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Statement by Mr. Bhalla and Mr. Goyal on 2020 External Sector Report (Preliminary)
Executive Board Meeting
July 24, 2020

1. We thank Staff for a comprehensive report on the external sector containing in-depth analysis in the wake of COVID pandemic, outlook, and policy prescriptions in the near and the medium term. We broadly agree with the overall assessment and offer the following observations.

2. With the pandemic, investors' sentiment turned negative, triggering capital flow reversal and downward pressure on currencies in most emerging markets and developing economies. The report notes that capital outflows and currency depreciation were relatively moderate in economies having strong fundamentals, currency valuation aligned to an equilibrium level, holding large forex reserves, and had access to bilateral swaps from Federal Reserve. This observation suggests an important point - the country's own forex reserves remain most important, and the first line of defense against the upheaval in the global market conditions and the global safety net has remained inadequate. Although attempts have been made, we need to revisit the available financing facilities. The stigma attached to IMF facilities probably continues to be a critical factor as we observe that not a single country has opted for SLL so far. Importantly, the availability of bilateral swap lines remains a key factor in guarding against the global volatility and desisting countries from accumulating excess reserves or undertaking CFMs.

3. We broadly agree with the assessment that, going forward global trade volume would experience some contraction, fall in commodity prices, and decline in remittances and earnings of the tourism and hospitality sector. The analysis shows that the severity of this downturn would depend upon the alternative assumptions/ scenarios, viz., a second outbreak of COVID or a faster recovery. We feel that even under the scenario of the second wave of COVID, the downturn may not be as severe as projected. The second wave of pandemic may not be associated with the second round of lockdown. As countries may mostly respond with social distancing, face masks, and more effective testing, the economic impact should be

moderate. Secondly, with continued monetary accommodation by major economies and lower for longer scenario, the possibility of tight global financial/ liquidity conditions also seems remote.

4. We note that under the second outbreak scenario, oil prices have been projected to move up by 12 percent compared with 8 percent under the faster recovery scenario. Given that oil demand should comove with economic recovery, these assumptions appear inconsistent. *Staff may like to respond.*

5. We welcome granular details provided in the report assessing each of the 30 major economies. We have a few specific observations. On page 14 of Chapter 1, the impact of the fall in oil prices on oil trade balances of individual economies has been shown. *Can Staff elaborate on underlying price and volume components?*

6. We note that the external balance assessment (EBA) is based on 2019 data. Given that the economic scenario has undergone significant changes since then, the 2019 assessment may no longer be valid and needs to be updated.

7. Chapter 2 investigates the relationship between IIP components and external stress episodes using a probit panel exercise. Results strengthen and support the views generally held by the policymakers with regard to management of capital flows. Generally, equity flows are preferred to debt flows; long-term debt is preferred to short-term debt; debt denominated in local currency is preferred to denominated in foreign currency. However, there is an interesting and somewhat surprising result about debt liabilities. Exercise observes that in the case of EMDEs, while the debt denominated in foreign currency significantly adds to stress probability, the effect of the debt denominated in local currency is statistically insignificant. Experience on the ground does not support this result. Unless the conversion of local currency proceeds into foreign currency is significantly constrained due to administrative conditions and shallow forex market, debt denominated in local currency would also bring pressure on currency valuation and foreign exchange reserves of the country in the event of outflows. *Are there some outliers leading to such results? Staff may like to comment.*

8. Further, the exercise defines sovereign debt default, debt-restructuring, and the IMF-supported program as an ‘external stress episode’. Interestingly this list includes non-disbursing and precautionary arrangements as well. That means country availing SLL would have also been considered as the one experiencing external stress. *So, as observed in paragraph 2 above, the stigma attached to IMF precautionary lending is for real? Staff may like to comment.*

Comments specific to India

9. We note that India has been classified among countries whose current account balance and REER gaps are broadly consistent with macro 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 current level (-15.0 percent) is estimated to be (-) 2.4 percent of GDP. *Can Staff elaborate what are the real GDP growth and inflation numbers considered for arriving these estimates?*

10. Report observes that "… Progress has been made on FDI liberalization, whereas portfolio flows remain controlled. India's trade barriers remain significant". In this context, it may be mentioned that the limits for FPI investments in Central Government securities (G-secs), State Development Loans (SDLs) and corporate bonds were enhanced under the medium-term during 2019-20. Also, the limit for FPI investment in corporate bonds has been further increased from 9 per cent to 15 per cent of outstanding stock for FY 2020-21. For investment by non-residents in securities issued by the Government of India, the quantum of investment permitted under the Voluntary Retention Route (VRR) was doubled in January 2020 along with other flexibilities and a third separate route, *viz*., Fully Accessible Route (FAR) was operationalized in March 2020. **Thus, the remark "*portfolio flows remain controlled*" are not justified and need to be dropped.**

11. Similarly, the **remarks about trade barriers again are not justified and need to be removed**. **IMF report must ensure that they follow even handedness in their approach while dealing with individual countries.** There is no mention of trade barrier in the case of some major economies which have embarked upon massive trade restrictions in the recent period with serious repercussions for the global value chain and economy.

12. Further, it has been mentioned in the context of India, "*External vulnerabilities remain, stemming from volatility in global financial conditions and an oil price surge,…..*". *first,* a surge in oil prices is unlikely given the current demand-supply situation in the crude oil market and the depressed global growth scenario. Secondly, it also contradicts to the assumption of "*lower oil prices*" for projecting CA deficit.

13. Although the remittances globally, on average, are expected to decline by 20 percent, the impact on individual economies varies. For India, remittances have been projected to fall by about 50 percent. *Staff may like to elaborate on specific factors considered for arriving at a larger fall in the case of India.*

14. On page 45 of Chapter 1 (Table 1.7), it is mentioned that REER index of INR appreciated by 5.8 per cent in 2019 over 2018. This is much higher than that derived from indices published by Reserve Bank of India (0.7 per cent) based on 36-currency trade basket and BIS (2.1 per cent). Since the REER is a critical variable in the External Balance Assessment methodology, the source of REER variable used for India may be mentioned.