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Statement by Mr. De Lannoy, Mr. Etkes, and Mr. Hanson on 2020 External Sector Report
(Preliminary)
Executive Board Meeting
July 24, 2020

We welcome the 2020 External Sector Report (ESR), acknowledging the uncertainty as a result of the current unprecedented crisis. While it is difficult to assess external imbalances and policy challenges going forward, the ESR is useful in documenting the situation of imbalances before the start of the pandemic crisis. Yet even under normal circumstances, assessing external imbalances is challenging and depends on the underlying methodology, as well as applying an element of judgment, as appropriate. We appreciate that the required element of judgement is presented in a transparent way for the current account assessment, and encourage further transparency in how such judgement is applied to the staff-assessed REER gaps. We note that the current account norms and policy conclusions presented in the 2020 ESR are in general broadly aligned with those of the European Commission and the European Central Bank.

Global outlook

We broadly concur with the assessment of the global situation, and the uncertainty in the near-and medium-term outlook on external balances. We share the assessment of the pandemic's heterogeneous impact on countries given their economic structure and institutional settings, notably the impact on several emerging markets and developing economies. We note that a better understanding of the motives behind the sharp increase in private savings (pent-up demand versus precautionary savings) may improve policy advice related to external imbalances. We agree that quick central bank action was and will be vital regarding the volatile response of capital flows and exchange rates to the pandemic shock. In that regard, we note that the ECB has concluded several bilateral swap and repo line arrangements with central banks within and outside the EU in response to the COVID-19 crisis. Moreover, the ECB has introduced a new Eurosystem repo facility for central banks (EUREP), which aims to provide euro liquidity to a broad set of non-euro area central banks in crisis times and safeguard the smooth transmission of monetary policy in the euro area. Likewise, we agree with the important role of the fiscal response.

We underline the ESR's spotlight on risks regarding cross-border trade integration, reshoring of production and trade restrictions, notably as regards to countervailing duties based on exchange rate assessments. Without prejudice to our position on the WTO consistency of those duties, we agree with staff that they may be counterproductive for the country that imposes them (retaliation), could potentially impinge on desirable monetary policy decisions, and could complicate any effective dialogue and economic surveillance over the underlying macro-structural distortions affecting external positions. Reshoring of production in the wake of the pandemic can harm productivity and hamper economic recovery. The goal of promoting economic resilience can also be achieved by enlarging stockpiles instead of moving production within national borders and by diversifying supply chains. We also support the ESR's call to modernize the multilateral rules-based trading system and restore a well-functioning WTO dispute settlement system.

<u>The external position of the euro area</u>

We take note of staff's assessment of the euro area's external position, indicating that in 2019 it was moderately stronger than the level implied by medium-term fundamentals and desirable policies. The ESR's policy recommendations linked to EU's external balances are broadly aligned with those of the EU. We agree with the justification for staff's adjustment to the euro area figures, which is consistent with that of the 2019 ESR.

We note that the ESR concludes that, on aggregate, domestic policy gaps contribute only marginally to the current account gap of the euro area. Instead, the External Balance Assessment (EBA) estimates attribute most of the euro area current account gap to foreign macroeconomic policies and un-identified factors. We also note that the policy recommendations for individual economic assessments mostly reflect the situation as of last year, and could be more aligned with recommendations in the main text. The euro area entered the pandemic with remaining stock and flow imbalances in some Member States. We note that while aggregate euro area imbalances are moderate at most, imbalances persist for some euro area Member States, both in flow and stock terms, and that proper policy actions help address these imbalances as underlined in the ESR as well as in the EU recommendations linked to the Macroeconomic Imbalance Procedure

The external outlook presented in the report broadly concurs with projections by EU institutions. We broadly agree with the distinction between near-term and medium-term risks. We concur with the report that for some euro area Member States, tourism is a particularly relevant factor in shaping external balances during the pandemic. In that respect, we highlight the strong fiscal response to the lockdown shock by euro area Member States and the political agreement on the EU's Recovery and Resilience Facility. We stress that the actions proposed under the Next Generation EU framework contain a strong focus on sustainable and transformative public investments with the potential to crowd in private investment and to foster productivity growth in the medium-term.

