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2013 PILOT EXTERNAL SECTOR REPORT—INDIVIDUAL ECONOMY ASSESSMENTS

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IMF staff regularly produces papers covering multilateral issues and cross-country analyses. The following documents have been released and are included in this package:

- The **Staff Report** on 2013 Pilot External Sector Report—Individual Economy Assessments, prepared by IMF staff and completed on June 20, 2013 for the Executive Board's consideration on July 10, 2013.

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

The documents listed below have been or will be separately released.

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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2013 PILOT EXTERNAL SECTOR REPORT—INDIVIDUAL ECONOMY ASSESSMENTS

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CONTENTS

INDIVIDUAL ECONOMY ASSESSMENTS

A. The External Sector Assessments

The external sector assessments use a wide range of methods, including the External Balance Assessment developed by the IMF's Research Department to estimate desired current account balances and real exchange rates (Boxes 6, 7 and Annex III of the Pilot Report describe the methodology and challenges). In all cases, the overall assessment is based on the judgment of IMF staff drawing on the inputs provided by these model estimates and other analysis and the estimates are subject to uncertainty. The assessments were initially based on the Spring 2013 WEO and an exchange rate reference period of the average of 2012. Potential policy responses are those which would work to reduce imbalances.

The assessments discuss a broad range of external indicators: the current account, the real effective exchange rate, capital and financial accounts flows and measures, FX intervention and reserves and the foreign asset or liability position.[1, 2] The individual economy assessments are discussed with the respective authorities as a part of bilateral surveillance.

B. Selection of Economies Included in the Report

The 29 systemic economies analyzed in detail in this Pilot Report and included in the individual economy assessments are listed below. They were chosen on the basis of an equal weighting of each economy's global ranking in terms of purchasing power GDP, as used in the Fund's *World Economic Outlook*, and in terms of the level of nominal gross trade.

Australia	Indonesia	Singapore
Belgium	Italy	South Africa
Brazil	Japan	Spain
Canada	Korea	Sweden
China	Malaysia	Switzerland
Euro area	Mexico	Thailand
France	The Netherlands	Turkey
Germany	Poland	United Kingdom
Hong Kong SAR	Russia	United States
India	Saudi Arabia	

[1] In this report pertinent aspects of the capital and financial account are discussed for each country. In line with BPM 6 the capital account covers capital transfers and transactions in non-produced nonfinancial assets; and the financial account covers direct investment, portfolio investment, financial derivatives and employee stock options (other than reserves), other investment. Reserve assets which are also included in the financial account are discussed separately in the section on FX intervention and reserves.

[2] The IMF Emerging Market reserves metric included in these pages applies the full weight of M2. However, the presence of capital controls lowers the risk of capital flight, reducing the precautionary level of reserves needed against these possible outflows for countries with controls.

C. Domestic and Foreign Policies and Imbalance Calculations: An Example

The thought experiment. A simplified example could help to clarify how policy distortions are analyzed in a multilateral setting and how the analysis can distinguish between domestic policy distortions where a country might need to take action to reduce its external imbalance and those that are generated abroad and where no action by the home country is needed (but where action by others would help reduce the external imbalance).

Take a stylized example of a two country world.

Country A has a large current account deficit, a large fiscal deficit and high debt.

Country B has a current account surplus (matching the deficit in Country A but it has no policy distortions.

External imbalances. The analysis would show that Country A has an external imbalance reflecting its large fiscal deficit. Country B would have an equal and opposite surplus imbalance. Country A's exchange rate would look overvalued and Country B's undervalued.

Policy gaps. The analysis of policy gaps would show that there is a domestic policy distortion in Country A that needs adjustment. However, the analysis for Country B would show that there were no domestic policy gaps—instead adjustment by Country A would automatically eliminate the imbalance in Country B.

Individual economy write-ups. While the estimates of the *overall external sector position*, needed *current account adjustment*, and associated *real exchange rate over/undervaluation* would be equal and opposite given there are only two economies in the world, the *individual economy assessments* would clearly identify the quite different issues and risks facing the two economies. In the case of Country A, the *capital flows* and *foreign asset and liability position* sections would note the vulnerabilities arising from international liabilities and the *potential policy response* section of the *overall assessment* would focus on the need to rein in the *fiscal deficit* and *limit asset price excesses*. For the Country B, however, if there were no domestic policy distortions the write up would find no fault with policies and would note that adjustment among other economies would help to reduce the imbalance.

Implications. At the current time, fiscal policy is the area where it is most important to distinguish between domestic and foreign policy gaps (as the contribution of foreign policy is most marked). As discussed later an elimination of the fiscal policy gap in deficit advanced economies could help reduce surplus imbalances in other economies by around 1 percent of GDP.

