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Statement by Mr. Bevilaqua, Mr. Saraiva, and Mr. Barroso on 2020 External Sector Report
(Preliminary)
Executive Board Meeting
July 24, 2020

We thank staff for the well-written External Sector Report (ESR) and the outreach to country authorities and external sector experts. We acknowledge the effort to incorporate a host of implications from the Covid-19 pandemic with a bearing on external balances. We also commend staff for exploring the effect on capital flows and external fragility arising from the different components of the international investment position.

The report strikes the right tone for the near-term policy priorities, with a proper focus on overcoming the first phases of the pandemic fallout. Policy should indeed focus on the health emergency and on supporting the economic recovery, including with measures targeted to the most affected households and fiscal support to investment where policy space is available. However, as the recovery progresses, and considering the different stages of this process across jurisdictions, policy should also facilitate reallocation of workers and capital to new sectors and thriving businesses. It is also important to improve governance frameworks and accountability to both avoid misallocation and speed up the deployment of scarce fiscal resources. The Fund and policy makers should monitor the emerging trends in sectoral and spatial reshuffling in the global post-pandemic economy, and their likely impact in terms of CA norms for different groupings of countries (viz., advanced economies, emerging market economies, low-income economies, commodity exporters, etc.). *Any thoughts staff could share on this would be welcome.*

While we support the broad lines of the medium-term policy recommendations, we do miss a thorough discussion of possible breaks in savings behavior. Indeed, the hardest hit countries could experience higher levels of savings either for precautionary reasons or in response to the wealth destruction during the pandemic. Public savings rates could also rise, the more so in the presence of pressures to restore debt sustainability or given political opportunities to push for structural reforms. The public health expenditure (proxy for social security) could prove less than adequate to tackle those concerns given the disproportional effect on health expenditures and the simultaneous broad increase in social expenditures. It is also not clear if the crisis will lead to more permanent changes in social safety net structures to warrant a change in savings behavior. In such a scenario of a slow post-pandemic recovery, with fiscal stimulus being withdrawn by lack of fiscal space, and savings being boosted by several different factors, we might be facing a structurally new equilibrium with "permanently" lower interest rates and deflationary pressures. Despite this wealth of factors likely impinging on savings behavior, the medium-term policy recommendations seem hardly different from standard policy recommendations for previous external balance assessments. *We expect that staff could elaborate on these concerns even before more data becomes available to settle the matter.*

Regarding the short-run external pressure during the pandemic, we support the report's claim that floating exchange rates and international reserves act as effective buffers to capital flow volatility. Indeed, we welcome the result (Box 1.4) that international reserves and access to US Federal Reserve dollar swap lines seemed effective to counter the capital outflow pressures experienced during the pandemic. This is clear evidence of the potential direct and knock-on benefits from a robust framework for deploying the SLL facility to serve a select but relatively broad group of countries. Still on the theme of capital flow volatility, the report mentions capital outflow management measures as a way to counter high outflow pressures under specific circumstances. While recognizing the legitimacy of the tool in a limited set of cases, the report puts too little emphasis on possible adverse consequences, such as the higher premium to invest in the country and its negative impact on potential growth, not to mention multilateral consequences such as negative externalities to peers. *Does the report suggest that there is scope for a wider use of CFMs beyond what is currently prescribed by the Institutional View?*

A similar result to capital flow volatility also holds for exchange rate volatility, although in this case the exercise seems a bit more fragile. Indeed, the third-party economic risk index adopted for the exercise (Box 1.5) seems to include the recent exchange rate depreciation as one of its components, leading to an obvious circularity. It is also not clear what is the marginal impact of international liquidity since it is included in the regression only as part of the third-party index. Finally, and perhaps less important, it is not clear why should we keep the oil export status in the estimating equations given that it is not statistically significant. Still, the results are consistent with the intuition that good fundamentals matter and good access to foreign currency liquidity matters to buffer the economy from otherwise large shocks to the nominal effective exchange rate. The cross-cutting theme of the stock buffers and external fragility is further explored in the second chapter of the report.

The results in the second chapter are broadly in line with the revised MAC DSA framework recently discussed at the Board. However, there are important conceptual differences, at least one of which requiring amendment before publication. In a sense, results are hardly surprising, with international reserves insuring the economy against external crisis and sovereign debt loading on the risk factor. Regarding the estimating equations, it seems that net international position should always be included in the regressions, possibly interacted with gross positions. Conceptually and empirically, being a net creditor, and more specifically a net creditor in foreign currency, should lead to very different dynamics during a crisis, irrespective of any additional effect coming from gross positions. Broadly, results appear comparable with the "new MAC DSA" set of results, and the teams would benefit from a joint discussion of their models. The main difference here lies on the exclusion of stress events in sovereign spreads or inflation rates in the event definition, and the inclusion of a broader set of Fund arrangements.

The inclusion of non-disbursing and precautionary arrangements as stress events seems particularly questionable and should be corrected before publication. Such an inclusion not only could bias the empirical estimates because of access criteria, but also, and more importantly, it misrepresents facilities that are designed to send good signal to markets. While access to FCL and PLL may presuppose that the country is facing heightened external stress, the very nature of a precautionary arrangement is to preempt the impact of a mounting stress and act to dissipate it before it fully materializes on its shores. Moreover, the high-bar qualification criteria for such facilities implies a seal of approval from the Fund to the policies adopted by qualified countries. Finally, the first chapter shows that higher access to liquidity is effective in buffering the economy against external shocks, indeed introducing an additional source of bias in the crisis probability estimates.