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**Statement by Mr. Inderbinen, Mr. Trabinski, and Mr. Tola on 2020 External Sector Report
(Preliminary)
Executive Board Meeting
July 24, 2020**

We thank staff for the 2020 External Sector Report (ESR). This year's ESR edition not only analyzes the 2019 external sector of major economies but also provides a valuable outlook on possible implications of the COVID-19 crisis for global external positions. We first provide general comments, followed by comments on this Chair's ESR economies, Poland and Switzerland.

General comments on the 2020 ESR

We encourage staff to continue their monitoring of external vulnerabilities and to review their analysis in the 2021 ESR when more data become available. We agree that the COVID-19 crisis constitutes a major shock to external positions of systemically important economies. However, we would like to underscore that the lack of complete data for 2020 presents a major limitation for the assessment. As staff underlines, insufficient data do not allow to draw clear conclusions on the overall effect of the COVID-19 crisis on countries' external sectors. As more data become available, staff would be in position to better evaluate whether the COVID-19 crisis will have a lasting impact on external balances.

Restoring external balances should rely primarily on sound economic structures. While mitigating short-term effects of the current crisis is necessary, addressing economic and policy distortions over the medium term requires the implementation of reforms that enhance productivity, encourage private investment, and lead to fiscal consolidation.

We fully support staff's call to avoid policies that distort trade. We support a multilateral, open, and rules-based trading system. Trade-restricting and trade-distorting measures should be rolled back because they harm the recovery and are welfare-diminishing for all parties involved. International trade is not a zero-sum game. Excessive bilateral and aggregate trade balances should be addressed primarily through the removal of underlying structural distortions. In this context, we share staff's recommendation that efforts should also focus on capturing the increasing importance of trade in services and e-commerce.

The multilateral analysis for the 2019 external sector positions should have been more nuanced. The ESR's strength lies in staff's multilateral and holistic analysis. Even though the analysis of the COVID-19 crisis' impact is valuable and timely, like Mr. Rosen and Ms. Pollard, we regret that the normative analysis for 2019 in Chapter 1 is not as elaborate as in previous years. The ESR is a key part of the Fund surveillance and a reference for the public. Clear communication of staff's assessments and the underlying assumptions should be a priority.

The ESR relies strongly on current account (CA) balances to draw important conclusions, but these balances are just one element of a larger picture. The reliance on CA balances comes with several caveats, not least with regard to the assessment of exchange rates and the international investment position (IIP) and its components, as shown in Chapter 2. We therefore remain skeptical about mechanically linking the CA to the exchange rate. The Swiss case clearly shows that the exchange rate models point to a different assessment than the CA model (fig. 1.3). In this context, we reiterate our view that the EBA models should be given equal weights in the assessment. *Will staff integrate the findings of Chapter 2 in the EBA methodology?*

The assessment of Poland

Regarding the Polish economy, the recent improvement in CA has led the IMF to the conclusion that the external position is stronger than medium-term fundamentals and desirable policies. This is mostly due to gradual improvement in trade balance over last years, where exports of goods and services picked up, amidst growing specialization in the production of goods for final consumption. Also, in case of Poland, the external position typically improves when GDP growth is lower. We broadly agree with the IMF assessment, while pointing out that cyclical adjustment in CA in Poland is not sufficient, which implies that the estimated scale of the REER misalignment is overestimated. The above factors are not accounted for in the standard cyclical adjustment, and their omission could lead to the mismeasurement of cyclical adjustments in the future.

The assessment of Switzerland

In the authorities' view, the Swiss CA balance is not excessive and the change in its assessment cannot be explained by underlying distortions or exchange rate movements. We note the change in the assessment of Switzerland's CA balance from "in line" in last year's ESR to "moderately stronger" than the level consistent with medium-term fundamentals and desirable policies. However, as underlined by staff, there is significant uncertainty surrounding this year's assessment, which makes it difficult to draw conclusions. It is unlikely that the increase in the Swiss CA balance compared with last year is due to underlying macroeconomic distortions or exchange rate movements. Instead, the increase in the Swiss CA balance could be largely explained by higher net investment income and complex measurement issues, which are independent of policy:

> **First, the increase in the Swiss CA balance is due to higher investment income, in particular because of lower income payments on FDI to non-residents.** However, this component of the CA is often subject to large, usually downward revisions, linked to the timing of data collection. This was the case for the 2017 and 2018 CA balances, which were subsequently revised downward by 3.4% and 2% of GDP, respectively. As rightly noted by staff, a downward revision of the CA balance may reduce or close the gap, and thus change its assessment.
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> **Second, complex measurement issues overstate the Swiss CA balance.** As noted by staff, measurement issues linked to retained earnings on portfolio equity investment and to the compensation for valuation losses on fixed-income securities arising from inflation explain around 3.5% (in terms of GDP) of the CA. Valuation losses are a significant feature of Switzerland's external position. While Switzerland runs persistent CA surpluses, it also has a stable NIIP, reflecting persistent negative valuation changes. It is thus likely that other measurement issues play an important role. In particular, recent studies point to a third measurement issue associated with default risk.[1] *How does staff plan to account for this measurement issue?*

The Swiss franc continues to be highly valued. As noted by staff, both EBA REER models point to a significant overvaluation of between 13.5 and 19.7% for 2019. As of May 2020, the REER has further appreciated by 3.9% compared with the 2019 average. Negative inflation, reaching -1.2% in Q2 2020, also suggests a highly valued Swiss franc. For various structural reasons, the CA is a poor indicator for the exchange rate in the Swiss case. Consequently, the assessment of the exchange rate cannot be inferred from the CA balance alone.

We welcome the recognition of foreign exchange interventions as a tool to ensure appropriate monetary conditions. In a small open economy, exchange rate movements matter for inflation and economic activity. The past decade has seen repeated waves of rising global uncertainty, such as during the great financial crisis, the EU sovereign debt crisis, and now the COVID-19 crisis. These periods of heightened uncertainty have been associated with significant inflow surges into Switzerland because of the safe-haven status of its currency, and thus appreciation pressure on the exchange rate. Even though there is still scope for the interest rate to be lowered further, the space is constrained by the effective

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[1] See Adler, G., Krogstrup, S., and Garcia-Macia, D. (2019) "The measurement of external accounts," IMF Working Paper No. 19/132, and Herkenhoff, P. and Sauré, P. (2020) "The impact of credit risk on international investment income and the current account." University of Mainz, mimeo.

lower bound. Foreign exchange interventions are thus necessary to maintain appropriate monetary conditions and ensure price stability, especially in a context of persistent undershooting of inflation.