as FDI and lending, contributing to their economy.

Presentational enhancements, the use of more neutral language and the inclusion of a cross country comparison table are welcome steps towards improving the transparency, consistency and evenhandedness of the overall framework. Notwithstanding the progress made, we still see room for improvement in increasing transparency in staff judgments by providing more detailed justification for staff's assessment. Further, we would have preferred a more detailed and specific explanation of why country specific adjustors were applied in what circumstances. We note that in some country cases, following the refinement of EBA methodology, previously existing adjustors have been removed without further description. Staff's view would be welcome. Finally, we encourage staff to prioritize the creation of guidelines for 'desirable policy levels'(P*) to enhance transparency as detailed in the next steps of the April 2018 technical briefing.

We reiterate that the model should be complemented by country specific considerations for more precise and evenhanded analysis, given its inherent limitation. As evidenced by the presence of large residual, even with recently refined methodology, the external position cannot be assessed solely by the model. We encourage staff to continually review and evaluate the effectiveness of the model, while seeking more relevant factors to explain the current account dynamics. We suggest taking the manufacturing share (as a percentage of GDP) into account, as the recent analysis by Korean authorities implies the fixed effect is positively related with average manufacturing share mainly due to the role of providers of capital goods in the context of the global value chain.

Even with continued and welcome refinements to the model, measurement issues remain. When applied across a broad range of countries, it is important to ensure the analysis has been done in the level playing field with precise data based on the same criteria. In this regard, we again call on staff to encourage member countries to adhere to the international guideline set out in BPM6 as the basis for compiling sound and consistent BOP statistics, especially in the area of retained earnings, merchanting and processing trade data.

The weakening link between current account and the REER needs to be taken into account in constructing policy advice. Many academic papers, including from the Fund, have noted the weakening relationship between these two variables with the rise of global value chain in the current international trade system. Non-price factors such as changes in competition, shift in taste and quality are now becoming more relevant aspects for competitiveness, rather than relative prices.

We note the staff's policy advice that 'in economies with strong external positions and fiscal space a less restrictive fiscal stance would help promote external rebalancing. Following the Board discussion on Assessing fiscal space – we are reminded that fiscal space is one thing, and the decision to use it is another. Would it be desirable to take an expansionary fiscal stance to reduce the current account surpluses, even when the output gap is closed or turned into positive? Staff's view would be welcome.

Mr. Palei and Mr. Snisorenko submitted the following statement:

We thank staff for the 2018 External Sector Report and for the companion papers on Individual Economy Assessments and Refinements to the EBA Methodology. While the ESR is being pushed to the level of flagship publications, the precision and credibility of its estimates remains elusive despite the significant resources devoted to this exercise.

We note that excess global imbalances have remained broadly unchanged in 2017 with persistence of large excess surpluses in several advanced economies, including Germany, the Netherlands, Sweden, Korea, and Singapore, and concentration of excess deficits in the United States and United Kingdom. The U.S. dollar appreciation in response to procyclical fiscal policy and faster monetary tightening could further widen the U.S. current account deficit and corresponding surpluses in other economies and, hence, aggravate trade tensions. It may also bring disruptive adjustments in emerging market economies. Overall, we find that the main policy recommendations from 2017 ESR remain relevant, while the value added by the new report in terms of policy recommendations seems to be rather limited. We continue to view the ESR as a largely technical exercise, which should support comprehensive multilateral and bilateral surveillance conducted through other means and presented in other Fund products.

We welcome the refinements to the EBA methodology focused on improving the modeling of demographics and the measurement of external positions, as well as foreign exchange interventions and credit excesses. The latest set of refinements has marginally improved model's overall statistical fit, but we agree with other Directors that the call for continuing judicious reliance on staff judgement in evaluating country specific circumstances remains unchanged. We also welcome the introduction of the complementary tools aimed at capturing the role of structural policies in explaining excess current account imbalances.

We continue to have serious reservations about the use of third-party perceptions-based indicators of institutional quality (ICRG and/or WGI) as the inputs in quantitative analysis. We do not believe that the ICGR indicator is based on expert opinions. This indicator is lacking reliability and transparency, and it is provided by a private company PRS Group. We find it inappropriate for the IMF to endorse such indicators or to promote the sales of the PRS Group products. We regret that it seems to be the case now, as the site of this company states: "Our results are consistently and independently back-tested for relevance and accuracy by such organizations as the IMF and by scholars at leading universities, including the Fuqua School of Business and the National Bureau of Economic Research." From this specific point of view, the use of the WGI seems to be preferable.

We found the analysis of the influence of trade costs on current accounts to be timely and relevant to recent developments. It suggests that effective export costs have statistically significant impact on current accounts. We encourage more in-depth research in this area.

Mr. Kaizuka, Mr. Saito and Mr. Komura submitted the following statement:

Overall current account excess imbalances remained unchanged and have recently concentrated in advanced economies. Reducing excess imbalances is a critical issue for the global economy. Since CA balances reflect domestic IS balances, countries should take appropriate macroeconomic policies and structural reforms to reduce their excess imbalances. In this regard, we strongly support that the staff reports underscore the necessity of implementing macroeconomic policies and structural reforms to achieve domestic and external objectives. Related to this point, staff analyses the effects of trade policies on CA balances, indicating their limited relationship consistent with theoretical predictions. We support staff's view that protectionist policies should be avoided as they are likely to have significant deleterious effects on domestic and global growth while limited impact on external imbalances.

As simply looking at CA balance statistics for countries does not enable to identify underlying imbalances and associated distortions, we appreciate the EBA/ESR exercise facilitating discussions about necessary policy actions to reduce excess imbalances, and thereby achieve sustainable growth of the global economy. As global value chains (GVCs) have been expanding and deepening, it is essential to discuss the issue of imbalances in the context of multilateral problems, avoiding scaling down the topic to bilateral ones.

Methodological Update

We agree with staff that a search for better methodology should be viewed as continuous and evolving process. Further work will be warranted. Given the important role of the Fund to contain risks arising from excess imbalances, the Fund needs to continuously improve EBA methodology which is a multilateral monitoring tool to assess CA balances for each country. Our authorities therefore made several suggestions, such as using capital-weight to calculate REER, instead of trade-weight, and better capturing norm related to income balances by taking rate of returns differentials into account. It is regrettable that the updated methodology does not reflect these suggestions, partly due to data limitation. We are of the view that the Fund needs further efforts to improve the EBA methodology.

Staff Judgement

While further refinements are necessary going forward, staff judgement will remain essential because no models can be perfect. We share the staff's view that staff judgement remains essential as the updated model cannot capture every aspect of current account dynamics. Staff always need to consider limitations of models and make adjustments if necessary. Also, we would like to underscore that staff judgement should be made in a well-grounded, evenhanded, and transparent way. In this regard, we highly welcome that two previous adjustments related to domestic distortions and offshoring, which were applied only to Japan, have been appropriately removed.

Country teams need to make adjustments systematically. In the first place, in considering adjustments, every country team should have adequate opportunities to engage in discussions with Executive Directors and the authorities from an early stage of analysis to well capture county specificity. Then, country teams need to judge necessity of adjustments systematically. In this regard, while it is welcoming that developing the complementary tool aiming to help well-grounded and evenhanded adjustments or policy advice regarding product market and labor market distortions, we look forward to seeing reasonable usage and further work on other structural distortions as well as refinements on product market and labor market distortions.

Exchange Rate Assessment

The current methodology to assess REER entails critical limitations. Exchange rate assessments continue to be based on, for the most part, staff's view of the current account gap, mapping into exchange rates by using trade elasticities estimated separately. However, there exit several shortcomings including the followings:

First, it is unrealistic to assume that global excess imbalances can be resolved by REER adjustments. Although, of course, we recognize the Fund recommends economic adjustments by macroeconomic policies and structural reforms as well, estimating REER gap from trade elasticities itself basically assumes that CA gap would be resolved through the adjustment of trade balances if REER goes to the desired level. However, in a growing number of countries, especially advanced economies, income balances, which reflect an accumulation of domestic and external investment and are not well adjusted by exchange rate, dominates over CA balances. Therefore, this method inevitably depicts an unrealistic path to reduce excess imbalances for those countries in fact.

Second, developments of GVCs have also weaken the linkage between trade balance and REER, leading to lower trade elasticities. Again, although the current method assumes to reduce excess imbalances through the adjustment of trade balances, the impact of exchange rates on trade balances have also declined due to expanding and deepening of GVCs.

Third, capital transactions are main driving factors of exchange rates. FX transactions are amount to about 5 trillion dollars per day while annual trade transactions are 22 trillion dollars in 2017. Such large capital transactions significantly affect exchange rates. The current method may not well capture the effects of large capital transactions on REER gap.

Against this backdrop, we consider that the current method, and more broadly, almost automatically linking CA assessment and REER assessment have been losing the validity for certain countries. At the same time, we also agree with staff that the current REER model cannot not be a workhorse model. While we support the Fund work to identify CA gap, the Fund should not almost automatically link CA assessment and REER assessment for all members.

In sum, currently, because of their limitations mentioned above, it is inappropriate, and even misleading, to estimate REER gap for free-floating currencies, like Japanese yen, by using CA gap and trade elasticities as well as the current REER model. If the Fund would like to keep assessing exchange rates for free-floating currencies, the Fund should rely on a reliable tool to directly estimate REER norm. We encourage staff to make such efforts.

Having said so, we reemphasize our clear support for the Fund to assess CA gap to achieve sustainable growth in the global economy by containing global excess imbalances.

Japan Specific Issues

The adjustment related to nuclear power plant shutdown is not appropriate. Staff adjusts the cyclically-adjusted CA by +0.1 percent. Staff seems to consider that increased energy imports following nuclear power plant shutdown are temporary because the authorities set the desired target level of energy mix in 2030 pursuing to cover 20-22 percent of overall energy production by nuclear power. However, we would not cling to the numerical target as guaranteeing safety of each power plant is top priority. We therefore do not have specific schedule or plan to achieve the target.

The country page should list 'Japan specific factors' to enhance transparency. The one in the 2017 ESR listed three factors — JGB-UST spread, portfolio rebalancing, and temporary speculative short positions against the yen — as 'Japan-specific factors' which affects REER but are not included in the REER model. In the same context, the country page in the 2018 ESR mentions 'Japan-specific factors' but does not list those factors specifically. We believe that for transparency purpose, the 2018 ESR should list those factors as in the 2017 ESR, so that any readers fully understand the explanation in the report.

Mr. Armas and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the 2018 External Sector Report (ESR) and its supplements. Overall, the global outcome of the current account around the world remains broadly unchanged. We recognize the important efforts made by staff to improve the EBA model through the 2018 refinements and welcome the steps to improve the transparency process on the report before presenting its final result. For the latter, staff judgement in consultations with the authorities is warranted, understanding the peculiarities involved in each member state.

We reiterate our support for the EBA methodology and welcome the appropriate selection of themes presented in the ESR. Considering that for the first time the ESR will be launched in a press conference, we take positive note of the efforts made in this presentation so that it becomes palatable for the bigger audience. This theme is central to the IMF mandate by identifying the policy set up for 30 systemic member states. It is striking that for some member states their economic policy appears inconsistent with FX regimes and CA positions. The spillover effect of these member states poses risks for global stability. The publication of the report might help illustrate to the wider audience on the potential sources of vulnerability for economic growth. On the other hand, we found Box 3 illustrative on how to mitigate these risks going forward.

Almost half of the global external imbalances are not explained by fundamentals and desirable policies. This sole measure and magnitude of the potential source of vulnerability speaks by itself. Policy actions are needed sooner rather than later, specially in advanced economies, to avoid and abrupt correction or disruption worldwide, as we have seen during the 2008 GFC. We found Box 4 enlightening on how the spillover effects could affect other member states' growth prospective. Our institution has a major role and responsibility to show that multilateralism works for all, and is capable to offer timely policy and financial assistance to the membership to minimize the negative spillover effects that a build-up of external imbalances could create.

The political uncertainty created on the real ability to deliver needed reforms is tightening the financial conditions and raising protectionism. We fully agree with the staff assessment of the situation and concur with their recommendations to address global imbalances. In this regard, we would like further thoughts from staff on the speed and breath of the adjustment for CA surplus counties versus CA deficit ones. We do not see the policy reaction function linear between these two types of countries.

Still resounding in our mind is a powerful message for emerging markets that was picked up by the 2017 GFSR on financial conditions, which is related to what is discussed in the ESR today. Emerging market countries are losing their grip to steer domestic financial conditions, when external shocks materialize. The analysis becomes relevant for policy makers not only in advanced economies (for the spillover effects on financial conditions they can exert to other member countries) but to the authorities in emerging markets. The need to better calibrate the reaction function to external shocks becomes relevant. And according to some measurements, 20 to 40 percent of the variation in domestic financial conditions could be altered by global financial conditions. In some countries this percentage could go up even higher. This development becomes troublesome acknowledging the section IV of the ESR report, where key policy actions taken by systemic countries are contrary to stabilizing external positions.

In times of increased financial stability risks exerted by global external imbalances, precise information and high communication skills are needed from the IMF, other international and regional organizations, as well as credit rating agencies. These skills might play a critical role to moderate much of the volatility and liquidity risks. Timely and transparent information to differentiate specific situations by region and by country is critically needed. One communication challenge is to explain that a CA surplus or deficit could be an equilibrium depending on the underlying variables of the CA Norm of each country.

Mr. Gokarn and Mrs. Roy submitted the following statement:

We thank staff for a comprehensive and substantial report. The report says that, despite some shifts in staff-assessed norms and cyclically adjusted current account balances, global current account gaps remained broadly unchanged at about 1.5 percent of global GDP in 2017 in a few large economies with growing concentration in advanced economies. This indicates that about 40-50 percent of global surpluses and deficits cannot be attributed to fundamentals and desirable policies. Under baseline policies, current account surpluses and deficits are projected to further widen and concentrate in AEs. Persistent excess external imbalances — amid weak automatic adjustment mechanisms and key policy actions contrary to stabilizing external positions — pose risks to the global economy. Weakening stock positions could also lead to sharp and disruptive currency and asset price movements over the medium term as debt limits are approached and, consequently, spending falls abruptly. Could staff elaborate on the country-specific debt limits which put them at the risk of disorderly adjustment in the medium-term? Is the situation similar to the pre-2008 global imbalance situation?

In the context of excess global imbalances, the staff report says that the US Tax Cuts and Jobs Act (TCJA), passed in December 2017 may have repercussions that go well beyond US borders through its potential impact on widening of the US current account balance. However, Box 6 notes that though the projected absolute real annual world oil price increase for 2018 is similar in magnitude to that observed between 2004 and 2005 (US$16-17), in a much-changed landscape of energy independence, the US trade balance has become largely insulated from energy price changes, and, going forward, higher world energy prices may improve the US trade balance. Could staff elaborate on the net effect, of US tax policy change and its relative self-sufficiency in the oil and gas sector, on the US current account gap? What is the sustainable level of CAD for the US?

On the discussion of trade costs and current accounts, the staff report states that while trade costs do not appear to be a key driver of current account imbalances, lower trade costs can boost trade and foster a more efficient allocation of resources and boost productivity. Could the staff indicate the impact of increase in trade costs through multi-country imposition of trade barriers on global excess imbalances?

Specific Comments on India

In the staff report, India is classified among countries whose current account balance and REER gaps are broadly consistent with domestic fundamentals. As per the assessment, the current account deficit (CAD) for India that would stabilize the ratio of net foreign assets (NFA) to GDP at the benchmark NFA/GDP level is estimated at (-) 2.3 percent of GDP. The estimated NFA/GDP used for India is (-) 13.0 percent of GDP. It is not clear whether the estimated NFA/GDP at (-) 13.0 percent is the benchmark used to work out the sustainable level of CAB. If it is so, then in case of India, the estimated NFA/GDP at (-) 13.0 percent is not only inconsistent with the estimated sustainable level of CAD of 2.3 percent but also appears to be on lower side. If the NFA to GDP ratio is to be stabilized at (-) 13.0 percent, the consistent level of CAD would work out to be about 1.5 percent. If, instead, CAD at 2.3 percent of GDP is considered to stabilize the NFA/ GDP ratio, the consistent ratio for the latter will be about 20 percent. The current NFA/GDP ratio at end-March 2018 is 16.3 percent. Staff comments are welcome.

The staff report mentions that, in India, progress has been made on FDI liberalization, while portfolio flows remain controlled. However, it may be noted that portfolio flows in the debt segment have been gradually liberalised in recent years. As per the revised medium-term framework released on April 6, 2018, the limits for FPI investment in Central Government securities are set to increase further by 0.5 percent each year to 5.5 percent and 6.0 percent of outstanding stock of securities in 2018-19 and 2019-20, respectively.

Refinements to the External Balance Assessment Methodology and the External Sector Report - Technical Supplement

We have two sets of comments: (i) on the refinements attempted in this exercise and (ii) on the refinements not attempted in this exercise.

On the Refinements Attempted in this Exercise

First, to better understand the impact on the aggregate savings pattern of an economy while assessing the current account situation, as an additional indicator for demographics, the paper looks at the proportion of prime savers in total working population. The paper presumes that cohorts aged 45-64 typically have the highest saving rates, so that a higher share of prime-age savers should imply a higher aggregate saving rate. The paper says that for a small group of countries, consideration for exceptionally high adult mortality rates could be given to shifting down by 5 years the definition of prime age, working age and old-age dependency. Which are these countries?

Even in countries which do not have high adult mortality, workers may enter and leave the workforce at earlier ages. Especially, countries with higher populations have lower retirement ages of 58/60. Also, the total amount of saving would depend on the employment and income level. How can these factors be incorporated in the model to give better estimates of savings rates?

We agree that the inclusion of a wider set of variables to better capture the role of institutional quality will improve the robustness of the model but we are not clear about the rationale behind choosing indicators from the ICRG survey under the revised methodology. The choice is critical, especially, as there are questions about the robustness of ICRG as a third-party indicator, because ICRG's underlying surveys, used to construct the index, rely mainly on experts' views. The WGI indicator appears to be better constructed than the ICRG indicator as it includes information from more than 30 surveys of enterprises, citizens, and experts. While the ICRG survey provides a longer-time series data but, since the paper finds that results are similar if the WGI indicator is employed, we wonder why the ESR methodology is not adopting WGI indicator as the primary indicator.

The presence of large residuals remains an issue, confirming that complementary tools and judgment will remain essential in arriving at external assessments. However, most of the complementary tools like exploring the impact of structural factors and trade costs on the current account are not yet fully developed and judgment will remain essential in arriving at external assessments. We are glad to learn that notwithstanding important limitations, illustrative refinement exercises were conducted and are available upon request. In this situation, presentational refinements in terms of more standardized country framework and greater transparency will certainly help countries to understand the assumptions and variables that have gone to individual country assessments.

While exploring the impact of structural factors, staff will set desired policies to the frontier of labor and product market regulations, which is defined at the lowest level for OECD indicators across countries for each year, since a lower level implies less burdensome regulations. This needs to be further discussed, especially in the case for labor market institutions given that lowering regulation in abor markets has led to a sharp decline in labor's share in total income in the advanced economies with concomitant socio-economic tensions arising from inequality, exclusivity in the growth process and lack of sharing of globalization's benefits.

Data collection seems to be of the utmost importance. We would like to know whether any action plans are being prepared for collection of such vast amounts of granular data for various refinements and complementary tools.

