



## IMF MULTILATERAL POLICY ISSUES REPORT

### 2014 PILOT EXTERNAL SECTOR REPORT

July 29, 2014

IMF staff regularly produces papers covering multilateral issues and cross-country analyses. The following document has been released and is included in this package:

- The **Staff Report** on the 2014 Pilot External Sector Report, prepared by IMF staff and completed on June 26, 2014 for the Executive Board's consideration on July 11, 2014.

The Executive Board met in an informal session, and no decisions were taken at this meeting.

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**International Monetary Fund**  
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## 2014 PILOT EXTERNAL SECTOR REPORT

June 26, 2014

### KEY POINTS

- External sector dynamics in 2013 were shaped by several interrelated developments. A stronger though uneven recovery in advanced economies began, resulting in first steps toward monetary policy normalization. The beginning of exit from unconventional monetary policy in the U.S. initiated a tightening of global financial conditions and a round of capital flow volatility and substantial EM depreciations. With a subsequent recovery of demand for EM assets, supported in part by policy responses, many EM currencies strengthened again.
- While external imbalances overall continued to gradually narrow in 2013, in aggregate they are almost twice as large as would be consistent with fundamentals and desirable policies. Recent changes have been mixed, as some excessive imbalances narrowed—partly from fiscal consolidation by external deficit economies—but a number widened.
- Policy actions required to further narrow excess imbalances vary but include medium-term fiscal consolidation, limiting financial excesses, and structural reforms to facilitate adjustment in deficit economies, and various policies that support stronger domestic demand in surplus economies. In some surplus economies, policy adjustments include moving toward more market-based exchange rates, avoiding sustained, one-sided foreign exchange market policies and reducing capital account restrictions. More broadly, policy actions are needed on both sides of excess imbalances. Many economies have their own roles to play, and policy adjustments by all would be mutually supporting, with benefits in terms of growth and reducing financial risks.
- Over a number of years, the global pattern of current account balances has narrowed but also rotated gradually into a new composition. The relative importance of excess imbalances of the world's largest economies has diminished. Among other economies, some cases of new excess imbalances have emerged, and in the last few years cases of excess deficits have grown in terms of number and size. While some longstanding adjustment needs remain, the new landscape brings a changing locus of policy priorities and possible risks.
- The global financial environment is likely to remain complicated for some time, and economies will need to digest the effects of asynchronous monetary exit and gradually tighter conditions. Capital markets, and demand for EM assets, may remain prone to volatility and sell-off episodes. In a changing and uncertain external environment, risks related to external financing needs, capital flow reversal and disorderly currency movements will be relevant. At the same time, as financial conditions overall remain relatively easy, risks of asset price and demand booms remain. Policies to address economies' specific vulnerabilities, and to secure underlying external adjustment where needed, will be essential.

The IMF's Third Pilot External Sector Report presents a multilaterally consistent assessment of the largest economies' external sector positions and policies for 2013 and the first part of 2014. The report integrates the analysis from the Fund's bilateral and multilateral surveillance to provide a consistent assessment of exchange rates, current accounts, reserves, capital flows, and external balance sheets. Together with the Spillover Report and Article IV consultations (with their heightened focus on spillovers), this Report is part of a continuous effort to ensure the Fund is in a good position to address the possible effects of spillovers from members' policies on global stability and monitor the stability of members' external sectors in a comprehensive manner.

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## Glossary

AE	Advanced Economies
CA	Current Account
CDS	Credit Default Swaps
CGER	Consultative Group on Exchange Rates
EA	Euro Area
EBA	External Balance Assessment
ECB	European Central Bank
EMBI	Emerging Market Bond Index
EPFR	Emerging Portfolio Fund Research
ES	External Sustainability
ESR	External Sector Report
EM	Emerging Markets
FCL	Flexible Credit Line
FDI	Foreign Direct Investment
FX	Foreign Exchange
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
IMF	International Monetary Fund
INS	Information Notice System
NIIPs	Net International Investment Positions
REER	Real Effective Exchange Rates
TPP	Trans-Pacific Partnership
TTIP	Transatlantic Trade and Investment Partnership
TISA	Trade in Services Agreement
VIX	Chicago Board Options Exchange Market Volatility Index
WEO	World Economic Outlook
WTO	World Trade Organization

## INTRODUCTION

1. **The IMF’s Third Pilot External Sector Report (ESR) presents a multilaterally consistent assessment of the largest economies’ external sector positions and policies for 2013 and the first half of 2014.** The report integrates the analysis from the Fund’s bilateral and multilateral surveillance to provide a consistent assessment of exchange rates, current accounts, reserves, capital flows, and external balance sheets.

2. **The 2014 Pilot ESR** is structured to first give an overview of developments in key external sector dimensions and then provide an evaluation, an *assessment*, of the external sector positions of individual economies, including of what needs to be done to close external gaps (Box 1). While the emphasis is on fresh assessments of recent positions, the report also puts these in the perspective of developments and trends of the last few years. A final section discusses implications of the analysis for external positions in the future, and flags the nature of relevant risks linked to external positions.

3. **The report emphasizes the continued importance of identifying**

**and correcting gaps in economies’ external positions.** Such gaps reflect underlying distortions that undermine welfare and bring risks to stability, for both individual economies and the global economy. As gaps by their nature are interconnected across economies, they need to be analyzed and confronted from a multilateral perspective. Overall progress on reducing gaps has continued, gradually, but in recent years progress has been mixed, with some setbacks. Globally, the size of gaps remains significant in macroeconomic terms, though with a changing composition that implies changing risks.

4. **The companion paper “2014 Pilot External Sector Report—Individual Economy Assessments”** discusses in greater detail the external sector position of each of the 29 economies covered in this ESR.

### Box 1. Key Concepts

This Report uses several terms to refer to the external sector.

**Current account imbalances** refer to any current account balance different from zero; i.e., surpluses or deficits. Such imbalances may be appropriate or inappropriate.

**Current account gaps**, or **excess imbalances**, represent the difference between actual current account imbalances and those assessed by staff to be consistent with fundamentals and desirable policies. They reflect distortions and other factors. Such gaps are discussed in the Assessment section of this Report.

**External sector position** covers the overall assessment from the external indicators used in this Report, namely current account balances (and the counterpart capital and financial account balance), international investment positions and exchange rates. (Note: for an external sector position weaker (stronger) than expected, the exchange rate is stronger (weaker)).

## CONJUNCTURE

### A. The Global Setting

5. **The global environment has remained dominated by sub-par levels of output and growth, coupled with appropriately accommodative monetary policies, including of the**

**major reserve currency economies.** Global growth strengthened in the second half of 2013, with much of the contribution coming from advanced economies. But global output remained below its potential level, with negative output gaps in nearly all economies, and the global output gap widened in 2013. In the U.S. and U.K, stronger growth prospects permitted the first steps towards the normalization of monetary policy, while supportive monetary conditions are expected to persist in Japan and the euro area. The beginning of exit from unconventional monetary policies in major advanced economies has changed the external environment for emerging economies, tightening financial conditions amid a slowing in their output growth rates. The outlook is for some pickup in growth in emerging and developing economies—supported by strengthening external demand from advanced economies—though this will be in a setting of tighter financial conditions. While global financial conditions for now remain clearly on the easy side and volatility indicators are currently low, global markets may remain prone to selloff episodes. EMs remain vulnerable to potential financial shocks, including from a re-pricing of credit risks or a resurgence in EM sovereign risk premia.

	2011	2012	2013	Projection 2014
<b>World Output</b>	3.9	3.2	3.0	3.6
Advanced Economies	1.7	1.4	1.3	2.2
Emerging Market and Developing Economies	6.3	5.0	4.7	4.9
<b>Output Gap (percent)</b>				
World	-1.6	-1.8	-2.1	-1.9
Advanced Economies	-2.7	-2.7	-2.8	-2.2
<b>Commodity Prices (U.S. dollars)</b>				
Oil	31.6	1.0	-0.9	0.1
Nonfuel*	17.9	-10.0	-1.2	-3.5
<b>London Interbank Offered Rate**</b>				
On U.S. Dollar Deposits	0.5	0.7	0.4	0.4
On Euro Deposits	1.4	0.6	0.2	0.3
On Japanese Yen Deposits	0.3	0.3	0.2	0.2
<b>Financial Indicators***</b>				
U.S. 10 Year Bond Yield (percent)	2.8	1.8	2.3	2.7
VIX Index (percent)	24.1	17.8	14.2	13.9
EMBI Global Spread (basis points)	342	342	318	329

\* Average based on world commodity export weights.

\*\* Six-month rate for the United States and Japan. Three-month rate for the euro area.

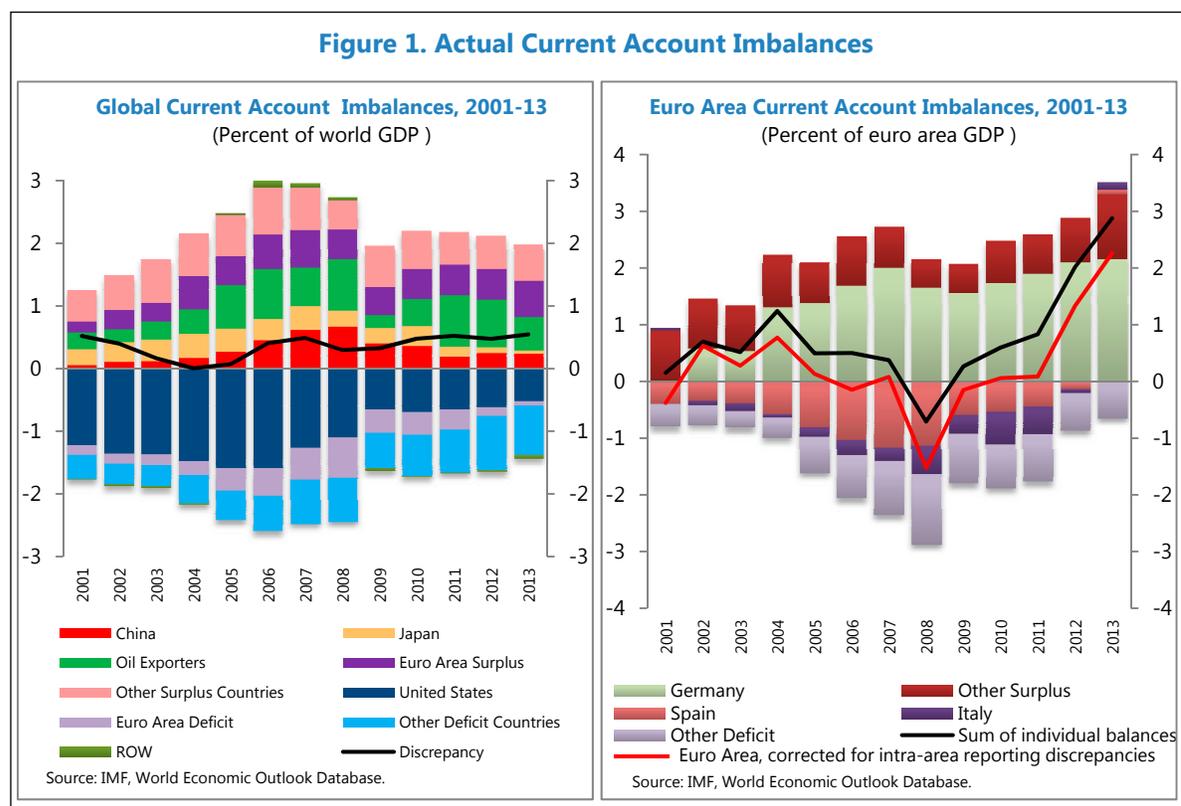
\*\*\* Period averages. 2014 values are the average through June 16, 2014.

## B. Current Account and Exchange Rate Developments in 2013–14

### 6. Viewed from a global aggregate perspective, the recent trend of gradual further narrowing of current account imbalances continued in 2013—but was not uniform.

From their peak around 2006–07, such imbalances contracted sharply in the global crisis—reflecting the confluence of the global asset price collapse, the sudden stop in trade and financial flows and a sharp decline in commodity prices—before widening in 2010. Their subsequent narrowing has been more modest (Figure 1). The largest contributors to narrowing global imbalances have been the U.S.—reflecting a sustained increase in the private saving rate and rising energy production—and the euro area deficit economies, where external deficits have

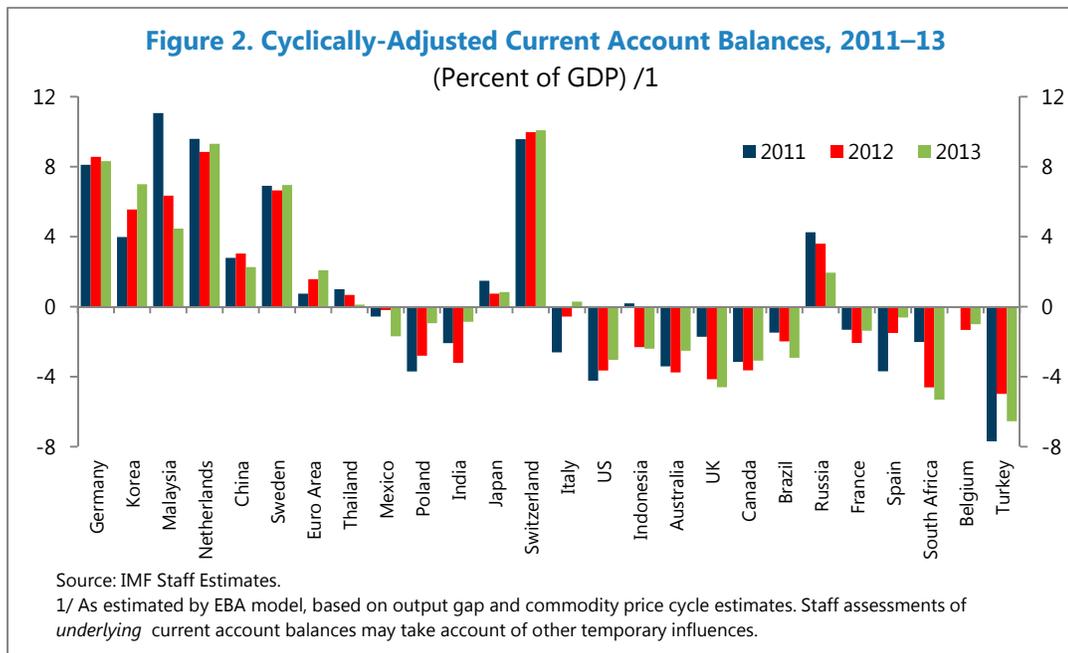
been nearly eliminated from demand compression and, more recently, relative price adjustments. Among surplus economies, strong investment growth, sluggish external demand and real appreciation account for the narrowing of China's current account, while in Japan, demographic trends and adverse shocks have lowered the external surplus to near-balance. Current account surpluses of oil exporters have been more volatile in this period, mirroring the path of oil prices.



**7. However, not all imbalances have stayed on a narrowing trend; some have widened in recent years—and the global configuration of current account balances gradually has taken a new shape.** In recent years, as the significance of the world's three largest economies in the global pattern of current accounts has receded, current account imbalances have migrated to a larger number of smaller economies. Surpluses have widened for the euro area surplus economies (Germany, the Netherlands) and in Korea. On the deficit side now are predominantly "other deficit economies" which include EMs (such as India, Indonesia, Brazil, Turkey and South Africa), and AEs (such as U.K., Canada, and Australia). The widening deficits among some EMs can be traced to the expansionary policies that supported activity after the global financial crisis which, however, were only partially reversed or reversed too slowly as output rose above potential in 2010–12, further widening current account deficits.

**8. In 2013, while the cross-country pattern of current account imbalances remained broadly steady, current accounts of some economies shifted notably—even after accounting for cyclical influences.**

- This includes the narrowing of estimated cyclically-adjusted deficits of India,<sup>1</sup> Poland and Spain, and to a lesser extent Australia (Figure 2). Cyclically-adjusted surpluses narrowed in Malaysia and Russia.
- But other such imbalances widened, with growing deficits in Turkey and Brazil, and a rising surplus in Korea.
- Among the largest economies, changes in cyclically-adjusted balances were generally smaller, though not insignificant. The surplus of China and the deficit of the U.S. both narrowed modestly. Japan's surplus was steady at about 1 percent of GDP in cyclically-adjusted terms. But the euro area surplus expanded, even as the balances of euro area surplus economies were little changed from 2012, on account of further narrowing of deficits of euro area deficit economies.



**9. Current account movements in 2013 in general appear more related to shifts in countries' own domestic demand rather than external demand,<sup>2</sup> with fiscal policies contributing.** Across ESR economies, rising (falling) cyclically-adjusted fiscal balances generally were associated with increases (decreases) in cyclically-adjusted current accounts in 2013.

<sup>1</sup> Part of the narrowing of India's deficit reflects the impact of temporary administrative restrictions on gold imports; the estimate of the cyclically-adjusted current account for FY2013/14 in Figure 2 does not take into account this temporary effect.

<sup>2</sup> The predominant role of domestic demand shifts, which in turn affect both current accounts and output, is suggested by the cross-country pattern of developments in 2013, relative to 2012: economies with rising current accounts generally had their output gaps decline (become more negative) than did those with falling current accounts. Such a cross-country pattern is typical in the short run.

The same pattern is evident also in current account shifts over the last several years, particularly when economies' fiscal positions are measured against a world average position (i.e., it is the relative fiscal position that influences current accounts). As will be discussed later, the global fiscal position has consolidated over the last three years, with implications for the assessment of current accounts.

**10. The relationship of recent short-run movements of current accounts to exchange rates is more complex and difficult to disentangle in 2013, amid substantial currency volatility.** Trade may respond only with lags, and some movements in real effective exchange rates (REERs) may not persist long enough to see their potential expenditure-switching and production-switching effects play out. Looking within the year, the largest currency movements in 2013 were the depreciations of EM currencies after May—but those must be viewed in the context of previous and subsequent real appreciations. Many EMs experienced sizable REER appreciations in the quarters before May 2013, and nominal appreciation later in the year, coupled with inflation rates in excess of their trading partners' (Figure A1). Moreover, some currency movements may have occurred as responses to new developments in trade and trade balances, with adverse developments triggering depreciation and positive developments bringing appreciation.