D. Individual Economy Assessments—by Economy

	Australia	Overall assessment
Current account	**Background.** Australia's current account has been in deficit for most of the period since 1861 (with an average deficit of 4 percent since 1984). The deficit widened from 2.3 percent of GDP in 2011 to 3.7 percent of GDP in 2012 (3.5 percent of GDP cyclically adjusted), led by large increases in capital spending in the resources sector. **Assessment.** A variety of econometric approaches suggest that the cyclically-adjusted current account is about 1 to 2 percent of GDP weaker than implied by medium-term fundamentals and desirable policy settings; some of this gap likely reflects mining-related investment imports. The current account deficit is expected to widen as investment in the resources sector is expected to peak sometime in 2013/14, and the terms of trade and interest rates on external borrowing normalize.	The external position appears weaker than the level consistent with medium-term fundamentals and desirable policy settings. The gap appears to be partly driven by cyclical influences, carry trades, and an investment boom which is projected to peak in the coming years. Model based estimates also suggest a real exchange rate overvaluation. **Potential policy responses** Part of the overvaluation is attributable to cyclical influences and carry trades (given central bank policy rates are higher than in most other advanced economies), and should dissipate naturally. The government's medium-term fiscal consolidation plan should help boost national saving. Additional steps to encourage higher private savings would be appropriate.
Real exchange rate	**Background**. In 2012, the real effective exchange rate was 30 percent above its 1990–2012 average. Despite some declines in export commodity prices, the Australian dollar remained high in 2012, in part related to capital inflows toward Australian government debt. **Assessment**. Australia has experienced a structural savings/investment imbalance for some time in part related to a capital intensive mining sector resulting in a strong exchange rate. These structural factors aside, and after accounting for some depreciation since May, model results would suggest that the real exchange rate remains overvalued by 5-15 percent. Aside from these structural factors, there are a number of short-term factors contributing to the current overvaluation of the exchange rate, including the continued gap between domestic and foreign interest rates and increased portfolio inflows. The high exchange rate is accelerating structural change by increasing price competition for the non-commodity tradable sector.	
Capital and financial accounts: flows and measures	**Background**. The investment boom has been funded predominantly from the profits generated by the resources companies. Net capital inflows into the resource sector have partially offset the decline in net capital inflows into the banking sector and have contribute to the increase in net FDI flows into Australia. Australia also received large inflows in recent years into bond markets given its sound fiscal position relative to other advanced economies, relatively high interest rates and buoyant growth prospects. **Assessment**. The credible commitment to a floating exchange rate and strong fiscal position limit vulnerabilities from capital flows.	
FX intervention and reserves	**Background**. A free-floater since 1983. The central bank did brief but large intervention in 2007–08 when the market for Australian dollars threatened to become illiquid (as bid-ask spreads widened) following banking sector disruptions in the United States. The authorities are strongly committed to a floating regime, which reduces the need for reserve holding. **Assessment**. Although domestic banks' external liabilities are sizable, they are either in local currency or hedged with little or no counterparty risks, so reserve needs for prudential reasons are also limited.	
Foreign asset and liability position	**Background**. Net foreign liabilities are high at 58 percent of GDP. Without a depreciation, liabilities would be projected increase to above 65 percent of GDP by 2018 by FDI and long-term debt inflows. **Assessment**. Even in the highly unlikely event where domestic banks are seriously hit by external shocks and suffer a major loss, the government's low debt position allows it to offer credible support. Gross external liabilities of banks are large, with reliance on wholesale funding. Banks' external funding continues to pose a risk, although the maturity of funding has improved since the global financial crisis.	