On the Refinements not Attempted in this Exercise

IMF's ESR provides estimates for current account (CA) gap and REER gaps for individual countries. Key inputs for the external assessments are the numerical estimates from the IMF's External Balance Assessment (EBA) models which have their own limitations. Estimates are based on panel data and country-specific estimates are worked out using a semi-elasticity of CA to REER. The semi-elasticity of CA to REER is again based on the underlying assumption of common elasticity of exports and imports which may not hold true. Has any exercise been conducted to take care of this issue?

The revised methodology on desirable forex intervention level sets the medium-term intervention (FXI) to 0 as an operating principle. However, if a country considers its current forex level inadequate, then it has to build-up reserves in the medium term. Assuming FXI equivalent to zero in case a non-zero FXI is desirable may lead to an upward bias in the equilibrium level of exchange rate for a country. The composite metric that the IMF is using for assessment of the reserve adequacy of countries is still debated. We feel that this refinement exercise should also have taken a look at the IMF's reserve adequacy metric. While we agree that this metric is an improvement over the conventional reserve adequacy indicators, it should, however, be interpreted with caution for cross-country analysis. For any country, the desired level of reserves ultimately depends on domestic policy choices to deal with external shocks, the availability of alternative sources of liquidity (swap arrangements) and other country-specific features which are left out of the model. Also, the source of reserves is an important aspect which needs to be considered. Finally, the reserve adequacy of a country needs to be seen from the perspective of whether the reserves are an outcome of capital flows rather than current account surplus. Reserve requirements of the CAD countries are much higher than those of the surplus countries and this critical aspect is ignored by the RAM, which was forcefully brought home to us when the adequacy of the reserves was suddenly questioned by the markets in the mid-2013 turmoil for a number of economies. Thus, we reiterate that IMF should clearly distinguish between current account deficit countries from those having surplus while constructing composite metrics of reserves. Could staff comment?

Even after refinement, the ESR would continue to use the flawed Quinn's index of capital controls to capture the degree of imperfect capital mobility. Under "Some issues remain for future analysis and potential refinements", it is stated that "The measures of capital mobility could be further refined, for example, to consider both de-jure and de-facto aspects, although there is no unique or commonly accepted way for defining the latter." Since, there has been considerable criticism of the Quinn's index we are disappointed that no refinement of this crucially flawed aspect of the ESR was reported in this paper. Given the detailed information available with the Fund, it could develop a more sophisticated index that captures reality better.

In conclusion, perusal of the required refinements to the External Balance Assessment methodology and the External Sector Report indicates that this 2018 review is merely the beginning of a very large and detailed exercise of bridging the gaps in data and analyses in the ESR methodology. The aim should be to fill the gaps in data and analyses pinpointed so far – both by countries and by the staff – and also continue the process of identifying further gaps, which will need to be addressed by the time of the next review in 2023. For example, an investigation of the role of income distribution or productivity gains in driving current account imbalances and their ramifications would need to be looked into in the future for a more informed and accurate ESR.

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

The External Sector Report lies at the core of the Fund's multilateral surveillance mandate. It is an essential tool to inform policies that are both well-suited at the national level, and consistent in a global perspective. In a context where excess global imbalances have proven to be persistent, increasing traction of policy recommendations remains crucial, by (i) continuously improving the underlying methodology, and (ii) ensuring that the Fund's multilateral and bilateral advice remain well aligned. We strongly welcome the upcoming release of the report, for the first time, at a press conference; increased outreach to the public can indeed foster debate and may contribute to improve traction of staff advice.

We commend staff for an excellent set of reports. Following April's preliminary discussion on technical refinements, we now have a more complete view of the EBA methodology revision, including its outcomes. With stronger analytical underpinnings, the technical refinements led to significant improvement in the models. Beyond technical questions, we broadly support staff's analysis and recommendations and would like to provide additional comments:

Persistence of Excess Global Imbalances

Current account imbalances have been reduced in the wake of the Global Financial Crisis, in a context where external imbalances were identified among the main factors that contributed to the crisis. While significant progress has been achieved since then among net debtor countries, notably within the euro area, as well as in China (although at the price of rising domestic vulnerabilities), in correcting their external imbalances, large current account surpluses remain in some creditor countries, reflecting an overall shortfall in aggregate demand. This largely asymmetric adjustment has weighted on global growth. Over the past few years, excess current account imbalances have persisted and are now increasingly concentrated in a few advanced economies. If left unaddressed, persistent flow imbalances would lead to a widening of stock imbalances and pose risks to the global economy.

Going forward, excess imbalances may rise again, increasing risks. The US tax reform and associated procyclical fiscal stimulus, as shown in box 5, will lead to a widening of the US current account deficit. This should not be instrumentalized or used as a pretext to further escalate protectionist policies, that would ultimately be detrimental to all. Additionally, the widening of current account deficits in some emerging economies (notably Argentina and Turkey) is a source of concerns as the global environment becomes less benign notably due to the ongoing monetary policy normalization in advanced economies. Conversely, excessively high current account surpluses in a few countries have proven to be very persistent, underlining the weakness of price adjustment mechanisms. Consequently, decisive policy actions are needed to address these imbalances in a growth-friendly way.

Policy Recommendations

We broadly agree with staff policy recommendations to tackle excessive global imbalances. In the euro area, significant imbalances persist and could over time threaten the stability of the currency union. On the debtor side, while much progress has been achieved, we concur that further action is needed, especially on the fiscal and competitiveness fronts. In France, efforts are underway to reduce the fiscal deficit, increase competitiveness and improve education and training, in line with staff advice. At the same time, more effective actions are also needed in large current account surplus countries to support domestic demand, to boost potential growth, and to create the conditions to promote wage growth, thereby facilitating the rebalancing of the euro area.

We welcome the operationalization of complementary tools, outside the EBA model, to fine-tune policy advice. As shown in box 3, product and labour market reforms affect current account balances. While product market reforms would be beneficial in all countries, such reforms would also contribute to the external rebalancing in surplus countries. Similarly, staff only mentions labour market reforms in the case of debtor countries; the ESR report recognizes the need to boost wages in Japan but falls short of doing so for Germany, even though the article IV report suggests emphasizing the need for higher wage growth in the authorities' public communication. Integrating this article IV recommendation into the ESR would allow for a better alignment of multilateral and bilateral advice. We also wonder whether the highest degree of flexibility in labour markets is the appropriate benchmark for labour market reforms, particularly at a time when concerns about inequality, inclusive growth and the sharing of globalization's benefits are growing.

Methodological Refinements

We welcome the methodological changes set in place for the 2018 External sector Report, with refinement in the EBA estimation specification leading overall to an improvement in estimation fit and robustness. Following discussions in April, which emphasized the stronger analytical underpinnings of the proposed changes, the methodological revisions seem to have yielded well-behaved empirical results. While the previous ESR specifications had included demographic interaction terms that induced considerable year-to-year changes of current account norms for the euro area and some of its Member States, the new specification models nonlinear demographic effects more directly. In this regard, we would have appreciated a more detailed analysis of the stability of the new estimated norms.

That said, methodological improvements should remain an ongoing and continuous process. We welcome this year's focus on the potential links between trade costs and current accounts, and take note that effects of trade policies on current account imbalances are likely to be small. More generally, the underlying determinants of savings and investment in the non-financial corporate and household sectors should be further analysed to support more tailored policy advice. In particular, the 2017 External Sector Report shed light on the role of corporate savings in driving current account imbalances. We strongly welcome the preliminary analysis on corporate savings presented in box 7. We fully concur with staff that further research is needed in this area, especially on the role of corporate income taxation, profit shifting activity of multinationals, corporate governance structure and wealth distribution. We look forward to further analysis from staff on these issues.

Mr. Hurtado and Mr. Montero submitted the following statement:

We welcome the 2018 External Sector Report (ESR) as a surveillance tool to assess the evolution of global imbalances in a multilaterally-consistent manner. This year, the ESR is underpinned by a refined External Balance Assessment (EBA) methodology which has led to improvements in the main models. This notwithstanding, analytically-grounded staff´s judgement remains essential to fine-tune external assessments, and we acknowledge the efforts to increase its transparency in the 2018 ESR. This also means that, although being useful tools, neither the EBA nor the ESR can provide unequivocal answers and exact information on the excessiveness of imbalances.

We note that progress in reducing global imbalances has stalled since 2013, with global current account balances broadly unchanged in 2017 and a greater concentration of surpluses and deficits in Advanced Economies (AE). Under baseline policies, current account surpluses and deficits are projected to further widen and concentrate in AEs. Although large and persistent external imbalances in key economies pose risks to the global economy, the economic policies in many of these countries are generally inadequate for the reduction of imbalances, in terms of both direction and intensity, and in some cases aggravate imbalances. This contradiction is evident in the fiscal stance of surplus and deficit countries alike. Moreover, in both cases rebuilding policy space is needed at the current cyclical juncture, so structural reforms should be playing a greater role, which is usually not the case.

We broadly support staff´s policy recommendations to address imbalances, which are essentially the same as in 2017, but we believe that they would have benefited from a sharper analysis of external positions by type of saver. We miss a decomposition of current account balances into net savings by sector (government, non-financial corporations and households), such as the one depicted in Figure 20 in the 2017 ESR, which pointed to the key role of corporate saving behavior in driving large and sustained surpluses

—household saving differs little between surplus and deficit countries. We call on staff to include this type of analysis in the ESR report going forward. Staff comments are welcome. We commend staff for further advancing this analysis in Box 7. We concur that further research is required to better understand why corporates' net lending keeps rising and is being hoarded in cash.

We think that the treatment of stock imbalances in the report would benefit from greater depth. We miss more details about the contribution of valuation changes, cumulative CA and growth effects to NIIPs. On the normative side, no considerations are made regarding the adequateness of countries' NFA positions. Moreover, we find the treatment of stocks imbalances somewhat unbalanced, since only the risks posed by large debtor positions are highlighted, with no reference to the problems that large and sustained creditor positions can pose.

We find some inconsistencies between the external assessments in the Euro Area Art. IV and in the ESR for euro area economies. The latter report puts emphasis on asymmetries in competitiveness within the euro area as the main cause of external imbalances, while the former report focuses on excessive current account surpluses in net creditor countries, which we believe is more accurate. Could staff comment on this? Much progress has been made in net debtor countries since the onset of the GFC, as attested by the evolution of their REER ─as shown in Table 2, REER gaps are small in debtor countries, but large in creditor ones─, and, above all, their external accounts. Thus, and given that policy gaps do not seem to explain a significant portion of external imbalances in net creditors, staff should look carefully into what distortions to saving and investment decisions are more likely to explain these imbalances and elaborate on more tailored policy recommendations.

We find staff´s analysis of the US tax reform and the current account (Box 5) interesting. We concur with staff that the fiscal stance will likely lead to a substantial deterioration of the current account in the short term. However, we are not fully convinced on the assessment over the medium term, which is based on an accounting approach rather than on a macroeconomic one. We would have expected an analysis of how the main items in the tax reform will affect the patterns of government saving and investment, and those of corporates and households in the medium run. Staff´s comments are welcome.

We welcome the analysis in section V on trade protectionism and current accounts, which is timely and provides some novel results. We note that the main macroeconomic effects from trade policies are those related to economic efficiency and sectoral allocative effects. However, there may be some other channels, related to fluctuations in income and intertemporal prices, through which commercial policies may have an impact on saving and investment decisions, as highlighted in the report. The empirical results suggest that effective export costs have a small impact on the current account, particularly in the pre-GFC period, while barriers to imports are not significant. This would imply the US barriers to imports are not going to help reducing its external deficit. In this regard, we think that some intuition for this finding should be provided. What are the channels of impact? Moreover, we note that the estimated coefficient for export costs in the period 2001-2014 (Text Table 1) is -0.020 and its standard error 0.079, i.e. four times larger. How can it be statistically significant at the 10 percent level? Finally, we praise staff for trying to convey a balanced view on trade protectionism by highlighting other distorting practices beyond trade tariffs, such as SOEs subsidies, forced transfer of technologies, or weak investment and intellectual property protection. We support staff´s call for a revamped multilateral rules-based trading system that addresses all these distortions.

Finally, regarding the EBA methodology, we commend staff for the many enhancements introduced, which help to provide more credibility to external assessments. We would like to suggest, nonetheless, several areas of improvement which we have pointed out in the past. As shown by some recent analyses, the impact of its determinants on the CA is highly heterogeneous across countries, especially when comparing developed and developing economies. We believe that the issue of heterogeneity merits more attention, as it may be an interesting way of capturing distortions that are currently being neglected. Additionally, the current EBA framework would benefit from a formal treatment of stock imbalances, which should be a medium-term target for IMF's analyses. And lastly, despite the general improvement in the goodness of fit, the new EBA version still yields large residuals for several countries, which calls for caution in interpreting the results.

Ms. Erbenova, Mr. Just and Mr. Varga submitted the following statement:

We appreciate the opportunity to discuss the 2018 External Sector Report in a formal Board meeting before its publication. We welcome the update of the methodology and staff's continued efforts to further improve the multilaterally consistent assessment. Overall, we find the report very informative and generally balanced this year, with its focus on those economies where excess imbalances are persistent or rapidly growing, creating risk for sustainability and long-term growth. As the global trend in current account imbalances has been concentrated in advanced economies and a few emerging markets since 2013, we concur with staff's main message that the automatic stabilizers may not be sufficient and targeted policy actions may be required to restore balance over time, especially in large deficit countries where excessive imbalances are posing great risks also on a global level.

The euro area's external position was moderately stronger in 2017, while significant imbalances persist among Eurozone countries. However, we note that as the economic recovery continues in Europe, the current account surplus is projected to shrink modestly in 2018 and that a large part of the current account gap is attributable to policy gaps outside the euro area. We note that one of the largest reassessments of the current account norms took place for Germany, and thus its positive current account gap has widened further (see Box Figure 2.1. on page 10). At the same time, though, only a small portion of this current account gap can be explained by German domestic policies (see Figure 8 on page 14). To a lesser extent, this also applies to the Netherlands. Relative to this weakness, the policy recommendations given in the report to Germany seem therefore fairly strong. Staff's comments would be appreciated.

Staff's judgement on the individual current account positions and their transparent presentation is essential to give credible and tailored policy advice. Given the inherent limitations of the underlying models, their results should not be used in a mechanical manner, as individual adjustments are needed to capture country-specific trends and one-off effects. We note that the ESR reports the full results as ranges only for 26 out of 49 countries, while for the remaining 23, point estimates are included in the technical supplement. We are concerned that reporting only a point estimate could send a wrong signal of precision and, in some cases, raise additional questions how staff adjusted the norm. Compared to the 2015 methodology, the cyclically adjusted EBA current account norm for the Czech Republic (Table 1) is now estimated to be lower, mainly due to negative contributions of net foreign assets and demographics, while the effect of policies is now zero. Only the contribution of GDPCC (convergence) remains positive. The adjustments for Hungary are similar, also reflecting the change in methodology. We wonder whether the estimate for the EBA norm for the Czech Republic reflects staff judgement to the same extent as it is applied to the 26 countries. We see the increased negative current norm for the Czech Republic as questionable, given the advanced economy status, a transition process with the EU average that is complete, and negative demographic trends. We would strongly prefer if staff used a more detailed presentation for non-systemic EBA countries included in the Technical Supplement (i.e. applying an adjustment for country-specific factors and publishing the current account norms as ranges), as the current approach of showing only point estimates does not include sufficient acknowledgment of the uncertainty they carry and does not facilitate a critical review of the estimates. Can staff provide a presentation for all EBA countries, including the 23 non-systemic members, to facilitate better policy advice and ensure an evenhanded approach?

We welcome the timely analysis on the relationship between trade costs and current account balances. We concur with the empirical results that in a globally integrated world, trade policies of realistic magnitude have no significant effect on current account imbalances. Therefore, we consider protectionist policies to be very inefficient tool to address imbalances and they should be avoided, as imposing barriers will have a negative impact on overall economic growth and welfare, domestically as well as globally. We agree that lowering trade barriers and strengthening the multilateral trading system are an important part of pro-growth oriented strategies, while pursuing prudent fiscal policy and increasing competitiveness are essential to reduce current account deficits.

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

We thank staff for the comprehensive and informative set of external sector reports, which aim to provide a holistic view of the external imbalances from a multilateral perspective. In 2017, the overall global current account surpluses and deficits remained broadly unchanged with growing concentration in Advanced Economies (AEs), furthering the trend since a few years ago. We concur with staff that persistent external imbalances pose risks to the global economy, and stress that reducing imbalances requires a joint global effort in reducing both internal and external policy distortions.

Unilateral protectionism is not the solution to global imbalances. A country’s external imbalances can be aggravated by procyclical factors. Faster monetary tightening, overly rapid currency appreciation, and procyclical fiscal policy would likely result in significant widening of a country’s current account (CA) deficit, contributing to aggregate global imbalances. Trying to address CA deficits through unilateral protectionist measures will disrupt international trade. In this regard, we welcome and fully share staff’s call on all parties to resist protectionist policies and make efforts to revive trade liberalization and strengthen the rules-based multilateral trading system. The fund should also urge the relevant countries with excessive CA deficit to take proper measures to reduce its imbalances.

Addressing external imbalances in a constructive, sustainable manner requires a comprehensive approach, including through the adjustment of an economy's own domestic policies. To effectively tackle external imbalances, one therefore needs to get to the bottom of the problem, where structural reforms play a critical role in eliminating the policy distortions. We therefore encourage deficit countries with weaker-than-warranted external positions to raise private and public savings, strengthen export competitiveness, and enhance education and training for their labor force, while countries with stronger-than-warranted external positions should increase investment and consumption.

The Fund's external sector assessment methodology needs to be continuously subject to test in practice and become truly transparent, consistent, and evenhanded. The EBA methodology has experienced a painful evolution. We welcome staff's strive for further improvement in the latest refinement exercise. Given the model's limitations, we continue to stress the need for caution when using model-based estimates to make external assessments. Meanwhile, staff's judgement in the assessment process should be exercised in a transparent, consistent, and evenhanded manner.

The case of China represents a good example illustrating why model-based results require careful interpretation. From 2016 to 2017, China's EBA-estimated CA norm experienced a directional shift from a surplus (0.2 percent of GDP) to a deficit (-0.4 percent of GDP), representing a change of over US$60 billion. The reverse in direction and sizeable change in just one year put the seriousness of past estimates into question, and raise uncertainties over the latest estimated CA norm.

In recent years, China's CA surplus has declined from the peak of 9.9 percent of GDP in 2007 to 1.3 percent in 2017. Despite the continued narrowing of China's CA surplus in recent years and progress in rebalancing the economy, the EBA-estimated gap persists and even increased in 2017, resembling a moving target. Furthermore, staff suggests that fiscal and credit policies have been key drivers of China's narrowing CA surplus, and these policies have offset other underlying distortions, such as inadequate health spending. In our view, staff has oversimplified China's policies, for the following reasons:

First, while the expansionary fiscal and credit policies may have a cyclical impact on the CA, they also contain important structural elements. For example, part of China's fiscal spending consists of compensation to those workers directly affected by the reduction of excess capacity and the shutting down of zombie SOEs. This, in turn, strengthens the social safety net. Meanwhile, credit policies in China have contributed to productive infrastructure investments with significant structural and social impact, including the reduction of regional inequality and improving housing affordability of the lower-income segments of society. Second, describing China's credit policy as having undergone "marked relaxation" since 2013 does not give due regard to the notable efforts made by China in recent years to reduce leverage. Finally, the limit on overseas RMB withdrawal by payment cards is part of China's anti-money laundering efforts, and is unrelated to cross-border capital flows. It may not be appropriate to use this measure out of context to explain capital movements in the external sector assessment.