**11. Notwithstanding a number of episodes of marked currency volatility, in the last several years only a few economies have experienced very sizable real exchange rate shifts which have been sustained.** South Africa had significant REER depreciation after mid-2011. Japan experienced a large real depreciation more recently, concentrated in late 2012 and early 2013, which has remained in place. So far, neither economy has experienced any strengthening of its current account; this suggests the importance of lags, but also of structural factors and adverse shocks that may have required depreciation (see the individual economy assessments and Box 2, on the case of Japan). In some cases, structural changes in the nature of global trade, including the increased outsourcing of production beyond domestic borders, the rise of global supply chains and exporters' local currency pricing strategies, which lower the exchange rate responsiveness of trade, may be important.

**12. The overall movements of real exchange rates in 2013 were, if not large in most cases, generally in the directions that would be consistent with narrowing of excess imbalances—if such movements are sustained and are accompanied by appropriate shifts in domestic demand.** In comparison to their average values of 2012, real exchange rates did appreciate in some surplus economies (China, Korea) and depreciate in deficit economies (Canada, South Africa, Turkey, U.S.).

**13. Still, taking fresh stock as of May 2014, the configuration of real exchange rates of ESR economies continues to show only very few cases of sizable shifts relative to 2012.** Comparing May 2014 REERs with average levels of 2012 (Figure 3, and Figure A1):

- The largest movements are the depreciations of Japan (-25 percent), South Africa (-15 percent) and Canada (-9 percent), and the appreciation of Korea (+13 percent).

### Box 2. Japan's External Position One Year after the Yen's Depreciation

Last year's ESR found the yen to have become moderately undervalued (from a previous position of moderate overvaluation) after the 20 percent real depreciation from 2012 to mid-2013. This year, the real exchange rate, and current account, are assessed as broadly consistent with medium-term fundamentals (even though there has been no appreciation since the previous ESR). As outlined in this Box, the assessment is subject to a high degree of uncertainty given the underlying structural changes and policy shifts underway in the Japanese economy.

Japan's goods trade balance has been in deficit for three years now. Although the yen depreciated rapidly over October 2012–May 2013 (reversing a 20 percent real appreciation during 2008–2012), so far this has failed to arrest the decline in the trade balance. As a result, the current account balance has remained on its declining trend since 2007.

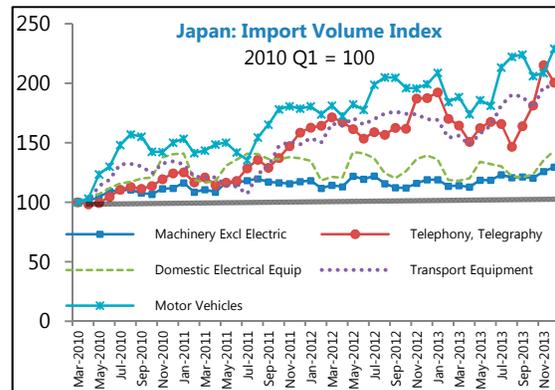
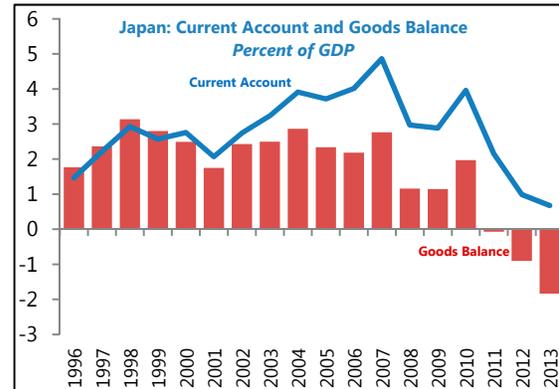
Structural factors are exerting a drag on the trade balance and making it less responsive to the movement of the yen. The rising share of offshore production—exceeding 20 percent of overall manufacturing output—and Japan's upstream position in the global supply chain have reduced the sensitivity of exports to fluctuations in the yen.

On the import side, with the supply of domestic nuclear power likely to be permanently lower, a portion of the current elevated energy imports will persist. Finally, imports of consumer electronics and IT devices have soared during the last few years and structurally increased the import share in Japan's domestic final demand.

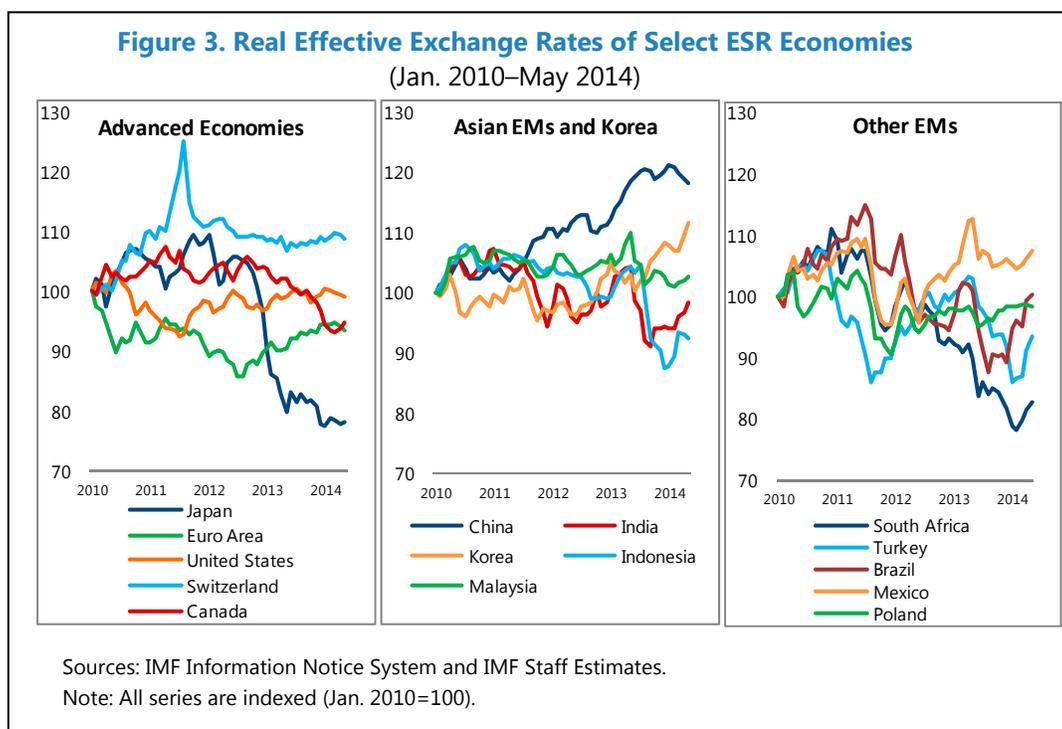
Some factors weighing on the current account are transitory—cyclically weak demand for capital goods (a large portion of Japan's exports), low pass-through from yen depreciation to local currency prices in export markets, a fraction of the elevated energy imports, and rush demand for consumer goods ahead of the consumption tax increase this spring. Once these temporary factors unwind, staff assess that the trade balance will remain in deficit and the underlying current account balance will rise to at most 2 percent of GDP, close to the level consistent with desirable policies and medium-term fundamentals (or norm; see Japan assessment page). The implied gap between the underlying current account and the CA norm is therefore assessed to be centered on zero.

Amid the various temporary and structural factors at work, estimates of the underlying current account and the current account norm have a high degree of uncertainty. Bands around the implied current account gap of zero range from  $-1\frac{1}{2}$  to  $1\frac{1}{2}$  percent of GDP, reflecting plausible ranges of variation for energy imports, international competitiveness, potential growth, and fiscal adjustment. This range translates into wide exchange rate bands of -15 percent undervaluation to +15 percent overvaluation, based on a relatively low sensitivity of the trade balance (as a share of GDP) to the exchange rate.

For the time being, uncertainty about Japan's external assessment will remain elevated. In addition to the above factors, the assessment assumes the implementation of desirable macroeconomic policies and in the case of Japan this requires full implementation of all three arrows of Abenomics. The effects of the new policies on the external balance are uncertain given that they are trying to accomplish several goals—accelerate growth, lift inflation, lower public debt. As the policies are being implemented, the assessment will be revisited in the future as outcomes become clearer.



- Among the largest economies, movements have been smaller, as the U.S. REER is little changed as of May, while the REER of the euro area has appreciated from its trough in mid-2012. The REER of China is 6 percent stronger than its 2012 average.



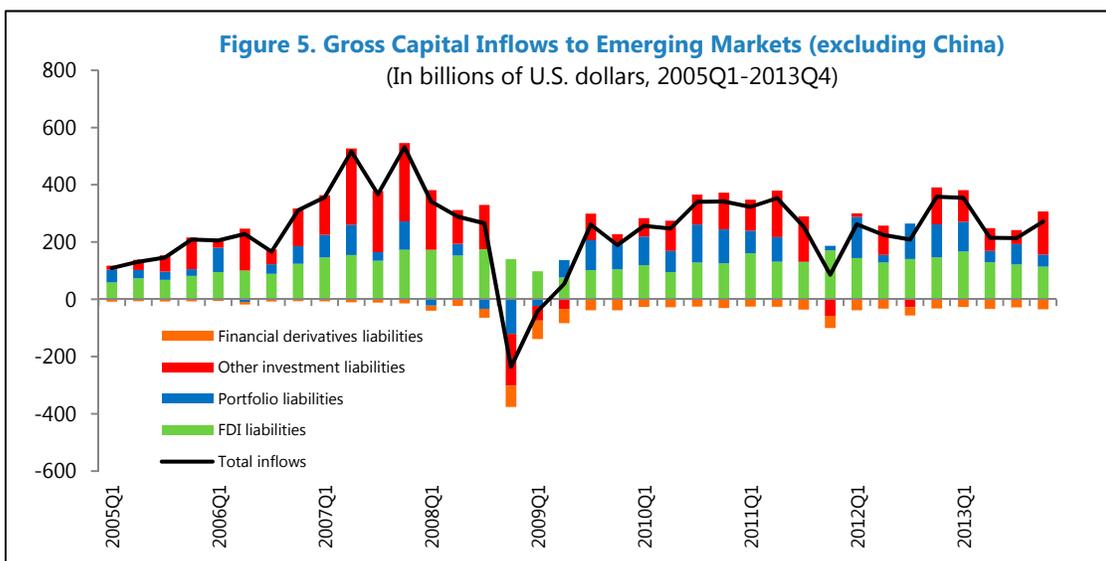
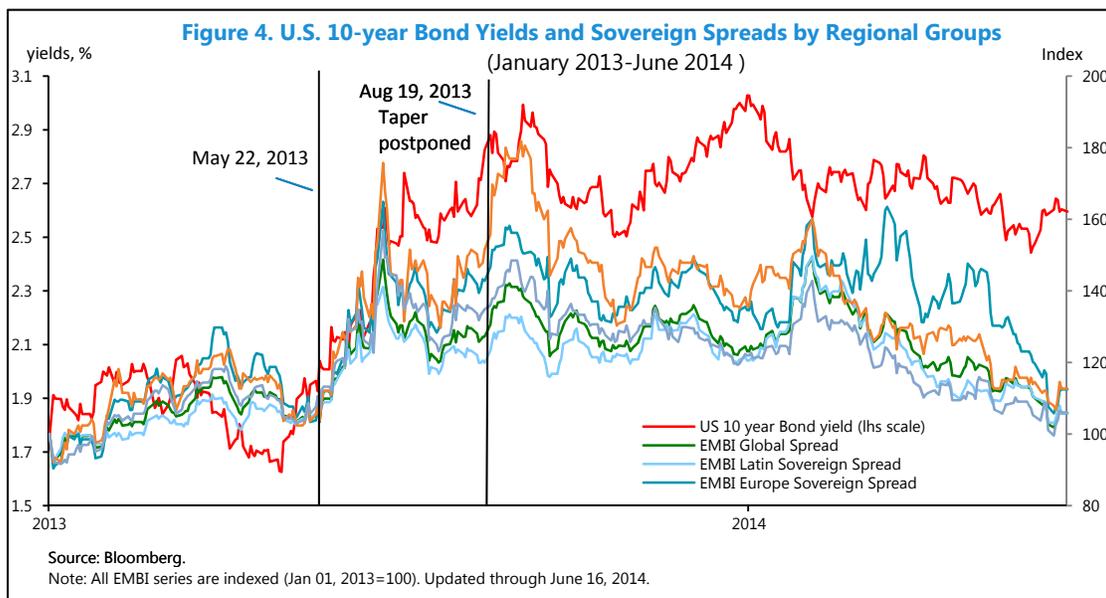
### C. External Financing: Shifting Capital Flows and Asset Repricing

**14. For 2013 as a whole, aggregated capital flows did not show a major swing, but there was an unsettled financing picture within the year—particularly turbulence following the May announcement on tapering of U.S. monetary stimulus.** This announcement, and the resulting rise in U.S. bond yields, was sufficient to provoke financial market turbulence especially in EMs, where spreads on sovereign bonds also rose (Figure 4). In turn, this prompted a range of policy responses in EMs, including monetary tightening, CFM measures, FX intervention and some cases of fiscal policy tightening.<sup>3</sup>

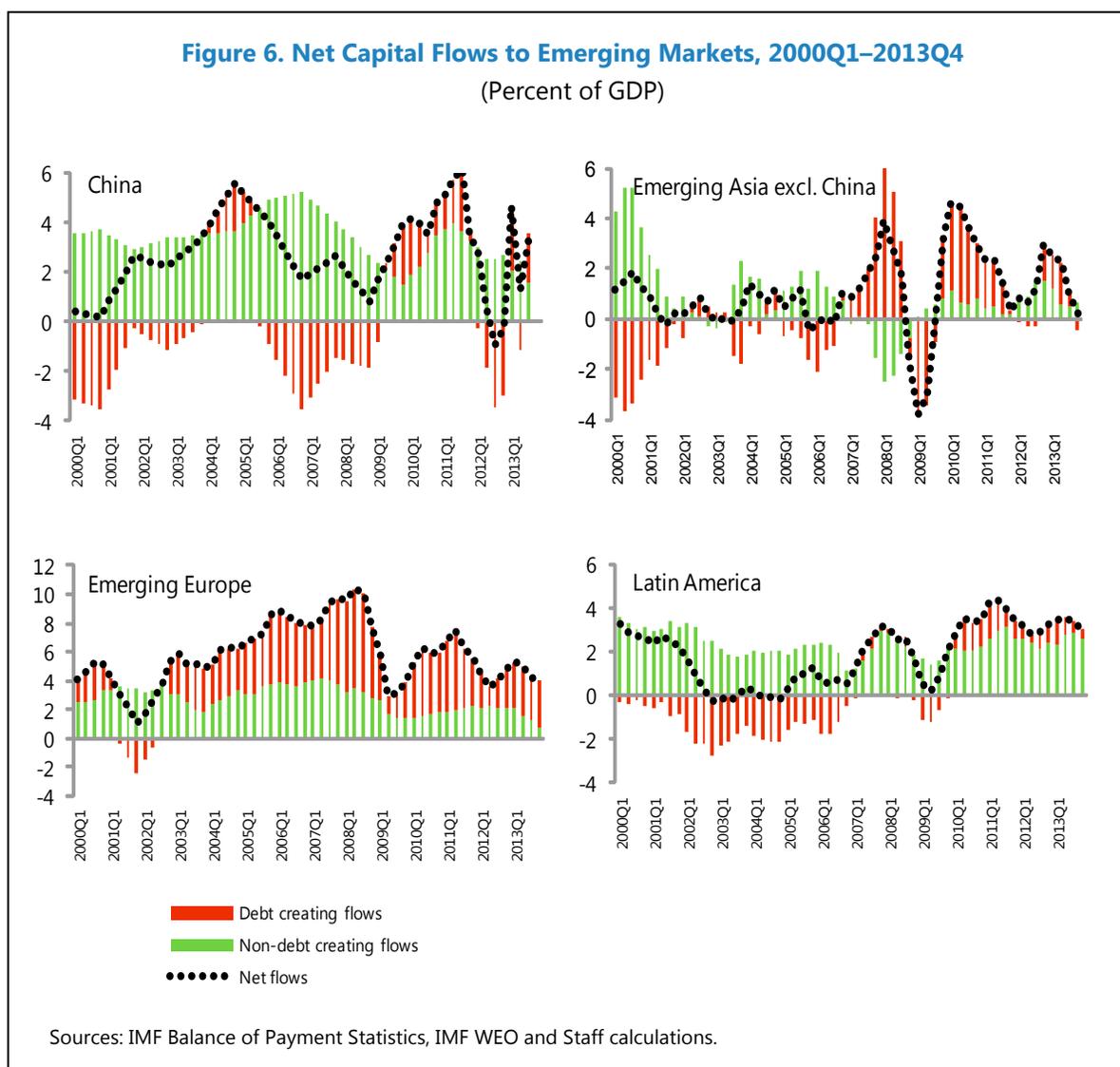
**15. While the shock to demand for EM assets did not result in cases of “sudden stops” to nearly all inflows, within the year there was considerable retrenchment in some capital flows and significant repricing of assets.** Gross inflows to EMs dipped in the second quarter of 2013 before recovering moderately (though not to pre-tapering levels) by the end of 2013

<sup>3</sup> Examples include the government and the central bank of Indonesia, which announced or implemented a series of measures, including fiscal measures after May 2013, aimed at reducing macroeconomic imbalances, neutralizing inflation pressures and maintaining financial stability; and India, where the government has taken a number of fiscal consolidation measures since the tapering announcement.

(Figure 5). The retrenchment in EM inflows was driven by a marked decline in portfolio inflows, while FDI remained fairly resilient and the initial moderation in other investment (primarily banking-related) inflows was followed by a sharp bounce back to a level higher than in the pre-tapering period. The geographical pattern of net flows reveals significant market differentiation across EM regional groups, as Asian markets (excluding China) in particular saw large declines in net debt-creating flows in the post-tapering period (Figure 6). Capital inflows to China, on the other hand, followed a different pattern, rising markedly in 2013 after a lull in 2012 (see below). In time, part of the shock was undone, as seen for example in the eventual decline of EM sovereign spreads. Policy responses played a stabilizing role. But the financial shock was not entirely reversed, as the U.S. long-term bond yield did not fall back, and local currency bond yields also rose.



