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Statement by Mr. Guerra, Ms. Arevalo Arroyo, and Mr. Montero on 2020 External Sector Report
(Preliminary)
Executive Board Meeting
July 24, 2020

We thank staff for a well-articulated and comprehensive External Sector Report (ESR). While we are facing a crisis like no other, we remain convinced that the ESR and the EBA provide crucial analysis central to the Fund's policy advice. We commend staff for including preliminary estimates of the effects of the COVID-19 pandemic in countries' external position and acknowledge the complexity of this endeavor given the prevailing uncertainty and lack of data. While we broadly agree with the staff assessment, we have specific methodological concerns regarding the inclusion of non-disbursed precautionary arrangements as part of the definition of stress events, an aspect that departs from previous literature in the subject.

The policy challenges

In these unprecedented times, IMF should strongly advocate for increased multilateral cooperation and avoiding the imposition of trade restrictions that could erode the recovery. The world economy entered the COVID-19 crisis already facing high vulnerability levels and policy challenges. The pandemic caused a sharp decline in global trade and remittances flows, lower commodity prices, and tighter external financing conditions. From the policy perspective, as the report states, the current situation calls for a dismantling of undue trade and non-trade barriers. Of particular concern is the fact that restrictions on medical supplies are already affecting LICs. The Fund should not stay silent regarding these measures that are impacting the most vulnerable.

- Decrease in economic activity because of the COVID-19 lockdowns impacted global trade, but additional factors may have also had an effect. Along the lines of the October 2016 WEO analysis, *does staff have any preliminary update/assessment on how previously existing and new trade barriers are currently affecting global trade activity?*

- While we appreciate the information regarding trade measures from the Trade Alert Report data set, we believe further work is needed in this regard. Going forward, an annex with more detailed information on trade measures and a descriptive analysis should be part of the ESR. As staff indicates, trade restrictions, particularly in major economies, may have a direct impact on global external balances which would warrant additional analysis.

- While some progress has been made, tariff and non-tariff measures continue to dampen the global trade outlook. Certain de-escalation in trade tensions throughout 2020 has taken place with important advances such as the signing and entering into effect of the Mexico-United States-Canada agreement. Nevertheless, a source of high uncertainty to the world economy is the US-China trade tensions. Additionally, the deterioration in non-tariff measures on investment and technology areas is cause for concern. *We call on staff to continue efforts to include non-tariff measures into the external sector analysis. Does staff consider there are data limitations?*

- In the current context, open trade measures can play a vital role in the medical response to the pandemic. We echo staff's view that international supply chains can play an important role in supporting the production of essential medical equipment and the development of vaccines and medical tests. Also, we underscore it is essential to find ways to share intellectual property rights to allow all countries to expand production of vaccines and tests. Relatedly, we note there is an ongoing process of renationalization of supply chains, in part to reduce geopolitical vulnerabilities but also to mitigate potential bottlenecks when production of certain goods is concentrated in a few locations. We call on staff to monitor these developments and to produce a deeper analysis of both their causes and possible negative consequences for the global economy.

High uncertainty calls for a robust fiscal and monetary policy response to the crisis, and a comprehensive assessment of the measures needed to rebalance the global economy going forward. We concur with staff that it is extremely difficult to assess the overall impact of the COVID-19 crisis on external balances. However, previous experience from the global financial crises (GFC) illustrates that the policy response can generate some persistent structural distortions. Given that the response to the pandemic, both in the monetary and fiscal fronts, has been stronger than in the GFC, one would also expect a persistent impact on the composition of global imbalances and their underlying structural drivers. Thus, even though uncertainty remains regarding the path and nature of the recovery, a multilaterally consistent analysis will remain necessary to promote a shared understanding of the underlying distortions and reforms needed to rebalance the global economy going forward.

- The necessary fiscal response by member countries has to be followed by a clear medium-term strategy to address fiscal imbalances, in particular in countries with excess current account deficits. This is of utmost importance for many emerging market economies that could be impacted by tighter global liquidity conditions in case of a second COVID-19 wave scenario. Also, the fiscal stance in some major economies will have to be recalibrated and carefully communicated so as not to unduly affect global market conditions.

