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Statement by Mr. Tanaka, Mr. Harada, and Mr. Nagase on 2020 External Sector Report (Preliminary)
Executive Board Meeting
July 24, 2020

We thank staff for the 2020 External Sector Report (ESR), which timely analyzed the impact of the COVID-19 crisis on the External Sector. In addition to this, we welcome that the report analyzed the issues derived from diversified stock positions as agreed by the G20 under Japan's Presidency in 2019. Reducing excess Current Account (CA) imbalances remains a critical issue for the global economy, and we believe the Fund can greatly contribute to this area by conducting assessment of the CA.

That said, **we restress that the staff's external assessment framework has rooms for further improvements**. As we have pointed out since before, there are clear issues on the following two points; 1) Real Effective Exchange Rate **(**REER) norm is calculated by overall CA gap norm divided by CA/REER elasticity and 2) EBA model does not fit well and therefore it cannot lead to concrete policy advice to address CA gap.

Exchange Rate Assessment

We would like staff to brush up their methodology and develop more reliable tools to assess exchange rates, while treating their current analysis on REER norms as preliminary based on a hypothesis. We welcome the staff's continuous efforts to deepen their analysis in the ESR, which incorporate that of the stock imbalances this year and that of the compositions of CA and economic structure of each country, including the research on invoicing currency and global value chains, last year. However, we regret to say that such analysis cannot justify the defects of the current calculation method for the exchange rate assessment.

In order to reasonably evaluate the exchange rate, calculation method of REER norms and gaps should be improved. In the ESR, REER Gap is calculated as a quotient of CA Gap, which is derived by the EBA model, and CA/REER elasticity. However, on this point, we have to keep the fact in our mind that the relationship between CA and REER is not straightforward because; 1) it can be differently interpreted depending on time frame, i.e. short-term or long-term, and 2) CA/REER elasticity can be different depending on the compositions of CA, which reflects economic structure such as depth of global value chain (GVC). In case of Japan, we noted the staff's recognition that REER norm based on the EBA model cannot capture Japan-specific factors well.

On the time frame issue, our understanding is that the ESR focuses on the short- and medium-term assessment, which the adjustment mechanisms by exchange rate is not effective, instead of the long-term one. We should bear in mind that the CA and exchange rates are not strongly correlated in this time frame.

In this regard, we would like to point out that the impact of exchange rate on CA varies with time frame of assessment. In the long run, all receipts in foreign currencies will be converted to a home currency. Therefore, CA, which represents the total amount of net receipts, will correspond to the total demand for a home currency. On the other hand, in the short-term, when a part of trade surplus and income-account surplus haven't been consumed in the present term and kept as stock, CA won't correspond to the total demand for a home currency. For instance, if residents in Japan keep holding their receipts in US dollars earned by exporting goods and services, such transactions would not affect exchange rates. Adjustment mechanisms of exchange rate work only when the trade surplus and income-account surplus are converted to a home currency, but valuation loss can be caused only in the short and medium term, when they are not converted to a home currency. In this context, we note that staff pointed out in the ESR that the stock imbalances can be a risk for both debtors and creditors, and the risk for the creditors would be valuation loss.

On the composition of CA, adjustment mechanisms by exchange rates vary with each country depending on structural factors. For instance, the mechanisms can be weak in the countries like Japan, which have high ratio of income balance, deep financial market and high share of USD settlement in trade. In this relation, we would like to raise four key points to be considered on this matter:

1) Characteristics of income balance: We should be aware that the mutual impact of income balance and exchange rate is considered to be limited. Income receipts from external assets are accumulated as stock without currency transactions until they are used for consumption. In addition, if households and companies save their money based on long-term incentives that anticipate demographics changes, short-term fluctuations in exchange rates do not affect their decision.

2) Capital transactions without current transactions: We should take it into consideration that, due to the progress of financial integration, currency positions are created by capital transactions far more than by current transaction today. The REER can change without change in capital balance.

3) GVC: In case where a country has GVC, change in the REER may not affect trade of intermediate goods. In addition, due to the spread of the customs of the pricing-to-market, the impact of the fluctuations in exchange rates on the trade volume has been getting smaller.

4) Invoicing currency: It is understood that when invoicing currency is not a home currency, but a leading currency such as USD, it would be difficult to adjust trade balance by REER.

Policy Recommendations by the Fund in the ESR

The staff should improve its fitness of the EBA model. Under the current framework of the ESR, if there are "large unexplained residuals of the EBA CA gap", it is interpreted that there are special factors to the country. However, we understand this is a model fitness issue, and we encourage staff to improve the model and enable us to identify the hidden structural factors.

We encourage staff to propose more concrete policy recommendations to address imbalance issues which the ESR analysis identifies. For example, while assessment of Japan suggests that there is a “corporate saving’s distortions” as one of the bottlenecks, but staff do not give any proposal to address this matter.