**16. Although capital flow pressures were broad-based, investor differentiation across EMs was apparent, with retrenchment pressures most severe in EMs with large external financing needs, high inflation and other country-specific vulnerabilities.<sup>4</sup>** These economies included some assessed as having a weak (South Africa, Turkey) or moderately weak (Brazil, Indonesia) external position in the 2013 ESR. Some of these economies have since tightened macroeconomic policies and reaffirmed their commitment to structural reforms, and have seen the rise in their sovereign CDS spreads reversed.



<sup>4</sup> EMs that were more affected by turbulence in 2013 and early 2014 tended to have larger current account deficits and financing needs, and higher rates of inflation, in addition to more idiosyncratic risks; in some cases, expectations of medium-term growth prospects had been marked down recently (Spring 2014 GFSR, 2014 Spillover Report).

**17. Capital flow management (CFM) measures in EMs were used as a policy tool, albeit to a limited extent, to contain the pace and volatility of capital outflows.** Tighter monetary and fiscal policies were supported by a diverse range of CFM measures to limit currency fluctuations that arose subsequent to the May 2013 tapering announcement. In Brazil, substantial policy rate increases in the past year were accompanied by easing CFMs, including by reducing the tax rate to zero on fixed income and short FX derivative positions. Indonesia relaxed regulations on banks' short-term foreign borrowing and shortened the minimum holding period for central bank bills to attract foreign investors. India introduced a U.S. dollar-rupee swap window to attract foreign currency deposits from non-resident Indians, with the swap arrangement operating between September and November 2013.

**18. The potential implications for EMs' external positions of the recent tightening of external financing conditions are on several fronts, but do not yet appear to be major.** Such tightening, and the domestic policy responses it may trigger, will tend to slow growth of EM domestic demand, thereby pushing upward their current accounts. It may also induce EM currency depreciation and expenditure switching with some lag, also boosting current accounts.<sup>5</sup> However, the tightening of external financing conditions so far has been modest, and conditions remain easy by historical standards. As noted earlier, real depreciations generally have not been significant. Thus the tightening that has occurred so far does not seem to be a basis for a generalized, major rise in EMs' current accounts in 2014. The situation of course may be different in individual countries, particularly if financial shocks interact with idiosyncratic vulnerabilities to trigger a loss in confidence with consequences for both domestic demand and exchange rates.

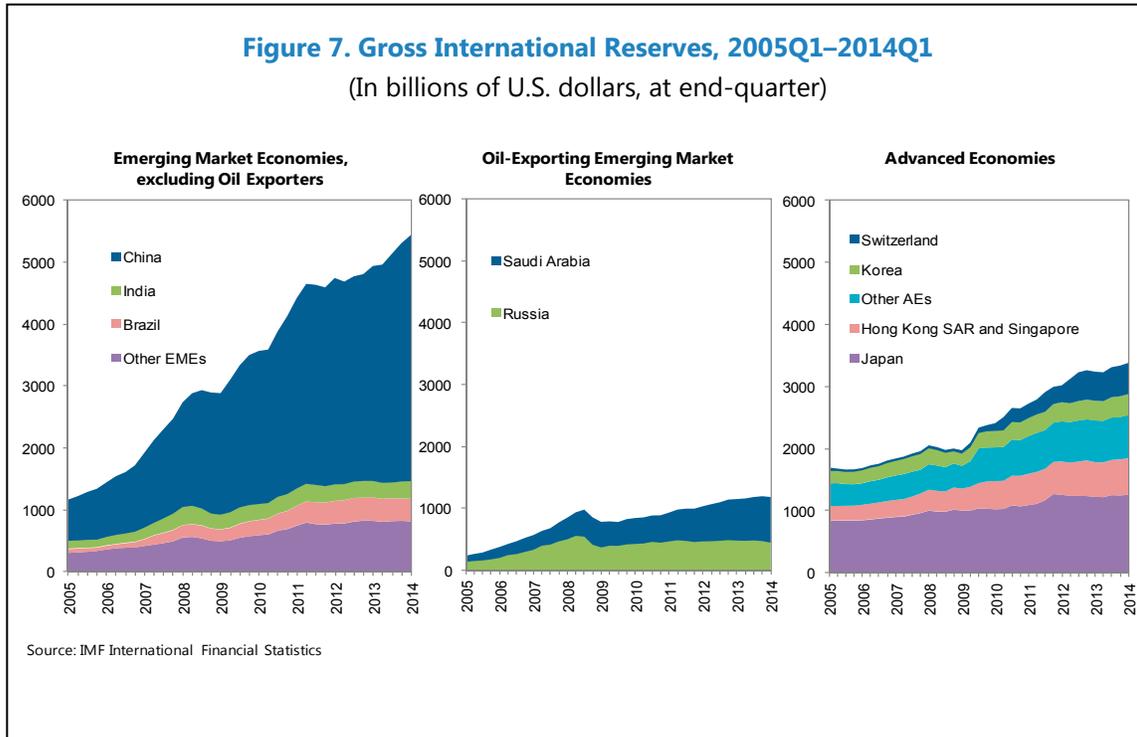
#### **D. Reserve Accumulation and Foreign Exchange Market Intervention**

**19. Viewed at the aggregate level, the accumulation of international reserves in 2013 was broadly in line with previous years.** Growth of emerging markets' total reserve holdings—mostly reflecting accumulation by China—resumed speed after a slowdown in 2012 (Figure 7). Among advanced economies, accumulation of reserve assets generally continued, but the total stock grew at a slower pace than in 2012. This pattern primarily reflects the role of Switzerland: as improved investor confidence in the euro area prompted a decline in safe haven flows to Switzerland, virtually no intervention took place there in 2013, after record accumulation in 2012.

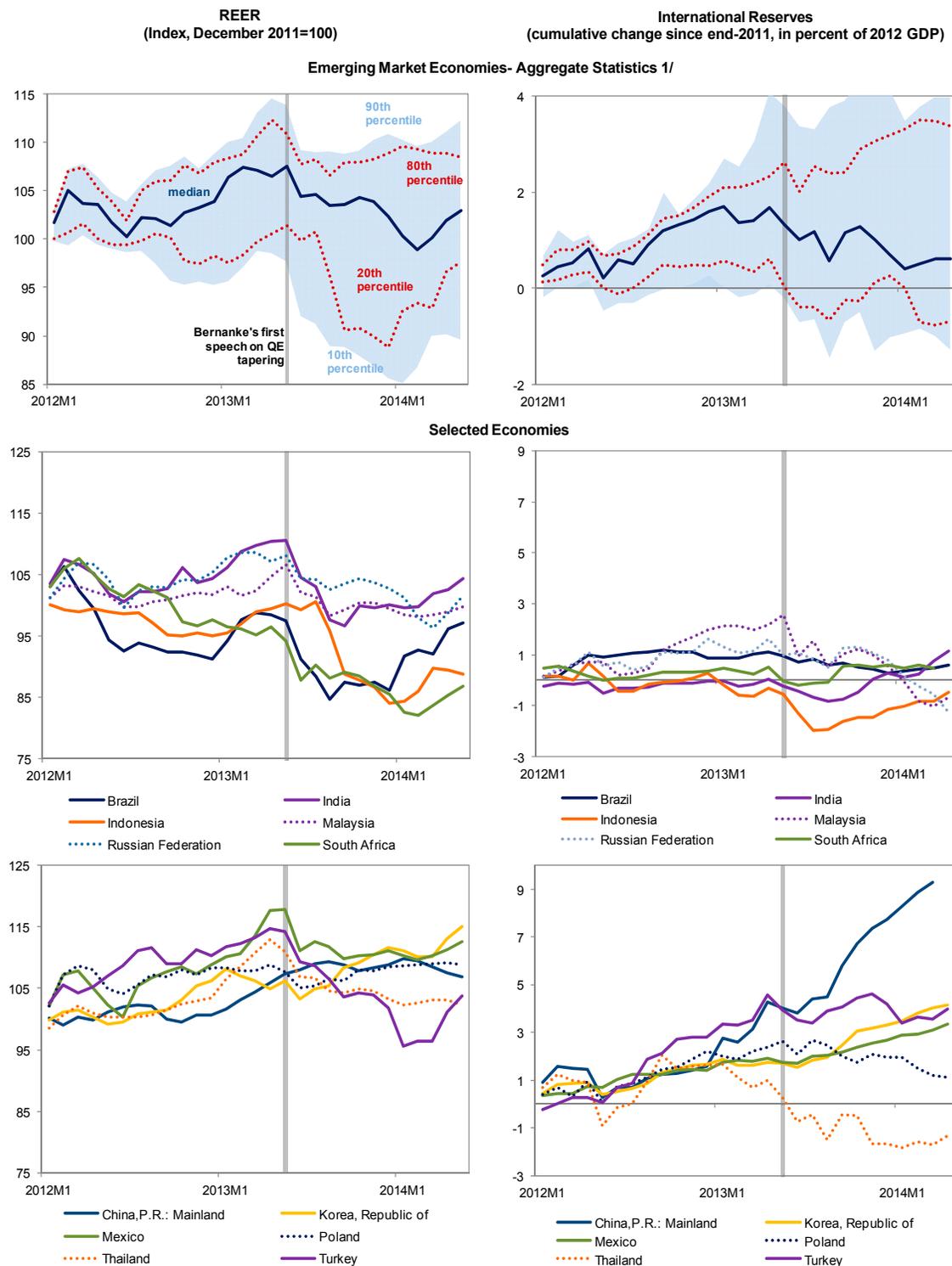
**20. But there was considerable variation within 2013, and across EMs, driven by shifts in global capital market conditions.** The U.S. tapering announcement in May 2013 triggered outflow of capital and currency depreciation in many EMs, where intervention in FX markets, in conjunction with monetary and macroprudential measures, emerged as policy responses (although significant exchange rate flexibility was also a part of the successful response in some EMs). In most cases, the real depreciations and reserve decumulation experienced after May 2013 followed opposite trends seen during the second half of 2012 and early 2013 (Figure 8). Amid

<sup>5</sup> Moreover, the tightening that is associated with stronger AE growth may have positive implications for EMs' external demand (2014 Spillover Report).

such volatility, 2013 year averages for REERs remained broadly in line with 2012 in many countries—only Brazil, Indonesia and Thailand experienced year-average depreciations. Reserves declines after May 2013 were especially pronounced in Indonesia, Malaysia, Thailand and Russia (although Indonesia’s reserves had mostly recovered by May 2014); while China, Korea and Mexico increased reserves holdings. As noted, in China, after a significantly slower pace in 2012, reserve accumulation accelerated during 2013, mirroring a return of large capital inflows. In the first quarter of 2014, reserve accumulation remained strong while the renminbi depreciated somewhat against the U.S. dollar.



**Figure 8. Real Exchange Rates and International Reserves, January 2012–May 2014**



Sources: IMF *International Financial Statistics* and IMF staff calculations.

1/ Reports statistics for the group of emerging market economies included in the ESR, plus Korea.

## ASSESSMENT

### Approach

**21. Staff assessments of external positions are multidimensional, analyzing together distinct but interrelated dimensions.** The exposition here starts with the appropriateness of current accounts and real exchange rates, then focuses on assessment of external balance sheets, and of official reserves positions and related policies.

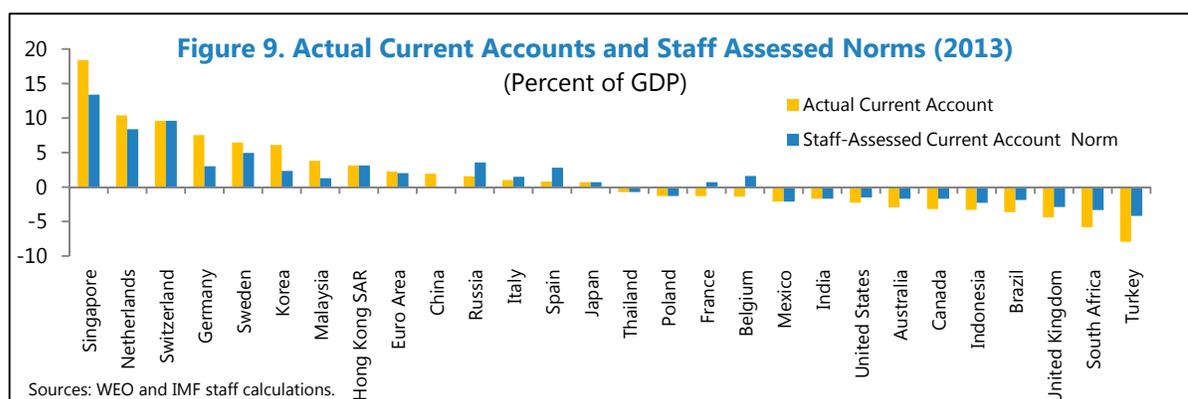
**22. The nature of the staff assessments is a normative evaluation, emphasizing the role of policies and potential distortions.** In contrast to other exercises, the aim is to identify deviations (“gaps”) from what would be *appropriate*—based on economies’ fundamentals and desirable policy settings, and allowing for appropriate temporary influences—rather than from what might be *predicted* for the future. This means that a staff assessment of a current account or exchange rate gap today does not imply a predicted future movement, since the distortions that give rise to gaps could be sustained. Moreover, when current accounts and exchange rates fluctuate temporarily—e.g., as a consequence of temporary shocks and appropriate policy responses to those—the staff assessments allow for such fluctuations to be appropriate.

**23. The assessments draw on several analytical tools and a wide range of data, together with the staff’s interpretative judgment.** The EBA model estimates of current account and exchange rate gaps are a starting point, but do not determine the assessments (Box 3). Other key inputs include the Fund’s reserves adequacy metric and analysis of external balance sheets.

### Assessments

#### A. Assessment of Current Accounts and Real Exchange Rates

**24. In 2013 most economies ran current account balances that went in the direction—surplus or deficit—appropriate to their circumstances.** The assessments generally do not call for balanced or near-balanced current accounts; by taking account of the appropriate influence of countries’ differing characteristics, as well as temporary factors, the assessments call for a wide dispersion of current accounts (Figure 9).



### Box 3. Use of the External Balance Assessment (EBA) Methodology in the ESR Assessments

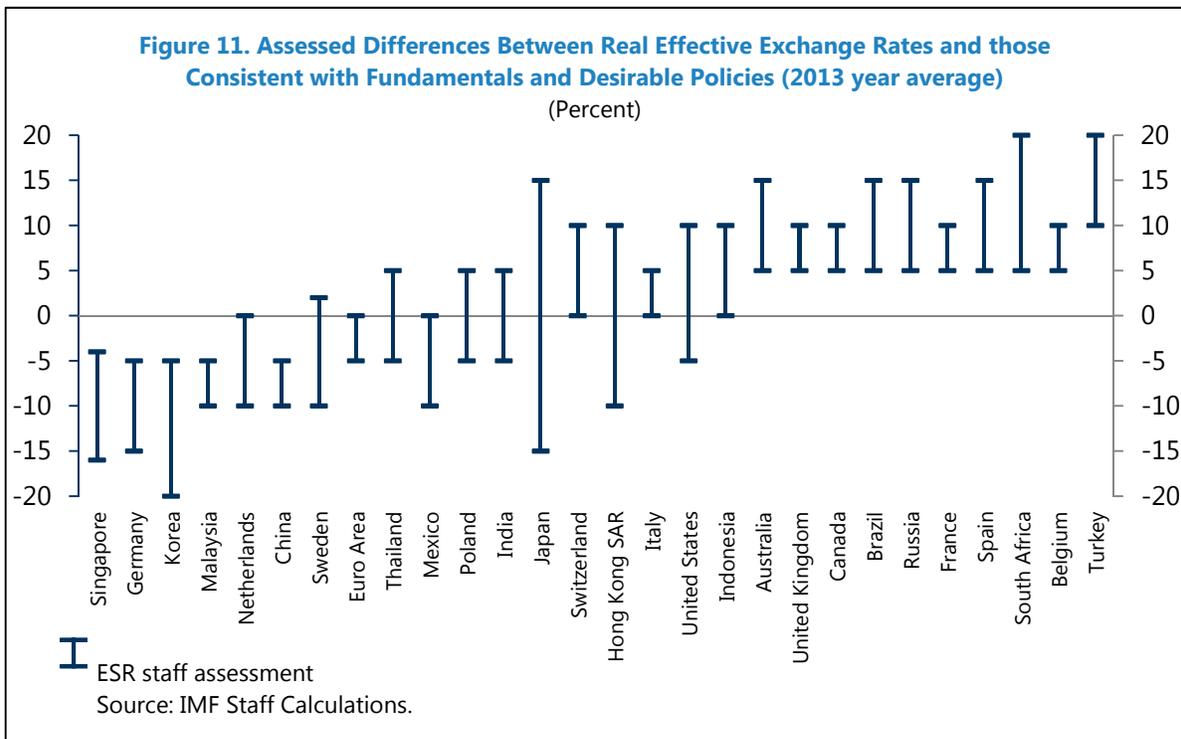
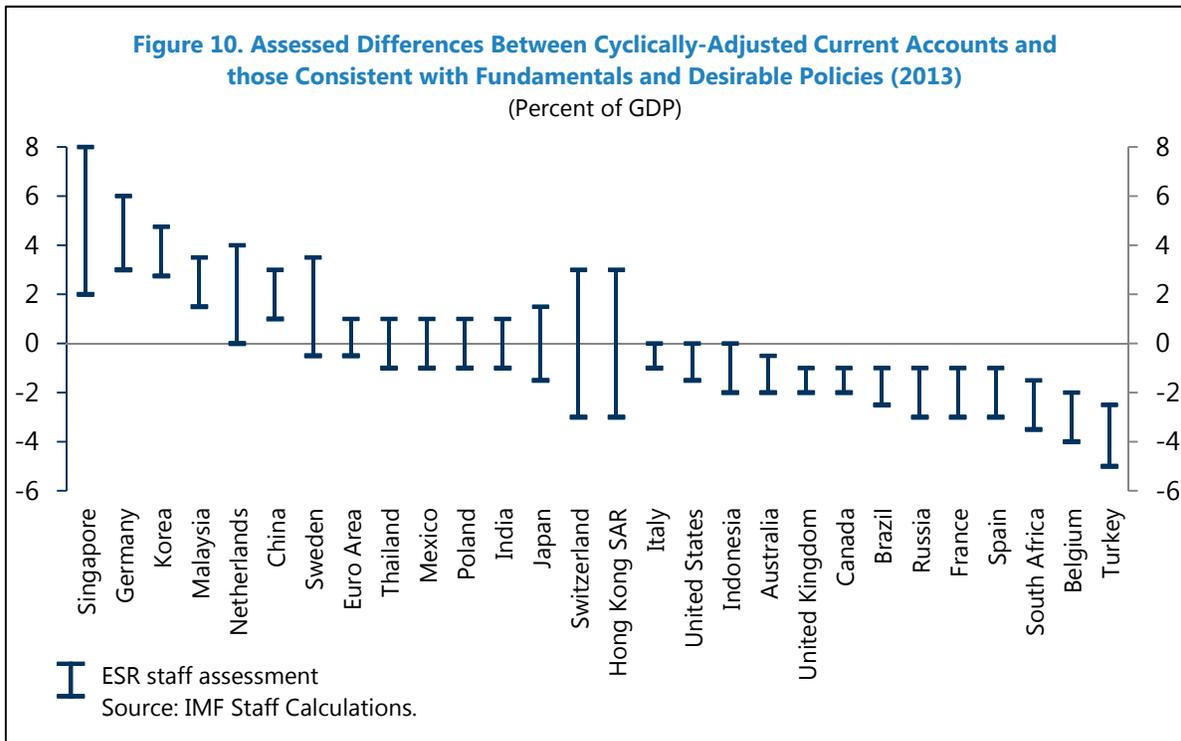
**The ESR draws, along with other inputs, on estimates using the EBA methodology; in particular the EBA version 2.0 that was introduced in the 2013 Pilot External Sector Report.** (See IMF WP/13/272 (2013) for details of the methodology).

