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Statement by Ms. Mahasandana, Mr. Tan, Mr. Abenoja, Ms. Susiandri, and Ms. Yoe on 2020 External Sector Report (Preliminary) Executive Board Meeting July 24, 2020

We thank staff for the well-written 2020 External Sector Report (ESR). We value staff's updates on the global imbalances and the impact so far from the COVID-19 pandemic. However, the backward-looking EBA exercise using 2019 data is less useful in the current environment as the global economy has been hit by unprecedent shocks from the pandemic. The analytical study in Chapter 2 that looks at the composition of IIP to ascertain preexisting external vulnerabilities is a step in the right direction, but further studies should be explored. We offer the following comments for consideration.

On Chapter 1 – assessment of global external positions and policy priorities

We welcome the narrowing of global imbalances in the years preceding the COVID-19 crisis. However, the outlook has become more uncertain since the pandemic, which has caused significant changes, possibly even structural shifts, to the patterns of international trade and finance. It remains difficult to ascertain the impact on different components of the balance of payments due to the limited available data at this time and the uneven impact across countries. **We encourage the Fund to continue further analytical work in the areas below to understand the underlying drivers and possible structural changes to help shed light on future external sector dynamics.**

- **Commodity trade balances, tourism and remittances are important channels affecting the evolution of the current account (CA) balances for a large number of emerging market and developing economies (EMDEs) and small states**. A better understanding of the impact of the pandemic on these channels will be increasingly important to help inform the flagship reports as well as discussions with authorities during bilateral surveillance. *Staff's comments are welcome.*

- **To mitigate the risks of increased trade restrictions and a further retreat from economic integration which could hinder post COVID-19 recovery, it would be useful to study the changes in global value chains and shifts in trade policies to help determine the scarring effects.** The Fund should also continue to play a central role in steering global policy discussions by providing analytical evidence on the adverse impact of trade protectionism and promoting the benefits of a multilateral trading system.

Given the magnitude of the shock, the COVID-19 pandemic and the associated policy responses can have fundamental implications for CA balances and real exchange rates. For instance, the pandemic's impact on trade and investment such as tendencies towards renationalization of supply chains or a greater scrutiny on FDI to prevent foreign takeover of undervalued firm may alter the historical linkages between macroeconomic variables, with implications on external rebalancing during and immediately after the pandemic. As staff suggested, there is great uncertainty in the evolution of supply chains, cross border investments and private savings behavior in the aftermath of the crisis. *In this regard, we are interested on staff's plans to deepen the analysis on these fronts.* Furthermore, it would be important to review the EBA methodology which continues to assume a linear relationship between the identified CA gap and the REER gap using a country-specific elasticity, even though the staff discussion note on "Dominant Currencies and External Adjustment" has recognized the limitations of the exchange rate channel in facilitating external adjustment. *In staff's view*, *how has the COVID-19 pandemic affected the relationship between CA and REER? How would this impact the Fund's REER assessment and EBA framework?* The efficacy of traditional policy advice to help narrow external imbalances may also need to be re-examined in the post-pandemic period. For example, efforts to boost investments and discourage private savings in economies with CA surplus could face challenges when demand remains weak, sentiment is subdued and excess capacity persists. *Staff's clarification and comments are* welcome. It would also be useful to consider the implication of debt overhang on economic recovery and investment in the post-pandemic period as economies with excess CA surplus may face challenges in boosting investments to facilitate rebalancing.

A careful analysis of the underlying drivers of persistent external imbalances is crucial for identifying the right policy options to facilitate the adjustment over the medium term. As the relationship between CA and REER may be changing, we caution against a narrow focus on the CA gap itself and exchange rate adjustments. It is more constructive to focus policy discussions on diagnosing the drivers of the CA gap so as to tailor the macroeconomic and structural policies to address the underlying distortions.

In particular, suggestions for macroeconomic policies and structural measures to address external imbalances should take into consideration specific country circumstances. For cases where fiscal policy adjustment is needed, the timing of fiscal consolidation should be carefully calibrated to ensure that the economic recovery is on a solid footing before shifting the policy stance. The composition of fiscal spending is also important, as a well-considered shift in fiscal policy from boosting consumption to promoting long-term investments can help to address structural bottlenecks and promote durable growth while supporting fiscal consolidation. For those requiring deep structural reforms, we encourage staff to continue to closely engage with the authorities for a better shared understanding of the underlying weaknesses and how reforms can be part of a broader roadmap to address imbalances and promote sustained long-term growth.