We suggest that the staff assessed REER for the euro area should be more explicitly described as "broadly in line with fundamentals", as the reported REER gap remains limited and not significantly different from zero. The EU institutions consider the euro's real effective exchange rate to be close to its equilibrium, subject to the uncertainty underlying such estimates, **as illustrated by the differing REER model estimates reported in the ESR**. **Thus, like last year, we encourage staff to give REER models the same weight as the CA model,** and provide more detailed information on the decomposition of the REER models like they did for the CA model. The staff assessment could therefore acknowledge this point more explicitly by repeating the footnote included in the 2019 ESR report that "the staff assessed REER gap is within the interval generally described as broadly in line with fundamentals".

<u>**Methodological notes**</u>

Staff candidly notes that "changes in macro-economic fundamentals compared with 2019 may affect … equilibrium values" (P.10). Indeed, the possibility of changes in equilibrium values following the COVID-19 crisis calls for staff's cautious approach in using the normative EBA analysis for policy advice. We encourage staff to examine plausible structural breaks in the EBA models due to the ongoing crisis. *Were structural breaks in the EBA models following the GFR or other crises empirically examined and observed? What are the implications of possible changes in equilibrium values on application of EBA models in multilateral and bilateral surveillance?*

We note the large unexplained variation in EBA gaps and we support efforts to improve the model. Residuals account for the majority of the EBA gap for Belgium (-2.7 percent out of -3.5 percent) and The Netherlands (4.6 percent out of 7.2 percent), implying a significant degree of uncertainty about the assessment. As large and volatile operations of multinationals may impact yearly flows, we think current account gaps should be evaluated over the medium term. We support efforts to strengthen the EBA model, through including the structure of pension systems, corporate savings, and structural policies. In the meantime, we believe policy implications should be treated with caution. *Could staff comment on plans to review the EBA CA and REER models? Does staff agree that it would be important to look into the role of the structure of pension systems and corporate savings?*

Further steps are needed to adjust to the effect of multinationals on the current account balance. The presence of multinationals with a large degree of foreign ownership can distort current account balances by overstating the savings that are attributed to the country of residence. Statistical conventions prescribe that income from abroad (the operational result of foreign subsidiaries) is included in the definition of the savings surplus, whereas foreign investment is not. This partly explains the Dutch savings surplus. We welcome the staff adjustment in the EBA assessment for The Netherlands and we would be in favor of horizontal solutions to account for this issue.

We welcome the methodological focus on stock imbalances and stress the importance of their composition. The results confirm earlier research that the tolerance of external debt stocks is potentially highly country-specific, as the IIP composition differs across countries. External debt liabilities are found to increase the crisis probability, while portfolio equity and FDI liabilities don't play a significant role. The chapter underlines the importance of assessing stock imbalances and their composition besides the current focus on flow imbalances. In this respect, we wonder whether there are plans by the IMF to develop country-specific numerical benchmarks for external stock imbalances, in analogy with what is done for current account balances. EU macroeconomic surveillance already makes use of country-specific benchmarks for the net international investment position.

More detailed data is needed to strengthen the external sector assessment and improve policy recommendations, in particular for corporate savings. It is difficult to interpret corporate savings behavior on the basis macro-economic data. For The Netherlands, granular data from DNB on savings by SMEs and large companies helped uncover the dynamics of the savings surplus. In addition, the 2019 ESR stressed that data collection efforts are needed to properly attribute income from multinationals across countries. *Does staff agree that data collection efforts are needed to improve the assessment of corporate savings, both for multinationals and SMEs? Can staff comment on ongoing initiatives to improve data on corporate savings?*