**EBA analyzes current accounts and exchange rates based on fundamental economic characteristics as well as policies—and potential policy distortions.** The EBA methodology draws on panel regressions to derive values of current accounts and exchange rates that would be consistent with an economy's "fundamental" characteristics, such as demographic factors and the level of economic development. EBA also includes policies—fiscal, monetary, public health expenditure (which influences household saving), capital controls and foreign exchange intervention. For each of these policies, staff assessments of desirable policy settings offer a view on policy gaps. EBA also includes a third, separate exercise (the CGER's "ES" method) that focuses narrowly on the distinct question of assessing the external sustainability of NIIP positions and current account balances. This exercise is used to inform the assessments only in cases where NIIP stabilization is a dominant concern.

**The output of the EBA analysis is a set of estimated "Total Gaps" for both current accounts and real exchange rates.** These gaps are the sum of the estimated contributions of the various "policy gaps"—which in turn consist of separately-estimated contributions of domestic policy gaps and foreign (i.e., spillover) policy gaps—and a regression residual. Annex Figure A10 shows the EBA-estimated policy gap contributions to 2013 current account balances.

**The current account and exchange rate gaps shown in the ESR are staff assessments and reflect not only the EBA estimates but other information and judgment.** EBA estimates constitute a multilaterally-consistent set of starting points for country assessments, but are not adopted mechanically. In cases where the regression residual is large, a judgment needs to be made on whether it reflects only distortions not captured by the EBA regression model or instead reflects fundamentals missed by the model. For some countries, one of the EBA regression-based approaches may fit much better than the others, suggesting it should be given more weight in the ESR assessment. The separate EBA analyses of current accounts and exchange rates may not be equally reliable, and there is no presumption of giving them equal weight in assessments. In general, the current account regression-based approach, which is able to take full account of cross-country information, is likely to be more accurate. The essential problem of estimates based on real exchange rate regressions is that real exchange rate *indices* cannot be compared across countries, so that an estimate of a real exchange rate norm is strongly influenced by the exchange rate's own past average—which is often sensitive to the sample period chosen, and moreover may reflect the influence of distortions that have been sustained over time. However, where special difficulties apply to the current account analysis, the exchange rate regression-based approach may be more reliable. Thus, the staff-assessed gaps reported by the ESR will often differ somewhat from one or both of the EBA estimates for a given economy, but overall there is a strong cross-country correlation between the assessments and the estimates from EBA (see Annex Figures A5 and A6). Recognizing the uncertainty inherent in the EBA econometrics and in the interpretation of the policy gaps and regression residual, and in external assessments more broadly, the ESR reports current account and exchange rate gaps as ranges.

**An essential feature of the EBA methodology is its multilateral consistency; this is preserved in the set of ESR gaps.** That is, current account gaps "add up" in the sense that assessments of too-strong balances are matched by those of too-weak balances. The same holds for real exchange rates.



**25. However, the assessments in many cases find the size of current account imbalances in 2013 to differ from appropriate levels.** Figure 10 shows the staff-assessed current account *gaps* for each of the ESR economies, presented as ranges in light of the recognized uncertainties around such assessments.<sup>6</sup>

**26. Among the world's four largest economies, the picture for 2013 includes some current account gaps, though none that appears very large when viewed relative to the size of the economy in question:**

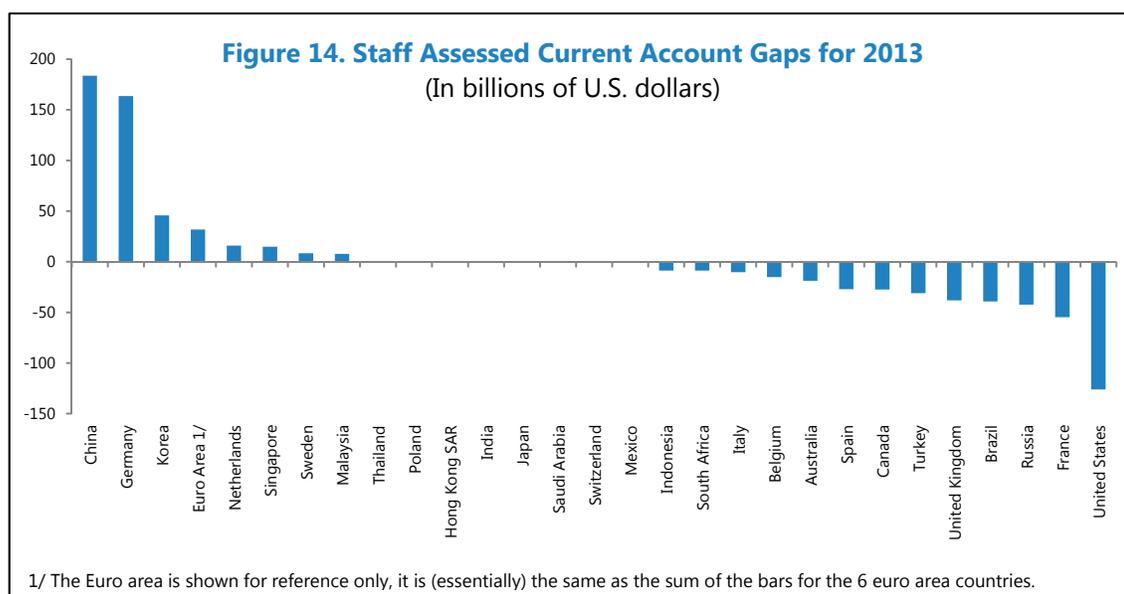
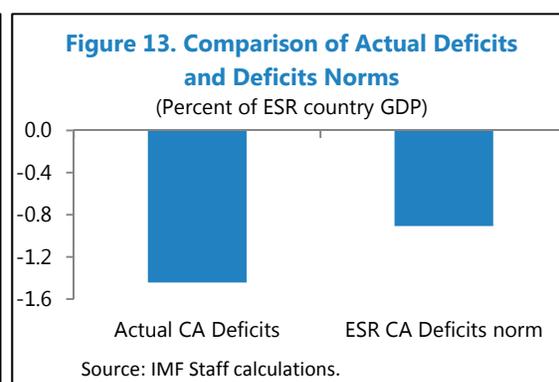
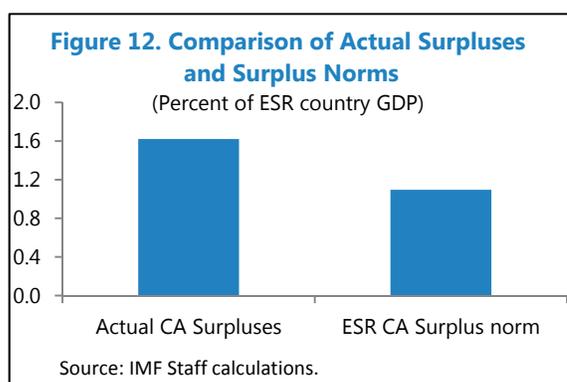
- With the continued narrowing of the deficit of the U.S., owing to ongoing fiscal consolidation and the boom in the energy sector, the midpoint of the negative gap range for 2013 is a bit less than one percent of U.S. output.
- China's surplus, though much reduced from the past, is above its staff-assessed norm level for 2013, by some 1 to 3 percent of GDP.
- For Japan, the assessment is subject to special uncertainties, and the assessment cannot identify a clear gap for 2013 (see Box 2 on Japan).
- For the euro area, as a whole, the current account surplus is assessed to be only slightly too high—but this masks gaps of many economies within the euro area that are sizable. Among the larger euro area economies, current accounts remain above norms in Germany and the Netherlands, but are below norms in Belgium, France and Spain (despite a further notable improvement in Spain in 2013), and slightly below the norm in Italy.

**27. Relative to the previous ESR round, assessments have shifted notably in a number of economies—including sizably reduced current account gaps in Malaysia, Spain and Sweden.** But assessed gaps are now larger for Korea, Turkey and Belgium. In Russia, a new gap emerged, as the current account surplus fell below its norm. The factors behind these changed assessments are wide-ranging, including not only movements in actual current accounts but also shifts in norms arising from changes in fundamentals and revised staff assessments of cyclical conditions and of desirable policy settings (see the accompanying paper on Individual Economy Assessments for details).

**28. Taking a global perspective on the assessments, the aggregated balance of surplus economies, and the aggregated balance of deficit economies, remained excessive in 2013.** For the set of ESR economies, Figures 12 and 13 show that sums of actual surpluses, and of actual deficits, are almost twice as large as the sums of the staff-assessed norms of those

<sup>6</sup> The widths of these gap ranges vary, reflecting the *relative* degree of uncertainty across countries. Uncertainty is especially high in financial center economies with relatively large balance sheets and extensive presence of multinational firms. Uncertainty also tends to be larger where the EBA regression has a larger unexplained residual requiring interpretation (see again Box 3).

economies.<sup>7</sup> The aggregate excesses were each about 0.7 percent of the GDP of ESR economies, slightly down from the previous ESR assessments for 2012 (a bit more than  $\frac{3}{4}$  percent). Looking within those aggregates, Figure 14 shows the gaps of individual economies in common units. Contributions to the excess surplus side are concentrated in just a few economies, especially China (reflecting the large size of its economy) and Germany. Contributions to the excess global deficit are much more diffuse. The largest contribution remains that of the U.S. (reflecting the size of its economy), but this is now less than a third of the total. Thus the relative composition of global gaps in 2013 is substantially different from the pre-crisis period, when gaps from an ESR-type exercise would have been dominated by the U.S. and China.<sup>8</sup>



<sup>7</sup> This aggregated comparison is meaningful in light of the typical nature of the gaps. Among the economies with non-negligible current account gaps, the nature of the gap is predominantly of excessive deficits or surpluses: i.e., the current account balance goes in the right direction but goes too far. The exceptions are Russia and Spain, which have surpluses judged too small. Belgium and France have deficits while their norms are small surpluses. Excluding these economies from the comparison would not change the overall picture.

<sup>8</sup> As the assessments are multilaterally consistent, the assessments of too-strong current accounts are balanced by cases of too-weak current accounts (Figure 14).

**29. The pattern of REER gaps broadly parallels the pattern of CA gaps, reflecting the joint and consistent nature of such assessments** (see Figure 11).<sup>9</sup> Considering the midpoints of the gap ranges, the largest REER gaps for 2013 as a whole are those of Turkey and South Africa on the too-strong (appreciated) side, and on the weak side those of Germany, Singapore and Korea (although the REER of Korea recently has strengthened).

**30. As the assessments above refer to the current accounts and average real exchange rates of 2013, a question is whether latest developments in 2014—if sustained—would point to a changed assessment.** The individual economy assessments in the companion paper take this up in detail, where relevant. As of May 2014, among the ESR economies there were no cases in which REER levels differed greatly from the average 2013 levels, but REERs were some 6 to 7 percent stronger for Korea and the U.K.; and some 5 percent weaker for Canada, Indonesia and Japan. If maintained, such movements could lead to changes in staff's assessments, depending also on other developments and shifts in fundamentals.

## B. Assessment of the External Balance Sheet

**31. The assessments take account of the level and trajectory of the net international investment position (NIIP), from a sustainability perspective (see Figures 15 & 16), but also the size and structure of the external balance sheet.** While there is no unique threshold below which the current NIIP level is judged to be too weak,<sup>10</sup> assessments show more concern when the NIIP is unusually negative, and/or where projections of output growth and the current account indicate a weak trajectory. The gross size and composition of the external balance sheet also informs the assessments of individual economies, particularly where gross liabilities are large and include substantial short-term debt, or if the position is subject to large stabilizing or destabilizing valuation effects. (As gross external positions today are often many times larger than net positions—see Annex Figure A2—such valuation effects potentially can be very large if assets and liabilities are not matched).

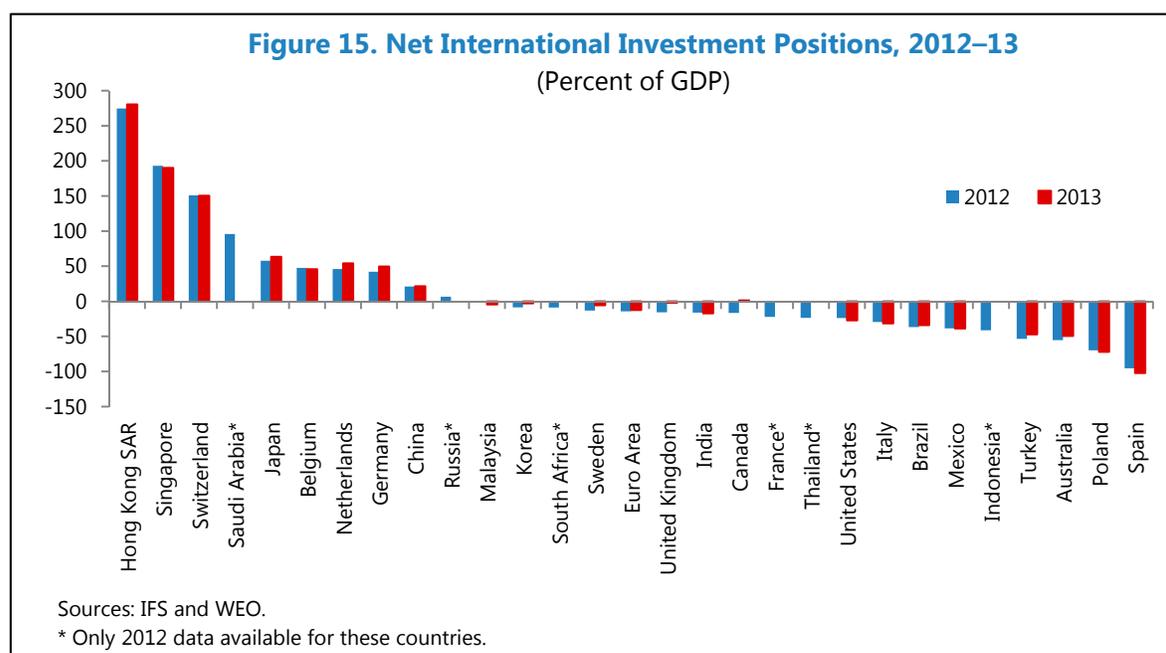
**32. Among the net debtor economies:**

- Spain's position remains the weakest among the 29 ESR economies, and the need to strengthen this continues to dominate the assessment. Adjustment in Spain has been considerable, but staff assess that the slight current account surplus needs to rise somewhat further to improve the NIIP position at an adequate pace.

<sup>9</sup> The correspondence is not exact, largely because the semi-elasticity of the current account balance (measured as a share of GDP) to the real exchange rate differs, notably from differences in country openness (trade shares).

<sup>10</sup> One indicative threshold for NIIP is the EC's -35 percent of GDP (European Commission, 2011), which is motivated by several objectives. A threshold of -50 percent of GDP, defined in the context of reducing the probability of an external crisis, is suggested by the empirical analysis of Catão and Milesi-Ferretti (2013). That study however also shows the relevance of the composition of the external balance sheet, and of the current account balance, rather than considering only the current net external position.