Overall, we believe the current track record of the EBA CA norm of China suggests some uncertainties over the reliability of the model. Therefore, we continue to emphasize that the norm should be used only as a reference in the Fund's surveillance and be interpreted cautiously. To enhance traction of the Fund's advice, we encourage staff to avoid over-generalizing a country's policies, such that their recommendations can be more tailored to a country's circumstances.

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

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

We welcome the 2018 External Sector Report (ESR), which we, overall, find well-balanced. We take note of the assessment of global imbalances for 2017 - recognizing that assessing current account and stock imbalances is challenging, dependent on the exact specifications of the underlying methodology and will always require a considerable element of judgement.

We take note of Staff's assessment of the euro area's external position, indicating that in 2017 it was moderately stronger than the level implied by medium-term fundamentals and desirable policies. In 2018, the current account surplus is projected to shrink modestly as the region's economic recovery continues and oil prices have increased from the 2017 level. Policy recommendations linked to EU external balances by Staff and the European Commission have been broadly similar in recent times. We however note that only a small portion (0.3 p.p.) of the current account gap of the euro area identified according to the 2018 ESR can be attributed to domestic policy gaps, whereas a larger part is attributed to policy gaps outside the euro area (0.4 p.p.) and to unidentified factors (policy model residuals – 0.6 p.p. when accounting for staff adjustments).

We agree that policy levers affecting the current account are mainly at the national level and that countries need to take steps in this regard. Significant imbalances persist in the euro area. However, the main drivers are excess savings relative to investment in the non-financial corporate and household sectors, although government balances also play a role in some countries, as highlighted by Staff. The underlying determinants of savings and investment in the non-financial corporate and household sectors should be further analyzed to support more tailored policy advice. We believe that further integrating financial markets and the broader EU single market, in the context of the deepening of the Economic and Monetary Union, would also help to reduce imbalances in Member States.

While much progress has been achieved among net debtor countries in correcting their external imbalances, large current account surpluses remain in some creditor countries, reflecting an overall shortfall in aggregate demand. The net international investment positions of the most indebted Member States have been improving, albeit at a slow pace, and sustained rebalancing efforts are still needed to address vulnerabilities stemming from large stocks of public or private debt. In that respect, the current EBA framework would benefit from a formal treatment of stock imbalances, which could be a medium-term target for Staff's analyses. At the same time, further efforts are also needed in large current account surplus countries to support domestic demand, to boost potential growth, and to create the conditions to promote wage growth, thereby facilitating the rebalancing of the euro area. We would like to emphasize that it is not the task of euro area monetary policy to facilitate relative price adjustments within the euro area, as recommended in the report (Page 35). Rather, this requires structural policies – primarily at the national level.

Moreover, we welcome the staff adjustment justifications for the euro area. We also note that Article IV assessments reflect both old and new ESR figures where such revisions are relevant. Finally, we note that Staff assesses the REER gap for the euro to range between -8 percent and 0 percent in 2017, based on three methods, one implied by the current account gap and two REER-based regression approaches. Like the European Commission, we also assess the euro's REER to be broadly in line with fundamentals.

We take note of the methodological revisions for the EBA current account norms. These revisions aim to make the impact from demographics more robust and less volatile, and current account norms more stable over the short-to-medium term., which is welcome. In some cases, the greater stability comes at the expense of increased residuals, as short-term fluctuations in the current account cannot always be captured. We appreciate that the current account norms presented in the 2018 ESR for many economies are converging with those estimated by the European Commission and the European Central Bank, but would like to encourage Staff to undertake further analyses of the stability of the norms.

The methodological revisions seem to have yielded well-behaved empirical results for some countries in line with what could be expected from discussions in April. Overall, we reiterate that the refinement in the EBA estimation specification is welcome and presents an improvement in estimation fit and robustness for some countries. The previous ESR specifications had included demographic interaction terms that induced considerable year-to-year changes of current account norms for the euro area and some of its Member States. The new specification models nonlinear demographic effects more directly. In this regard, a detailed analysis of the stability of the estimated norms is encouraged.

It is unclear to what extent the adjustment for “measurement bias” has been applied consistently across countries. Compared to the 2017 ESR, the new estimates do not include anymore the ‘financial center dummy’ that aimed at capturing specific measurement issues related to the corporate financial center status in selected countries. Instead, the 2018 ESR aims to adjust for such and related measurement biases, by the means of “staff-adjusted CA gaps”. The discrepancies in such adjustments seem striking. According to Table 3, the 2018 ESR adjusts for such effects only in a limited set of cases (Canada, South Africa, Switzerland and the United Kingdom). There is no adjustment for other countries that constitute such centers, or are, e.g., subject to specific features such as merchanting or persistent net errors and omissions. We would prefer a detailed explanation about how such adjustments were carried out, and how it was ensured that such adjustments were carried out in the same manner for all ESR countries. The current approach based on ad hoc corrections raises concerns about horizontal consistency and thus calls for more transparency.

Finally, the revisions have affected the estimated impact of private-sector credit on current account norms. The 2018 ESR uses credit deviations from a time-varying HP filter, instead of the 2017 ESR approach that employs credit deviations from country-specific long-term averages. For most euro-area countries, credit is below what the filtering approach suggests. As a result, many euro area countries display sizeable domestic credit gaps. It is unclear how these sizeable credit policy gaps have been reflected in the individual country assessments. The individual assessments do not, or hardly, mention such gaps despite their substantial size in some cases. We would consequently prefer more clarity on this point and what they entail for the narrative and policy conclusions.

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

I will begin by highlighting a few points. We have come quite a way and made important strides in our external sector surveillance in recent years. The External Sector Report (ESR) is now in its seventh year. We started out with a pilot, then a standard report. We have moved from informal meetings of the Board to engage, to a formal Board discussion this year. This year, for the first time, Mr. Obstfeld will launch the report with a press conference, and we will, through the Communications Department (COM), make other efforts to raise the profile of the report, which we believe is appropriate.

We have also gone to lengths to improve the presentation, the transparency, and we have spent all year trying to upgrade and improve the analysis underpinning these assessments. Many of the changes we have made have benefited from Directors' feedback, and we hope to get more feedback today. But with all the progress that we have made, we have to recognize that the analysis of external imbalances is inherently complex and subject to uncertainty. We will continue our efforts to find new approaches, incorporate new insights, take account of lessons learned. This was done in the refinement of the model this year, and will be an unending process.

I know some of the assessments will remain contentious, and there are and will be disagreements over the causes of the imbalances; but I believe it is an important report. The report's key objective is to alert the global community of the risks that come from these imbalances and highlight the shared responsibility to address them in a way that is supportive of growth and does not undermine global stability. That role is particularly important in the current conjuncture.

The Economic Counsellor and Director of the Research Department (Mr. Obstfeld) made the following statement:[1]

I would like to start by expressing my gratitude to Directors for their thoughtful feedback, as expressed in their gray statements. The difficult job of assessing external positions to address external imbalances before they become too risky, which is at the core of our mandate, is one that elicits strong opinions and often differences of views about their roots. This forum allows for an open discussion on what different member countries can do to address imbalances before they become too risky.

Let me respond and reflect on some of the general themes raised in the gray statements related to two issues: First, the characterization of risks from excess imbalances, especially when compared with last year's ESR; and second, the results of the methodological refinements that we have carried out over the year.

On the risks from excess imbalances, our analysis indicates that after narrowing in the aftermath of the global financial crisis, global imbalances have remained relatively unchanged over the past five years, although rotating toward advanced economies. Deficits are concentrated in the United States and the United Kingdom, with surpluses showing remarkable persistence in northern Europe and parts of Asia.

The current configuration of imbalances does not pose an imminent danger from the point of view of global stability. Let me be clear about that. However, as discussed last Friday in our World Economic and Market Developments (WEMD) discussion, plans by the United States to run a higher fiscal deficit will likely lead to higher U.S. current account deficits, with mirroring larger surpluses in the rest of the world. Procyclical fiscal policy may also result in a faster pace of monetary normalization, which could prove disruptive to emerging and developing economies, especially the more vulnerable ones, in part due to the interest rate effects and in part due to the exchange rate effects.

Meanwhile, limited actions by surplus countries, including China, Germany, Korea, and the Netherlands, suggest that these global imbalances will grow and persist over the medium term. We need deficit and surplus countries alike to resolve the problem of global imbalances.

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

Persistent imbalances, where debtor countries run deficits and creditors the reverse, which is the pattern we see, lead to a widening of stock positions and raise the likelihood of disruptive currency and asset price adjustments down the road. These price adjustments for debtors imply corresponding losses for the creditors, and if history is any guide, these large adjustments could have harmful effects on global growth.

Therefore, relative to last year, we see increased risks from policy actions that will exacerbate imbalances in key deficit countries, and from insufficient action by many excess surplus economies to address their own imbalances. The persistence of these current account imbalances is itself a risk, and it also leads, rightly or wrongly, to protectionist sentiment in deficit countries. An escalation of protectionist policies will come at the expense of domestic and global growth, but likely without much of an effect on imbalances, as this year's ESR analytical work suggests.

Imbalances are by no means a valid excuse for protectionism. As the report outlines, there are alternative ways for excess deficit and surplus countries to reduce imbalances. In fact, there is a strong case to work toward reviving liberalization efforts and strengthening the multilateral trading system, particularly to promote trade in services where pending gains from trade liberalization are substantial for all.

Having discussed the risks, I will now turn to the second set of issues related to this year's methodological refinement. In April, we presented to the Board the conceptual case for the refinements to the external balance assessment (EBA) models, which drew on Directors' previous feedback and insights gained over the past few years. Directors have now seen the model results, or as Mark Sobel from the United States said, they have tasted the soufflé; and while some may like it more than others, not everyone is fully pleased. Some may have wanted more butter. Others may have wanted more sugar. Others would have preferred to have kept it longer in the oven. I believe we can agree that this soufflé is better than the previous one and much better than not having dessert at all.

The model remains imperfect, but we do see these refinements as enabling a better starting point in the difficult job of assessing a country's external position. The model renders a more conceptually intuitive distribution of current account norms where countries with similar characteristics such as demographics, income level, and institutions, end up being grouped together. Yet, we continue to see a need for well-justified and transparently presented staff judgment. This will remain inevitable.

Refinements have allowed us to reassess and rethink the role of certain factors. In the process, we have learned that some previously applied measurement adjustors were not sufficiently grounded or that contributions to demographics appear to have been less than previously estimated. We share the view that the resulting changes to staff-assessed norms or gaps may pose a communication challenge, but not a reputational risk to the Fund. We are a learning institution, and it is natural to reassess our previous views. Instead, we see the reputational risks emerging from not addressing shortcomings in the methodology when they become evident.

Going forward, continued efforts will be necessary to incorporate new insights and lessons learned into our methodology. There are many areas that require further exploration, including to better understand the role of corporate saving, of pensions, of measurement biases, and of structural policies. Progress in these areas will also require increased collaboration with country authorities, including on the data front, where constraints remain significant.

Mr. Castets made the following statement:

We welcome the opportunity to discuss the latest ESR, which is a central piece of the Fund's monitoring of surveillance, which is at the core of the Fund's mandate. We also welcome the efforts made to raise the profile of the report with the press conference.

We issued a gray statement, so I will touch on two points for emphasis, first on recommendations, and then on the EBA methodology revision. We broadly share the staff's analysis and recommendations and we also fully subscribe to the presentation made today, particularly on the importance of recalling the risk adjustment. We commend the staff for the quality of the report.

Excess imbalances remain high. They may even widen in the near future given the expansionary U.S. fiscal policy; so we reiterate our strong view that protectionist policies would do more harm than good, hurting growth while having only a small effect on external imbalances. More generally, in light of the persistence of current account imbalances, especially on the surplus side, stock imbalances will likely widen, which could cause potentially disruptive adjustments further down the road.

Within the euro area, rebalancing is critical to ensure the stability of the currency union. There is, therefore, a need to recalibrate the policy mix in deficit and surplus countries. In particular, we strongly support the staff's advice to excess surplus countries with fiscal space to allow for greater fiscal stimulus, especially by boosting physical and human capital, as detailed in the staff's response to Question No. 9.

However, fiscal policy alone is unlikely to be sufficient to address persistent excess surpluses. Persistent surpluses need to be addressed through structural reforms, especially in currency unions where the use of the exchange rate is ruled out. In this context, we welcome the development of complementary tools outside the EBA model. There is clearly scope for product and labor market reforms to contribute to external rebalancing. That being said, more work is probably needed on what the optimal policies should be. This is not an easy question. For example, regarding labor markets, how could the consistency of the ESR and country-specific recommendations be improved when we know that reflation is needed in a country such as Japan, or that internal appreciation in countries such as Germany is recommended by the staff?

More generally, ensuring that the Fund's multilateral and bilateral advice remain well aligned is a key element of increasing the traction of policy recommendations.

Turning to the revision of the EBA methodology, I fully subscribe to Mr. Obstfeld's remark that the Fund being a learning institution can be seen as a reputational risk. We commend the staff for the excellent work on the revision of the EBA methodology, the new specification has stronger analytical underpinnings and produced well-behaved outcomes.

We see merit in the revision of the modelling of demographics, which have led to more stable current account norms, and in the treatment of measurement issues, which has been fine-tuned compared to the previous specifications relying on the financial sector variable.

That being said, we emphasize that methodological improvements should remain an ongoing and continuing process. On the net foreign assets (NFA) variable, as mentioned by Ms. Pollard, we would see merit in reexamining the case for including the NFA variable in the current account regression. The statistical significance of the NFA variable is closely linked to the persistence of external excess imbalances.

On corporate savings, we reiterate our longstanding views that additional work is needed. The 2017 ESR showed us that it matters greatly to explain current account imbalances, to understand persistent external current account surpluses, so in our view, better understanding is required on that aspect.

Mr. Kaizuka made the following statement:

I appreciate this valuable opportunity to discuss this important EBA exercise. Back to the soufflé terminology, I will not put wasabi in the soufflé, but rather add some sweetener to the soufflé.

We attach great value to the Fund's work on the ESR, as the exercise can identify the current account gap and underlying distortions in the country, and propose the proper macroeconomic policy structural reforms, which would solve the distortions and the imbalances.

In the case of Japan, although we are not fully convinced by the report's analysis of product market restrictions, we would make every effort to engage in labor market reform, including raising wages and fiscal consolidation, along with the Board's suggestions.

Second, we welcome the analysis of the impact of the trade policies, the trade costs, on the current account. The message that the current account balance is primarily macroeconomic in nature, and that protectionist measures will have only limited impact on external balances and a significantly deleterious effect on domestic and global growth—this message should be emphasized in the current juncture, together with our message in the World Economic Outlook (WEO) on protectionist developments. At the same time, the message that the linkage between trade costs and external imbalances is weak should not be used to justify any existing trade-distorting barriers.

Turning to the EBA's methodological refinement, we appreciate the longstanding effort by the Research Department (RES), the Strategy, Policy, and Review Department (SPR), and the area department, which is the Asia and Pacific Department (APD) in the Japanese case. We have continuous dialogue with the relevant departments; and those departments made a trip to Japan for outreach, which was greatly appreciated by our authorities. As a result, the EBA model has been refined, and room for adjustment was substantially reduced and evenhandedness was enhanced. Such adjustment factors like structural distortion or offshoring, which were applied only to the Japanese case, have been eliminated in this year's exercise.

But we would like to emphasize that no model can be perfect, and there may be a need for adjustment in the future; and in that particular circumstance, we should not shy away from a necessary adjustment. In relation to that, we ask the staff to work more to define the complementary tool and to make it clearer how the tool will be applied to individual country cases.

On the real effective exchange rate (REER) reassessment, we have a strong reservation, as we repeatedly emphasized in past discussions. It is logically not convincing to use the trade elasticities to calibrate the norm for certain countries with free floating currencies, where the linkage between the exchange rate and the current account is limited, and the exchange rate is to be decided by a massive capital transaction, not by trade-related transactions. There should be a completely different approach to these countries if it is still necessary to identify the exchange rate norm for these countries.

Mr. Palei made the following statement:

Mr. Obstfeld may not be aware of it, but we should be careful with our references to Mr. Sobel from now on. There will be a separate discussion on this topic by the Board. But I am not a big fan of desserts produced by the central government, as opposed to small, private bakeries, even if it is produced by the most enlightened ruler, like RES.

My comments will be limited to just one area of the methodology used in producing the ESR, and it is about the quality of institutions. Mr. Gokarn asked a question about the merits of using the World Governance Indicators (WGI) versus the International Country Risk Guide (ICRG) indicator produced by the private company, PRS Group. In the staff's written response to Question No. 25, the staff noted that the main argument in favor of using the ICRG was the length of the time series. While we understand this rationale, we believe that other considerations, not just convenience for regression analysis, should play a role in the choice of the third-party indicators (TPIs).

In our gray statement, we also commented on this choice and raised whether it is appropriate for the Fund to promote the sales of private company products. The PRS Group says on its website: "Our results are consistently and independently back-tested for relevance and accuracy by such organizations as the IMF."

We did not ask this question in the gray statement, but we would like to know the staff’s opinion. Is this an accurate statement? Is it ethical from the Fund’s point of view? In the digest produced for Fund staff, the disclaimer clearly states, “Staff is not able to assess conclusively the validity, reliability, and impartiality of each indicator.” We feel there is a contradiction between what the PRS Group says on its website and how we use these indicators and how the guidelines advise the staff on using them.

However, there are other considerations as well, for example, those related to transparency, mentioned by Mr. Lipton. The methodology used by the PRS Group is available only to the subscribers, so the public and the users of the ESR, including their authorities, do not necessarily have access to this methodology. Another consideration is that we have no idea what experts this company is using. We do not know who these experts are, what kind of experts they are, and so on. For example, when we deal with the Doing Business Indicators, we know who the experts are, what they are experts in, and we know their telephone numbers. We can call them. We know their addresses. In this case, it is a complete black box.

On the broader topic of the TPIs reflecting the quality of institutions and governance, there are other indicators such as people’s trust in key country institutions; and this issue of trust was raised by the Fund and was discussed in the recent Annual and Spring Meetings. Other more actionable indicators would be the progress and development of electronic government, and countries like Estonia and Finland are leading the pack; while India or Mexico ranked better than some of the advanced economies. Maybe this is also a good measure of the quality of governance and institutions.

I understand we are not at the end of the journey. It is a long journey for us. We can improve it further, but I would like to hear the staff’s comments on the choice between the WGI and the ICRG.

Mr. Jang made the following statement:

I thank the staff for a helpful and informative set of papers. Given the increasing prominence of the ESR since its inception, it is critical that the key messages from the report are clear and framed to maximize traction. The ESR’s most important contributions at the current juncture are lowering trade costs in order to address the inefficiencies that affect national saving and investment. Protectionist policies should be avoided, as they will have a limited impact on external balances. Foreign exchange intervention played a limited role in driving excess external imbalances in the periods examined, and domestic policies can play a more prominent role in tackling excess global imbalances.