<table>
<tr><th></th><th>Belgium</th><th>Overall assessment</th></tr>
<tr><td>Current account</td><td>Background. The current account had been in moderate surplus for two decades before the crisis, although on a secular decline—turning into a modest deficit in the crisis years as exports dropped.
Belgium's role as a financial center complicates the assessment of the appropriate current account balance (the cyclically-adjusted current account surplus is estimated at 0.4 percent of GDP), but Belgium's export market share has declined steadily since 2000.
Assessment. The cyclically-adjusted current account appears broadly in line with medium-term fundamentals and desirable policies. As trading partner growth recovers, a return to a modest current account surplus of about 1¼ percent of GDP is expected. Such a surplus is consistent with medium-term fundamentals, including an aging population.</td><td rowspan="5">Trends in trade and unit labor cost point to an external position moderately weaker than suggested by medium-term fundamentals and desirable policy settings.
The main vulnerability comes from market perceptions about the viability of the fiscal path and the cross-exposures of the sovereign and the banks.
Potential policy responses
Continued steady fiscal adjustment (based on structural targets) is needed to reduce vulnerabilities, and wage moderation and productivity enhancing structural reforms (in the labor and product markets) are needed to restore cost and non cost competitiveness.</td></tr>
<tr><td>Real exchange rate</td><td>Background. In the last two years, unit labor costs have outpaced those in Belgium's three main trading partners (Germany, France, and the Netherlands), as wages have grown faster, pushed by sticky inflation and wage indexation. In 2012, Belgium has also fallen behind its main economic partners in terms of export performance.
Assessment. Models point to a real exchange rate moderately stronger by around 0 to 10 percent than the level consistent with medium-term fundamentals and desirable policy settings.</td></tr>
<tr><td>Capital and financial accounts: flows and measures</td><td>Background. Financial account outflows have predominantly taken the form of portfolio investments until the crisis. In 2008–12, temporary asset divestments (including those associated with Fortis, Dexia, and KBC) generated net inflows that exceeded substantial net outflows in loans and other investments. Once these effects wear off, a return to moderate net capital outflows of 1¼ percent of GDP is expected.
Assessment. Belgium is vulnerable to a drop in investor confidence owing notably to the large refinancing needs of the sovereign and banking sectors.</td></tr>
<tr><td>FX intervention and reserves</td><td>Assessment. The euro has the status of a global reserve currency. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</td></tr>
<tr><td>Foreign asset and liability position</td><td>Background. The net international investment position has improved very sharply from 32 percent of GDP for 2002–07 to 67 percent at end-2011, mostly reflecting valuation effects on FDI (positive valuation effects of FDI assets and negative valuation effects of FDI liabilities) Net international assets are expected to deteriorate slowly going forward, suggesting some weakening in the external position.
Assessment. Despite Belgium's decline as a financial center, gross foreign assets at end-2011 amounted to 505 percent of GDP. Belgium is vulnerable given the relatively large financing need of the government.</td></tr>
</table>

	Brazil	Overall assessment
Current account	**Background**. Despite subdued growth and some real depreciation, Brazil's current account deficit increased slightly in 2012 on the back of weakening terms of trade, strong domestic consumption and supply-side constraints. The cyclically adjusted current account deficit was -1.8 percent of GDP. A large sustained fall in commodity prices could widen sharply the current account deficit. On the upside, important oil discoveries should boost exports and help stabilize the current account deficit in the longer term. **Assessment**. The cyclically adjusted current account appears (-1¾ to -2¾ percent of GDP) weaker than would seem consistent with medium term fundamentals and desirable policies. Various methods suggest a current account norm in a range of -2 to -1 percent of GDP. However, the envisaged pickup in growth and investment in the short to medium-term is likely to increase the current account deficit to between 3½ and 4 percent of GDP for some time.	Brazil's external position appears moderately weaker than implied by medium-term fundamentals and desirable policy settings, **Potential policy responses** Further efforts to increase national saving than the ones currently contemplated are needed, including by advancing with pension reform and shifting the structure of public spending away from consumption towards investment. It will be important to maintain a macro policy stance and a policy mix that moderates demand and facilitates rebalancing, along with use of capital flow management measures to manage volatile capital flows.
Real exchange rate	**Background**. Brazil's real effective exchange rate has appreciated by about 25 percent (on average) in the last 10 years. **Assessment**. A combination of indicators suggests that the real exchange rate is overvalued by some 10-15 percent. Model-based estimates suggest that the real effective exchange rate is above the level implied by medium-term fundamentals and desirable policies, partly reflecting sizable net capital inflows.	
Capital and financial accounts: flows and measures	**Background**. Brazil has attracted sizable capital inflows. Until recently, the pickup in FDI flows has been broadly commensurate with the widening current account deficit. Net portfolio inflows have been moderate in the past 12 months. Looking forward, net portfolio inflows may increase if growth picks up and the interest rate differential increases. A wide range of macro policy tools has been deployed to manage large capital flows pressures. Since 2010, capital account restrictions have been applied to moderate flows and influence their composition. There is some evidence that these measures have helped reduce portfolio inflows though the evidence for persistent effects on the exchange rate is less clear. **Assessment**. The composition of flows has a favorable risk profile, but this can change quickly and managing flows will likely remain a challenge.	
FX intervention and reserves	**Background**. The flexible exchange rate has been an important shock absorber with central bank intervention focused on reducing the pace and volatility of exchange rate changes. **Assessment**. Reserves have increased to more than adequate levels with respect to various criteria including the IMF's composite adequacy metric. There is no need for further reserve accumulation for precautionary purposes, although temporary further accumulation could be part of an overall strategy to manage capital inflows.	
Foreign asset and liability position	**Background**. Brazil's NFA position has improved over recent years on the back of falling external debt, reaching -30 percent of GDP in 2012, but is projected to deteriorate again modestly over coming years. **Assessment**. In the longer term, as Brazil's large *pre-sal* oil reserves come on line, added efforts to increase savings and NFA would be appropriate to strengthen further Brazil's external position.	