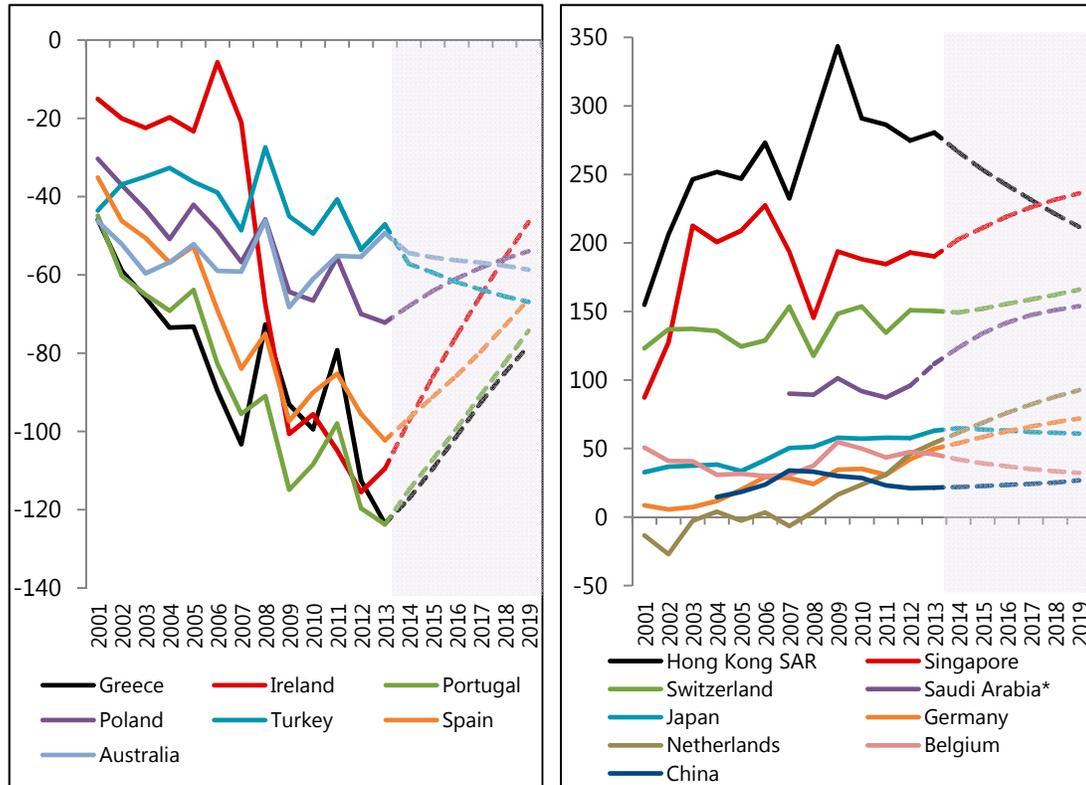
- Within the euro area, the deeply negative position of Ireland turned a corner in 2013, and those of Greece and Portugal are set to turn a corner in 2014, following substantial current account adjustments and amid an improved growth outlook.
- Turkey's net debtor position is more moderate, but the prospect of a continued decline of the NIIP is among the reasons the staff assessment calls for a narrowing of the substantial current account deficit.<sup>11</sup>
- For Poland and Australia, projected current account deficits are smaller, the NIIP trajectories are broadly stable or rising, and potential concerns are muted by other considerations, including the structure of the balance sheet.
- Among these economies, Australia as well as Turkey benefitted from sizable valuation gains in 2013, related in part to depreciation of their currencies.



<sup>11</sup> A further consideration in the case of Turkey (among other EMs, including for example South Africa) is that currency valuation effects act in a stabilizing direction. That is, if a negative shock were to trigger depreciation, the currency valuation effect in itself would tend to improve the NIIP (abstracting from other effects of the shock). A similar consideration is noted in the assessment of Australia.

**Figure 16. Evolution of Net International Investment Positions, 2001–19**

(Percent of GDP) 1/



1/ Projections for 2014–19 based on current account, capital account and GDP growth projections from the Spring 2014 WEO, and assume no valuation effects.

\* Actual data through 2012, projected for 2013–19.

### 33. While concerns about sustainability do not symmetrically arise for economies with large positive NIIP, those positions may be symptoms of excess flow imbalances.

The positions of net creditors reflect a history of current account surpluses, which may continue to the present; the assessment of those flow surpluses (above) varies across such economies.

- Those with the NIIP positions that are largest in relation to their economies' size are smaller economies that act as financial and trade centers (and for which assessments have a high degree of uncertainty, as noted earlier). Of these, the high current account surplus of Singapore is assessed to be stronger than appropriate, and the NIIP to GDP ratio is projected to rise over the medium term. No clear current account gaps are identified for Hong Kong SAR and Switzerland, for which NIIPs are projected, respectively, to decline and rise slightly (above Figures 10 and 16).
- Saudi Arabia's large net creditor position and current account surplus are assessed to be broadly appropriate for an oil-based economy saving part of its non-renewable resource revenue for intergenerational purposes. (On the other hand, the modestly positive NIIP

and current account of Russia, another oil exporter, is judged to be somewhat too low in light of such intertemporal considerations).

- Of greater relevance from a global balance sheet perspective are the economies with the largest absolute NIIP, Japan, China and Germany. (Together, these three economies represent more than half of the net creditor side of the global balance sheet (Figure A3)). Germany's position is projected to rise over the medium term, reflecting a sizable current account surplus that is assessed to be stronger than appropriate. The positions of Japan and China are projected for the coming years to be broadly stable in relation to their own GDP, slightly falling for Japan and slightly rising for China.

### C. Assessment of Foreign Exchange Intervention Policies and Reserve Adequacy

**34. In general, FX intervention policies since 2012 appear to have been aimed mainly at dampening sharp movements in exchange rates against a backdrop of volatile capital flows.** In many cases, FX interventions were deployed to counter excessive short-term exchange rate volatility and prevent disorderly conditions (along with other policies, as noted). While exchange rates tended to move in directions consistent with narrowing REER gaps in 2013 and early 2014 (Figure 17), FX intervention policies were not always in the directions supportive of such narrowing.

- In some countries (China, Korea), FX purchases—or non-spot market interventions<sup>12</sup>—were deployed in the context of remaining real exchange rate undervaluations (Figure 18).<sup>13</sup> Amid strong reserve buffers (Figure 19), China allowed real exchange appreciation in line with previous trends while reserve accumulation accelerated in response to sizable capital inflows during 2013.<sup>14</sup> Korea continued its path of reserve build up, amid reserve buffers already adequate from a precautionary perspective, and the Bank of Korea also increased its FX forward position by US\$12 billion in 2013—although alongside a sizable appreciation.
- At the other end of the spectrum, Brazil and to a lesser extent Indonesia conducted FX sales—or equivalent non-spot operations—during 2013, amid still overvalued currencies; such interventions were undertaken in response to the short-term volatility that arose after May 2013. In the case of Brazil, these FX interventions followed sizable depreciation.

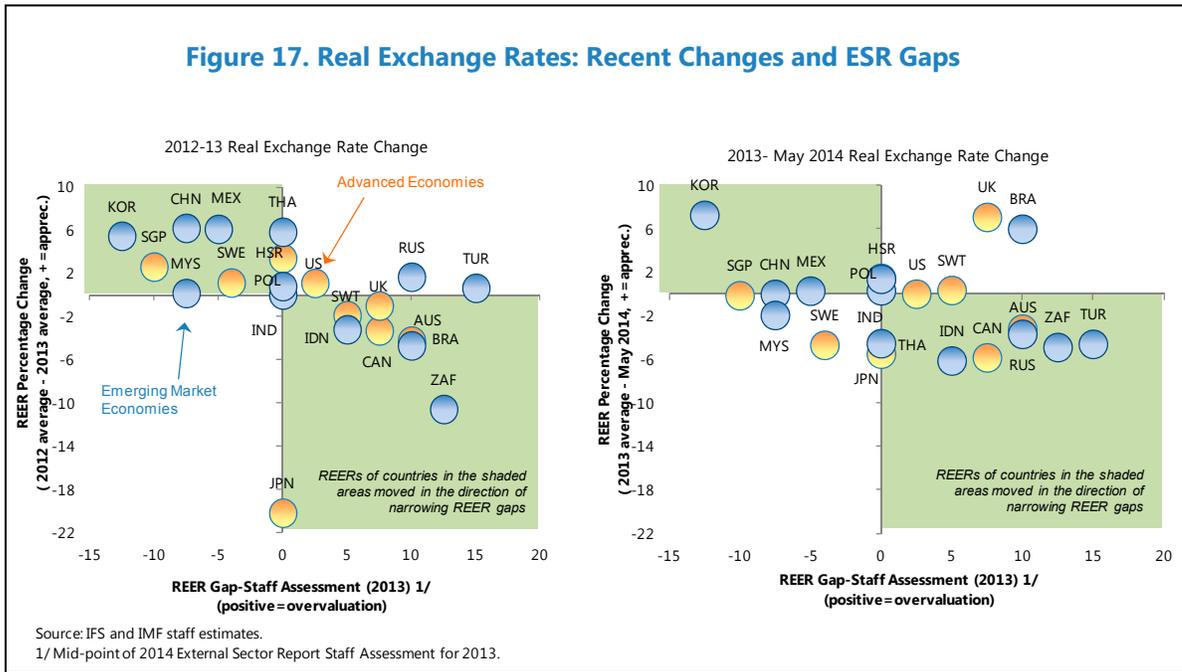
<sup>12</sup> Changes in off balance sheet (i.e., non-spot) FX positions, which can be an additional pillar of intervention, have become sizable in some countries, for example, adding to (Korea) or subtracting from (Brazil) central banks' net FX positions.

<sup>13</sup> Sweden increased its borrowed currency reserves by about 10 percent of GDP in early 2013 for precautionary motives.

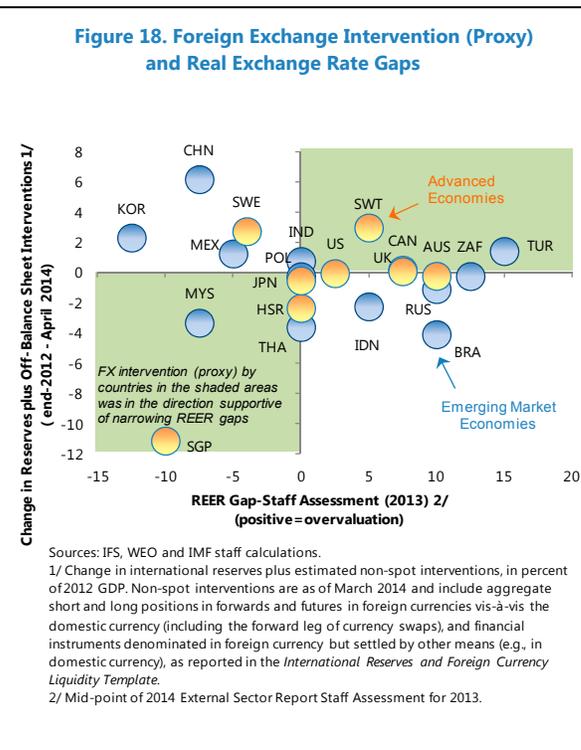
<sup>14</sup> During the first quarter of 2014, China's reserve assets increased by about US\$126 billion, amid a slight depreciation of the renminbi.

- Mexico and Turkey strengthened FX liquidity buffers for precautionary motives, in line with staff recommendations.

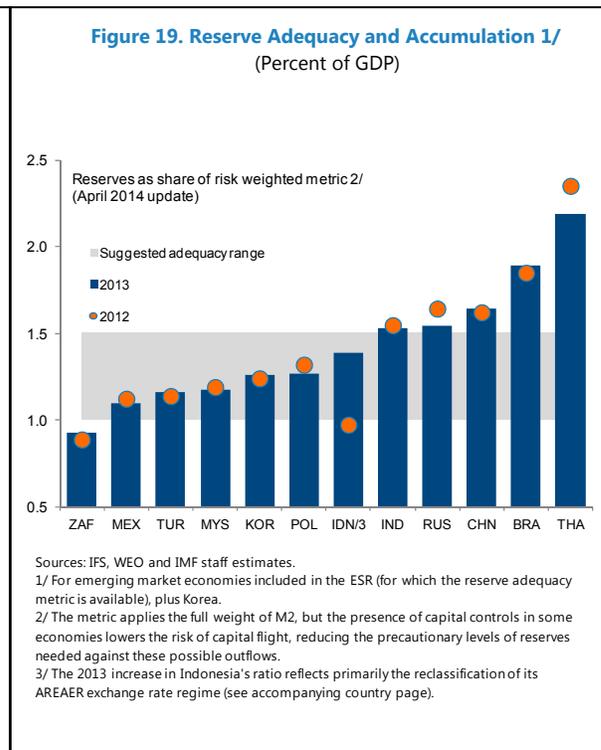
**Figure 17. Real Exchange Rates: Recent Changes and ESR Gaps**



**Figure 18. Foreign Exchange Intervention (Proxy) and Real Exchange Rate Gaps**



**Figure 19. Reserve Adequacy and Accumulation 1/ (Percent of GDP)**



**35. Reserves levels remain adequate, or above adequate levels, for most emerging market economies.** Despite some cases of declines in 2013, reserve levels in most emerging economies remain adequate from a precautionary perspective (Figure 19). In some cases (Brazil, China, India, Russia, and Thailand), reserves are above the range suggested by the Fund's current metric for assessing reserve adequacy (ARA).<sup>15</sup> Moreover, the ARA metric may overstate the current need of some countries to hold reserves, in particular those with restrictions on capital outflows, such as China.<sup>16</sup> Only South Africa remains with reserves below the suggested range, while Mexico and Turkey—at the lower end of the range—would also benefit from having larger buffers in light of country-specific features not fully captured by the current adequacy metric (see further details in individual economy assessment paper). The FX liquidity buffers of Mexico and Poland continue to be bolstered by the availability of the FCL.

## POLICIES TO REDUCE EXTERNAL GAPS

**36. That aggregate global imbalances are smaller than in the pre-crisis period should not take attention away from the need for policies to address today's remaining excess imbalances.** Such imbalances by their nature reflect distortions and carry risks, and as such need to be confronted for the purpose of promoting welfare and stability. This applies from the perspective of individual economies, but multilateral considerations are also relevant.<sup>17</sup> As imbalances are inherently interconnected, addressing excess imbalances may have broader benefits in terms of reducing risks of adverse spillovers and possible systemic risks. As discussed further below, multilateral considerations are relevant also in the process of adjustment: the benefits of adjustment will be greatest, and possible transition costs least, if those with excess deficits and those with excess surpluses act to reduce their respective imbalances. This would ensure a mutually supportive and balanced adjustment process, which is especially important at a time when global output remains below potential.

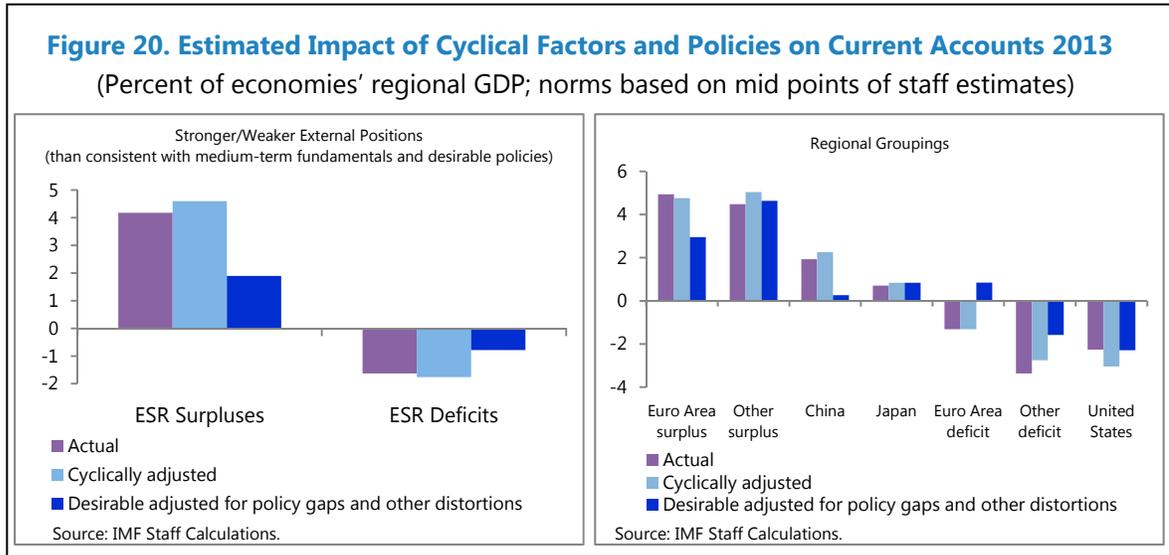
**37. The need for further policy action is in proportion to the size of remaining external imbalances.** As noted, actual current account imbalances in many surplus and deficit economies are considerably in excess of those justified by fundamentals and desirable policy settings.

<sup>15</sup> The Fund's 2011 Assessing Reserve Adequacy metric is a composite measure of reserve adequacy for precautionary purposes. It is based on possible sources of outflows during crises, including risks from a loss of export income, resident and non-resident flight, and short-term debt rollover. *Assessing Reserve Adequacy—Further Considerations* (December 2013) found that the metric had improved the analysis on reserves relative to traditional benchmarks, but suggested some refinements to better capture some country specific circumstances; staff work in this area is ongoing.

<sup>16</sup> The presence of restrictions on capital outflows may diminish the need for reserves, as these are likely to reduce risks of large capital outflows. The ARA metric does not account for this, arguably giving excessive weight to broad money as a basis of reserves needs. Applying a reduced weight in cases with significant restrictions on capital outflows, such as China, could substantially raise the ratio of reserves to the metric. Going forward, as China plans to open its capital account over time, the appropriate weight on broad money would rise, and so also reserves needs.

<sup>17</sup> Blanchard and Milesi-Ferretti (2011).

Cyclical factors, including with respect to commodity prices, in most cases make relatively small contributions to current account imbalances; policy gaps and other distortions are assessed to play a much larger role (Figure 20). In aggregate, the size of the needed underlying adjustment and rebalancing of demand across countries remains large enough to be of global macroeconomic significance, again suggesting the value of a multilateral perspective.



**38. The nature of the policies appropriate to reducing excess imbalances is indicated by the diagnosis of their origins.** Reversing policy distortions that give rise to such gaps—such as excessively loose fiscal policy, or policies that distort private saving rates—is essential. Even where gaps reflect distortions in private sector behavior, as in demand or credit booms, it falls to policies to prevent, or otherwise to counter, those excesses. In some cases, an exact understanding of distortions' nature may not be possible, but policies to counter large current account gaps may still be appropriate, not least out of concern for stability. Finally, policies may also play a role in facilitating and speeding the process of external adjustment.

**39. Needed policy actions vary by country—as set out in the companion paper—but the contours of the global policy agenda for reducing excess imbalances are the same as in the previous ESR.** In the broadest terms, policy actions to reduce such gaps in deficit economies include fiscal consolidation, steps to moderate excesses in private demand, and structural reforms to facilitate adjustment, with various policies that would support stronger domestic demand needed in surplus economies. Reducing gaps in some cases will also require adjustments in capital account and reserves intervention policies.

**40. Fiscal policy is particularly relevant today, as fiscal consolidation remains a key policy need in many economies, and is progressing in some—with consequences for their external imbalances and those of others.** Negative fiscal gaps remain in many though not all AEs, and in many EMs also. Staff identify an aggregate or global fiscal policy gap of some  $-2\frac{1}{4}$  percent of GDP, reflecting the combined differences between underlying fiscal positions in 2013

and appropriate objectives for medium- and longer-term fiscal positions. Consolidations in AEs and some EMs in 2013 have narrowed the global fiscal gap, from -3 percent in 2012 (April 2014 Fiscal Monitor) and 3½ percent in 2011.