We also agree with the staff's view that the non-zero external imbalance from both an individual country and global perspective can be necessary and beneficial over the course of economic evolution. We appreciate the staff's efforts to enhance the presentation of the result by using more neutral language and including cross-country comparison tables, but given the increasing prominence of this report among consumers outside the Fund, there is more to be done to ensure that the results generated are both robust and firmly and clearly understood, including the extent to which there are limitations. In this vein, we need a continued effort to both refine the EBA model and increase the transparency of staff judgment. The prepared models should be viewed as continuous and evolving. Specifically, we must continue to search for more relevant variables to strengthen the explanatory follow-up to the model.

My Korean authorities suggested as one of the candidates based on the fact that countries with high manufacturing share tend to have current account surpluses due to the role they play as providers of capital goods in the global value chain. We would be grateful if the staff could explore this aspect further in future work.

Measurement in the balance of payments sector is another important task we have to address for the analysis to be more rigorous and evenhanded. That being said, we recognize the inherent limitation of all models, especially when applied across a broad range of countries. While they can be a useful tool to inform and guide our analyses, they can only be an imperfect representation of reality; and therefore, the staff's judgment remains essential in external assessment.

Notwithstanding the progress made, we still see room for improvement when it comes to increasing the transparency of the staff's judgment by providing a more detailed justification for the staff's assessment. We would have preferred more detailed and specific explanations of why country-specific adjustors were applied and in what circumstances.

Mr. Ostros made the following statement:

We thank the staff for a good report on a complex topic, which I find well balanced and nuanced. There may well be differences in views in the Board, but I believe we all agree on the value of the ESR as a global public good. I also thank the staff for their openness to discuss the modelling. It is valuable to have that exchange of views with the staff.

This year's assessment shows that global external imbalances remain excessive, and this is a potential source of vulnerability to the global economy. As the automatic adjustment mechanism seems to be weak and policy actions have clearly fallen short of addressing the needed adjustment in both surplus and deficit countries, global flow and stock imbalances will continue to widen in the near-term.

One major change since our discussion last year is that the major deficit country, the United States, has changed its path, choosing a strongly expansionary procyclical fiscal policy, thereby further contributing to a widening of imbalances. The United States will become an even more important contributor to global and current account deficits because of its fiscal easing. The projections that the U.S. deficits will grow to about 17 percent of GDP over the next five years is worrying not only for the U.S. economy, but also from a political sustainability perspective.

I welcome the staff's analysis showing that protectionist policies do not have much direct effect on the excess global imbalances, but they do have significant spillover effects in terms of weaker growth potential, not least for developing countries. We support the call for strengthening the multilateral trading system and agree with most Directors that unilateral protectionism is not the solution.

We continue to encourage countries to ensure that excess imbalances are addressed in a growth-friendly manner with decisive policy actions. Next year, we will probably have a situation where there is an increased current account deficit in the United States and maybe an even stronger call for expansionary fiscal policy in Germany and other countries with surpluses.

It is also time to take into consideration the risk that comes with that policy advice, if we think that we are heading toward the next recession and should not deplete all the buffers that we have. I would like to hear Mr. Obstfeld's analysis on this. Should we, because of expansionary fiscal policy in the United States, be even stronger in demanding expansionary fiscal policy in other countries?

I welcome the recent refinements to the EBA methodology, even if the results indicated, as noted by Ms. Pollard, that the fountain of youth has not been located in Sweden. That is a pity. They have this time been focused on the EBA current account model, and the updates represent a step forward in delivering a more reliable assessment tool.

However, it is not the last step, and we highlight that the EBA model refinements are part of a continuous effort to maintain and improve key tools for rigorous external sector assessments. The role of merchant trading has to be investigated further. The translation of the current account gap into the REER using trade elasticities also needs further work and even more transparency. This exercise has shown that the deeper we go into the EBA current account model, the more it becomes clear how challenging it is to find models with high explanatory powers, and how necessary the staff's judgment is when assessing the external balance of individual countries. Therefore, I repeat that it is crucial to ensure that country teams continue to make relevant, transparent, and well-documented adjustments and that we continue to use the model result as a basis for our discussion but not as the sole truth. The risk estimates from the model should not be used in a mechanical manner.

To conclude, I want to highlight that providing multilaterally consistent external sector assessments remains a complex but important exercise, and we thank the staff for their work.

Ms. Horsman made the following statement:

We also thank the staff for the latest edition of the ESR and their efforts over the past year to enhance the analytical underpinnings of external sector assessments and to expand the report's coverage of issues that are currently attracting global attention. We have long supported this exercise, which lies at the core of the Fund's mandate, and find that it is more important than ever at the present conjuncture.

With escalating trade tensions and uncertainties regarding the future of trade arrangements more generally, external assessments based on a common analytical framework and consistent evenhanded treatment of country-specific considerations can facilitate a more grounded discussion on solutions. A broad-based disorderly unwinding of excessive global imbalances would penalize all countries. The Fund, through the ESR and other surveillance products, has a central role in identifying these imbalances, estimating their impacts on both individuals and the global economy, and communicating compelling cases for domestic policies that help societies transition to more productive and sustainable futures.

We commend the marked strengthening of the ESR over the past year, and we believe it can go even further. This includes greater candor on projections of the potential costs and distributional implications of counterproductive measures or disorderly adjustment of imbalances; greater detail on staff adjustments to model-driven results; greater focus on policy advice that would spur more timely action; and finally, more candor on where data gaps prevent more fulsome analysis.

But ultimately, the decision to act is a political one. This chair has been calling for greater visibility of the ESR to elevate the debate. We welcome the press release, but we still need to ensure that the messages both reach and resonate with our leaders.

We have two practical suggestions. First, we should think about how to succinctly update Governors prior to the Annual Meetings. Integration into the flagships is one step, but perhaps a brief annex in the Global Policy Agenda (GPA) or a one-pager would have a higher, more-targeted readership in addition to the flagships.

Second, how do we get Governors to debate the key issues in a constructive manner? Perhaps the Early Warning Exercise could be used to set up the discussion this year. Can we orchestrate a discussion whereby Governors highlight important adjustments they are making to a more balanced global economy?

Mr. Inderbinen made the following statement:

I thank the staff for the new edition of the ESR and the hard work, including on the refinements to the EBA methodology. We issued a gray statement, so I will limit myself to a few overarching remarks.

First, country-specific information and staff judgment remain an integral part of external sector assessments. There has been progress in modelling current accounts and real exchange rates, but models can only capture so much, and it is important for the staff to ensure consistency and transparency when exercising judgment and when including country-specific information.

Second, we continue to believe that we should not put too much weight on the current account model. At least for some countries, real exchange rate models give more information about the external position than the current account model does alone. The analysis would also benefit from a greater focus on stock positions, and particularly valuation effects, as well as capital flows and the financing of the current account deficit.

Third, we welcome the complementary tools to account for structural policies. As Mr. Ostros and Ms. Sun put it in their gray statements, structural reforms are bound to play a greater role at this stage, as output gaps are closed and buffers need to be strengthened.

Fourth, we would like to echo Ms. Pollard's point on the need to discuss external sector issues in greater depth in the body of staff reports, instead of just inserting the country page as an annex. There appear to be marked differences in this practice across countries. We understand that the staff can prioritize topics in bilateral surveillance, but assessing external stability lies at the core of the Fund's mandate.

Lastly, we urge for caution in the way that current account gaps are translated into exchange rate gaps using trade elasticities, and we do note from the answer to Question No. 41 of the written responses that the staff is considering presenting elasticities estimates in future ESR reports, and making methodologies and estimates public in a forthcoming working paper. We urge the staff to follow through on this and to publish the elasticities used to translate current account gaps implied into current exchange rate gaps.

Mr. Meyer made the following statement:

We thank the staff for the informative and concise report. We have issued a long gray statement in which we have included a number of more detailed technical comments. I will try to avoid those and focus on a few general remarks.

We fully support the work. We thank the staff for the extensive outreach, and we stand ready to give input to further improve the methodology. My main point is that both surplus and deficit countries have their role to play in reducing global imbalances. However, we are worried that despite the favorable global growth environment in both deficit and surplus countries, fiscal policies remain too loose, and there remains a sizeable negative global fiscal gap. Given this, we see a need to put a strong focus on domestic policy gaps.

This ESR is also the opportunity to test the recent refinements of the EBA model. Having a multilaterally consistent assessment of external positions is a challenging endeavor, as many Directors alluded to, and we appreciate that the staff continuously strives to improve the EBA. However, even after significant methodological refinements over the years, residuals that cannot be explained by fundamentals or policy gaps remain large. While we acknowledge that the recent refinements seem to have made the EBA model a better fit for a number of countries, this cannot be said for other countries, for example Germany, where the largest part of the EBA gap cannot be explained. In this regard, I also join Mr. Inderbinen in calling for caution when interpreting residuals. The staff should avoid automatically equating unexplained current account gaps with distortions, and recognize that residuals can also be explained by fundamentals that are not adequately covered by the model. I was a bit concerned by the answer given, where there is a presumption that the gaps from the model are distortions. That should be up to the judgment of the country desks that know the case best.

Overall, the staff should stay mindful of the limitations of the EBA model and rely on staff judgment as an integral part of the analysis. When applying judgment, the staff must be careful to ensure consistency over time and countries. Here we see room for improvement, as pointed out in our gray statement in more detail.

I would like to support two more points that Mr. Agung made in his gray statement, and those were convincing. First, he made the point that current account balances consistent with the norm are by no means a clean bill of health, especially the results from directionally offsetting policy gaps. This is acknowledged in the report, but that might be a topic that should play out more clearly going forward because it is an important point.

The next point that I want to underline is that we are not totally convinced that the external position is the best anchor for a domestic reform agenda. For example, when asking for structural reforms, we would agree with Mr. Agung that this should be centered around domestic policy objectives, particularly in the case of structural reforms where implementation challenges often stem from domestic political economy constraints.

We would welcome further work on the effect of corporate savings and the current account. That is an important topic to identify gaps.

Finally, we welcome the progress that has been made toward more neutral language, even though we still see room for further improvement. We do not see the need to speak of excess imbalances, as the word imbalance already implies the excess. While we acknowledge the importance of maintaining consistent language across all Fund products, we encourage the staff to continue striving for a more neutral presentation. It is quite interesting, if one reads the Main Themes in Grays, the first and second paragraphs discuss global imbalances, and it is clear that presentation is not consistent because one is talking about the descriptive part, the other one is discussing the normative part, and both talk about global imbalances.

Mr. Spadafora made the following statement:

First, I would like to congratulate the staff for an excellent report, which adds a powerful voice to the risks that protectionist policies are posing and demonstrates that they are a zero negative sum game.

I have a few technical comments. Overall, we agree with the assessment of Italy's external position in 2017, and we welcome the recent revisions made to the underlying EBA methodology, which in part reflects some issues raised by our chair last year, and which have led to more plausible estimates of current account gaps for Italy than in the past.

We also appreciate the effort made in the 2018 ESR and its technical supplement to increase the transparency of both the EBA methodology and the staff's judgment, as well as to improve the effectiveness of the presentation of results. For example, we welcome the recap of calculations and figures concerning the current account in the individual economy assessments, and we would recommend that the same recap be introduced also for the Regional Economic Outlook.

In the future, it will be desirable to avoid volatility in the norm due to either data revisions or methodological changes, as it limits the possibility of building a reliable time series of imbalances for a given country.

The two REER models, including the EBA, have also been refined so as to be consistent with the corresponding variables in the current account model. However, the fit of both models has marginally deteriorated, continuing the need for more a more general refinement of the REER regression framework as well.

Partly as a result of this weaker explanatory power, the 2018 ESR, similarly to past editions, assigns a smaller weight to the REER estimates than to the current account estimates. Yet an acute appraisal of external imbalances requires a comprehensive approach that jointly considers several reliable models, including the REER regressions. Indeed, given the manifold assumptions underlying all models, no model in particular, if properly constructed and estimated, should be considered superior, nor should estimates derived from non-current account models be dismissed without convincing justifications.

Finally, I want to mention something that Mr. Leipold, who is in Italy for the Article IV consultation, sent me by email a few minutes ago. It is a quote from one of the two gentlemen whose busts are in this Board room, Mr. Keynes, which elaborates on the automatic adjustment and blamed, "impoverishment and social discontent and even wars and revolutions on the secular international problem of balance of payments imbalances." It traces this failure to a singular characteristic of almost all international monetary systems over the past 500 years—namely, that they place the main burden of adjustment on the country which is in the debtor position in the international balance of payments. He believes that this remains the case, as well evidenced by the ESR.

Mr. De Lannoy made the following statement:

We issued a gray statement, so I will focus on a few key issues. First, we thank the staff for the comprehensive and well-drafted ESR. The report clearly analyzes the evolution of actual and so-called excessive current account gaps in 26 systemic economies. We also welcome the limited and cautious analysis of REER gaps in the main report. However, like other empirical analyses, external sector assessment is subject to a level of uncertainty. This uncertainty could be better reflected in the report by presenting all the results as ranges rather than point estimates. Uncertainty also suggests interpreting current account and REER gaps as a mixture of imbalances and uncertainty, rather than imbalances only. For example, the change in the so-called excessive current account gap of the Netherlands following the refinements mainly reflects changes in our understanding. Future refinements may shrink the so-called excessive gap again.

The uncertainty embedded in formal models also highlights the importance of country team judgments and why multiple models should be used instead of an institutional preference for a one-size-fits-all model. Like several other Directors, we caution against overreliance on the current account model only.

Finally, the ESR covers 26 systemic economies and leaves a group of 23 other economies in a position where the results are partially reported as point estimates in some tables. Like Ms. Erbenova, we encourage the staff to include more data on the adjusted ranges of gaps in the other 23 countries to enhance transparency and ensure evenhanded treatment of all 49 EBA countries.

Last but not least, I would like to support Ms. Horsman's suggestions to increase the visibility of the research with our Ministers and Governors.

Mr. Agung made the following statement:

I thank the staff for a comprehensive set of papers. We issued a gray statement, so I would like to limit our remarks for emphasis.

Our chair agrees that persistent external imbalances are suboptimal and could pose risks to global stability and growth in light of a big automatic adjustment mechanism. We support additional analytical work on how external imbalances affect global growth and constructive dialogue on how they can be addressed. We view this rebalancing process as a shared responsibility among all countries, rather than putting the onus on surplus countries.

Economies with excess deficits may have more incentive to adjust, not because of the multilateral effect on their imbalances, but because of domestic sustainability concerns. In this vein, a more powerful way of catalyzing action in surplus countries is to make a stronger case for why a staff policy recommendation makes sense domestically, as echoed by Mr. Meyer. This means that the recommendation has to be calibrated based on domestic circumstances and should aim at promoting sustainable and inclusive growth. We believe the staff has been working in this direction, and we encourage them to continue.

Before I conclude, I would like to touch on the analytical framework underpinning the ESR. Despite refinement, the regression residual remains largely accounted for by the EBA estimated gap. As such, we join other Directors in underscoring that staff judgment remains essential as long as it is done in a transparent and consistent manner.

More importantly, we reiterate our position that caution should continue to be exercised when interpreting the results of model-based assessment to ensure effective policy advice.

Mr. Hurtado made the following statement:

We also thank the staff for the report. Our chair was supportive of this line of analysis, and we issued a gray statement along those lines. I also wanted to thank the Acting Chair and Mr. Ostros for their initial remarks, which were very useful.

I did not intend to speak, but I was convinced to do so because of these initial remarks. However, I would like to repeat a point from our gray statement. Although they are useful tools, neither the EBA nor the ESR can provide unequivocal answers and exact information about the excessiveness of external imbalances; and I believe this is consistent with what has been mentioned by other Directors.

The approach that Mr. Ostros took in his initial remarks was important, because after reading the report, I thought it was rich in terms of analysis and the results and the different comparisons; but frankly, it could have benefited from more on the possible consequences of the results. The results are clear, but what happens afterward?

There are at least three consequences of those results. Some of them are treated scarcely, but they are certainly there—for example, the risk of protectionism or the risk of faster monetary tightening because of excessive or borderline external imbalances. I can also think of the risks that we emphasized this morning in the European Union session, in which there may be externalities in growth for certain neighbors when imbalances are excessive in certain countries. But frankly, Mr. Ostros made important points about the risks when these imbalances accumulate and then there is a net asset position which is very positive or very negative, and he used the words "risk of price adjustments down the road." This is an important point, and it is a bit speculative what may happen; but some examples of that would probably increase the visibility of the report, as was suggested by Ms. Horsman. That would be useful, because when I see some of these imbalances accumulate and persist, I wonder what may happen, and I wonder what kind of price adjustments may present themselves down the road.

Mr. Armas made the following statement:

We thank the staff for the 2018 ESR and the supplements and for the important effort made to improve the EBA model with the 2018 refinements. We take positive note of the enhanced transparency of the report's process before its result were presented. We issued a gray statement, and after reading the staff's written responses, we have four additional comments.

First, the EBA model and the staff adjustment is our best way to address external imbalance, but the complexity of the task calls for a humble approach; so there are two concepts I want to stress. One is that we agree with and recognize the staff's efforts. We are on the frontier of trying to make that assessment, but further work is needed on issues such as the quality of data, country specificities, definition of gaps, desired policies. These call for a humble approach.

We welcome the candid details of the EBA results, but at this stage the most controversial issue is that almost half of the estimated global external imbalance are not explained by fundamentals or desired policies.

Second, we believe further work is needed to reconcile the current account norm, which is a flow variable, with the relevant stock variable states, NFA, as shown by Question No. 48 about India. Also, the composition of external asset and liability is relevant in this regard. It is different in a country which has only short-term external debt. We believe that the country with the same characteristic, but 100 percent of the FDI as an external liability, the adequacy of international as percentage of any relevant metrics, GDP, import, or external debt, in a steady state should be made consistent with the definition of the foreign exchange intervention gap. In addition, foreign exchange intervention can smooth global external imbalance depending on specific country circumstances.

Third, we believe that models are useful tools to estimate economic behavior, but judgments are also necessary; and judgment always should prevail in any model. Judgment is important, but given that judgment is made by the staff, who study many countries, we have to be cautious about that. I am speaking about Question No. 33 regarding the comparison between Australia and Canada, where I notice the different views of each team country; so there must be an effort to talk among the staff and get some consensus about applying the same criteria for similar characteristics.

Finally, the policy recommendation of each country should be comprehensive with only one consistent message across different reports—either Article IV reports, the ESR, or the flagship reports. It may happen that a policy action to face domestic macroeconomic challenges may be different, particularly in the short-term, than policy actions needed to close the current account gap. The ESR document should avoid making a policy recommendation that contradicts Fund advice in other documents.

For instance, in the case of Argentina, on Table 5 on page 35, there is one recommendation regarding the fiscal policy which calls for a more ambitious medium-term consolidation plan. My question is, does it mean that fiscal policy should make additional adjustment beyond the one established in the recent economic program, or is it after the fiscal changes resulting from the last Article IV consultation?

Mr. Gokarn made the following statement:

I thank the Chairman for the opening remarks—very useful in setting the context—and we thank the staff for the report itself and Mr. Obstfeld's opening remarks. We issued a fairly detailed gray statement. We have a few points to make for emphasis. Three of them are related to methodology, and one is related to the summary table, Table 5, which translates results into policy recommendations.

