EXECUTIVE BOARD MEETING

SM/20/101
Correction 4

July 24, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **2020 External Sector Report—Chapter 2**

Board Action:	The attached correction to SM/20/101 (7/2/20) has been provided by the staff:
Factual Errors Affecting the Presentation of Staff's Analysis or Views	**Page 4**
Comments	Regressions underlying the analyses were corrected to exclude precautionary and non-disbursing agreements.
Questions:	Mr. Leigh, RES (ext. 34747) Mr. Adler, RES (ext. 35648) Mr. Rabanal, RES (ext. 36784)

external debt assets and liabilities, and (4) official and private foreign assets. The analysis goes beyond that of other studies by exploring the role of the aforementioned IIP components using a new data set on the currency composition of external assets and liabilities compiled by IMF staff in collaboration with authors at other institutions (Bénétrix and others 2019). To identify episodes of sovereign debt default or restructuring, the chapter uses updated versions of the data sets of Das, Papaioannou, and Trebesch (2011) and Asonuma and Trebesch (2016) as well as Paris Club reports.

The main findings of the chapter are as follows:

- Not all components of the IIP relate equally to the likelihood of external stress episodes. The net IIP declines in the run-up to an external stress episode and, the more negative it becomes, the greater is the likelihood of external stress materializing. However, within the IIP, the analysis can be usefully complemented by analyzing gross positions: in particular, gross external debt liabilities are stronger predictors of external stress than are equity liabilities or private external debt assets. Having a larger stock of foreign official reserves acts as a mitigating factor, lowering the likelihood of an external stress episode, although with diminishing effects.
- In addition, the type of gross external debt that matters most appears to differ across advanced and emerging market and developing economies. When the whole sample is considered, external debt liabilities are strong predictors of stress, irrespective of the currency denomination. But foreign-currency-denominated debt liabilities are particularly relevant for predicting external stress in emerging market and developing economies. ~~Private sector holdings of external debt assets in foreign currency are also related to a lower risk of external stress, although only for emerging market and developing economies.~~
- Beyond the IIP structure, the analysis confirms the role of traditional external stress predictors, such as large current account deficits. Higher levels of global risk aversion increase external financing risks, suggesting an important role for global "push" factors in triggering external stress, especially in countries with preexisting external vulnerabilities.
- The chapter finds that the nature of external vulnerabilities for emerging market and developing economies have rotated over time. For example, while before the Asian financial crisis a central external vulnerability was a low level of international reserves, the central vulnerability ahead of the global financial crisis was more related to the size of current account deficits. In the years preceding the Great Lockdown, elevated gross external debt liabilities and their foreign-currency-denominated component were a central vulnerability for emerging market and developing economies, although relatively small current account deficits and relatively high levels of foreign exchange reserves helped mitigate these risks.
- Preexisting external vulnerabilities also amplify the macroeconomic costs of an external stress episode. For countries with large current account deficits, elevated foreign-currency-denominated debt, and low levels of reserves, real GDP falls by about 4.1 percent within two years of an external stress episode, while for countries with more limited external vulnerabilities, the decline in real GDP levels is typically about 1 percent. Similarly, the real