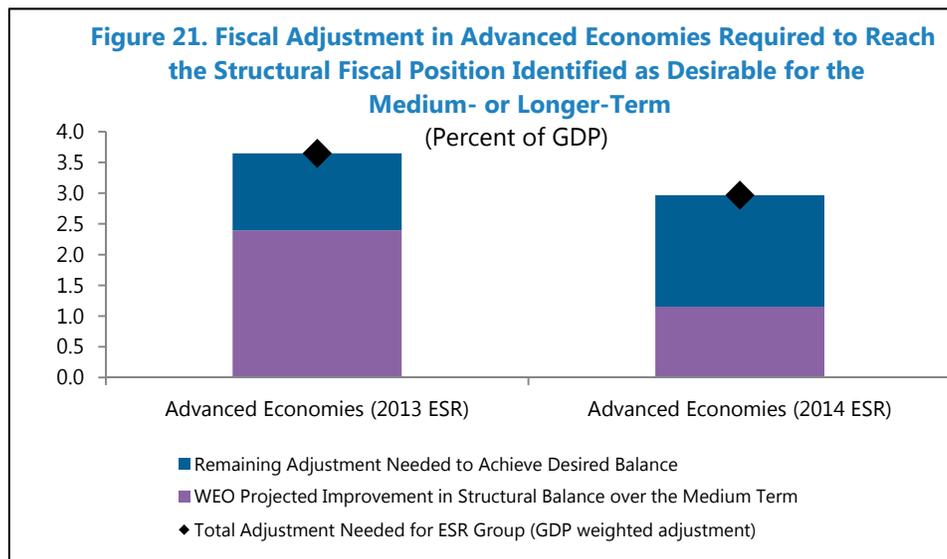
**41. This global fiscal gap remains large enough to have implications for the analysis and the unwinding of external gaps.** Since an economy's current account depends not simply on its own fiscal position but on those of others, the size and future path of the global fiscal gap needs to be considered. For an economy with no gap in its own fiscal policy, the EBA model estimates that this global fiscal gap distorts its current account balance upward by about ¾ percent of GDP (and this may be an understatement).<sup>18</sup> (See also Annex Figure A10, on EBA-estimated policy gap contributions). More typically, for an economy with its own fiscal policy gap of about -2 percent of GDP (i.e., the same size as the global fiscal gap), the opposing effects on its current account fully offset each other. The impact of the country's own fiscal shortfall is thus hidden by the effect of others' fiscal gaps—for as long as the latter remain in place.

**42. The future correction of the negative fiscal policy gaps in the largest advanced economies would be expected to affect current accounts—and possibly also growth—around the world.** Outcomes would depend on when this adjustment occurs and on what other developments may accompany it. In a scenario in which fiscal consolidations were accompanied and offset by a parallel rise in private demand in the same economies, current accounts and growth might show little change. The most desirable outcome, in terms of reducing excess external imbalances and avoiding a decline in global aggregate demand, would involve rising domestic demand in the economies with excess current account surpluses—ideally, spurred by policies that address underlying distortions. This would include structural policies to remove distortions that have held back domestic demand.

**43. Among the ESR economies, negative fiscal policy gaps are particularly sizable in Japan and Spain, followed by the U.K., France, and the U.S.; further progress on fiscal consolidation in these larger economies will shift the global fiscal policy gap.** Although not expected, a too-rapid consolidation by economies representing a sizable share of world output, could undermine the still uneven global recovery, as it is not clear when and where demand in surplus economies will pick up. Large fiscal expansion in external surplus economies is not the answer, as the staff assessments for those economies call for expansions only in Germany and the Netherlands (over the medium term, by somewhat less than 1 and 2 percent of GDP, respectively). More broadly, the assessments of economies with excess surpluses call for a range of other policy actions and reforms, some of which would take time to gradually boost domestic demand. Implementation of reform plans in China would be of global significance, particularly in light of that economy's size.

<sup>18</sup> This estimate, which utilizes a coefficient from the EBA current account panel regression, might well be understated, as such estimates are likely to be biased toward zero (Leigh et al, 2010).

**44. While too-rapid fiscal consolidation is to be avoided, fiscal policy should not become complacent and neglect to plan ahead.** The pace of fiscal consolidation in many AEs is projected to slow in 2014 as average debt levels stabilize and the focus shifts appropriately toward supporting a still weak recovery. Indeed, since the time of the previous ESR, staff projections of structural fiscal balances 5 years ahead (from the *World Economic Outlook*, based on current policies) have actually declined by some ½ percent of GDP, notwithstanding recent consolidation, although they still imply some further consolidation over the medium term (Figure 21). In some cases, including Japan and the U.S. it will be important to develop concrete and credible medium-term fiscal consolidation plans—not as a means to influencing their current accounts, but to ensure sustainability of public debt and stable growth for the future.



**45. In the euro area, current account gaps remain high for many economies, and the assessments call for policies on the part of both surplus and deficit member countries.** The policy agenda for deficit economies has included substantial fiscal consolidation, but this needs to be complemented by further adjustment of relative prices, which would be facilitated by product and labor market reforms which will also boost productivity and growth. In economies with excess surpluses, it would be appropriate to raise public investment, as well to implement structural reforms that raise productivity of smaller firms (for example, in the Netherlands) and boost domestic demand (Germany, Netherlands). At the level of the euro area as a whole, monetary policy is also relevant, and the assessment supports further monetary easing if the outlook for inflation does not improve. Such easing, while geared chiefly to avoiding the risks associated with too-low inflation, would also give a better chance to the shifts of relative prices within the euro area that are needed for external adjustment (Box 4).

### Box 4. External Positions and Rebalancing in the Euro Area

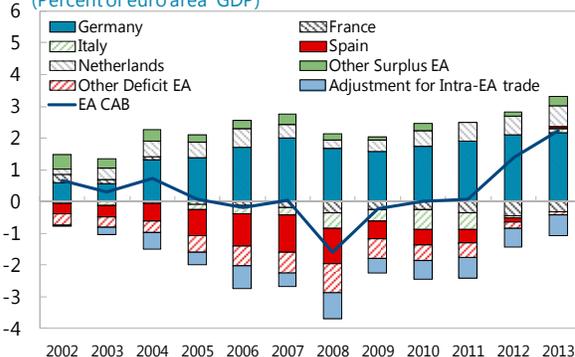
**The euro area current account has continued to rise since the crisis.** The current account balance is estimated to reach 2.3 percent of GDP in 2013 (text chart), up from a balanced position in 2011 and a deficit of 1.5 percent in 2008, mostly on the back of rising exports to rest of the world. Looking ahead, the current account is forecasted to be sustained at the current level.

**Within the euro area, however, external positions differ greatly and external adjustments among member states have been asymmetric.** On one hand, current account balances in large surplus countries (e.g., Germany and Netherlands) reached their highest levels in 2013, although Germany's surplus with the rest of euro area narrowed significantly (text chart). On the other hand, those with negative balances have seen deficits shrink substantially, in some cases coming from recovering exports outpacing import growth (e.g., Spain, Ireland, and Portugal), in other cases due to import declines and mild export growth (e.g., Greece). Part of the adjustment owes to cyclical factors, as weak domestic demand compresses imports in these deficit economies, but it also comes from structural components including lower potential output and medium-term expected growth. Relative price changes have taken place, gradually, in deficit economies—evidenced by improved export performance—but their further adjustment could be challenging under the current low inflation environment.<sup>1</sup> Wage adjustments so far have had a limited impact on export prices, and weak euro area demand has been a drag on exports.<sup>2</sup>

**Further rebalancing in the euro area relies crucially on near-term policy support and advancing structural reforms.** In the short run, accommodative monetary conditions would help support domestic demand and facilitate relative price adjustments, which are slowed by the current low inflation environment. Meanwhile, boosting investment in surplus countries will improve potential growth with positive spillovers to the euro area. Further structural reforms in product and labor markets—though with different country-specific priorities in surplus and deficit economies—are necessary to raise productivity and support the reallocation of resources. In addition, continued progress on area-wide policy initiatives—notably on banking union and financial market development, among broader reforms to complete the Single Market—can help reduce external financing constraints, ensure more risk sharing, and facilitate lending and investment.

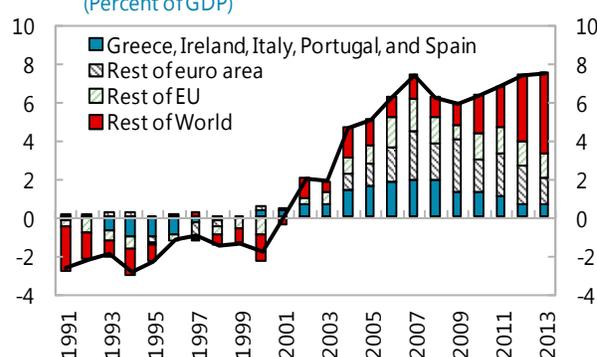
**Euro Area: Current Account Balances**

(Percent of euro area GDP)



**Germany: Current Account Balance by Region**

(Percent of GDP)



<sup>1</sup>IMF Staff Discussion Note 14/02 "Adjustment in Euro Area Deficit Countries: Progress, Challenges, and Policies," forthcoming.

<sup>2</sup>See Box 1.3. External Rebalancing in the Euro Area, World Economic Outlook, October 2013, IMF.

**46. While the excess surplus imbalances of China and emerging Asia have declined over the years, their remaining gaps indicate a range of policy needs—as does the rising surplus gap of Korea.** In general there is room to strengthen social safety nets (weaker safety nets tend to distort saving rates upward) and to implement financial reforms. The latter includes appropriately-paced liberalization of capital account restrictions in China and other emerging Asia. In China, while high investment since the global financial crisis has diminished the current account surplus, there is a need to rebalance domestic demand toward consumption expenditure.<sup>19</sup> Among some of these economies, greater exchange rate flexibility would be useful; given the adequacy of reserves, one-sided reserve accumulation over long periods should be avoided.

**47. For economies with excess deficit imbalances, which are mainly EMs but also include smaller AEs, the policy agenda is broad and perhaps most pressing.**

- In most cases the agenda includes fiscal consolidation, in varying degrees. Moreover, some EM deficit economies (Brazil, South Africa and Turkey) are characterized by too-low private saving rates, and structural reforms would be useful to correct distortions that depress saving. Structural reforms to remove supply bottlenecks are also relevant in some economies.
- While the expected gradual tightening of monetary policy in reserve currency economies will likely have some impact on actual real exchange rates and current account imbalances, a need for adjustment to correct underlying excess deficit imbalances will remain.
- For many EMs, deficits have widened in recent years, amid surging domestic demand that may have reflected an excessive private sector response to easy global financing conditions or procyclical fiscal policies (including failure to unwind policies that were initiated countercyclically). The correction of too-weak current accounts will need to include both moderation of domestic demand and a degree of depreciation of the real exchange rate. Relevant policies include macroprudential tools to avoid excesses in credit, asset prices and domestic demand; and fiscal consolidation. Where success in moderating domestic demand is achieved, domestic monetary policy will be able to be less restrictive than otherwise, facilitating desirable real exchange rate adjustment in those with flexible exchange rates.

**48. On trade policy, a continuing effort should be made to avoid trade restrictions; care should be taken in trade negotiations to avoid fragmenting the multilateral trade system.** The agreement in Bali in December 2013 renewed the international community's commitment to the WTO after years of stalled progress, but it focused on a relatively narrow set of issues, most notably trade facilitation, and substantial issues still lie ahead to conclude the

<sup>19</sup> Successful implementation of China's announced reform blueprint will move the economy to a more balanced and sustainable growth path. Reforms include strengthening the social safety net, moving to a more market-based exchange rate, further opening the capital account, financial market liberalization, and opening the service sector to more competition—which, as implemented, will also rebalance China's domestic economy away from investment and toward consumption.

Doha Round. In the interim, trade negotiation efforts have focused on preferential agreements like the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) and on plurilateral agreements, such as the Trade in Services Agreement (TISA). These agreements have the potential to bolster global trade, leading to improved trade conditions and deeper forms of integration, including by addressing non-tariff barriers and regulatory coherence. But there is a risk of fragmentation of the global trading system if these agreements are not pursued in an open and transparent manner and are not actively complemented by renewed efforts to advance the multilateral trade agenda.

## OUTLOOK FOR EXTERNAL IMBALANCES AND RELATED RISKS

**49. The ESR assessments can shed light on the outlook for external imbalances and gaps, and on the nature of risks to watch going forward.**

**50. While the outlook for current account imbalances depends in part on cyclical conditions, estimated cyclical contributions do not themselves tell a clear story of future current account developments:**

- Current staff estimates of output gaps suggest that only a small part of the cross-country variation in current accounts reflects differences in countries' relative positions in the business cycle (Figure A9). Even so, the contributions of cyclical factors are non-negligible for some ESR economies.<sup>20</sup> For some, including the large economies of China and Japan, net cyclical impacts now appear slight. On the other hand, such contributions in 2013 are estimated to have been roughly  $\frac{3}{4}$  to 1 percent of GDP upward for the U.S., Italy, Netherlands, and Spain,<sup>21</sup> and roughly the same amount downward for the more cyclically-advanced economies of Germany, Australia, and most EMs (and more for Turkey and Singapore).
- As some of these cyclical contributions go in the direction of dampening current account imbalances, while others contribute to widening, the picture of cyclical effects on current accounts is mixed (although in aggregated terms, the former effect currently dominates, see Figure 20).
- Going forward, the implications for current accounts of narrowing output gaps will depend on the extent to which such gaps are closed chiefly by shifts in countries' own demand, and on whether they are closed synchronously. Considering also the uncertainty over the size of

<sup>20</sup> Figure A4 shows the cross-country pattern of staff's estimates of 2013 output gaps. Note that it is each economy's position *relative* to all others that determines estimated cyclical contributions to current account.

<sup>21</sup> The staff assessment for Spain considers the possibility that the negative output gap of that country could be wider than currently estimated, noting also that this would mean a weaker cyclically-adjusted current account.

output gaps, the conclusion is that today's estimated cyclical effects can only be suggestive as to the future of current account imbalances. As for excess imbalances (gaps), since the staff assessments are of underlying current accounts, the future unwinding of cyclical effects would not itself mean changes in such gaps.

**51. Since the drivers of underlying current accounts generally are not expected to shift quickly, the current constellation is unlikely to change greatly in the near term, but policies will have influence.**

As noted, further fiscal policy consolidation in advanced economies with deficits is likely to be gradual. In Germany, where the surplus gap is assessed to be substantial, the plans of the government for modest expansion of public investment will not greatly change the external position. In China, the other of the two surplus economies contributing to the bulk of the global excess surplus, implementation of the reform "blueprint" (noted earlier) would tend to support further narrowing of China's gap, relative to its own GDP. (Considering China's strong expected growth, its gap in absolute terms may continue to grow).

**52. The global pattern of current accounts and exchange rates will be shaped also by the expected gradual and asynchronous normalization of monetary policy of advanced economies—and by the firming of growth in those economies that motivates that monetary tightening.**

The *2014 Spillover Report* analyzes the macroeconomic implications of monetary exit extensively, in several scenarios; in general the estimated net consequences for current account imbalances are not large, and would not greatly alter the present overall cross-country pattern. Note again that normative external assessments make allowance for exchange rates and current accounts to fluctuate with changes in business cycle conditions and (appropriate) changes in monetary policy stances.

**53. The assessments also shed light on various risks, as discussed more specifically in the individual economy assessment paper; from the point of view of individual economies, the direct risks are clearest for those with excess deficits.**

While individual deficits today have not reached the extreme heights of some economies in the pre-crisis period, disorderly external adjustment in some deficit economies remains a risk, particularly in an environment of tightening external financial conditions, and if the policy/institutional environment were to deteriorate or other idiosyncratic shocks materialize. Moreover, country-level risks would have spillovers and carry the potential of becoming systemic, e.g, if a group of EMs with excess deficits were simultaneously affected by negative shocks. Certainly, disorderly external adjustment is in no one's interest, even if it would appear to reduce excess external imbalances—the purpose of correcting such gaps is to promote welfare and stability.

**54. The recent episode of capital flow volatility highlights the evolution of EM capital markets and institutional frameworks, but also the new policy challenges faced by EMs in case of a further abrupt tightening of external financing conditions.**

The likelihood and potential fallout from a sudden stop in EMs has diminished over the years as EMs have accumulated FX buffers (though perhaps more than necessary), lowered restrictions in FX markets, improved institutional frameworks, achieved more manageable debt levels and a lesser degree of "original sin" in balance sheet composition (April 2014 GFSR). On the other hand, an

increasing level of integration with global financial markets makes EMs' local currency assets more exposed to fluctuations in global risk appetite and liquidity. Those with high gross financing needs, whether from excess current account deficits or high amortization rates, would be more likely to be squeezed during tightening or sell-off episodes.