We should also be mindful of the negative side effects of exchange rate adjustments on balance sheet vulnerabilities and financial stability risks, which would undermine the usefulness of the exchange rate channel in external rebalancing especially amidst global economic shocks and constrained international reserves. D*rawing on recent country experiences and findings, we welcome a brief discussion on the option to use multiple instruments, including unorthodox toolkits, within an expanded toolkit to address the adverse impact of the exchange rate movements.*

On Chapter 2 – external stress and the composition of International Investment Position (IIP)

We welcome the insights and empirical evidence on how the composition of IIP affects the risk of external crises, which can help to inform the assessment of country-specific vulnerabilities. In particular, we note the findings that EMDEs with elevated foreign currency-denominated debt liabilities are more vulnerable to external stress, and that smaller CA deficits and higher levels of foreign reserves can serve as mitigating factors. **In view of the findings, the Fund's CA-based approach to assessing external imbalance which does not take adequate account of other factors such as exchange rate impact on asset prices and capital flows into foreign currency-debt liabilities, may need to be updated.** *Can staff comment on whether the findings will help to shape the Fund's future approach in conducting its external sector assessments?*

Further analysis of the drivers of external crisis is needed to help focus policymakers' attention on the more pressing external vulnerabilities that need to be addressed. In this regard, we encourage staff to look into the maturity profile of external liabilities and how it relates to the likelihood of an external stress episode. For instance, whether a country with a significant share of short-term external debt with repayment horizon of less than a year, faces greater external stress at a time when it is facing challenging external financing conditions. **In addition, policy advice should be geared towards addressing country-specific external vulnerabilities instead of focused on closing CA and REER gaps**. It is important to recognize that CA imbalances tend to be slow-moving as external adjustments will take time. Therefore, it is more helpful to focus on mitigating the risks of external crisis or external vulnerabilities in the meantime as external rebalancing takes its course. For instance, deepening domestic financial markets, developing hedging instruments and markets as well as implementing macroprudential measures are some of the ways that can mitigate risks while allowing countries to rely to some extent on foreign debt at a lower borrowing cost.

We are concerned about the methodology which considered access to the Fund's precautionary and non-disbursing arrangements as a "stress event". This contradicts the Fund's intention to provide positive signaling effect through these instruments to help members avoid a crisis and could reinforce the stigma associated with accessing these facilities. We strongly urge staff and management to revise the chapter before publication. *Staff's comments are welcome.*

On Chapter 3 – individual economy assessments

The pandemic has highlighted the shortcomings of the EBA model, which in turn undermined the usefulness of the assessments and policy advice. As outlined above, given the significant shock posed by the COVID-19 pandemic, the assessments produced by the EBA model based on 2019 data have become outdated quickly. Furthermore, as it is unclear whether and how the pandemic has altered the structure of the economy and channels of external adjustment, the EBA model may no longer be fit for purpose. We therefore caution the Fund against drawing conclusive policy advice on exchange rate adjustment from the model estimates. Staff should not place too much emphasis on any particular model estimate but instead strive to understand the underlying drivers of the external imbalances when providing policy advice. Given that the different models for estimating REER gap can sometimes produce contradicting results (as reflected in Figure 1.3.2), staff should also review the robustness of the models and the reliability of the results. For members beyond the 30 systemically important countries, we suggest that staff can provide external sector assessment that takes into account the impact of the pandemic and the crisis response on fiscal deficit, trade balance and exchange rate. *Staff's comments are welcome*.

Finally, we reiterate the importance for the Fund to exercise caution and sensitivity when communicating the ESR findings and policy advice. External imbalances should not be equated to misaligned exchange rates by default, especially now as the pandemic may have altered the relationship between exchange rate and CA balances and there is a need to deepen the understanding of this evolving relationship. The Fund should also communicate clearly the limitations of the EBA models such as the country-specific characteristics that have not been sufficiently captured in the CA norms.