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Statement by Mr. Rosen and Ms. Pollard on 2020 External Sector Report (Preliminary)
Executive Board Meeting
July 24, 2020

The United States continues to be a strong proponent of the External Sector Report (ESR) and External Balance Assessment (EBA). External sector assessments are core to the Fund's mandate. Indeed, the premise of Article IV surveillance is on the provision of information and consultations on exchange rates. Thus, we are glad to see that the ESR remains a priority even during the COVID-19 crisis.

Nevertheless, we recognize the challenges associated with the 2020 report. The assessment of external imbalances in the ESR is always a backward-looking process. Normally, this is not a problem as factors underlying the determination of current account balances do not shift abruptly. The year 2020, however, is not normal and the current global conjuncture was unimaginable when the Board discussed the 2019 ESR. We think the ESR provides a good balance given the current situation—reflecting on the pattern and determinants of external imbalances in 2019 while incorporating an analysis of factors that are shifting current account balances in the near-term and have the potential to produce longer-term changes.

External Imbalances in 2019

Chapter 1 notes that current account surpluses and deficits, which fell sharply during the Great Financial Crisis (GFC) have narrowed only modestly in recent years. This observation, on its own, provides little useful information. As staff indicates in Box 1.1, a balanced current account may not be desirable. What matters is the extent to which current account balances are excessive. More insightful than Figure 1.1, which shows the level of imbalances over time, would be a graph showing the path of excessive imbalances over time. We know that for some surplus and deficit countries, the level of imbalances in the run up to the GFC were excessive but much of the decline in imbalances since then has been on the part of countries with excessive deficits, not those with excessive surpluses.

We generally agree with the assessment of current account gaps in Figure 1.3 but would like to have seen some analysis of shifts in these gaps over time. It is our sense that the countries with current account positions weaker than implied by fundamentals and desirable policies have changed over time, but the countries whose current account positions are stronger and notably substantially stronger than implied by fundamentals and desirable policies have remained more constant. *Staff comments would be appreciated.* We also note the continued asymmetry in excessive imbalances, with no countries having substantially weaker than warranted current account balances for the third year in a row.

At the same time, we recognize that countries whose current account balance are considered broadly consistent with fundamentals and desirable policies may have offsetting underlying distortions, so that being in the "broadly in line" category should not necessarily be seen as a clean bill of health. For example, while we welcome the decline in China's current account surplus over the past several years, we agree with staff that the shift into broadly aligned is the result of offsetting policy gaps and structural distortions. More discussion of this in the report—and the attendant policy implications—would be helpful.

External Imbalances Outlook

We agree with staff that the contraction in goods trade this year is being driven by the output loss due to the COVID-19 pandemic. The pandemic is also key to explaining the sharp decline in services trade as tourism has collapsed. Figures 1.9 and 1.10 provide a stark illustration of the effects of the decline in oil prices and drop in tourism, respectively on current account balances of EBA countries. We note that some non-EBA countries are likely to see even more pronounced effects of these changes on their current account balances. While we recognize that the ESR does not cover these countries, we think including a box to consider the effects of the crisis on their current accounts would have been useful.

Staff's assessment that current account balances are likely to narrow this year seems reasonable as do the implications of the alternative scenarios detailed in Box 1.6. We also agree that assessing the path for current accounts beyond 2020 is difficult given not only the course of the pandemic but the potential structural changes resulting from the crisis. Thus, we encourage staff to not only analyze potential effects but consider how countries can adapt to these changes.

Policy Priorities

We concur with staff that near-term policy measures should be focused on addressing both the health and economic effects of the pandemic. We welcome the recognition in the ESR of the importance of the prompt and forceful policy responses by central banks and fiscal authorities to limit the negative effects of the crisis. We note in particular the action by the major central banks to ensure adequate global liquidity and calm international markets. Exchange rate flexibility has played a role as a shock absorber.

Exchange rate intervention can play a role to smooth disorderly adjustment but should be used sparingly and not to prevent necessary adjustments. We urge staff to be cautious in its statement in the ESR that capital flow measures (CFMs) on outflows could be useful. We recognize that in the midst of an extreme crisis, CFMs on outflows may be needed but these should not substitute for other policy measures. We also note that countries did not resort to CFMs on outflows during the height of the capital flow reversals earlier this year. Staff's statement may be seen as indication that countries should have considered using these CFMs or may need to do so during this crisis. Our concern is this could make investors even more cautious in returning to EMs.

Looking ahead, we agree that fiscal support will need to be removed over time to prevent debt problems but emphasize that for countries not at a high risk of debt distress, fiscal policy should remain flexible and growth-friendly, with support withdrawn gradually once recovery is firmly entrenched. We also emphasize that countries with excessive current account surpluses have a key role to play in stimulating domestic demand to help the global economy recover. Without durable efforts to strengthen domestic demand and reduce overreliance on exports in persistent surplus economies, imbalances that existed prior to the COVID-19 outbreak could worsen over time.

It is important to note that the crisis will not affect countries equally. Economies dependent on commodities, remittances, and tourism, as well as those with high foreign currency debt and low international reserves are likely to be most vulnerable. We would welcome tailored policy advice from the IMF on these economies that are acutely impacted to mitigate the direct effects of the crisis, while avoiding creating long-term imbalances.