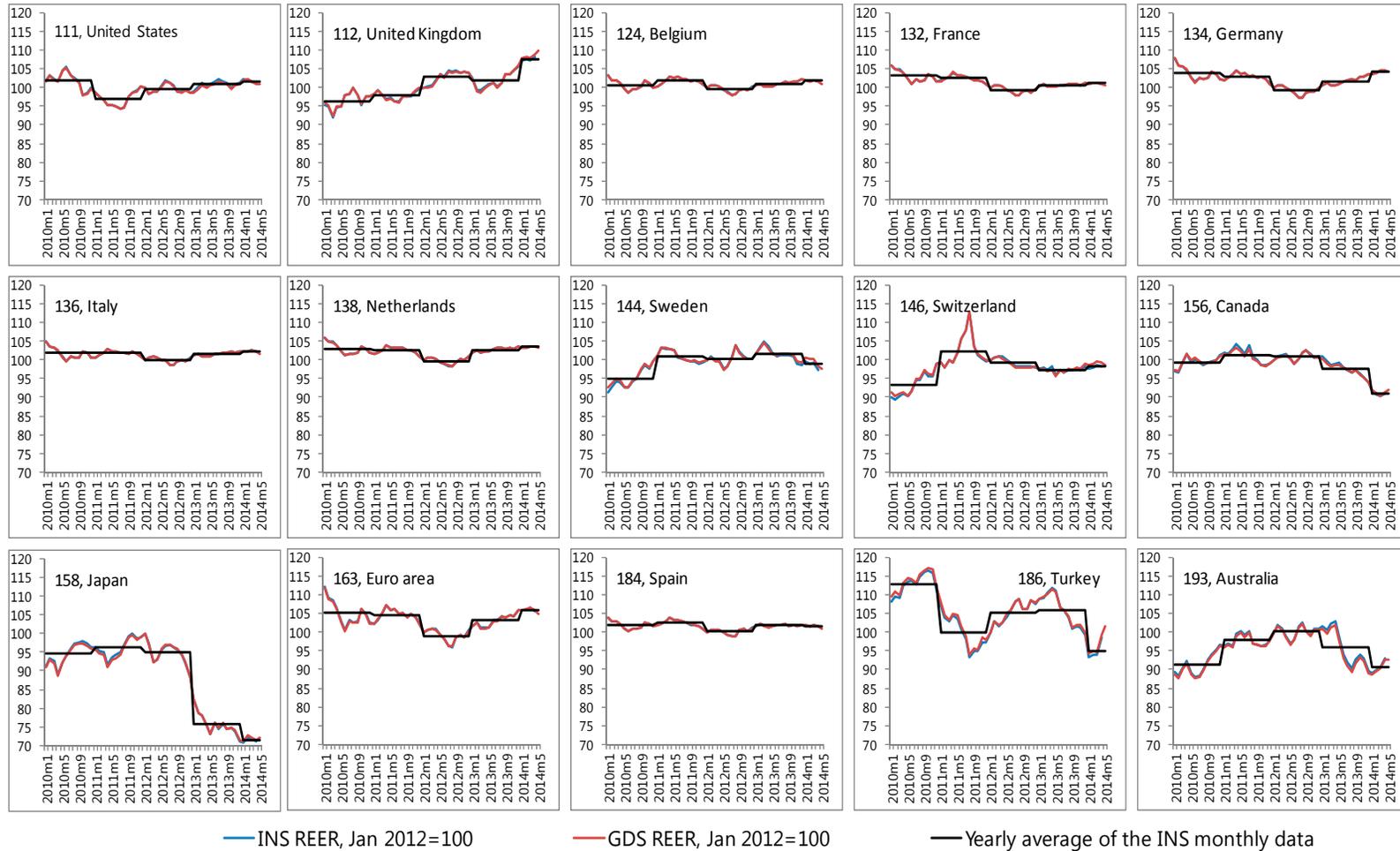
**55. As emphasized, the global size and configuration of current account imbalances has evolved considerably since the global financial crisis, including with a rotation of excess imbalances that has occurred in the last few years.** The new pattern likely diminishes some risks while giving rise to new ones; e.g. direct risks for the U.S. may now be lower than in the past while EMs with widening deficits face higher risks. The nature of such deficit-related risks, and their potential adverse spillovers to other economies, will depend in part on the location of excess deficits, e.g., on whether they reside in a large reserve currency economy or are more diffuse across EMs that have different degrees and types of financial interconnections with other economies. Macroeconomic and financial risks assessments at the global level will need to consider not only the new configuration of flow imbalances and gaps, but also relevant risks that lie in stock positions, that is, in external balance sheets and the details of their composition. Attention to such risks, as well as to systemic global financial issues more broadly, will be essential.

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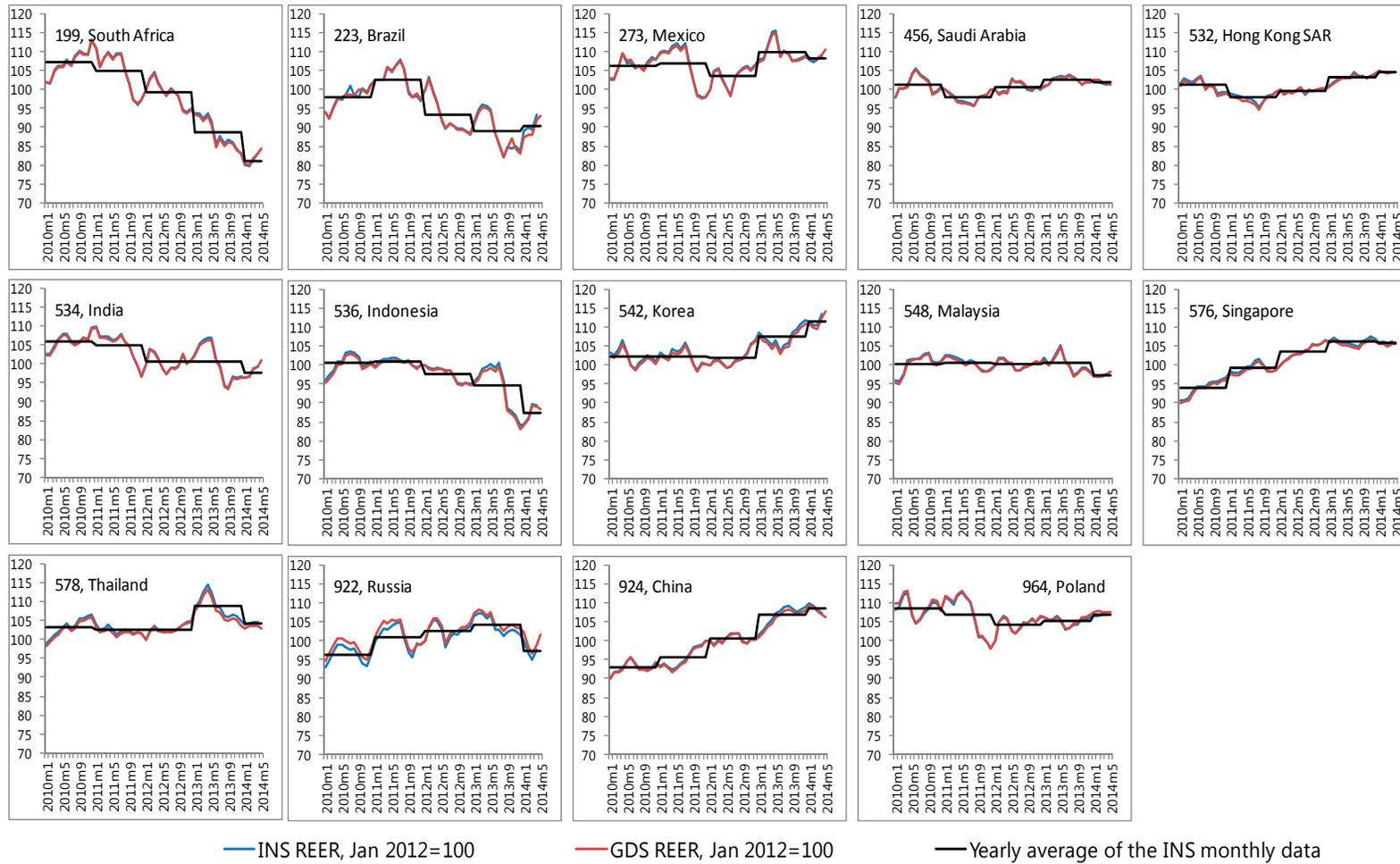
## Annex Figures

**Figure A1. Actual REER: Monthly and Yearly Average, 2010–2014**  
(Index Jan. 2012=100)

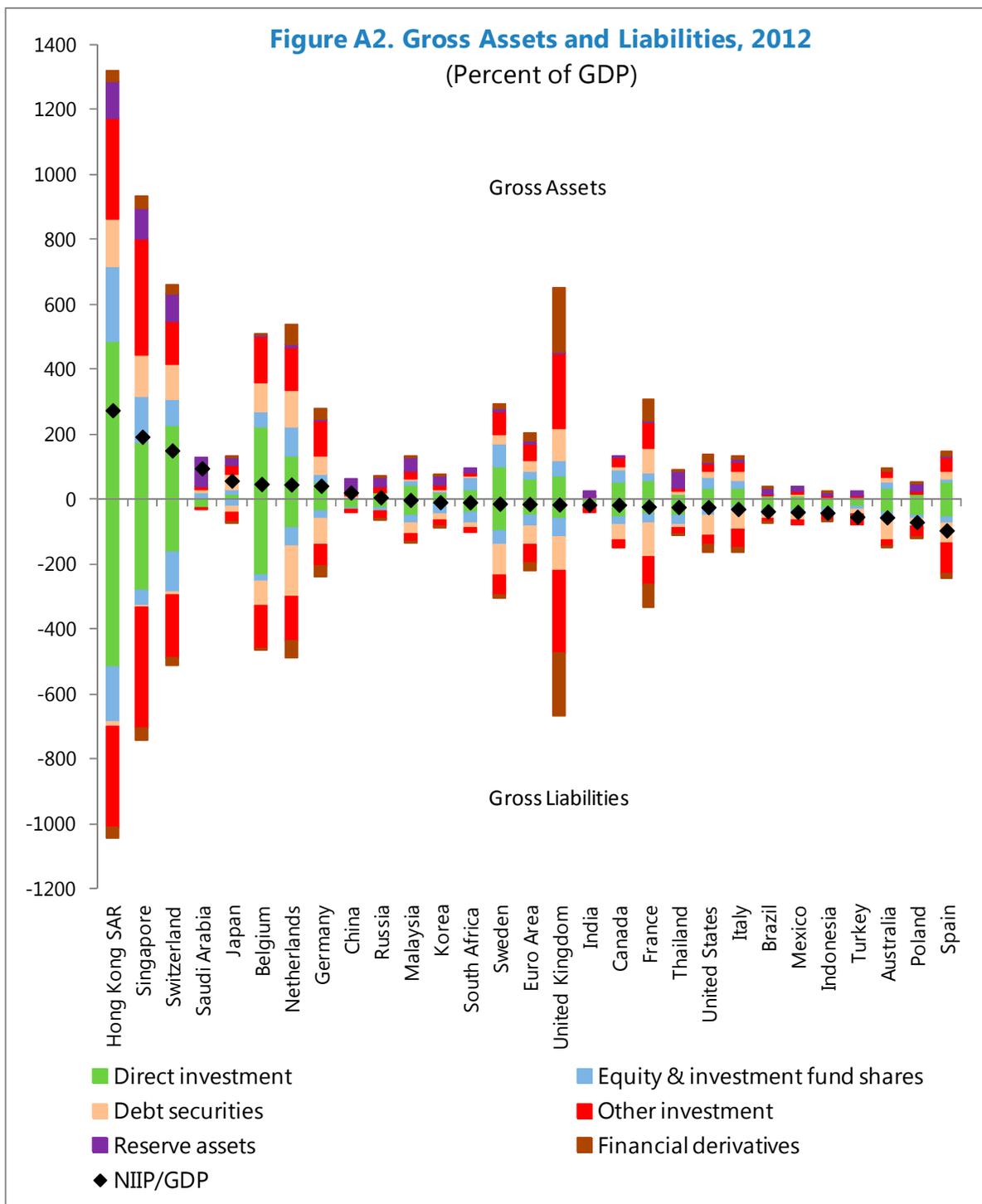


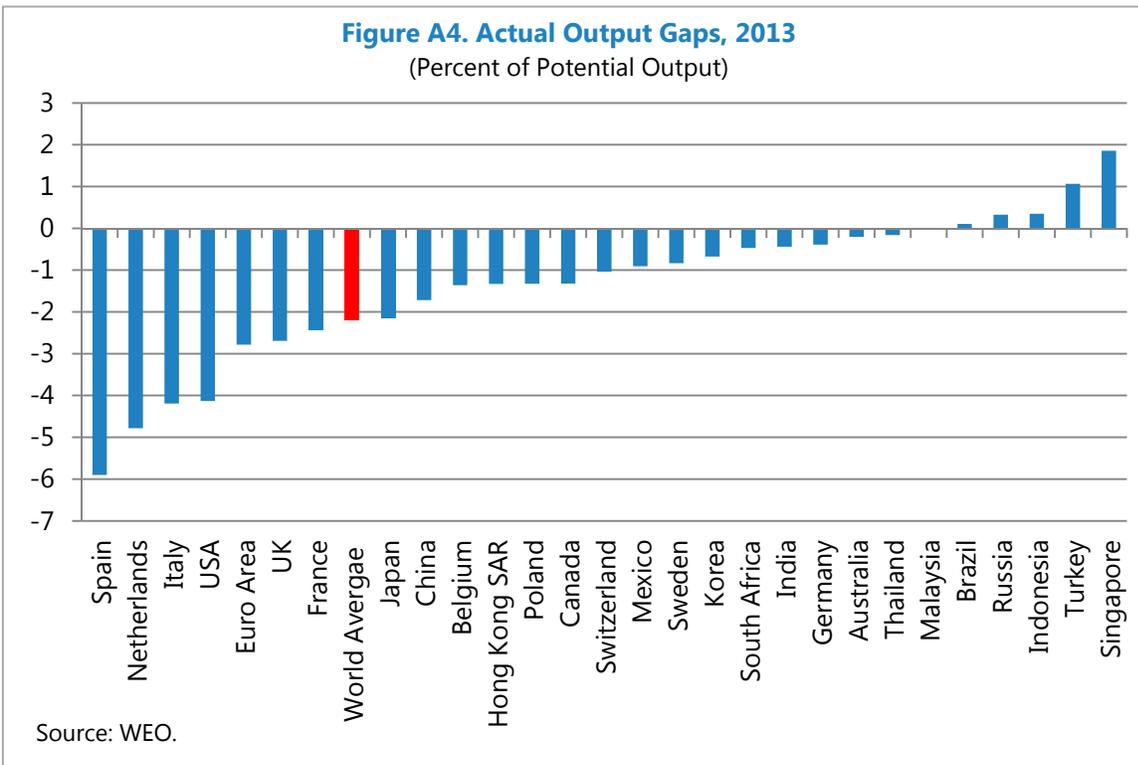
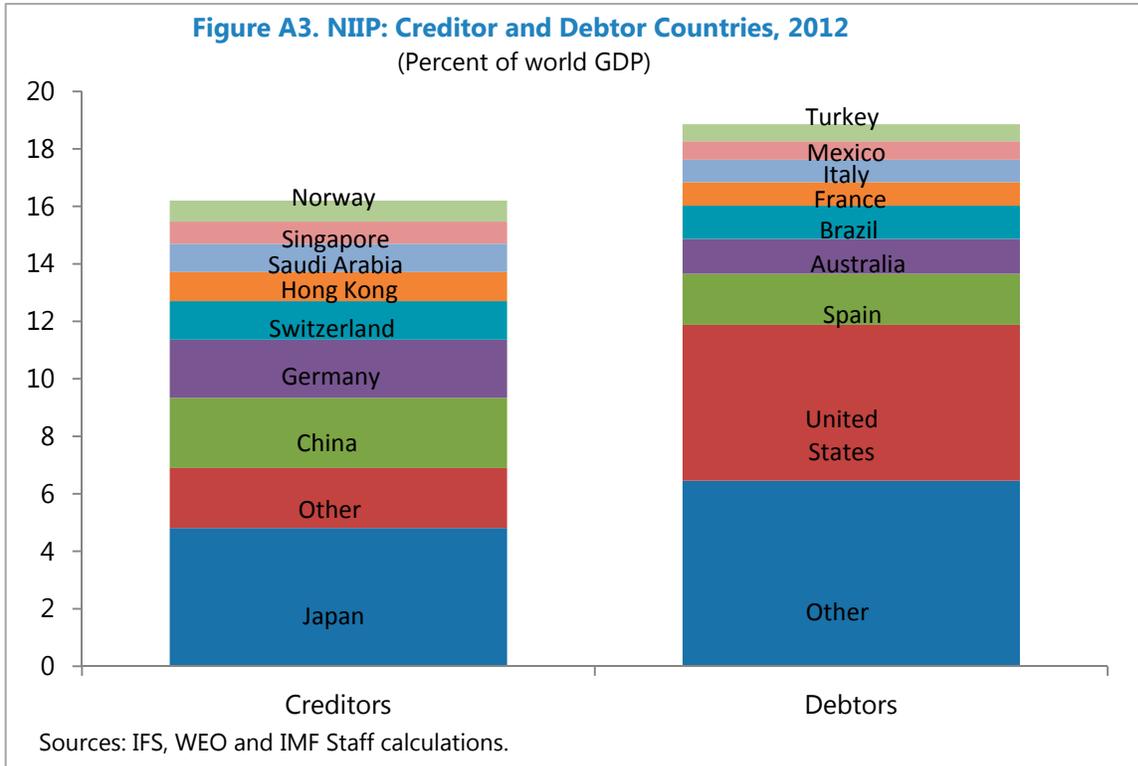
Sources: INS, GDS and IMF staff calculations.