First, we had a question on the impact of increasing trade costs through multi-country imposition of trade barriers on global excess imbalances. The staff's answer is based on data up to 2014, but the question was about the prospects of trade costs and global imbalances following current trade barriers being put up by major trading countries and areas. We wondered whether the staff had done any scenario building to make some assessments about the current situation.

Second, there has been considerable criticism of the Quinn index, and we are a bit disappointed that no refinement of this particular aspect of the ESR was reported in this paper. Given that the Fund has detailed information on the competence of this index, we wondered whether it is part of the work plan to develop a more sophisticated measure.

Third, I would like to reinforce Mr. Palei's comments on the choice between the ICRG index and the WGI. We appreciate the need for a longer time series for this modelling; but given that the ICRG indicator is a perception-based index, there is a question about whether a long time series of perception-based indices have more information content than relatively short, presumably somewhat more objective, indicators.

On the table itself, I note that there are 10 countries which are categorized as having broadly consistent outcomes; but only one, India, has no recommendation on the fiscal policy front. This must be the only time in the Fund's history that it has remained silent on India's fiscal situation, and that is going to last perhaps for the next two days when we get to the Article IV report; but I am wondering why for the other nine—where there is a broadly consistent outcome—the recommendation is for gradual consolidation, which is more in line with a country that has a moderately weaker outcome. Similarly, if we are to compare countries that are rated stronger, Malaysia, for example, with the Netherlands—the Netherlands is substantially stronger; for a stronger situation, one would expect what is indicated here, that an expansionary fiscal policy is required. Then why is Malaysia being asked to consolidate, even though its external balance is stronger? In terms of communicating these policy implications, some reconciliation of these relationships needs to be established.

Finally, I want to make a point about terminology, which I made in the earlier discussion. Stronger and weaker is a bit misleading, because stronger is an aspiration. Weaker is something one wants to avoid. But here it is a metric around the mean, so one wants both the stronger and the weaker countries to adjust toward the center; and that is not coming out if the staff categorizes countries as stronger and weaker in this debate.

Ms. White made the following statement:

I thank the Chairman and Mr. Obstfeld and his colleagues for their report. We issued a gray statement. I will just make a few points for emphasis.

First, we broadly agree with the staff's analysis. We note the persistence of external imbalances and welcome the Fund's ongoing vigilance, for these imbalances signal risks which may pose a threat to global stability and long-term sustainable growth.

Second, we welcome the improvements to the methodology and note Mr. Obstfeld's assertion that as a learning institution, we should expect the EBA methodology to adjust to changing realities, and in light of experience, we believe this is a sensible approach.

Third, on trade, we welcome the work done by the staff to examine the link between trade costs and current account balances. Mr. Gokarn has just asked an interesting question in this regard. We also welcome Mr. Obstfeld's remarks regarding trade and services liberalization. We agree it is liberalization rather than protectionism that will help foster growth and reduce risks more generally.

Finally, we commend the staff for the outreach and increased prominence of the ESR this year. We would also encourage the staff to continue to look for opportunities to increase transparency and accessibility, and Ms. Horsman's suggestions merit further consideration.

Mr. Jin made the following statement:

This is an important and helpful exercise, but this is also a complicated and challenging task for the staff to undertake. We cannot ignore the assessment, but we cannot wholly accept the assessment without any doubt or caution either.

In recent years, despite the continued narrowing of China's current account surplus and the progress made in rebalancing the economy, the EBA estimated gap persists, and even increased in 2017. From 2016 to 2017, China's EBA estimated current account norm experienced a directional shift from a surplus of 0.2 percent of GDP to a deficit of 0.3 percent of GDP, representing a seemingly small but important directional change. To many readers, the reverse in direction has called the seriousness of past estimates into question and raised uncertainties over the latest estimated current account norm, and this is perceived by many as a moving target. Despite the continued narrowing of China's current account surplus in recent years and the progress in rebalancing the economy, the EBA estimated gap persists and increased in 2017.

We continue to emphasize that the norm should be used only as a reference in the Fund's surveillance and should be interpreted cautiously. Historically, it is easy for both a current account surplus country and a deficit country to shrink or reduce their surplus or deficit, but it is difficult to shift completely from surplus to deficit or vice versa. Staff estimated that the current account norm for the United States is minus 0.7 percent, which is quite small; but I do not know whether the staff has considered the fact that as the major reserve currency issuing country, if the deficit were to shrink to such a small size, what would be the impact on the international monetary system?

Over the past several decades, the largest surplus countries have changed from one country to another; but the largest deficit country has remained the same. My question is, if the U.S. current account balance were to shrink to minus 0.7 percent, will there be a shortage of the dollar as we experienced in the 1960s, and will the Fund want to issue SDRs again? This is an issue that needs to be explored by the staff in the ESR.

Ms. Pollard made the following statement:

This chair has long been both a supporter and a critic of the EBA and the ESR. Our criticisms, however, were never aimed at changing the assessment of the United States, but simply to improve the accuracy of the modeling. We agree with others that there will never be a perfect set of products, and at the same time, we will continue to press for improvements. But that being said, the methodology, analysis, and transparency have come a long way since 2012; and we believe the latest methodological changes have resulted in a better, if not perfect, soufflé.

The staff is to be commended for their efforts and their responsiveness to our concerns. We encourage the staff to continue to examine issues such as measurement and structural factors, including corporate savings. We also urge member countries to provide better information to the staff, particularly with respect to intervention data, to improve the accuracy of the model. Like Mr. Ostros, we agree that the ESR is a global public good. This year's report again highlights the persistence of excessive current account surpluses and the asymmetry of the adjustment process. This can be seen by the dispersion of the current account gaps in Figure 6 in the report. No deficit countries have external positions that are deemed substantially weaker than justified by medium-term fundamentals and desirable policies, while five surplus countries have external positions substantially stronger than justified.

As Mr. Leipold and Mr. Di Lorenzo noted in their gray statement, this issue of asymmetric adjustment has been longstanding. Because of its size and openness, the United States has often played the role of importer of first and last resort. In the pre-crisis period when the U.S. current account deficit reached upward to 6 percent, we often heard calls for the need to reduce the deficit. Yet no country wanted to see a reduction in its own bilateral trade surplus with the United States. What we are now seeing is the United States taking bilateral action to address these imbalances because of its perception of the failure of the multilateral system to do so.

Mr. Saraiva made the following statement:

We thank the staff and Mr. Obstfeld for their hard work. This chair has been supportive of this work since its inception. It does not mean that there are not reasons for criticism and improvement, and I believe that the refinements that have been proposed so far seem to go in the right direction. We issued a gray statement, and I will touch on one question we raised.

But first, I would like to agree with what Mr. Ostros and many other Directors have emphasized—that we need to be modest about the results that come from the model, and in the end judgment continues to play a key role in defining the estimated norm for each country. The issue that we raised with the introduction of the refinement is that we see a flattening of the distribution, especially the new specification, which countervails the previous result—and so with the new model there are smaller surpluses and smaller deficits in terms of the norm. But what is not yet clear is if the adjustment that the staff makes to reach the norm has decreased with the new specifications of the model, and that is the question we asked the staff. This would be a good way to assess if the refinements have improved the estimate that the model is able to provide.

The Economic Counsellor and Director of the Research Department (Mr. Obstfeld) in response to questions and comments from Executive Directors, made the following additional statement:

There was an interesting point raised about the exchange rate's role and how it is being moved by capital versus trade account factors. Because exchange rates are so volatile, we rightly place less emphasis on that part of the model, but the underlying philosophy is that even though capital account fluctuations will move exchange rates in the short run, over the medium-term these movements depend on longer-term expectations, and those expectations are tied down by the need of external balance; so that is the fundamental philosophy underlying this. Of course, the devil is in the details, but we believe we are on firm ground linking the exchange rate to the current account.

On the issue of manufacturing share as a determinant of the current account surplus, I would advise caution because there is reverse causality. Countries with high spending relative to income will, all other things being equal, have smaller manufacturing sectors, because only the service sector can provide the amount of non-tradables demanded with the tradables being imported from abroad. It is certainly true that we see this correlation between manufacturing sector size and the current account, but which direction the causality runs is not clear. I would not want to take the manufacturing sector size as an exogenous determinant in our model.

On the question of fiscal policy recommendations, while we recommend that excess surplus and excess deficit countries alike must participate in the adjustment process, how much fiscal adjustment is needed depends on where countries are in terms of their domestic fiscal needs and the optimal fiscal policy. Countries which need to rebuild buffers but are nonetheless running deficits will be judged to have excessive current account deficits for that reason and should be retrenching fiscally, whereas those with more adequate fiscal space may have more room to expand. It is important to distinguish between what one might call a procyclical stimulus versus fiscal policies that may expand productive capacity in the longer run. I believe we should look at these very differently.

We keep debating the terminology problem, and I wish we could settle on something that everyone agrees on and that is not awkward-sounding; but, in our view, an imbalance is not a normative concept. It is just a non-zero balance. We do not view an excess imbalance as a redundancy. Of course, this is debatable; and I would like to come up with a better terminology, but terms such as an excessive non-zero balance, excessive positive balance, excessive negative balance, would be awkward, and theory tells us that not every imbalance is necessarily bad.

Finally, I want to make one point about stock disequilibria. It is important that the ESR over several cycles has started to focus more on these. It is an interesting fact that if one looks at ESR countries between 2017 and 2010, there is a strong tendency for countries that are net creditors to run current account surpluses over that period. This is clearly a recipe for an expanding asymmetry in wealth across countries, and eventually countries need to reduce expenditure within the envelope of the budget constraint, and these processes are not sustainable.

One big mitigating factor is that valuation adjustments tend to offset the increases in assets by creditors and in liabilities by debtors. There is a nice recent IMF working paper by Mr. Adler and a coauthor which demonstrates this. The offset is not enough to eliminate the divergent distribution of wealth, but it plays some role. This is a context in which one would want to consider how we think about different forms of financing of the current account—debt versus portfolio equity versus FDI—because this is one way in which these valuation effects will manifest themselves. Also, exchange rate effects will clearly be important.

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

I will address a few questions and allow my colleagues to add further. My plan is the following. I will make some comments about the policy traction. This was raised in the gray statements as well as in some of the interventions. I will also speak about the consistency of our policy advice and questions raised about Table 5, and end by making a comment about the use of TPIs, in this case the ICRG. Mr. Adler will comment on issues related to global value chains, the role of merchanting and how that affects assessments, as well as some of the data challenges that we are currently facing in the process. Mr. Kaufman will speak about the role of trade barriers and some of the work that is ongoing on this issue. Finally, Mr. Rabanal will comment on our work on the real exchange rate models and the tensions that exist with the current account models, as well as some of the elasticities that we have been estimating and our plans in that regard.

Let me turn to the issue of the traction of our policy advice. As previously stated by both Mr. Lipton and Mr. Obstfeld, we see the ESR as a report that warns of the risks related to global imbalances and the shared responsibility of the membership to address them in a way that is conducive to global growth. We find in the report that progress in reducing global imbalances has been limited, but that also masks a great deal of heterogeneity since imbalances have actually rotated toward advanced economies. We have seen progress in the reduction of excess deficits in some European countries, namely Spain, Portugal, Italy, which have moved from running deficits to running surpluses; and in some cases that adjustment has been supported by important structural reforms that have led to a reduction in unit labor costs, namely in the case of Spain.

Similarly, we also have seen some key emerging economies like Brazil, Indonesia, and South Africa, reduce their internal and external imbalances since the taper tantrum episode, through a combination of fiscal discipline, exchange rate flexibility, and structural reforms. It is clear that in these excess deficit cases that I have just highlighted, markets have played a disciplining role, a feature which is absent in excess surpluses cases. This is an important reason why we have asymmetries in terms of the pace and urgency of external adjustments.

That being said, some surplus countries have reduced their excess external imbalances, but they remain persistent and large in many cases. In a few cases where those excess surpluses have come down, they have come at the expense of domestic imbalances and vulnerabilities.

The fact that excess surplus countries do not face market discipline pressures does not justify complacency, and this is a big point we want to emphasize. Corrective actions that encourage investment and discourage excess savings would not only close external gaps but, more importantly, also close domestic gaps and over time lead to higher productivity and potential growth. We see our recommendations as necessary not only to address excess external imbalances, but also address domestic shortcomings.

We also agree that structural recommendations need to be much more granular and country-specific. We are not saying that product market reforms refer only to surplus economies. Labor market reforms can be important in the case of surplus countries as well, especially if they lead to higher wages, more labor force participation, and discourage excess savings. We make these types of recommendations in the case of both Germany and Japan.

Finally, in terms of the traction of our advice, it is also true that not all deficit countries are alike and that market pressures will vary, including depending on a country's creditworthiness and reserve currency status. This also should not breed complacency, as growing debtor positions in key advanced economies could end badly and become globally disruptive with negative implications for debtor and creditor countries alike.

On the issue of traction, there are policy areas that merit further exploration and a better understanding. The rise in surpluses in many advanced economies has been associated with a rise in corporate saving. Understanding why corporations are saving an increasing share of their profits is critical to formulating better policy advice. In this regard, more and more we need to ask questions like can tax policy encourage the distribution of dividends? Do corporate governance rules properly protect minority shareholders, who generally are more inclined to want dividends (instead of retained earnings)? Where the ownership of corporations is dominated by small or unlisted firms, what are the policy options there? Why is the corporate veil not being pierced or why the saving by corporations not being offset by households? And to what extent is this behavior underpinned by the skewed distribution of wealth? These are questions that we need to ask ourselves in determining how to address these imbalances in some surplus countries.

I would like to turn to the issue of the consistency of our policy advice. What Table 5 tries to do is summarize the policy advice that is included in the ESR page, and it is not necessarily exhaustive of all of the Article IV recommendations. There could be situations in excess surplus countries where, in the case of Malaysia, we may be recommending fiscal consolidation because its public debt level is high; yet also on the structural side we recommend policies to expand the social safety net to discourage excessive precautionary saving . Again, the policy advice is very country-determined and needs to be tailored. To say that a country has an excess surplus does not necessarily mean that it needs to expand the fiscal position, and that very much depends on public debt levels, et cetera.

In the case of Argentina, we see the current fiscal plan as appropriate to reduce excess imbalances, and we will look again at the formulation to see whether this needs to be clarified.

I will now turn to the point related to the use of TPIs, specifically, the ICRG. We conducted careful analysis related to the adequacy of the ICRG. In doing so, we looked at the adequacy of this indicator and compared it to the WGI, which is produced by the World Bank, the Brookings Institution, and the National Resources Institute. We found a close correspondence between the ICRG and the WGI. We stuck to the ICRG because of its much longer time series. We have data available since the mid-1980s, whereas in the other case (WGI), the data only start in the early 2000s. We also opted in the context of the refinements, to expand the set of indicators within the ICRG, where we included now the role of government stability, regulatory quality, which are indicators that are used in the WGI. In making this decision, we benefited from the work that the Fund has done on the third-party digest, and this allowed us to ascertain whether we would choose one versus the other.

On data availability, Directors have access to this data via the IMF library, and the public can also look at these indicators relative to the world average.

On the ethical issue that was raised and the fact that the IMF is explicitly mentioned on the PRS Group web page, our plan is to consult with the Legal Department and respond to the Board.

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

Some Directors asked about the consistency and evenhandedness in the application of adjustors for measurement, so I will elaborate on why we see our approach as broadly meeting these goals of consistency and evenhandedness.

As we discussed in the context of the EBA refinements earlier in the year, the relevant concept for external assessment is the real accumulation of external wealth by domestic residents. There are two prominent ways in which the existing statistics deviate from that economic concept that is relevant for us. One is due to the treatment of retained earnings from portfolio equity positions. The other is about the focus on nominal income, which includes inflation expectations, and they are not really a form of real wealth accumulation. In both cases, these are definitional differences between the statistics and the concept we are interested in. These definitional differences lead to systematic valuation changes in the international investment position, because the current account does not fully capture the real accumulation of wealth, but the international investment position properly captures the stock position, the stock of wealth.

The staff has developed methodologies for estimating the magnitude of these definitional differences or biases, but these estimates carry uncertainty because they require making certain assumptions. For this reason, while these biases can be estimated for most ESR economies, the staff has taken a conservative approach of introducing an adjustor for measurement only when these specific estimates point to considerable biases and can be corroborated by large and systematic valuation changes in the international investment position because of the mapping that I have just described. This approach is applied consistently across countries without relying on somewhat arbitrary definitions of financial centers which were used in the past.

There were also some questions about the reasons for discontinuing previous adjustors, so I would say that progress in our understanding of measurement issues has also meant identifying shortcomings in some of the previously applied adjustors, and this is a natural outcome of advancing our understanding on these issues. For example, in the specific case of merchanting, while there is some evidence of an empirical relationship between merchanting activities and current account balances, including some academic research on it, the staff's recent analysis in the context of the EBA refinements indicates that such a relationship does not point to measurement bias. I will elaborate on why that is the case.

True merchanting activities are key in other forms of exports of services and therefore do not garner special treatment. In the case of profit shifting by foreign companies, which could show imbalance of payment statistics as merchanting, this has the potential of biasing trade balance statistics without the corresponding offset in the income balancing statistics, precisely because the dividends and retained earnings attribute the corresponding profits to their ultimate owners. In other words, some forms of merchanting can affect the composition of the current account between the trade balance and the income balance but should not affect the overall balance, which is the measure of interest for external assessments.

We are ready to engage with country authorities to further study this and gain some insights on why we have this empirical irregularity in some cases, the conceptual basis for which we still do not fully grasp.

Similarly, other previously applied adjustors, for example, for the presence of global value chains for offshoring, have also been reassessed; and the staff's view is that while there may be some merit in such adjustors, a stronger conceptual basis, and especially clear methodologies for quantifying the importance, are yet to be developed.

I will conclude with a few words about data issues. The analysis of measurement now stands on a more solid conceptual footing, but it remains constrained by important data limitations. Estimates of measurement biases rely on a number of assumptions, mainly because of data constraints, which introduce uncertainty about these estimates and prevent the broad application of the adjustors across ESR countries. For example, the availability of statistics to reconcile external stock outflows, key elements of external sector analysis, remains low. Only about half of the EBA or ESR countries currently report data on the stock floor reconciliation, and this number is much lower if we focus on countries with sufficiently long time series of this data to allow for some analysis. For example, if we go to countries that report at least 10 years of data to reconcile the stock outflows, we only have a third or less of ESR and EBA countries.

Similarly, information on the currency structure of foreign assets and liabilities is limited and so is granular data on investment income, which are key elements to understand the role of financial returns in driving external positions, something that Mr. Obstfeld referred to when we think about valuation changes and, more broadly, financial returns on foreign assets and liabilities.

Finally, insufficient data in other areas is also a constraint on staff analysis. One of these areas is foreign exchange intervention, where the staff has made progress as part of the EBA refinements, for example, by broadening the coverage to include increasingly used foreign exchange derivatives; but this is also an area where our analysis continues to rely on proxies, which are subject to a margin of error as the availability of actual foreign exchange intervention data remains low. Given its direct link to exchange rate policy, limited foreign exchange intervention data is an important limitation to external sector assessments.

Another important area relates to structural distortions. We have developed a complementary tool to shed light on the role of product and labor market distortions in driving external imbalances, but limited data remains an important constraint preventing the inclusion of these aspects within the EBA model. This means that until comparable data become available, structural assets will unfortunately have to be assessed outside of the model. Greater collaboration from member countries in these areas of data provision remains key to support the Fund's work on external sector issues.

