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Statement by Mr. Ronicle and Mr. Chrimes on 2020 External Sector Report (Preliminary)
Executive Board Meeting
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Amid difficult circumstances, staff have produced a timely document which we see as a positive step in the evolution and maturing of the External Sector Report. Assessing external balances in a consistent-yet-meaningful way is an analytical challenge which sits right at the heart of the IMF's role, joining up the Fund's surveillance mandate (on fiscal, monetary, financial and structural issues) with its role as lender of last resort: in that respect, the External Sector Report should arguably be the strongest of the IMF's flagship reports.

We particularly welcome the enhanced coverage of conjunctural issues in chapter one: this is crucial for the relevance of the report in a COVID-19 context; it focuses on crucial questions, including the dramatic recent developments in trade and capital flows; and is well-pitched, with clear policy messages. Such analysis serves as a valuable complement to the more medium-term assessment provided by the External Balance Assessment results; it puts the EBA results in context and can be used to nuance policy advice at different horizons.

We would like to see future ESRs continue in this direction, in particular with enriched coverage of conjunctural issues. To that end, we would like to see staff deploy a broader range of analytical tools, such as those used in the Vulnerability Exercise, those developed as part of the Integrated Policy Framework, and capital flows at risk. Combining these tools with the norms from the EBA results would help provide greater context and more granular, horizon-specific policy analysis, enhancing traction with policymakers.

From an aggregate external sector perspective, the global economy entered the COVID-19 crisis in a better position than during the Global Financial Crisis. Global imbalances are smaller and largely concentrated between advanced economies with floating exchange rates, robust policy frameworks, and liabilities in domestic currency. Many emerging markets are arguably more resilient, having built up foreign exchange reserves, strengthened domestic capital markets and reduced their foreign currency exposures. There are of course important exceptions in specific countries, while rising debt levels were a vulnerability the Fund had flagged before the crisis. More generally, this more robust picture is in spite of regrettable global trade tensions. Box 1.2 is a useful reminder that deteriorating trade relations between China and the USA have had negative impacts on both economies and globally.

COVID-19 has been a massive shock to the global economy, propagated through external sector channels - but is itself exogenous to the global economy, rather than being the product of any underlying imbalances. As a public health crisis, COVID-19 is distinct from other recent episodes of economic or financial disruption – but authorities are still faced with the consequences of changing financial conditions, commodity price swings, capital flow reversals, and slumps in trade, tourism and remittance volumes. Some of these may be transitory shifts, though there may be longer-lasting external sector effects in some areas. Meanwhile, the shocks associated with the crisis could crystallize pre-existing risks in a number of countries.

It is therefore right that the report pays attention to a range of both COVID-19-related and structural concerns. We welcome the striking analysis on the drivers of capital flow reversals and the trade collapse and, in line with our comments on the format of the ESR above, would have liked to have seen this integrated further into the main text. The work on tourism and remittance flows is also very welcome. We encourage staff to build on this and apply tailored approaches to smaller economies not explicitly covered in the ESR. Small and developing states are often particularly vulnerable to these shifts and would benefit from closer attention; the policy trade-offs they face can be particularly acute.

The discussion of global supply chains is also interesting. We recognize that the COVID-19 shock has brought into sharp relief the trade-off between the benefits to economic growth of greater openness and the increased volatility associated with greater exposure to overseas shocks. This has highlighted the (lack of) resilience of international supply chains – particularly, but not exclusively in the area of medical and other strategic supplies. But if countries retreat within their own borders, evidence suggests that this would lead to a reduction in productivity, when the opposite should be our goal. Rather, openness can be safe if managed properly. It is not at all clear that reshoring production is a way to create safe openness. *What do staff make of the argument that disruptions to global supply chains imply a need for greater supply chain <u>diversification</u> (which might involve some reshoring, though equally need not be about national borders)?*

We agree with the majority of staff's broad policy recommendations, and indeed we are encouraged by many aspects of the economic policy response to external sector challenges resulting from COVID-19. There have been substantial, creative and early fiscal and monetary policy actions across a wide range of countries (including the use of unconventional monetary policy in some emerging markets). Though there have been instances of foreign exchange intervention, many countries have used exchange rate flexibility effectively to act as a shock absorber during this crisis. Recourse to capital flow management measures has been limited to date. A few economies with strong policies and policy frameworks have taken welcome early action to seek support through the IMF's precautionary instruments, and we hope more will follow. We share staff's views on trade policies (where country responses have been more mixed), and we agree that using tariffs to target bilateral trade balances is likely to introduce further undesirable distortions to trade flows. *We would welcome more clarity about what staff have in mind when they call for "a broader net of bilateral and multilateral swap lines"*.

In some places, the limits of the EBA methodology impinge on policy advice, warranting a richer use of analytical tools. For example, we are not convinced how relevant the general recommendations for some "excess deficit" countries – including the United Kingdom – will be for policymakers, and the model residual continues to more than explain the UK current account gap relative to its norm. Similarly, we find it hard to understand some other country findings, including that some countries with significant near-term external vulnerabilities, warranting a build-up in reserves, have norms that point to deficits being appropriate. In terms of the EBA methodology, this largely reflects scope for catch-up growth (financed by capital inflows) – while that may be appropriate in the medium-term, it makes for a jarring assessment in the current context, illustrating the need for complementary analytical tools and a richer assessment at nearer-term horizons.

We called for further analysis of international investment positions during the Board discussion on the 2019 External Sector Report, so we are pleased to see chapter 2 of this year's report. The negative correlation between net valuation gains and current account flows is a striking relationship that needs to be better understood. As staff highlight, it has important implications for the interpretation of external flows, with creditor countries making losses on national savings and deficit countries using valuation gains to finance deficits. Staff demonstrate that stock dynamics can be valuable predictors of external stress – accordingly, we hope to see greater coverage of capital account flows and stock dynamics in future ESRs. We would also welcome further analysis into the extent to which persistent valuation gains reflect the composition of external assets and liabilities, differential rates of return, etc. and the extent to which they can be sustained to finance external positions.

Finally, we are deeply uncomfortable with the treatment of precautionary and non-disbursing arrangements in chapter 2, which risks undermining the Fund's overarching message on the value of precautionary arrangements. We therefore strongly urge staff and management to revise this chapter before publication. Specifically, we think it is problematic to describe application for a precautionary or non-disbursing arrangement as a "stress event". The Fund's positive message on these arrangements has been, and ought to remain, that precautionary facilities are a prudent response to a potential balance of payments need. They are an endorsement of strong policy frameworks, seeking to boost confidence – aiming to avoid a crisis, not representing one. For qualifying countries, they are often a more desirable, less costly and less distortionary policy response than other options. Furthermore, including non-disbursing arrangements in the stress sample feels methodologically questionable – not least as it distorts the sample by excluding countries which have chosen not to apply for a precautionary arrangement (instead pursuing less desirable and/or less proactive policies), as well as countries with weaker policy frameworks who do not meet the qualification criteria.