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

We thank staff for an informative and concise report. Global imbalances have come down significantly since the global financial crisis and current account balances have further narrowed in many countries in 2019, albeit at a modest pace. While a further narrowing in current account surpluses and deficits seems likely, the outlook is clouded by substantial uncertainties. In the case of the German current account surplus, however, there is evidence that the combination of recent shocks may contribute to a significant reduction of the German surplus.

Staff rightly underlines that in the near term, policies should focus on the health emergency and on easing the burden of infection containment measures on households and firms. At the same time, emerging market and developing economies already experiencing balance of payments pressures should undertake appropriate policy measures to address risks of an external crisis. These should include seizing opportunities to strengthen international reserve buffers and limiting a further build-up of foreign-currency denominated external debt. Indeed, it is worth noting that in countries entering the crisis with comfortable reserve buffers, these have proven to be helpful in cushioning the shock.

Moreover, we support staff's call to avoid policies that distort trade and to work towards reducing trade barriers instead. This is also crucial in order not to further deepen the crisis and complicate the recovery. More generally, we reiterate our view that sound domestic policies in an environment of open markets and a rules-based, multilateral system represent the best response to concerns about global imbalances going forward.

We also broadly agree with the staff's general policy recommendations over the medium term. For economies with persistent current account deficits the report underscores the need to embark on fiscal consolidation while safeguarding growth-enhancing expenditures and social safety nets, and to increase export competitiveness through appropriate structural policies. Surplus economies with fiscal space should further strengthen domestic sources of growth and prioritize reforms that encourage investment, in particular in the areas of digitization and environmentally friendly technologies. As noted by staff, this is one of the key aims of the new fiscal recovery package enacted recently in Germany.

Germany's large-scale fiscal response to the crisis is likely to also be beneficial for trading partners. More generally, however, we would like to highlight that the current account surplus is mainly a result of private sector decisions in international trade and investment, domestically and abroad, and managing it is not the (main) objective of domestic policy choices. That being said, the first signs of recovery in Germany seem to be driven by domestic consumption.

We note that staff projects the German current account surplus to decrease considerably in 2020. While the projected large decrease of the current account in the context of the COVID-19 pandemic might not entirely persist in the years to come given a variety of factors such as a potential rise in precautionary savings, the pre-crisis trend of a narrowing of Germany's current account balance is expected to continue over the medium term.

Given the high model and estimation uncertainty, we would like to reiterate that a cautious interpretation of EBA "norms" and residuals is warranted. With regard to the REER estimates, the Bundesbank, based on its own estimates, currently does not consider the REER as significantly undervalued, and instead assesses German price competitiveness – depending on the measure used – to be only slightly undervalued or even neutral within reasonable error bounds.

We thank staff for a pertinent and thought-provoking chapter on the capital structure of countries' external assets and liabilities and mostly agree with the conclusions. As suggested by staff's analysis, the composition of countries' external liabilities is an important determinant for the vulnerability of an economy to external shocks. Higher debt-type liabilities – in particular if denominated in foreign currency – not only seem to increase the susceptibility to external shocks but can also increase the severity of a crisis.

Staff therefore rightly accentuates that limiting a buildup of external vulnerabilities requires monitoring various components of the international investment position and maintaining adequate buffers in the form of official and private sector reserves.

On a more technical note: We acknowledge that the chapter's findings on the drivers of external crises seem to be robust to alternative definitions of stress episodes. However, we consider that the vast majority of identified external stress episodes used in the baseline estimations are purely determined by the presence of an IMF arrangement. It could be argued that the probit regressions simply identify factors that can predict whether a country will be under any Fund-supported program. Against this backdrop, it is crucial to carefully differentiate between different IMF facilities and only select those that are designed to address an actual balance of payments need. As far as we understand, the analysis also includes non-disbursing and precautionary arrangements typically designed to demonstrate commitment to a reform agenda for countries without an actual balance of payments need.

The inclusion of these arrangements might also drive the results regarding the consequences for debtor countries with different levels of pre-existing vulnerabilities (Figure 2.6). ***Staff comments would be welcome.***

We concur with staff on the need to support countries vulnerable to a fall in remittance inflows, including by seeking to reduce remittance fees. However, we do not share the view that this should be achieved by offering incentives such as subsidies to remittance service providers. In our view, policy measures should rather aim, as a matter of priority, at enhancing cross-border payments more generally. The CPMI report to the G20 on "Enhancing cross-border payments: building blocks of a global roadmap" sets out important areas where further work could assist in moving to an improved cross-border payment system and removing unnecessary barriers.

Concerning staff's call for a "broader net of bilateral and multilateral swap lines" (p. 21), we would point out that such swap lines serve very specific purposes in line with the mandates of the respective central banks. Their establishment carries potentially substantial financial as well as monetary policy implications that need to be considered carefully. Decisions must be taken in full autonomy, and the Fund as a trusted and neutral advisor should be careful not to infringe on this by actively advocating the creation of such swap lines, thereby possibly raising undue expectation on the side of potential recipient countries.

<u>Additional Technical Questions</u>

- The report mentions a potentially unsustainable increase in exposure to external assets and liabilities since the early 1990s (Ch. 1, p. 7). *Could staff comment on the relative external exposures of the private vs. public sector? Is the risk associated with external liabilities and assets a function of exchange rate risk and the risk for duration mismatch only, or are there other considerations that factor into the sustainability analysis?*
- The report discusses the impact of the COVID-19 pandemic on commodity exporters and notes a narrowing of current account gaps for these countries (Ch. 1, p. 13, 14). *Could staff elaborate on the relative contributions of lower oil prices and demand?*
- Reductions in global trade have been virtually ubiquitous involving both advanced and emerging economies (Ch. 1, p. 10). *Are there signs that the trade volume accounted for by emerging economies could recover quicker than in advanced economies due to a strong (temporary) devaluation of some EM currencies? Did staff assess to what extent dominant currency pricing dampens the effect of FX devaluation on EME exports?*
- *Could staff provide an assessment to what extent the existence of foreign reserves or the (perception of) sound reserve management affected currency valuations (Ch. 1, p. 12, 21)?*