- Major central banks have played a crucial role in alleviating the effects of the pandemic in global financial conditions and we commend their rapid and effective response. Going forward, given the size of central banks interventions through their balance sheets, it is vital to assess the implications of these interventions on the external sector positions of countries and monetary unions. In the case of emerging markets, some central banks have supported economic activity by increasing domestic credit through non-traditional measures. *Can staff elaborate on plans to analyze in more depth the effect of central banks support on the external positions? Any implications for the medium-term policy strategy?*

- We believe the report should be more comprehensive regarding the role of exchange rates in helping countries to adjust to a new equilibrium in the external sector, particularly for commodities exporters. We also believe a more nuanced view regarding the use of capital flow measures (CFM) and their effects on countries' external position is warranted. As noted in the Institutional View, there is no general recipe for the use of CFMs, as the precise measures in each case will depend on country-specific characteristics and circumstances. Therefore, specific recommendations on CFM could be misinterpreted as a general policy advice of the Fund. The report notes that most emerging market and developing economies transitioned from holding short positions in foreign currency in 1990s to long positions in 2017, reflecting a shift in foreign liabilities from foreign currency debt to equity financing and, in general, sustained accumulation of foreign exchange reserves. *What implications does this have regarding balance sheet effects and FX flexibility? Staff comments are welcome.*

- The report presents an interesting analysis of how the COVID-19 shocks have disproportionally affected countries more reliant on remittances and tourism. IMF should follow closely these economies and support their policy efforts given their limited space for maneuver to confront a shock that can be more protracted than currently expected. Of strategic relevance will be to support small economies with adequate and timely technical assistance so that they can enhance their monetary policy operational frameworks. This is crucial so that these countries can be adequately prepared to deal with external sector challenges and risks. *In addition, regarding IMF supervisory activities on the external sector positions, could staff confirm whether all EBA countries are included in the proposed list for upcoming Art. IV consultations? To adequately assess external sector gap adjustments, it is necessary to have an effective surveillance process in place.*

- We concur with staff that the adoption of currency-based countervailing duties (C-CVDs) would be counterproductive, not the least because they could interfere with desirable monetary policy decisions in other countries. Relatedly, we support an open, stable, and transparent global trading system and call for enhanced efforts to modernize the multilateral rules-based framework. In this vein, we welcome staff's recognition that for trade integration to succeed, we need robust social safety nets and more proactive policies to facilitate labor market adjustment. This message should feature more prominently in the report. *Finally, the report mentions the need for a broader net of multilateral and bilateral swap lines. Can staff elaborate on the main ideas behind this proposal?*

The external position analysis

We welcome the analysis presented in Chapter 2. External assets and liabilities as a share of GDP more than tripled from the early 1990s, mostly driven by systemic economies. This Chair has been calling for a more comprehensive analysis of external sector stock positions. We appreciate the chapter tries to shed light on which preexisting conditions pose the greatest risks of external stress by focusing on the effect of the composition of countries' external stock position, including the role played by the type of instrument (debt versus equity) and currency denomination. The results, as expected, stress the importance of currency mismatches and excessive leverage in driving financial crises and in determining the response from output and external balances (with larger and more protracted responses).

As expressed in the introduction, and as noted by Mr. Ronicle and Mr. Chrimes on their gray, **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 precautionary arrangements. We therefore strongly urge staff and management to revise the chapter before publication. Specifically, we think it is problematic to describe application for a precautionary or a non-disbursing arrangement as a "stress event".

Regarding precautionary programs, the Fund's positive message on these arrangements has been, and ought to remain, that precautionary facilities are a prudent response to potential balance of payments needs. They are an endorsement of strong policy frameworks, seeking to boost confidence – aiming to avoid a crisis, not representing one –. For qualifying countries, these arrangements are often a more desirable, less costly and less distortionary policy response than other options, such as reserve accumulation. Indeed, estimates do not consider the signaling effect that precautionary instruments provide, including potential access to supplementary reserve assets. *We call on staff to refine the definition of external stress and to include a variable for precautionary programs to control for their mitigating role against external shocks.*

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. All in all, the external stress dummy basically captures the demand for IMF arrangements –159 out of 176 of stress cases are Fund programs – which may or may not be related to the existence of a stress event.

We fully welcome staff's attempt to study the consequences of high NIIP positions for creditor countries. On average, creditor economies experienced substantial valuation losses in the aftermath of the GFC, highlighting the risks and costs of excessive external imbalances for these countries. The report is focused on effects at the individual country level, thus missing spillover effects across countries and impacts on global imbalances. Indeed, while after the GFC flow imbalances significantly diminished, stock imbalances continued to rise. This latter feature hints that the accumulation of net foreign assets (NFA) may not be self-stabilizing. In this regard, we reiterate our view that a more formal approach to the optimal NIIP position might be a desirable medium-term objective for IMF analyses. An optimal stock of NFA could also be used as an input for EBA regressions to avoid ad-hoc corrections and treat both debtor and creditor countries in a more balanced way.