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

We thank staff for the 2020 External Sector Report (ESR), which provides insightful analysis of global external developments amid an exceptionally challenging and uncertain global economic context. We broadly support the external sector assessment and the suggested policy reforms provided in the report and make the following reflections:

The historically high stocks of external assets and liabilities raise concerns over the build-up of vulnerabilities and potential risks of disruptive adjustments. During the past few years, bilateral trade tensions have contributed to currency and financial market fluctuations globally. Global excessive imbalances are fairly persistent and changed only a little last year. Stronger and weaker than desirable external positions continue to be concentrated in advanced economies. While China's current account has remained close to its normative level, the increased number of large EMDEs with weaker than desirable external positions warrants attention.

The contraction of global trade during the Covid-19 crisis has been pronounced and is comparable to the sharp drop during the global financial crisis. There are, however, clear compositional differences particularly with the significantly larger collapse of service trade due to travel restrictions, the sharp fall of tourism activity, and lower shipping volumes. The impact of Covid-19 on trade may have been amplified through global value chains (GVC) in sectors characterized by very complex value chain linkages, such as in electronics and automotive industries, or high dependency on specific production inputs from countries severely impacted by the virus. *Staff forecasts a 12 percent contraction of global trade in 2020 and we would welcome staff's expectations for recovery of trade as well as its sectoral composition.*

The Covid-19 shock has been a major disruption to EMDE capital flows and financial conditions, particularly during the early spring. Conditions have stabilized in recent months but remain vulnerable to further stress. Staff analysis also shows that country-specific fundamentals, in particular strong institutions and economic fundamentals as well as earlier implemented macroprudential policy measures, have been vital in providing resilience against capital flow volatility in EMDEs and in limiting the disruptive impact of sharp exchange rate swings. Many emerging market economies have also provided large monetary accommodation and ventured into unconventional monetary policy. *Bearing in mind the analytical work on the Integrated Policy Framework, could staff comment on whether and to what extent has the Covid-19 shock constrained EM central bank policies in supporting domestic conditions?*

The broader assessment for 2020 indicates that the narrowing of global current account balances is expected to be modest and significantly smaller than the decline during the global financial crisis. With the exceptionally large fiscal policy action, public savings are expected to decrease meaningfully but to be offset to a large extent by the increase in private savings. *Could staff comment on how the expected private savings impact would be divided between households and corporates? Past ESR analysis has noted the important role of corporate savings underpinning global imbalances, thus we would welcome analysis on how this may be impacted by the current crisis?*

Significant uncertainty surrounds the external outlook. We are particularly concerned about the risk of reversal in global integration, greater fragmentation and more restrictions, given the background of increasing protectionism and trade tensions in recent years. While we understand that the crisis has triggered a desire to increase the resilience of GVCs, for example by diversification or shortening of supply chains, large-scale reshoring of production would be economically inefficient and harmful for productivity.

We welcome the analysis in Chapter 2 which confirms the role of large current account deficits and low levels of reserves as important stress indicators, but also the vulnerabilities arising from the elevated external foreign-currency-denominated debt liabilities in emerging and developing countries. The external vulnerabilities increase the likelihood of a stress event, but also amplify the effects of the shock to the economy. We note the worrying assessment that the rise in debt ratios and the fall in foreign reserves currently underway in many EMDEs could increase the near-term likelihood of external stress episodes. This should be monitored carefully and calls for preparation of contingency plans in case the economic situation and global financial conditions deteriorate further.

On policy priorities, the near-term policy objective should be to address the health crisis and limit the economic hardship of households and firms. We note that during the Covid-19 crisis capital outflow measures have been used sparingly in EMDEs, which may have contributed to the quick improvement of financial conditions and market access. The recommended prudent steps for EMDEs to improve resilience appropriately emphasize the use of macroprudential measures, shifting away from foreign-currency debt liabilities, strengthening of external buffers and deepening of domestic financial markets. We would also highlight the importance of strong and credible policy frameworks and institutions as anchors of external stability.

Avoiding trade restrictions and other protectionist policies, which could increase the long-term economic scarring from the crisis, remains important. The adoption of currency-based countervailing duties is also very problematic and could lead to further tensions and politicization of foreign exchange markets. These policies are overall net negative for global growth, but their indirect effects, such as trade diversion as a result of protectionist policies, should be considered in the assessment of external imbalances. Rolling back harmful trade barriers as well as modernizing and strengthening the rules-based multilateral trade system would be very beneficial to the global recovery. Along with greater policy certainty, those actions would provide incentives for firms to invest, innovate, and expand their activities.

The medium-term policies to address excessive external imbalances should be growth-friendly and in line with the broader policy objectives of supporting sustainable, greener and inclusive economies, and the adoption of a comprehensive digital agenda. Excessive deficit economies should focus on structural policies to improve competitiveness. For excessive surplus economies encouraging productive investments and discouraging excessive savings are warranted. Gradually, when economic conditions allow, all countries should focus on ensuring medium-term fiscal sustainability. However, depending on the path of the current crisis, we would caution against tightening fiscal policy too early to avoid pro-cyclicality and long-term scarring effects.

<u>Specific comments on the ESR Individual Economy Assessment for Sweden:</u>
We note that the assessment of Sweden's external position has increased to "stronger", up from "moderately stronger" since last year. We appreciate that staff take the (large) uncertainties of the estimated CA gap (and its relationship with the REER gap) into account, by giving higher weight to ULC-based REER models in the evaluation of the krona. Doing this, staff's assessment is that the krona is undervalued by around 10 percent, which is reasonable.

Looking ahead, Staff anticipate the Swedish REER-gap to close, while the CA-gap is projected to remain positive (from the latest WEO). *Could staff comment on this discrepancy?*

We encourage further refinements to the CA-norm methodology for Sweden, as the current model does not fully capture the mandatory pension savings and large international footprint of Swedish multinational enterprises and the high level of merchanting.

Technical comments on the methodology:
We appreciate the use of ranges for the CA gap and the REER gap (Table 1.4), and we continue to strongly encourage staff to apply ranges also when EBA results are used in e.g. Article IV etc., which is currently not the case for all countries.

There is a strong need for transparency and consistency related to the estimation and use of semi-elasticities. Due to the inherent uncertainties related to trade elasticities, uncertainties should be carefully explained and properly accounted for. This extends into the work done, not only on ESR countries, but the full EBA and EBA-lite sample, since the overall methodology is similar.

We encourage a more consistent treatment of uncertainties related to the CA gap and the REER gap. Since the REER gap is proportional to the CA gap, and thus inherits all the uncertainties attached to the estimated CA gap, the respective uncertainty bands should also be proportional to each other (all else equal). We would suggest providing more details on how staff arrives at the uncertainty bands in future reports.