The staff representative from the Strategy, Policy, and Review Department (Mr. Kaufman), in response to questions and comments from Executive Directors, made the following statement:

I will comment on some of the key guiding principles for the use of TPIs and then make a few remarks on trade barriers.

On some of the guiding principles for the use of TPIs, one key element is transparency when selecting indicators and interpreting results, namely, in terms of how they are used to inform the overall assessment. A second key element is robustness, and the use of indicators should be one of many inputs and a complement to a quantitative discussion to reach a conclusion.

Third, it is important to take account of stakeholders' views, but the staff is expected to use judgment whenever there can be different interpretations. These are three of the key principles, and these are the ones that have informed the use of the indicators.

Let me mention a few things to complement what the ESR says about trade barriers. Trade barriers may not have a large effect on imbalances but can have effects on trade volumes, growth, investment, and productivity, and ultimately affect living standards and welfare, particularly of the poorer segments of the population.

The ESR also highlights that there are other policies that can have trade-distorting effects, such as industrial subsidies, weak protection of physical and intellectual property, and policies and practices that affect technology transfers. These are areas in which there is significant discussion taking place and where a constructive dialogue can contribute to a durable resolution of current trade tensions.

Further trade integration in areas such as services and e-commerce can have significant economic gains. This would require addressing challenging issues such as regulatory and market access issues, including commercial presence, data localization, et cetera, which would be best addressed at a multilateral level; and currently at the WTO, there are several plurilateral efforts which involve between 40 and 70 countries to address some of these issues. That is an innovation that started last December, and it is welcome, and it is recognized as one possible way forward.

The Fund together with the WTO and the World Bank, have continued to collaborate on these issues and will produce another joint paper by the fall on which the Board will be briefed.

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

I will address a few questions on methodological issues with the EBA model. There were a few interventions that asked how the deviations are reconciled when the current account and the real exchange rate models provide different assessments.

Let me just stress that in general it is not uncommon for different methods or models to arrive at different conclusions. In the case of the EBA model, the current account and real exchange rate models may provide seemingly inconsistent results as they capture different aspects of the data or can deliver different results at certain points in time, reflecting the rapid nature of real exchange rate movements as the current account tends to respond more slowly to those changes.

In general, the staff-assessed real exchange rate gaps are arrived at by using country-specific estimated semi-elasticities and mapping the current account gap derived from the EBA current account model into a real exchange rate gap. This preliminary estimate may be modified using information from the real exchange rate index and level models, and other relevant information that country desks may look at, such as recent evolution of unit labor costs or export shares, to arrive at the staff-assessed real exchange rate gap.

Why is it the case that we favor the current account model? It shows a more stable relationship, and also because the current account is ultimately the variable of interest to address external imbalances; and the exchange rate is one of the tools to address those, but other policies contribute to it, such as fiscal policy, health spending, and so on.

Also, as is well-known from the literature, it is more difficult to model exchange rates on the current account, so for this reason the real exchange rate model is viewed more as complementary information when tensions arise within the two models.

One reason that is not often cited when we provide answers to Directors is that the current account model is more intuitive to work with when it is time to introduce adjustors into the assessment. We can have some estimate on how to include those for the underlying current account for temporary factors such as declines in imports or investment, or for the norms, such as model factors or fundamentals, and it would be more difficult to incorporate those directly into the real exchange rate model. That is why we typically work from the current account model to arrive at the real exchange rate gap.

Then there were also a few questions on how these elasticities are estimated in the EBA model. Table 2 provides a benchmark elasticity that country desks use to transform a current account gap to a real exchange rate gap, and we agree with Directors that we need to be more transparent, and we will be so in the future. But let me explain how we arrive at these internal estimates.

There are three main sources. The first is the elasticities that were estimated during the CGER times, which is an elasticity of exports of .71 and an elasticity of imports of .92; and then using the country's export and import ratio to GDP, we come up with the semi-elasticity. These elasticities have been re-estimated over time. It is not that we use the pre-1985 elasticity. This gets updated often by re-estimating these export and import equations and then applying these openness indicators.

We have a third estimate that comes from a more direct approach, which is that we regress the trade balance on the real exchange rate to get the direct semi-elasticity. We will be providing more details on these methodologies and on the particular elasticities applied to other countries.

There was also a question about why the staff is still using the Quinn index, given that it has some shortcomings. The staff did extensive work on this issue in 2015, and we compared the euro area and de facto indicators of financial account openness and their indications for the EBA results.

Qualitatively, there was a fairly strong correspondence in the relative ranking of countries' openness across the euro area indicators, as well as the de facto financial integration indicator. Quantitatively, there was a small impact from using different indicators, so while no indicator is perfect, and the Quinn index has its shortcomings, the other index also has shortcomings, and the results tend to be robust. We would consider a different measure of account openness once we find an indicator that has more advantages than disadvantages.

Finally, there was a question on the size of the adjustors this time around given that there was a new model that is reliant on using adjustors. This year adjustors were used in 18 countries, down from 23 countries last year; and the average size of this adjustor has marginally increased from 1.1 to 1.3 percent of GDP. However, the aggregate discrepancy has declined significantly. Last year the aggregate discrepancy, shown at the bottom of Table 2, was .07 percent of world GDP. This year it is .03 percent of world GDP.

Mr. Palei made the following statement:

I do not want to appear too picky about these institutional quality indicators, and the reason I pay attention to this part of the methodology is because it was a significant change for the ESR, and the issue of global imbalances is a long-running issue.

I thank Mr. Cubeddu for the intention to consult with the Legal Department on the ethical side of this story, because we find it important. The appearance of the Fund's objectivity is important, and it goes to the credibility of the whole exercise.

I would like to correct Mr. Cubeddu, who attributed the WGI to the World Bank and the Brookings Institution. Those of us who worked on this digest produced by SPR know that those indicators are produced by individuals, Aart Kraay, who works at the World Bank, and Daniel Kaufman, who used to work at the World Bank, and who is now associated with the Brookings Institution.

In our statement, we have mentioned the issues of transparency. The methodology of the ICRG is not available to the broader public, and we do not know who the experts are. There is one survey underlying this indicator, and when we look at WGI, they may not be better. They may not be perfect—they are not—but they are based on 30 different surveys. However, SPR tells us it is better to have more indicators; so on this basis, we would favor the WGI in this particular case. However, I understand that the quality will never be perfect in this area, and the digest itself is a new document. It is evolving. Not everybody is aware of it. We are still working on it. It is an open issue and has to be revisited in the future.

Mr. Kaizuka made the following statement:

I thank the staff for the detailed answers. I agree with Mr. Obstfeld about the capital transactions and the exchange rate. I do not have any comment to make on that point, but I still have to be convinced about using the current account model and using the trade elasticity leading to the REER gap or REER norm for a country like Japan, where the major component of the current account surplus is not the trade account surplus, but the income account surpluses. There is also an empirical study that shows that the relationship between the exchange rate and the current account, especially for Japan, is diminishing.

I am not fully convinced about using trade elasticity to calculate the REER gap or the REER norm for a country like Japan. I will come back to the staff, and we already started the next round of the review today.

Mr. Castets supported Ms. Horsman’s proposal to raise Governors’ awareness of the EBA methodology and the ESR by including an annex to the GPA.

Mr. Spadafora made the following statement:

I would like to make a comment about a staff clarification. The staff mentioned Italy, Spain, and Portugal as countries for which the external position moved from deficit to surplus, and in the case of Spain, improvements in unit labor costs were cited as an underlying factor to explain the improvements. I want to caution the staff about the use of unit labor costs for two reasons.

First, production prices are declining because of technological advances and other factors. There is substantial empirical evidence that in the case of Italy, price-based measures of competitiveness—in particular, producers pricing in the manufacturing sector—are much more reliable in explaining external factors rather than unit labor cost-based measures.

The second point is that non-price competitiveness measures—in the case of some European and euro area countries, including Spain, Italy and

Germany, France—are very powerful in explaining external assessments. We have made this comment several times in the past. We believe that when assessing external performance, the focus on unit labor costs only is a bit simplistic.

Mr. Meyer made the following statement:

I have two comments. First, I thank the staff for commenting on this question of the imbalance. I quickly looked up possible definitions, and basically what it says that imbalance is a lack of balance, the state of being out of equilibrium or out of proportion. I would take up the staff's offer to try to come up with better wording because it is important to get the wording right so that also our colleagues on the political level take the work and the summaries seriously.

However, my desire to take the floor was triggered by the comment by the U.S. chair on the overall situation. Let me make the point that if the United States, in the run-up to the global financial crisis had a current account deficit of -6 percent, that was certainly not a sustainable situation. Growth rates were not sustainable, and there was clearly a subprime mortgage bubble in the United States that also is part of that huge current account surplus. So I challenge the argument that the fact that no action was taken by surplus countries now leads to bilateral or unilateral action. The situation back then was not sustainable, and then countries like Germany took a lot of action. Domestic demand is much stronger today, and I would like to remind colleagues that the domestic gap in Germany is .8 percent of our surplus. My bottom line is that going forward, there might be a situation where in the United States the service sector is too big and the manufacturing sector is too small. In Germany, maybe the manufacturing sector is too big and the service sector is too small. We are going into details on some of the structural elements, like product market or service market reforms, and that could be quite interesting to understand.

The following summing up was issued:

Executive Directors broadly agreed with the findings of the External Sector Report and its policy recommendations. They noted that global current account surpluses and deficits have remained broadly unchanged in recent years. At the same time, the concentration of excess imbalances in advanced economies has increased, on both the surplus and deficit sides, amid a widening of creditor and debtor positions. Directors noted with concern the projected continuation of this trend under baseline policies.

Directors cautioned that, absent effective automatic adjustment mechanisms and conducive policies, large and sustained external excess imbalances could pose risks to global stability and growth. They noted that the lack of progress in rebalancing could increase the likelihood of rising trade tensions, with negative implications for global trade, growth, and financial markets. Meanwhile, expansionary fiscal policy in key deficit economies operating above potential could lead to a faster-than-expected tightening of global financing conditions, and prove disruptive for emerging market and developing economies, especially the more vulnerable ones. Directors also emphasized that a further widening of debtor positions in key economies could result in a sharp adjustment over the medium term.

Directors broadly agreed that, with limited policy space and normalizing cyclical conditions, policies will need to be carefully calibrated to achieve domestic objectives while contributing to external rebalancing. In countries with weaker-than-warranted external positions, actions to strengthen public and private sector balance sheets should take priority, while monetary normalization proceeds gradually. In economies with stronger-than-warranted external positions and fiscal space, a more expansionary and growth-friendly fiscal policy would help support demand and productivity, thereby promoting globally-balanced growth. Directors highlighted the role of flexible exchange rates in facilitating external adjustment. They concurred that, where price adjustment is constrained by currency regimes, the focus should be on reforms to facilitate greater internal relative price adjustment, as well as improved risk-sharing mechanisms.

Directors agreed that well-tailored, growth-enhancing structural policies will need to play a more prominent role in tackling global imbalances. In general, excess surplus countries should prioritize reforms that promote domestic investment and competition, while excess deficit countries should prioritize reforms that strengthen external competitiveness and labor productivity.

Directors welcomed the analysis on the link between trade policies and external imbalances. They broadly shared the assessment that trade barriers undermine domestic and global growth, likely without a meaningful impact on current account balances. Directors called on all countries to work together to resist protectionism, revive liberalization efforts, and strengthen the open multilateral trading system—particularly to promote trade in services, where gains from trade are substantial but barriers remain high.

Directors welcomed staff's efforts to refine the External Balance Assessment (EBA) methodology, and better reflect the role of fundamentals and policies in explaining current account dynamics. While recognizing the progress in strengthening the conceptual underpinning of the models, they noted remaining limitations and inherent uncertainties, with some also pointing to changes in current account norms following refinements. Accordingly, Directors stressed the need to avoid mechanistic use of model-based estimates and to exercise caution when interpreting model residuals, which remain large in some cases.

Specifically, Directors highlighted the importance of using country-specific judgment and results from all EBA models and new complementary tools to arrive at final assessments. However, they also underscored that this judgment needs to be analytically grounded, transparently presented, and evenhanded. Noting estimation uncertainties, Directors appreciated the presentation of external assessments in ranges, and suggested that a similar approach be consistently taken for all countries. They encouraged further efforts to improve the methodology on an ongoing basis, and offered many suggestions that merit consideration in future refinements.

Directors stressed the unique role of the Fund in providing multilaterally consistent assessments of external positions and contributing to the debate on global imbalances. The quality and timeliness of data provision by its members is important in this regard. Directors welcomed the efforts to broaden the reach of the External Sector Report, while recognizing that continued work remains necessary to incorporate new insights. They also called for greater efforts to better integrate external sector assessments and policy advice into other flagship reports and bilateral surveillance.

APPROVAL: March 5, 2020

JIANHAI LIN
Secretary

Annex

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

Global Imbalances: Risks and Policy Recommendations

1. ***While we welcome staff communicating a clearer view of the severity of the issues, we felt these warnings should be more fully backed up with robust –and highly valuable - explanations that would fully justify their strength. We wonder if such a shift in tone was intentional?***

- Staff will respond to this question during the Board meeting.

2. ***On the surplus side, we have reservations about the narrative that imbalances are risky because they can be co-opted as a justification for protectionist measures, especially as recent tariff measures appear to be motivated by bilateral rather than multilateral trade balances. We wonder if this message, which is embedded across recent multilateral reports, could lend legitimacy to the imposition of inappropriate trade barriers***

- Staff will respond to this question during the Board meeting.

3. ***The apparent weakness of automatic adjustment mechanisms creates additional pressure for policy actions. While not everything can be fixed with public sector policies, it is the responsibility of prudent policymakers to create supportive conditions for smooth and orderly changes in private sector behavior and adjustment in prices. We would welcome staff's analysis of the reasons behind the weak automatic adjustment mechanisms and whether the weakness is expected to continue***

- Staff will respond to this question during the Board meeting.

4. ***We would like further thoughts from staff on the speed and breath of the adjustment for CA surplus counties versus CA deficit ones. We do not see the policy reaction function linear between these two types of countries.***

- Staff will respond to this question during the Board meeting.

5. ***The persistence of the excess external imbalances over the past year begs a few questions about the prospects of their reduction. In particular, are there signs that a recalibration of domestic policies where needed is underway or in the works?***

More generally, we would appreciate staff assessment of the traction of their policy recommendations as well as the adequacy of policy collaboration/coordination between countries. Could staff indicate the main impediments to further progress in reducing excess external imbalances?

- As discussed in this and last year's ESR, there has been a shift in excess imbalances towards advanced economies in recent years. Accompanying such shift, FX intervention has played a more limited role as a driver of imbalances (see detailed analysis on Box 3 of 2017 ESR). This shift in exchange rate policies has been in line with staff's policy recommendations, suggesting the latter has had some traction.

- Reduced FXI intervention raises the prospects of greater exchange rate flexibility, which is of the essence for progress in reducing imbalances. However, the observed increased in exchange rate flexibility is unlikely to suffice. Relative price adjustment will remain inherently constrained within common currency arrangements; while other policy (inadequate fiscal credit polices) and structural distortions, if unaddressed, will continue to drive external imbalances in key economies. These are the areas where further action is needed, both in surplus and deficit countries, as discussed in the report.

- Staff will respond to the second half of this question during the Board meeting.

6. ***We take note that imbalances are concentrated in AEs, with notably the steady increase of commodities prices helping reduce external imbalances in some EMDEs .It is not clear to which extent domestic policy actions may also have contributed to the reduction in external imbalances in some EMDEs. Staff comments are welcome.***

- The narrowing of EMDEs' current account deficits in recent years has been driven by a combination of domestic and external factors, including improved terms of trade. As discussed in greater detail in Box 2 of the 2017 ESR, policies were generally supportive of the narrowing of external deficits, with exchange rate flexibility playing an important role in the strengthening of current account positions, and tighter fiscal policies contributing ins some cases.

7. ***The apparent weakness of automatic adjustment mechanisms creates additional pressure for policy actions. While not everything can be fixed with public sector policies, it is the responsibility of prudent policymakers to create supportive conditions for smooth and orderly changes in private sector behaviour and adjustment in prices. We would welcome staff's analysis of the reasons behind the weak automatic adjustment mechanisms and whether the weakness is expected to continue.***

- Preliminary analysis indicates that limited exchange rate flexibility is a factor behind the persistence of external imbalances, as a significant share of global current account balances (especially surpluses) remains concentrated in economies where limited exchange rate flexibility constrains relative price adjustment, contributing to the persistence of imbalances over time. Progress has been made in allowing for greater exchange rate flexibility in key economies (see discussion on Box 3 of 2017 ESR), which should help with global rebalancing over time. However, relative price adjustment will remain inherently constrained in some economies (e.g., of common currency areas), which will need to rely more on other policy levers, including structural policies, to address competitiveness issues.
- Similarly, in some economies with flexible exchange rate regimes, persistent external imbalances reflect slow progress in addressing other policy (inadequate fiscal and credit) and structural distortions. These are the areas where further action is needed, both in surplus and deficit countries, as discussed in the report.

8. ***Higher US inflation and faster-than-expected interest rate rises may trigger a broader retrenchment of capital flows from emerging market and developing economies. In this regard, we have reservations about conclusion of Box 4 that recent financial market volatility has been idiosyncratic in nature. Some members of our constituency have seen substantial outflow pressures in spite of staff-assessed positive CA gaps and/or having further reinforced fundamentals since the taper tantrum. Staff's comments are welcome.***

- Box 4 focuses on the April 23-June 6 episode of financial market volatility (see the footnote in the box for details), studying the countries that were most affected during that particular episode. The discussion acknowledges that "EMDEs have witnessed considerable financial market volatility since April 2018". There is no presumption that certain countries were not affected, and Box 4 does not attempt to tackle the broader question of the likely impact of rising US interest rates on EMDEs going forward, and which countries would be affected. Rather, the focus is which countries were more affected in the specified episode.

9. ***Would it be desirable to take an expansionary fiscal stance to reduce the current account surpluses, even when the output gap is closed or turned into positive? Staff's view would be welcome.***

- Staff views is that, in the context of a closed output gap and an excess current account surplus, an expansionary fiscal policy directed towards increasing future productivity and growth could be desirable. This could be achieved by using available fiscal space to increase physical and human capital and fostering labor supply.

10. ***With international trade alone surging from roughly 40 to close to 60 percent of the world's GDP in little more than two decades, we wonder if wider current account imbalances and net international investment positions (NIIP) should not be a natural outcome.***

- Growing external imbalances may or may not be associated with rapid trade growth, although there is a potential mechanical relationship if trade grows faster than GDP. The literature on this topic provides an ambiguous response. Freund (2018), for example, shows that in the run-up to the GFC both imbalances as a share of GDP and imbalances as a share of total trade increased, suggesting that the growth in imbalances was associated with relatively high import growth in deficit countries and relatively high export growth in surplus countries. In other words, imbalances in the 1990s and 2000s boosted trade growth (and not the other way around). More importantly, to the extent that imbalances reflect inadequate policies or domestic distortions, they should not be regarded as "appropriate" or "natural" outcomes.