With regard to trade policies, as we stressed in our statement for the ESR last year, staff's focus is solely on tariffs. Domestic subsidies, forced technology transfers, non-tariff barriers, and other industrial policies may result in even greater external distortions than tariffs. yet these are not addressed in the ESR. On supply chains, the pandemic has led to a reassessment of global supply chains by both policy makers and firms globally. We also found staff's discussion of the new regulation allowing the United States to examine whether currency undervaluation could lead to a countervailable subsidy superficial: fair currency practices are a critical underpinning of an efficient and well-functioning trade system, and this policy is one aspect of a comprehensive legal regime of trade remedies designed to correct these unfair practices. In addition to not recognizing the role of the policy in a trade remedies context, the discussion did not acknowledge the role that unfair currency practices play in sustaining persistent misalignments.

EBA Methodology

The EBA methodology has strengthened over the years, notably with the most recent changes in 2018. We recognize the need to pause for a period before making further adjustments. Going forward, consideration should be given to improving or rethinking three variables in the current model.

First, we have repeatedly noted the weakness in the reserve currency variable. This variable should more fully capture the role of safe haven currencies in driving the current account balance. The safe haven concept is not adequately captured by the share of a currency in global reserves. For example, the currencies of some countries, such as, Japan and Switzerland, account for a small share of global reserves as indicated by Currency Composition of Official Foreign Exchange Reserve (COFER). Both the yen and the Swiss franc, however, are considered safe haven currencies, and these two countries have no problem either issuing debt in their own currencies or accessing external financing during times of stress. In addition, the model assumes the euro's role as a reserve currency has the same effect on the current account on every euro area member. This is the same as assuming that the dollar's role as a reserve currency has the same effect on the current account of the United States as it does for Ecuador.

Second, when EBA was developed in 2013 the inclusion of the lagged net foreign asset (NFA) position as a share of GDP was seen as an improvement on the use of the lagged current account in the Consultative Group on Exchange Rate Issues (CGER) model. We think the NFA variable, like its predecessor, has a fundamental flaw in that it justifies the perpetuation of large current account surpluses.

Third, staff has made much progress in refining the exchange rate intervention variable. Further progress would be aided by the reporting of intervention by EBA countries. We also encourage staff to consider more fully the effect of intervention on the current account and whether, even in the absence of capital controls, intervention can play a role.

The Board's ability to assess the variables in the EBA model would be aided by more details on the main factors determining the current account norms for ESR countries. The 2017 ESR had a chart showing the components of the norms based on the EBA model, and a less detailed version was published in the 2019 ESR. *Could staff provide the Board with an update of the 2017 chart and explain why this is not included in every ESR?*

We welcome the increased transparency of staff's adjustments to the current account gaps and note that such adjustments have become less numerous and generally smaller in size. We welcome, in particular, that staff, after 4 years, no longer assesses political uncertainty to be a factor supporting a current account surplus in Thailand. Some adjustments, however, continue to confound us. Last year, for the first time, staff adjusted upward the current account norm for Brazil, India, Poland, and Spain because of financing risk considerations related to the negative net international investment position (NIIP) of these countries. This year, the adjustment was not made for Brazil and Poland. Table 1.2 indicates that Brazil's NIIP deteriorated further in 2019. *We would like to know staff's explanation as to why the adjustment was considered important in the 2019 ESR but not the 2020 ESR?*

In addition, we note that China's current account gap was revised downward as a result of trade tensions and Mexico's current account gap was revised upward as a result of trade diversion. *Are we to assume that trade was diverted from China to Mexico or are there other current account gaps that should be adjusted to compensate for these changes?*

External Stress and the International Investment Position

In recent years staff has highlighted the importance of stock imbalances and Chapter 2 expands on this work. We welcome this analysis, particularly its focus on the components of international investment positions (IIPs) and not just the size of NIIPs. Staff find that for emerging markets and developing economies both foreign currency assets and liabilities affect the probability of external stress. The analysis of predicted probabilities, however, examines only the role of foreign currency debt and not the role of foreign currency assets. We would have liked to have seen more analysis of the latter.

Staff analysis indicates that the link between foreign exchange reserves and external stress is non-linear. This result makes sense as one would expect that beyond a certain point the accumulation of reserves does not lower a country's vulnerability. Nevertheless, we were surprised to see this point is reached only once reserves are 55 to 60 percent of GDP, a level that is reached by few countries (only Saudi Arabia in Table 1.3). Further analysis to indicate reasonable targets for reserves would be helpful.

We would like to see more analysis of the robustness of these results, as touched upon in Annex 2.1. Staff note, for example, that the results are robust to the exchange rate regime. Understanding the link between the exchange rate regime and the effect of foreign exchange reserves on external stress would be useful information for the Board. Annex 2.1 also notes that the results are robust to the inclusion/exclusion of the FCL. We recognize that countries tend to request FCLs in times of heightened stress, indeed that is a requirement for the approval. Staff should, however, be cautious in giving the impression that the request for an FCL or any precautionary program falls into the same category as a sovereign debt restructuring or default.