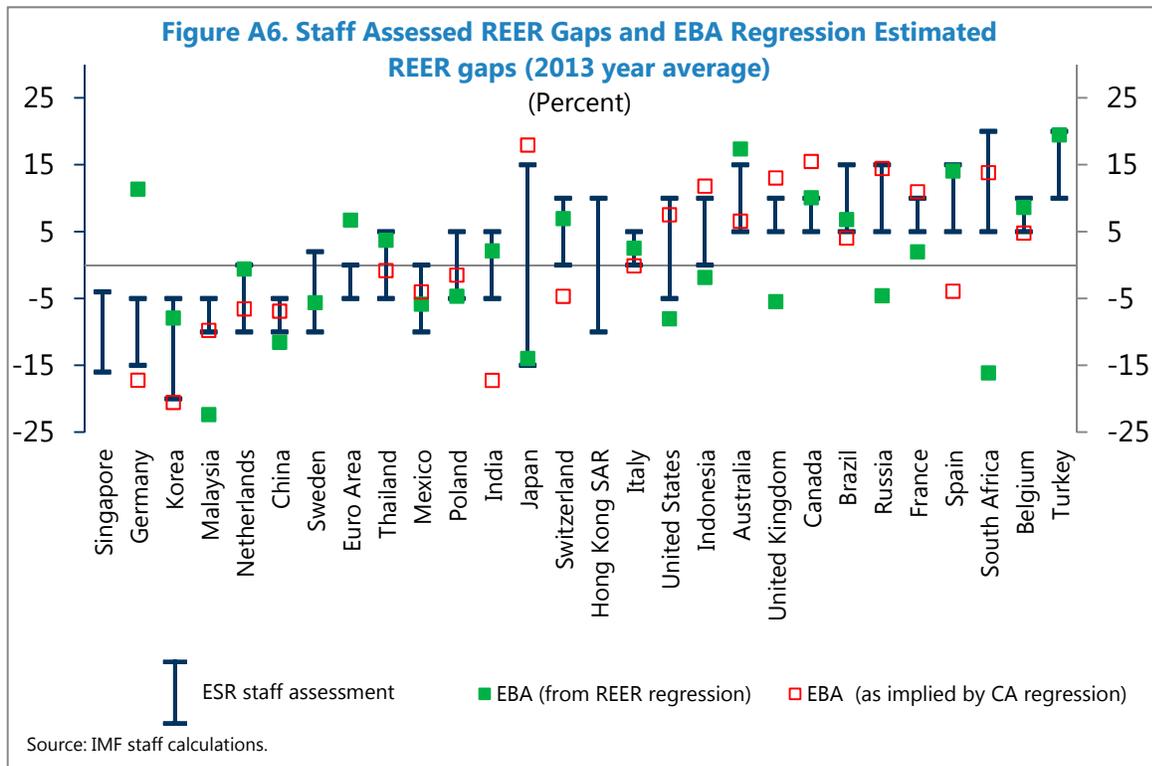
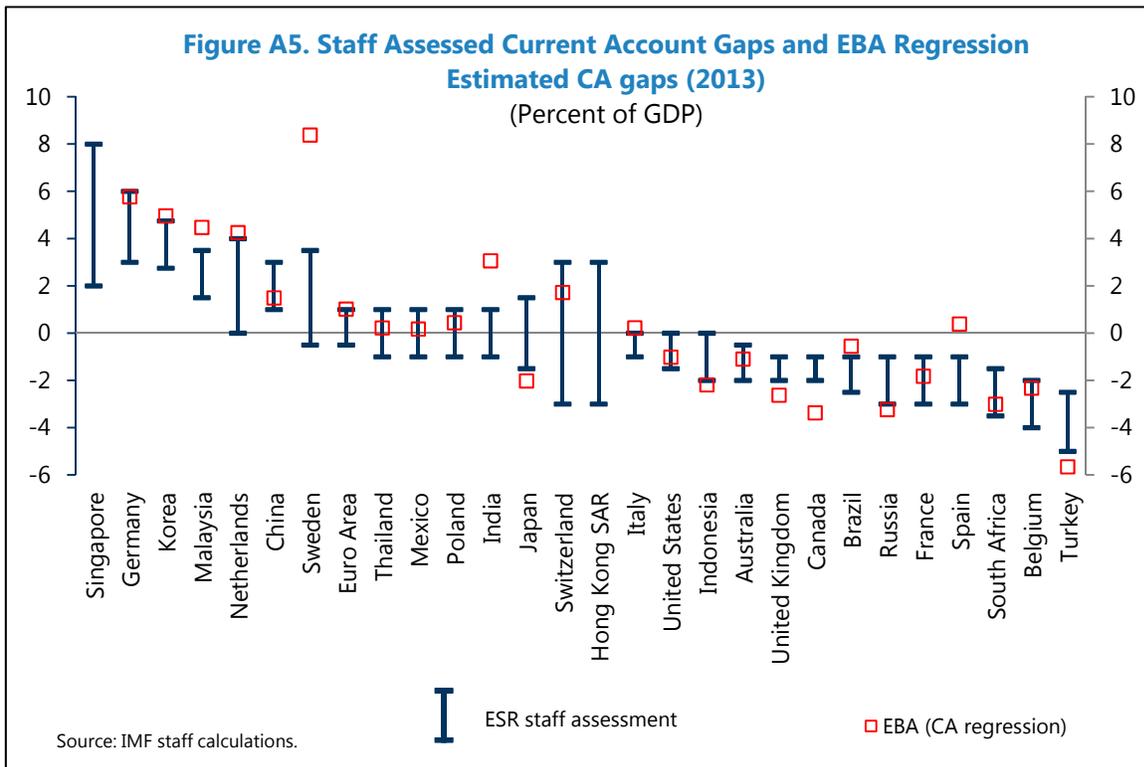
**Figure A1. Actual REER: Monthly and Yearly Average, 2010–2014 (concluded)**  
(Index Jan. 2012=100)



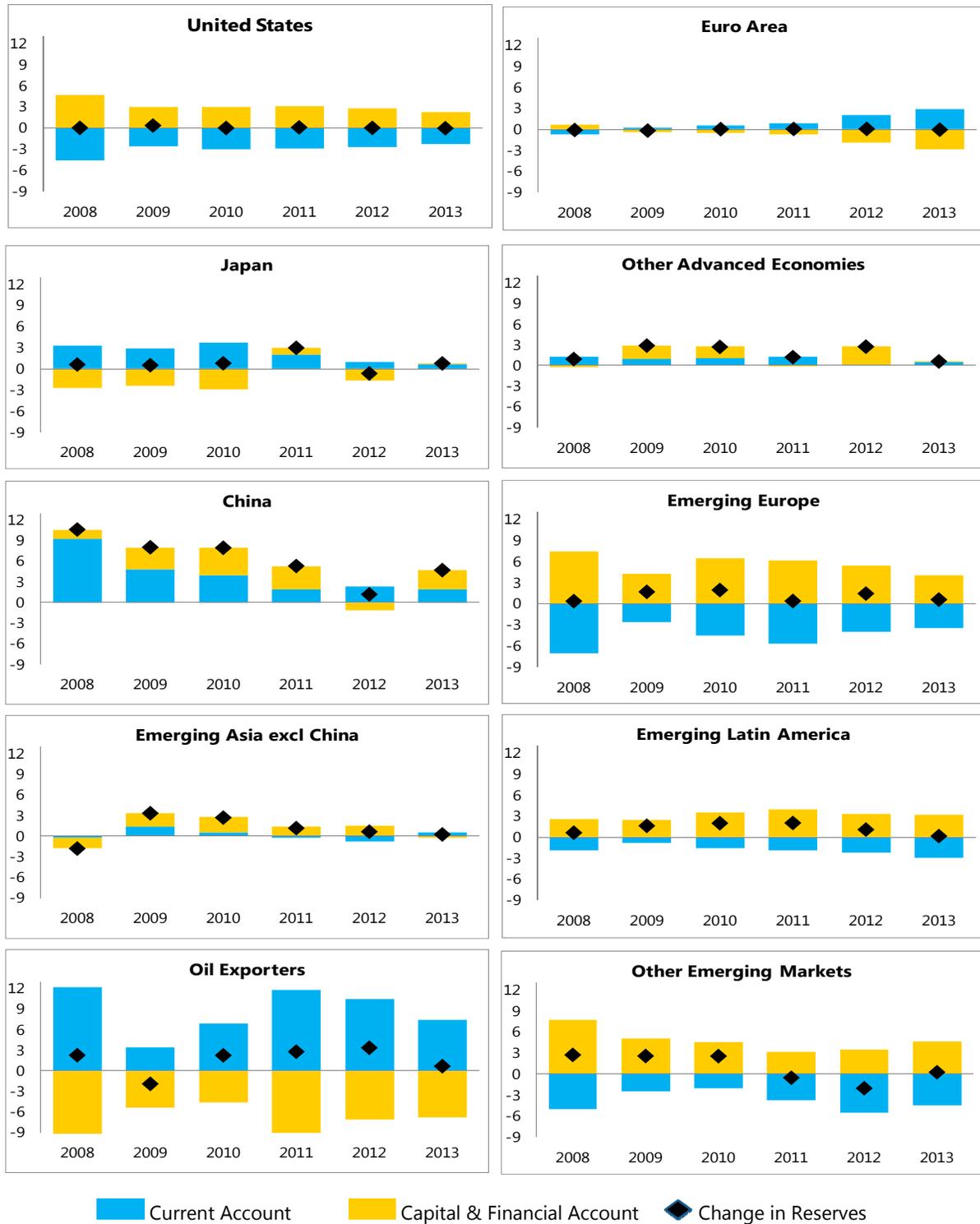
Sources: INS, GDS and IMF staff calculations.





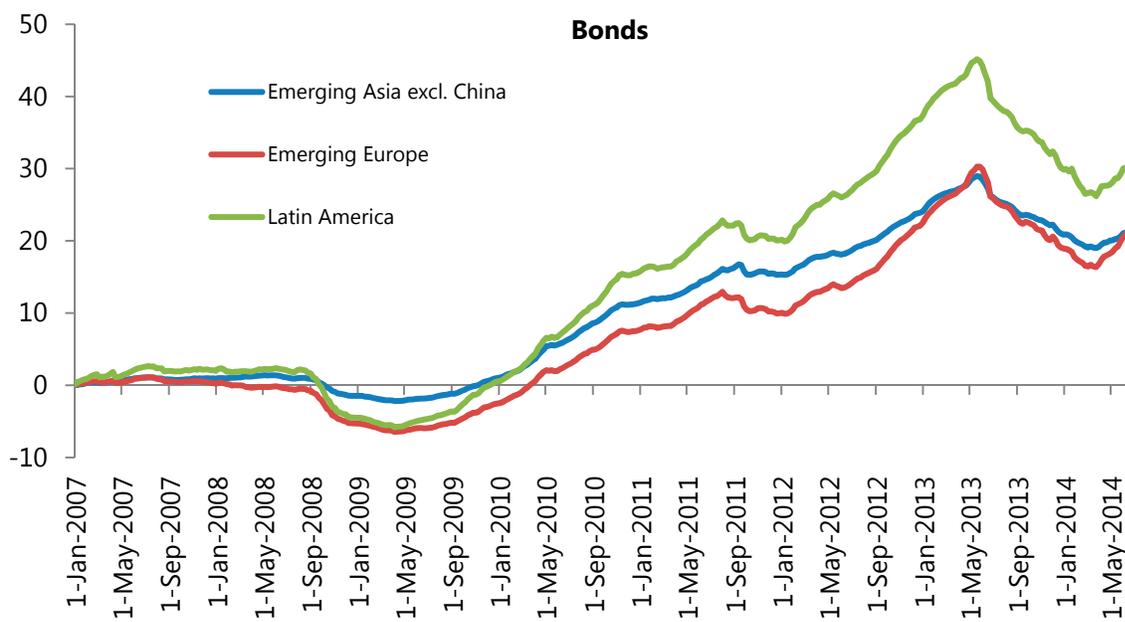
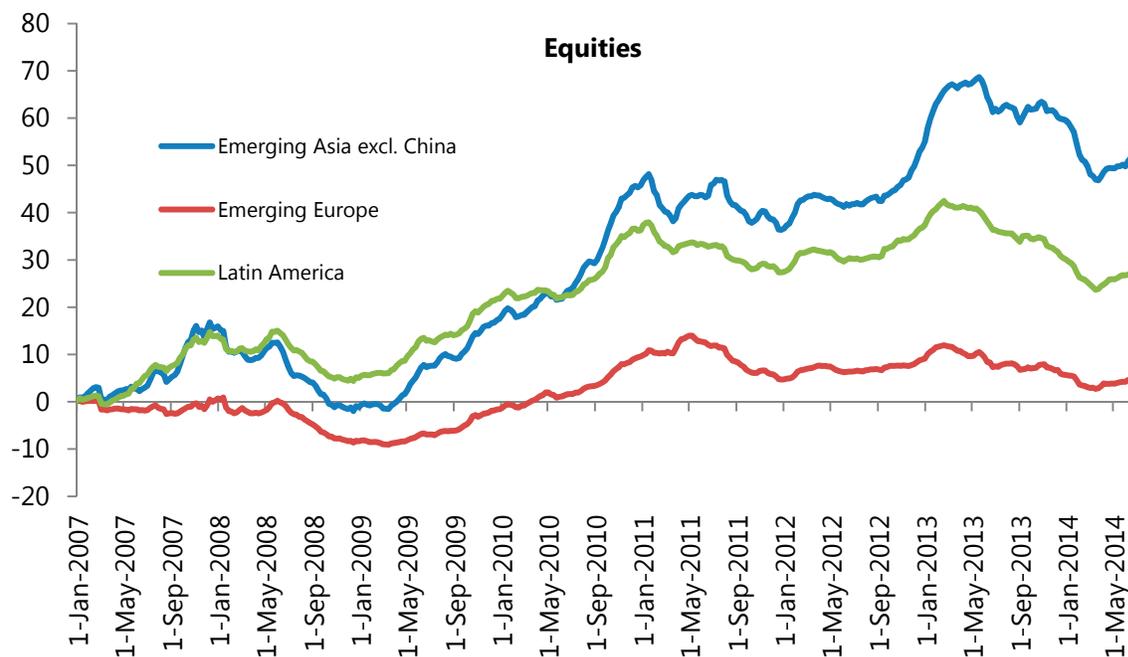


**Figure A7. Pattern of Current Account Balances and Capital Flows, 2006–13**  
(Percent of each economy's or region's GDP)



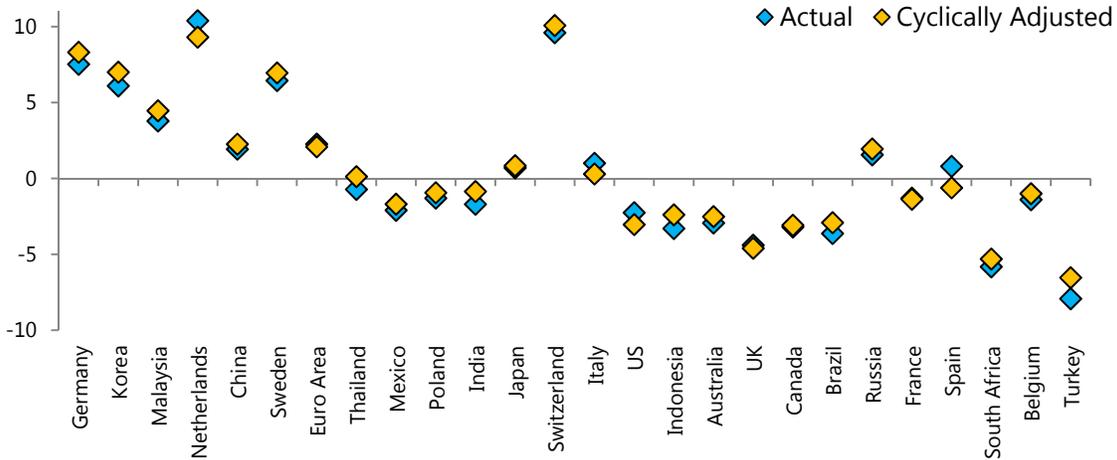
Source: IMF World Economic Outlook Database.  
Country groupings are broader than the 29 economies covered by the ESR.

**Figure A8. Cumulative Weekly Equity and Bond Flows to Emerging Markets, 2007-14**  
(In billions of U.S. dollars)



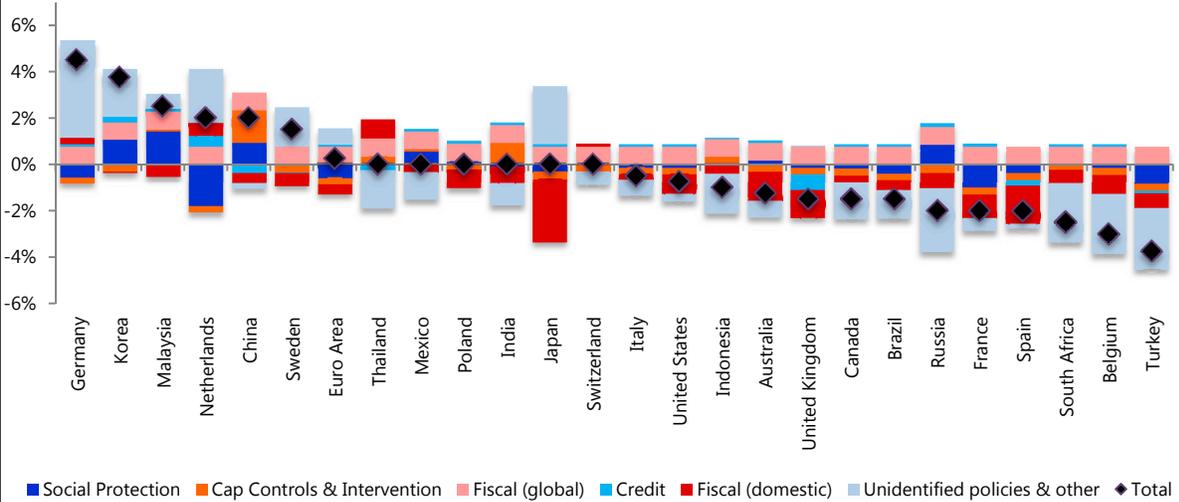
Sources: Haver Analytics and EPFR.  
Updated to June 16, 2014.

**Figure A9. Actual and EBA Estimated Cyclically Adjusted Current Accounts (2013) 1/**  
(Percent of GDP)



1/ As estimated by EBA model, based on output gap and commodity price cycle estimates. Staff assessments of underlying current account balances may take account of other temporary influences.  
Source: IMF Staff Estimates.

**Figure A10. Individual Economies: Contribution of Policies to Current Account Gaps (2013)**  
(Percent of GDP, based on midpoint of staff estimates)



Source: IMF staff calculations from EBA, incorporates desk judgment.

Note: Policy contributions are estimates from EBA (see IMF Working Paper 13/272) of how much deviations from desirable policies contribute to the gap between the cyclically adjusted current account and that consistent with medium-term fundamentals and desirable policies. Estimated contributions of individual policies may not coincide with staff's view in some cases. Deviations are measured for each economy relative to a global benchmark. For fiscal policy, the gaps are shown separately as a domestic policy contribution and a global fiscal contribution which illustrates how medium-term fiscal consolidation in the large advanced economies impacts the current accounts of others. The global fiscal policy gap is around -2¼ percent of GDP which has an effect on current account gaps of around ¼ percent of GDP. "Unidentified policies and other" are not solely from EBA but represent all the other factors that affect the current account gap, including uncertainty over the size of the gap.