11. ***Could staff elaborate on the country-specific debt limits which put them at the risk of disorderly adjustment in the medium-term? Is the situation similar to the pre-2008 global imbalance situation?***

- Country-specific debt-limits are difficult to estimate, in particular for advanced economies that have witnessed fewer default episodes over their history. Staff recognizes, however, that debt-to-income ratios in key advanced economies are historically high and cannot increase indefinitely without facing market discipline at some point. As the report shows, the global current account balances are now lower than in 2006-07, although their persistent concentration in a few key advanced economies and projected widening of IIPs carry risks going forward.

Trade Costs and Imbalances

12. ***Could the staff indicate the impact of increase in trade costs through multi-country imposition of trade barriers on global excess imbalances?***

- Staff found the contribution of trade costs to global imbalances to have been minor for a sample that covers through 2014. Analysis first sorted countries into CA surplus and deficit groups, and then calculated the actual and predicted values of the aggregate CA balance of each group. Decomposing the predicted values into those predicted by trade costs and other factors using the recently refined EBA model revealed the contribution of trade costs to global imbalances to have been a small fraction of the actual imbalances.

13. ***The empirical results suggest that effective export costs have a small impact on the current account, particularly in the pre-GFC period, while barriers to imports are not significant. This would imply the US barriers to imports are not going to help reducing its external deficit. In this regard, we think that some intuition for this finding should be provided. What are the channels of impact?***

- Being the current account balance the difference between a country's saving and investment, current account imbalances are thought primarily as a macroeconomic phenomenon. The long-run value of the current account is pinned down by macroeconomic fundamentals such as rates of time preference, demographics, and economic growth. Trade impediments reduce spending and income commensurately in the long run, and thus, the long-run current account balance may owe little to the structure of trade costs. Trade cost changes, however, can have transitional effects. For example, shifts in trade costs could affect CA balances if the resulting adjustment of consumption or investment is gradual (Joy and others 2018), or if trade liberalization takes place at different speeds in different sectors (Barattieri 2014). The small effects staff found for the exporting costs may be reflecting such channels. That said, staff's empirical exercise is reduced-form and not well-suited to identifying the exact channels through which trade costs can affect the current account

14. ***Moreover, we note that the estimated coefficient for export costs in the period 2001-2014 (Text Table 1) is -0.020 and its standard error 0.079, i.e. four times larger. How can it be statistically significant at the 10 percent level?***

- Please note that the numbers reported in parenthesis are p-values.

Methodological Refinements: Implications

15. ***In the 2017 ESR, staff assessed one third of current account balances were excessive. However, in this year's ESR, that same metric has jumped to a half. The report does not discuss what drove this change, which is particularly notable given the overall size of current account deficits have not materially moved over the last year. We wonder if the change is driven by the new methodology? Given that the overall size of global external imbalances has not changed significantly, can staff elaborate on the main reasons for the increase in the share that is not explained by fundamentals?***

- The increase in global excess imbalances, defined as the sum of excess surpluses and deficits, was relatively small and mainly related to a minor reassessment of the overall role of fundamentals and desired across the full set of ESR economies. Specifically, staff-estimated excess imbalances rose by only about 0.5 percent of global GDP, from 1.39 percent of Global GDP in 2016 to 1.45 percent in 2017.

Similarly, the share of excess imbalances relative to total global deficits and surpluses, rose from about 40 percent in 2016 to 45 percent 2017. The one-third figure quoted in the previous ESR was the lower bound estimate. Staff has now clarified that excess imbalances in 2017 are estimated have ranged between 40-50 percent of total global current account balances.

16. ***Staff should remain cautious when interpreting residuals and avoid automatically equating unexplained current account gaps with distortions. It should be recognized that fundamentals outside of the model can partly explain residuals. For example, the design of pension systems and its interaction with demographic factors could drive saving rates.***

- The EBA framework includes a wide range of variables reflecting country fundamentals and policies, consistent with the factors identified in the academic literature as drivers of current account balances. As such, the presumption is that model residuals reflect primarily distortions that push current account balances away from the level consistent with fundamentals and policies. However, when a clear case can be made that the model does not properly reflect key country characteristics, the framework allows to incorporate adjustors outside of the model.

17. ***We would seek clarity on how staff have taken pension savings into account in the technical methodology, outside of the demographic component of the model.***

- The latest EBA refinements introduced a demographics specification that allows for both formal transfer schemes, such as a PAYG pension system, and informal transfers to affect savings. This is done by linking the generosity of those transfer systems to the future old-age dependency ratio. The future old-age dependency ratio proxies for the relative size of the tax base from which payments are financed. This specification is used to overcome data limitations regarding the generosity of intergenerational transfer systems. As in previous specifications of the EBA framework, the view is that mandatory savings need not necessarily affect savings (and thus the current account) because households can offset mandatory programs by adjusting voluntary private savings. Furthermore, in the case of countries transitioning from a PAYG system to a fully-funded system, the resulting aggregate effect on savings is theoretically ambiguous and depends, in part, on the compensation of generations who receive PAYG payments at the start of the reforms. The effect of the design of pension systems on savings and the current account is a continuing and active area of study.

18. ***Data collection seems to be of the utmost importance. We would like to know whether any action plans are being prepared for collection of such vast amounts of granular data for various refinements and complementary tools.***

- Lack of sufficient data is an important constraint to further refinements to the EBA model, especially in the area of structural distortions. Staff has developed complementary tools applicable for a subset of countries to assess the potential role of structural distortions, and there are efforts underway to expand the set of (product and labor market) indicators to the full EBA sample. Data limitations are also important in other areas: for example, a deeper understanding of measurement biases requires greater efforts by national authorities and statistical agencies generate and provide granular external stock-flow reconciliation tables, as well information on the currency composition of foreign assets and liabilities. Similarly, the lack of comprehensive data on foreign exchange intervention (FXI) remains an important constraint on staff's analysis, not only as an input to the EBA model but also as critical information for assessing the role of exchange rate policies in facilitating or preventing external rebalancing.

19. ***We found Box 2 helpful in showing the impact of the EBA methodology change. We note that the current account norms have changed quite significantly for several countries. More extensive country level discussion on which component of the new model is driving the movements seems warranted, and unfortunately missing in the individual economy assessments.***

- Tables 5-8 of the Technical Supplement provide additional country-level details on the 2017 current account norms, comparing results of the 2015 and the 2018 (refined) models. In addition, in cases where results have changed markedly (e.g., Germany, Italy, Spain), individual country pages elaborate on the main reasons of such changes.

20. ***As regards the refinements related to the credit gaps, we wonder why staff deviates from its estimates in the EBA exercise for some countries (i.e. Indonesia, Spain, UK, Turkey, and Germany). In addition, neither for Spain nor for Germany, the definition of the desired credit gap levels is in line with the approach outlined in the Technical Supplement. Further explanation by staff is appreciated.***

- Unlike other policy variables, such as the fiscal balance or health spending, the credit gap is a proxy for financial excesses that needs to be estimated. The starting point is the BIS-type filter for the credit-to-GDP ratio described in the Technical Supplement. However, staff may apply judgement when, in its view, the estimate coming from the filter does not reflect accurately the country's financial conditions. Such judgement needs to be substantiated and discussed with the ESR coordinating group (similar to the discussion of the desirable level of policy variables).

21. ***The methodological revisions seem to have yielded well-behaved empirical results for some countries, yet residuals increased for other countries. Some questions***

remain, including why life-expectancy data for some emerging/developing countries is adjusted for the regression, rather than performing such adjustments ex post via staff adjustment.

- The input for the EBA model are based on the raw data. That is, all demographic variables are constructed in a uniform way, using the same data source (UN Population Prospects 2017). For some developing countries where adult mortality rates are unusually high, an adjustment is done outside the model following a consistent formula.

22. ***The paper says that for a small group of countries, consideration for exceptionally high adult mortality rates could be given to shifting down by 5 years the definition of prime age, working age and old-age dependency. Which are these countries?***

- Among the ESR countries, South Africa and Indonesia display adult mortality rates that are consistently higher and life expectancy at prime-age consistently and substantially lower than in the rest of the sample.

23. ***While the previous ESR specifications had included demographic interaction terms that induced considerable year-to-year changes of current account norms for the euro area and some of its Member States, the new specification models nonlinear demographic effects more directly. In this regard, we would have appreciated a more detailed analysis of the stability of the new estimated norms.***

- A main advantage of the new demographic specification is the enhanced stability of the norms over time, which is far more consistent with the slow-moving effects of demographics on international capital flows found in the academic literature (e.g. Backus, D., T. Cooley, and E. Henriksen, 2014). Further theoretical and empirical background on the demographic specification will be presented in a forthcoming IMF Working Paper. Staff stands ready to share preliminary results upon request.

24. ***Even in countries which do not have high adult mortality, workers may enter and leave the workforce at earlier ages. Especially, countries with higher populations have lower retirement ages of 58/60. Also, the total amount of saving would depend on the employment and income level. How can these factors be incorporated in the model to give better estimates of savings rates?***

- The retirement age is an endogenous outcome that depends on many factors, including policies and preferences, which can vary across countries. Staff allows for an outside-of-the-model adjustment to the life-cycle for countries where health risks lead to large and systematic differences in entry and exit from the labor force. The impact of income levels on aggregate saving/investment is captured by other variables in the current account model.

25. ***We agree that the inclusion of a wider set of variables to better capture the role of institutional quality will improve the robustness of the model but we are not clear about the rationale behind choosing indicators from the ICRG survey under the revised methodology. The choice is critical, especially, as there are questions about the robustness of ICRG as a third-party indicator, because ICRG's underlying surveys, used to construct the index, rely mainly on experts' views. The WGI indicator appears to be better constructed than the ICRG indicator as it includes information from more than 30 surveys of enterprises, citizens, and experts. While the ICRG survey provides a longer-time series data but, since the paper finds that results are similar if the WGI indicator is employed, we wonder why the ESR methodology is not adopting WGI indicator as the primary indicator.***

- As discussed in the Technical Supplement, governance concepts are difficult to measure using any kind of data. Perception-based indicators, like the ICRG, have the advantage of capturing perceived risks, which are determinant for investment decisions. However, because they are based on perceptions, they can change from year to year even in absence of changes in the actual fundamentals of a country. A comparison of the ICRG and WDI indicators pointed to a strong correlation between the two. However, an important limitation of using the WGI as the primary indicator is that reliable data is available only from 2002, which means that the previous periods needed to be estimated. Doing so would have added additional uncertainty to the regression estimates. Given the tradeoffs, staff opted for using the ICRG index as it provides for a sufficiently long time series, while it displays a strong correlation with the WGI indicators.

26. ***Finally, we take note that the estimated coefficient of the fiscal balance has decreased markedly in the refined model. Does staff have an explanation for this change in the coefficient?***

- While variations of individual coefficients reflect a confluence of changes to the EBA specification, the lower coefficient associated to the fiscal balance—which is now closer to the estimated value under the 2013 EBA model—is mostly related to the refinement of the credit excess measure. This result is consistent with a new literature suggesting that the financial cycle accentuates the procyclicality of fiscal policy. The intuition is that during periods of buoyant credit and/or high asset prices government revenues rise (beyond the business cycle) and the fiscal balance improves. Once the financial cycle is accounted for, the relationship between the fiscal balance and the CA naturally weakens, as the effect is partly soaked by the credit gap variable.

27. ***We join Directors who have previously sought clarity on why the actual level of reserves is deemed to not be aligned to an "adequate" level in the context of a freely-floating exchange rate.***

- The Fund's reserve adequacy metric for EMs complements traditional metrics and helps make a comparable assessment of reserve levels for precautionary purposes across the membership. The methodology to estimate the metric was developed based on the experience of past balance of payments crises, which were characterized by multiple channels of market pressure, suggesting that reserves are held against multiple vulnerabilities and a broad set of risks. Based on such experience, the metric covers the potential loss of export income, the risk of resident outflows (broad money), external debt rollover risks (short-term debt), and the risk of nonresident equity and debt outflows (other liabilities). The weights estimated for each variable to build the composite metric are based on the 10th percentile of observed outflows from EMs during exchange market pressure episodes. The metric recognizes that countries with lower levels of financial account openness and floating exchange rate regimes may, all other things equal, require lower reserve buffers for precautionary purposes.

28. ***Reserve requirements of the CAD countries are much higher than those of the surplus countries and this critical aspect is ignored by the RAM, which was forcefully brought home to us when the adequacy of the reserves was suddenly questioned by the markets in the mid-2013 turmoil for a number of economies. Thus, we reiterate that IMF should clearly distinguish between current account deficit countries from those having surplus while constructing composite metrics of reserves. Could staff comment?***

- Reserves are an important external buffer, which can help reduce the likelihood of balance-of-payment crises and preserve economic and financial stability in the event of shocks. Holding adequate reserves for precautionary purposes is therefore an essential element of a country's safety net. The assessment of the adequacy of reserve levels should be tailored to the specific country characteristics, external and domestic vulnerabilities, and circumstances. Where specific vulnerabilities are identified, country teams look beyond the Fund's reserve adequacy metric.

29. ***We thank staff for the summary discussion (Box 7) of the drivers of corporate savings and their contributions to current account surpluses. Can staff elaborate on the way the refined model captures the impact of corporate savings?***

- The EBA model does not directly incorporate corporate savings, as the latter is not a driver of the current account in itself, and its interpretation as a fundamental or policy distortion would be unclear. Key is to gain a deeper understanding of the institutional features and distortions behind high corporate savings. In this regard, the complimentary tool on structural distortions developed as part of the refinements—and described in detail in the Technical Supplement—sheds some light, pointing, for example, to the role of certain types of entry barriers. Further work on this area is needed and underway.

30. ***Comparisons with previous assessments are not internally consistent and should be de-emphasized. For instance, we find that Figure 11 of the 2018 ESR, which compares assessments since 2012, is misleading; to be fully consistent, it should rather be based on the application of the revised methodology also to past years.***

- Indeed, results of the different vintages of the EBA model are not necessarily consistent, and because of that, are not presented in such way. Instead, the comparison of current account gaps across time presented in the report (Figure 11) is based on staff assessed gaps, which take EBA results as a key input but ultimately reflect staff's views. A retroactive application of the latest EBA model would require an additional retroactive application of staff judgement.

31. ***We note in Box 1 that the overall assessment of a country's external position takes into consideration indicators beyond the current account and the REER, including the financial account balance, the international investment position, reserve adequacy, and other competitiveness measures. We would appreciate staff comments on whether the overall assessment of any country was changed based on other indicators from what was determined from the current account gap?***

- In the case of Spain, the EBA current account model points to an external position "broadly in line with fundamentals". However, staff assessed the current account to be 'moderately lower than implied by fundamentals' on the basis of NIIP considerations (reflecting the need to reduce a still large debtor position). Similarly, NIIP and financing risks considerations were taken into account for the assessments of Brazil, India, and Turkey.

Use of Judgement and Measurement Issues

32. ***Could staff elaborate on the extent to which judgment has been exercised in this year's assessments compared to last year's, following the refinements brought to the models? We would like to know whether the new estimated norms resulted in less ad-hoc adjustments by staff, i.e., whether deviations from staff-assessed to estimated norms have been reduced on average.***

- While the EBA models provide key numerical inputs, staff judgement remains necessary for arriving at external sector assessments, and significant progress has been made in ensuring more transparency, evenhandedness and consistency in the application of out-of-model adjustments. This year, adjustors have been used in 18 countries, compared to 23 last year (from a total of 29 ESR economies, excluding the euro area), although the average size of the adjustors has marginally increased from 1.1 percent of GDP to 1.3 percent of GDP.

33. ***Evenhandedness tends to be lacking across adjustments. Why, for example, is Australia's current account norm reduced by 0.9 percentage points because its size and population density mean it has higher investment needs than captured by the model, whereas Canada, a far larger country measured by geographic size, with a similar low population density, is not deemed to have a higher-than-modeled investment need? Canada's norm is lowered because its population projections differ from the UN projections. Have staff compared national estimates of population projections with the UN projections for other countries? For the second year, Thailand's current account surplus was reduced by close to 4 percentage points because of political uncertainty. Has staff considered an adjustment for the UK because of uncertainty related to Brexit? We also note that no idiosyncratic factors seem to raise a country's current account gap, which seems remarkable.***

- Both Australia and Canada are commodity exporters with high income per capita and strong institutions, which have run current account deficits for a prolonged period. Despite having similar current account trajectory, the long-term trend of their NIIPs are markedly different, pointing to current account measurement biases in Canada, but less to in Australia. Accordingly, the country team proposes an adjustor for measurement biases in Canada. For Australia, the country team is of the view that there are considerable investment needs, warranting an adjustor for this purpose.

- The UN statistics has been used during estimation stage for all countries. For the computation of norms, staff prefers to use the UN population projections unless country-specific circumstances warrant otherwise. For Canada, consideration was given to reflect the authorities' immigration targets that may not be fully reflected in UN projections. There is an adjustor for Germany to reflect uncertainty related to large/sudden immigration. In addition, consideration for adjustors has been given for some countries with high mortality rate at prime-age.

- For the UK, as stated in the ESR country page, the uncertainty associated with Brexit is reflected in the staff's current account gap range.

34. ***Other issues (e.g. global value chains (GVCs), offshoring or merchanting) were also explored but staff deemed the conceptual basis for making adjustments outside the model for these factors unclear. However, this led to the fact that recent External Balance Assessments did not contain discretionary adjustments for***

merchanting trade even though last year's respective assessments made quite sizable adjustments related to merchanting trade that were justified on the grounds of the relevant academic literature (see, for instance, 2017 Article IV Consultation for Denmark and Switzerland). In our view, this could leave the impression that staff's discretionary adjustments to the EBA CA gap are somewhat arbitrary which would undermine the reputation and credibility of the EBA exercise. Staff comments would be appreciated.

- Please see answer to question 35.

35. ***We note that in some country cases, following the refinement of EBA methodology, previously existing adjustors have been removed without further description. Staff's view would be welcome.***

- As part of this year's effort to refine the EBA methodology, staff has devoted considerable attention to issues of measurement, taking a fresh view at the conceptual basis for certain adjustors and developing a methodology for estimating the biases that warranted such adjustments. As a result, staff's understanding of measurement issues has advanced considerably, including on the somewhat weak conceptual backing of some previously applied adjustors. Staff sees this as a natural outcome of advancing its understanding of external sector issues. And while such changes may pose communicational challenges and possibly some reputational risks, staff is of the view that continuing with the application of unwarranted adjustors would pose greater risks.

- In the case of merchanting, for example, while there is some correlation between the extent of merchanting activities and observed current account surpluses in a few countries, staff's recent analysis indicates that such relationship does not point to measurement biases. Merchanting activities by domestically-owned firms are akin other forms of services exports, thus not warranting special treatment. Merchanting by foreign-own firms domiciled locally–possibly reflecting profit shifting—could bias upwardly the trade balance, but with a corresponding offset in the income balance. Thus, merchanting could affect the composition but should not affect the overall level of the current account balance. The merits of introducing adjustors for the presence of GVCs and offshoring activities have also been reassessed as part of the EBA refinements. These were also presented in the EBA refinement technical background notes, which were discussed with the Board earlier in the year. Our plan is detail these issues in the upcoming working paper on EBA refinements.

- It is important to recognize, however, that further work on measurement issues is needed; and a greater effort in data provision by member countries will be of the essence to make progress in this area. Staff plans to elaborate on these issues during the Board discussion

36. ***It is not really clear to us how the adjustment for "measurement bias" has been applied consistently across countries. […] Staff comments would be welcome.***

- As part of this year's refinements to the EBA methodology and ESR process, important progress has been made in understanding measurements issues, especially with regards to potential biases in the income balance of the current account. This has allowed staff to better ascertain when adjustments for measurement issues are appropriate. Moreover, staff has developed a methodology to quantify the two most prominent forms of measurement biases (i.e., inflation and retained earning biases) consistently across countries—see details in the ESR Technical Supplement, Section III.B. These estimates, however, are constrained by data limitations and, thus, rely on a number of assumptions. As a result, staff has taken a conservative approach of applying adjustors only when the estimated biases are sizable, and there is evidence of systematic valuation changes in the international investment position consistent with the estimates current account biases. Such criteria are applied uniformly across countries to determine whether an adjustor is warranted, and to determine its magnitude.

Role of Real Exchange Rate Models

37. ***Staff should avoid putting too much weight on the current account model alone, and additional indicators should complement the analysis of the external sector. The results of the exchange rate models should not be discarded. The analysis could further benefit from a deeper consideration of capital flows, international investment positions as well as the type of financing of current accounts deficits.***

- Staff gives greater weight to the current account model as opposed to the REER models, as the former is more intuitive and stable, and, more importantly, focuses directly on the main variable of interest—while REER models which shed light mainly on a channel of external adjustment. Furthermore, as recognized in the academic literature, modeling exchange rates is not an easy task because real exchange rates not only reflect the relative price of goods but also the relative price of assets. Considerations related to capital flows, IIPs and sources of financing are taken into account for arriving at staff assessment, although a deeper understanding of these aspects is indeed needed.

38. ***We note and welcome the limited and cautious nature of the analysis of the REER gaps in the current ESR. Unlike staff, we argue that CA models should not receive greater weight in estimation of REER gaps in comparison to REER models for few***

reasons. Exchange rates reflect current conditions and expectations, while CA models are "backward looking". In addition, updated exchange rate data are readily available, while CA data are available with lags and subject to revisions. Finally, CA models include additional uncertainty regarding REER gaps because of the uncertain elasticity. Indeed, in some cases the CA and the REER models point to gaps in opposite directions. Therefore, we encourage staff to apply a humble approach which is based on multiple models in future general and country reports. Moreover, we believe that country teams should apply judgement, which is not biased by an institutional preference for a specific model.

- To arrive to an external assessment, Staff takes account of estimates provided by several models, including the EBA CA, REER-Index and REER-level models, and the External Sustainability framework. While the EBA models, in general, suggest that countries with current account balances higher (lower)-than-warranted by fundamentals and desirable policies tend to have undervalued (overvalued) exchange rates, they sometimes give conflicting signals. The latter can reflect rapid exchange rate movements that are temporary or not yet fully reflected in the current account, rigidities related to the FX regime, measurement issues, or simply the inability of the models to fit a country's characteristics.

- Because no single model can capture all the characteristics of the external sector, Staff assessments necessarily rely on judgment by considering (potentially) omitted country-specific factors, the relevance of which relies on insights gained during the consultation process. The need for country-specific insights is especially important when the EBA models provide conflicting results.

39. ***Given the better fit of the REER-level model over the REER-index model, has staff considered eliminating the latter for EBA countries?***

- Staff generally agrees that in most cases the REER-level model provides better signals than the REER index model. That said, the REER index model still provides relevant country-specific information (it uses country-fixed effects) and data limitations prevent the REER level model for the full sample of EBA countries (which would leave some countries without any real exchange rate model). For these reasons, we are not considering eliminating the Index model.

40. ***We encourage staff to explore the implications of the growing literature on the Dominant Currency Paradigm for EBA evaluation of exchange rates. This paradigm suggests that trade between two countries is affected by the exchange rates of their national currencies vis-à-vis the USD even when none of these countries peg to the USD or use it as a national currency. To the extent this phenomenon is ascribed to international value chains of production (rather than***

price stickiness), the weight of the USD may be higher in the REER calculations in the medium and perhaps even the long run and may have implications for the EBA analysis. It seems that estimating models with REER weighted by the share of currencies in invoices is a possible step towards understanding the implications of this emerging paradigm. Staff comments are welcome.

- Price stickiness is the pre-condition for the currency invoicing to matter. Although GVC-related trade might make it optimal for countries along the chain to price in a common currency (e.g. USD) and make the Dominant Currency Paradigm (DCP) more prominent, sufficient stickiness in the price setting (in terms of invoicing currency) is still needed in order for the DCP to matter for the REER. When prices are flexible, they would adjust perfectly with exchange rate fluctuations and the invoicing currency would not matter.

- Most of the literature finds price stickiness to hold up to a horizon of 2 years or so. Since the EBA model assesses the "medium-term" REER movement, DCP might be less relevant given the medium-term horizon. That said, staff will continue to explore the implications of the DCP including its implications for the external sector assessment.

41. ***We see the need to enhance the transparency regarding the assumed elasticities used to calculate the REER gap that is implied by the staff-assessed CA gap. […] Against this background –and also given the fact that the estimated "common elasticities" seem to date back to pre-1985 –we would ask staff to prepare a Working Paper that estimates the respective elasticities in a comprehensive and structured manner. Staff comments would be appreciated.***

- While Staff places greater weight on the EBA CA model in most cases, the exchange rate assessment is also informed by the EBA REER index and level models, and views on the lags CA and REER movements. Hence, staff-assessed REER gaps don't always match with the REER gap derived from by applying the estimated semi-elasticity to the staff-assessed CA gap.

- While RES provides country teams with a range of semi-elasticities based on different methods, country teams often use their own estimates to reflect more updated data and country-specific factors. Staff is considering presenting these common elasticity estimates in future ESR reports, as well as to make public the different methodologies and associated estimates in a forthcoming Working Paper. That said, country-team insights on these elasticities remain of essence.

Other Methodological and Presentational Considerations

42. ***Comments on the impact of the persistence of these excess external imbalances on non EBA countries will be welcome.***

- The persistence of global excess imbalances carries risks that apply to the broader set of the membership. For example, a faster-than-expected tightening of global financial conditions could prove disruptive to EMDEs (EBA and non-EBA). Therefore, the general ESR policy messages are applicable to all countries, even if they are not explicit discussed and treated in the report. How these risks affect each country can be discussed in greater detail in the Article IV report and external sector country page.

- To clarify, there are 49 countries in the model EBA, representing over 90 percent of world GDP. The EBA sample coverage was guided by balancing several considerations: capturing a large share of the global economy, avoiding too much heterogeneity in the regression samples, and data availability. Most low-income countries and countries highly reliant on commodity revenues were excluded, in part because assessments of such cases require special considerations that would be too challenging to include in the EBA panel regression. Therefore, for non-EBA countries, the individual external assessments are based on the alternative EBA-lite methodology.

43. ***We would strongly prefer if staff used a more detailed presentation for non-systemic EBA countries included in the Technical Supplement (i.e. applying an adjustment for country-specific factors and publishing the current account norms as ranges), as the current approach of showing only point estimates does not include sufficient acknowledgment of the uncertainty they carry and does not facilitate a critical review of the estimates. Can staff provide a presentation for all EBA countries, including the 23 non-systemic members, to facilitate better policy advice and ensure an evenhanded approach?***

- The Technical Supplement aims at comparing EBA estimated norms for 2017 under the old (2015) and refined (2018) models for all 49 countries in the sample. EBA estimated norms are normally not presented in ranges (that applies to the staff-assessed norms), although Staff will make public the estimated *standard error* of the EBA norms for all countries in the detailed data it releases shortly after the ESR is made published.

- Staff (country teams and SPR) will work to ensure that Staff Reports and External Sector Pages for EBA non-ESR countries also include a thorough discussion and transparent presentation of ranges and adjustors.

Country-Specific Questions

Euro Area

44. ***We find some inconsistencies between the external assessments in the Euro Area Art. IV and in the ESR for euro area economies. The latter report puts emphasis on asymmetries in competitiveness within the euro area as the main cause of external imbalances, while the former report focuses on excessive current account surpluses in net creditor countries, which we believe is more accurate. Could staff comment on this?***

- Staff does not view the language of the two reports as an inconsistency. Both reports, as well as the euro area Individual Country Page, stress the need to facilitate relative price adjustment and boost investment to improve internal and external imbalances in the euro area. Specifically, the ESR (see para. 21, second bullet), recommends that: "*Reforming wage bargaining mechanisms to moderate wage growth and better align wages with productivity gains (France, Italy) and reducing labor market segmentation (Spain) could help in some cases. Policies that strengthen euro area integration on the banking, fiscal, labor and regulatory fronts are necessary to boost investment throughout the currency area and reduce its external imbalance*." A similar, more detailed language can be found in the euro area country page (and Staff Report) with recommendations on improving risk-sharing mechanisms, implementing structural reforms in creditor and debtor countries, and tailored fiscal policy advice.

Germany

45. ***Despite the new refinement to the EBA model, nearly all of Germany's EBA gap is not explained by the model. The particularly bad fit for Germany is somewhat disappointing because it continues to limit the insights offered by EBA […] Staff's choice of the desirable fiscal balance seems not fully consistent with Germany's fiscal rules that are enshrined in the constitution. […] A credit gap contributes another 0.4 percentage points. However, questions remain about the methodology used to estimate a large negative credit gap (- 9 percent of GDP) in the case of Germany. It seems that the results are not fully consistent with staff's refined methodology which yields a positive gap of 2 percent of GDP.***

- In general, the fiscal balance P* reflects the country team's views of the desirable fiscal balance over the medium term, and it may differ from the authorities' views. Staff assesses Germany's fiscal P* relative to the European fiscal rules. The fiscal P* is also fully consistent with Germany's national fiscal rules enshrined in the constitution, which suggest that most of Germany's fiscal space exists at the state and local government levels.

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

46. ***We were surprised to learn that in the case of Germany the overall contribution for this important – both empirically and theoretically well-established – explanation for the saving-investment balance has been reduced from 3 percent of GDP to less than one percent of GDP in just one year. Further elaborations by staff on the specific reasons behind this significant change are welcome.***

- The reduction in the demographic contribution to the norm is driven by both data revisions and model refinements. Keeping the CA model unchanged, but using the updated UN population projection vintage 2017 implies a reduction in demographic contribution from 3 to 2 percent of GDP (which is shown in Box Figure 2.1). There is a further reduction from 2 to 0.8 percent due to the refined demographic specification. This in turn reflects the fact that the static and dynamic effects of aging are now better captured by life expectancy and prime-age saver share respectively. In the 2015 model, the aging speed variable both confounded and compounded several effects of aging, leading to volatile demographic contributions across countries with similar demographic profiles. Staff is open to engage on these complex issues.

47. ***We note that one of the largest reassessments of the current account norms took place for Germany, and thus its positive current account gap has widened further (see Box Figure 2.1. on page 10). At the same time, though, only a small portion of this current account gap can be explained by German domestic policies (see Figure 8 on page 14). To a lesser extent, this also applies to the Netherlands. Relative to this weakness, the policy recommendations given in the report to Germany seem therefore fairly strong. Staff's comments would be appreciated.***

- Table 4 in the ESR shows that the domestic fiscal and credit gap contribute somewhat to the overall policy gap for Germany. That said, there remains a large unexplained residual, likely related to structural features of Germany's economy. The Germany individual country page (and Article IV report) provide a few structural policy recommendations to reduce excess saving and encourage investment, although further efforts are needed to understand the source of the sharp increase in net corporate saving. This is an area where staff plans to undertake further work, including to understand the role of tax policy, corporate governance and wealth distribution.

India

48. ***India is classified among countries whose current account balance and REER gaps are broadly consistent with domestic fundamentals. As per the assessment, the current account deficit (CAD) for India that would stabilize the ratio of net foreign assets (NFA) to GDP at the benchmark NFA/GDP level is estimated at (-) 2.3 percent of GDP. The estimated NFA/GDP used for India is (-) 13.0 percent of GDP. It is not clear whether the estimated NFA/GDP at (-) 13.0 percent is the benchmark used to work out the sustainable level of CAB. If it is so, then in case of India, the estimated NFA/GDP at (-) 13.0 percent is not only inconsistent with the estimated sustainable level of CAD of 2.3 percent but also appears to be on lower side. If the NFA to GDP ratio is to be stabilized at (-) 13.0 percent, the consistent level of CAD would work out to be about 1.5 percent. If, instead, CAD at 2.3 percent of GDP is considered to stabilize the NFA/ GDP ratio, the consistent ratio for the latter will be about 20 percent. The current NFA/GDP ratio at end-March 2018 is 16.3 percent. Staff comments are welcome.***

- Using the same approach as most of the countries in the EBA sample, the benchmark NFA/GDP used for India is -25 percent of GDP, which is the 2016 NFA/GDP as reported in the Wealth of Nations Database by Lane and Milesi-Ferretti.

Japan

49. ***The country page should list 'Japan specific factors' to enhance transparency. The one in the 2017 ESR listed three factors — JGB-UST spread, portfolio rebalancing, and temporary speculative short positions against the yen — as 'Japan-specific factors' which affects REER but are not included in the REER model. In the same context, the country page in the 2018 ESR mentions 'Japan-specific factors' but does not list those factors specifically. We believe that for transparency purpose, the 2018 ESR should list those factors as in the 2017 ESR, so that any readers fully understand the explanation in the report.***

- In the context of the EBA/ESR refinements this year, Staff streamlined ESR country pages, including by not listing all the details on the shortcomings or merits of the REER models for each country. That said, country staff reports can discuss in the needed details the country-specific nuances related to REER models. Going forward, staff plans to undertake work in this area to account for the rise of GVCs and financial integration.

Netherlands

50. ***Staff has removed the financial sector dummy from the EBA model and has instead chosen to make adjustments to account for financial sector biases (staff-adjusted CA-gaps). However, these adjustments need further clarification. The Netherlands has for example not seen an adjustment, while the financial center status of the Netherlands entails a concentration of corporations with high savings which staff cannot yet explain.***

- Staff has moved to make adjustment for known and analytically proven sources of measurement biases in the CA, most importantly the inflation bias and retained earnings on portfolio equity bias, which can lead to systematic divergence between cumulative financial flows and NIIP. In the Netherlands, these biases have been small in recent (the cumulative financial account has been roughly equivalent to the change in the NIIP). Staff is open to discuss these issues further, and work closely with the authorities to better understand the role of the financial centers, profit shifting, and the corporate taxation regime on the measurement of external flows and stocks.

South Africa

51. ***In this regard, the new CA norm of a surplus of 0.7 percent may further erode confidence in the reliability of the model. While we support the use of staff judgment in principle, we remain concerned about the lack of transparency around the way that staff apply such judgement. In respect of South Africa, the use of judgement results in a reversal of the EBA model's adjustments, due to "…special demographic factors relative to other countries in the regression sample…". Consequently, the CA norm returns to a deficit, this time of 0.4 percent of GDP. Staff comments on this would be appreciated.***

- In the refined 2018 EBA model, the effect of longevity on the current account is measured with life expectancy at prime age (45-50). However, the (negative) impact of life expectancy on the current account for a few low-life expectancy countries in the EBA sample might be overestimated as this lower life expectancy is driven primarily by high mortality rate at prime-age. South Africa belongs to this group of countries characterized by low life expectancy at prime age, where workers are expected to enter and exit from the workforce much earlier than elsewhere. In fact, studies suggest that work-life spans end on average 5 years earlier and income profiles also peak earlier in countries with the lowest level of life expectancy. This might reflect that, in these countries, there is a higher incidence of health risk, as well as more physically demanding work. To reflect these differences in the life-cycle, consideration is given to adjusting down by 5 years demographic indicators in the outlier countries. Staff's approach is transparent and evenhanded since a consistent approach is used to identify the outlier countries that could use the adjustor. This is explained in Para. 12 in the Technical Supplement, and staff plans to expand on this in a forthcoming IMF Working Paper.

Sweden

52. ***The staff-assessed CA norm decreased from around 3 percent in 2016 to 2 percent in 2017, which is in line with the decrease in the CA. The EBA model and staff assessments for 2017 are aligned, while there was a larger staff adjustment in 2016. On the other hand, this means that the revisions of the EBA model and staff assessments between 2016 and 2017 are quite different, roughly 3 percentage points and -1 percentage point respectively. We interpret this as giving substantially more weight to the EBA model (level) estimates in 2017 than previously, reflecting that the EBA estimate is now judged more reasonable. Is this a "coincidence" or should we expect that the assessment is more closely aligned with the EBA estimate also in the future?***

- The change in EBA model between 2016 and 2017 is a combined result of several refinements to the model, mainly to the demographics and credit specification. The refined model renders a better fit than in the past for Sweden, and hence the need for less adjustments. On why we no longer apply an adjustment for merchanting and financial center activities, as explained earlier, through our more recent granular work on measurement biases we have found that these activities in the case of Sweden do not imply an overstatement of the CA (e.g. the cumulative financial account is roughly equivalent to the change in the NIIP). Staff is open to discuss these issues further, and work closely with the authorities to better understand the role of these factors for Sweden.

United States

53. ***Could staff elaborate on the net effect, of US tax policy change and its relative self-sufficiency in the oil and gas sector, on the US current account gap?***

- The net effect of the current fiscal path will be to provide a near-term boost to the U.S. and to many of its trading partners. Overall, the current account deficit is expected to increase over the medium-term due to a stronger U.S. economy and the planned fiscal expansion, including the 2017 tax cuts. This will move the current account balance further from the level justified by medium term fundamentals and desirable policies.

- The marked decline in global oil prices weighed on aggregate investment from 2014 onwards. However, business investment in the U.S. should continue to strengthen over the near term—in line with solid demand growth and a recovery in the oil and gas sectors—contributing to the widening of current account deficit.

54. ***What is the sustainable level of CAD for the US?***

- The EBA model estimates a cyclically-adjusted CA for the U.S. of -2.2 percent of GDP, and a cyclically-adjusted CA norm of -0.7 percent of GDP. In 2017, the cyclically-adjusted CA gap was -1.5 percent of GDP (with a policy gap of -0.5 percent of GDP and an unidentified residual of -1.0 percent of GDP), whereas the External Sustainability Approach estimated a CA gap of -2.2 percent of GDP. On balance, staff assessed the 2017 cyclically adjusted CA to be 1.0 to 2.0 percent of GDP, lower than the level implied by medium-term fundamentals and desirable policies.

55. ***We find staff´s analysis of the US tax reform and the current account (Box 5) interesting. We would have expected an analysis of how the main items in the tax reform will affect the patterns of government saving and investment, and those of corporates and households in the medium run. Staff´s comments are welcome.***

- With the economy already at full employment, the fiscal stimulus in the U.S. is likely to translate into higher import growth, and an increase in the current account deficit (to around 3½ percent of GDP by 2019–20). This will also put upward pressure on the dollar and worsen the international investment position.

- In terms of savings and investment, the U.S. is likely to experience lower household savings, higher investment, and a weaker fiscal position. In particular, the household saving rate is predicted to continue falling—based on staff's medium-term forecasts and gains in household wealth—and eventually revert to the secular downtrend that was in place before the global financial crisis. Business investment should continue to strengthen in line with the expectations of solid future demand growth and a recovery in the oil and gas sectors. At the same time, the public sector saving-investment balance is expected to worsen. Combined, these effects are expected to lead to widening in the U.S. current account deficit of around 1 percent of GDP.