	Canada	Overall assessment
Current account	**Background**. From 2000 to 2012 Canada's current account balance shifted from a sizable surplus to a deficit of 3.7 percent of GDP (the cyclically-adjusted current account deficit is estimated by staff to be around 2½ percent of GDP in 2012, reflecting the large negative output gap in the United States). The deterioration reflects Canada's stronger economic rebound relative to its main trade partners in recent years, but also the significant real appreciation of the Canadian dollar and its weak productivity growth. At the same time, rapidly rising supply combined with limited refining capacity and lack of transportation infrastructure led to a large pricing differentials between the Canadian and global energy markets, limiting the positive impact on the current account from the boom in unconventional energy production. **Assessment**. Analysis suggests that the cyclically-adjusted current account is some 1-3, percentage points of GDP weaker than the value implied by medium-term fundamentals and desirable policies.	The external position appears weaker than implied by medium-term fundamentals. Export performance has been disappointing and net external liabilities have increased. **Potential policy responses** Continued efforts to improve labor productivity (such as budget programs aimed at improving labor skills and fostering research and innovation and higher investments in infrastructure to transport and export natural resources — would help to gradually bring Canada's current account close to the level implied by fundamentals and desirable policy settings.
Real exchange rate	**Background**. Canada's real effective exchange rate appreciated by 32 percent between 2002 and 2012, and is some 15 percent above its 1995–2012 average. Over the last decade, Canada's exchange rate has become increasingly correlated with oil prices, as petroleum exports surged. **Assessment**. Models suggest a real effective exchange rate overvaluation of 5–15 percent relative to medium-term fundamentals and desirable policy settings.	
Capital and financial accounts: flows and measures	**Background**. The large current account deficit of recent years has been financed primarily by net portfolio inflows. Average net portfolio outflows from 2000–07 turned into *inflows* of some 4½ percent of GDP as strong growth prospects, and relatively strong fiscal position and high interest rates made Canada a safe haven, putting upward pressure on the exchange rate (along with high commodity prices). **Assessment**. Canada has a fully open capital account. Vulnerabilities are limited by a credible commitment to a floating exchange rate and a strong fiscal position.	
FX intervention and reserves	**Assessment**. A free floater with minimal reserves who has not unilaterally intervened since September 1998.	
Foreign asset and liability position	**Background**. Canada's net external liabilities are modest (around -15 percent of GDP at end-2012), and would deteriorate moderately under current conditions. Canada has a positive net equity position and a negative net debt position vis-à-vis the rest of the world, reflecting sizable FDI and portfolio equity investment overseas. **Assessment**. Gross external debt, at 77 percent of GDP, is low relative to other advanced economies, and is a modest vulnerability. Canadian foreign assets are primarily in the form of FDI and portfolio equity claims whose value tend to decline during periods of global growth and stock market weakness, as well as when the Canadian dollar appreciates.	

	China	Overall assessment
Current account	**Background**. The current account surplus has fallen precipitously from its peak of over 10 percent of GDP in 2007 to 2¼ percent of GDP in 2012 (around 2½ percent of GDP cyclically adjusted) and exchange rate appreciation has been accompanied by very high investment, in turn driven by high levels of productivity in China, the cheap cost of capital and other factors of production, cyclical weakness in major advanced economies, and high oil and other commodity prices. There is less evidence, as yet, of a decisive shift toward consumption and lower national savings (as a percent of GDP). **Assessment**. China's cyclically-adjusted current balance is some 1-3 percent of GDP stronger than implied by medium-term fundamentals and desirable policies. The desired current account balance—the level consistent with underlying fundamentals and desirable policies—is estimated to range from 0 to 2 percent of GDP. This reflects the need for a package of measures including better social protection, corporate and financial reform, higher costs for a range of factors of production, less reserve accumulation and a stronger currency.	The external position appears moderately stronger and the currency moderately undervalued compared with the level consistent with medium-term fundamentals and desirable policy settings. The post-financial crisis narrowing of the external imbalance has been accompanied by a rise in domestic imbalances, with investment approaching 50 percent of GDP. Given the systemic nature of the Chinese economy, a reduction of these domestic imbalances over the medium-term would help foster global economic and financial stability. **Potential policy responses** The transition to a more balanced and sustainable growth model requires implementing a comprehensive package of reforms that includes financial sector, fiscal, exchange rate, and structural measures. China has made progress on several fronts, including widening the exchange band, liberalizing interest rates, continuing to gradually open the capital account, and strengthening the social security system. However, more progress is needed. The priorities include improving financial intermediation to better allocate investment and boost household income; moving to a more market-based exchange rate; strengthening the fiscal framework to rationalize infrastructure spending and shift the tax burden away from regressive social contributions; improving resource pricing; and opening markets to more competition. China is committed to rebalancing toward a more-consumer based economy, and the new leadership announced plans to re-energize the reform effort. The objectives and directions of the reform agenda are consistent with rebalancing and forceful and timely implementation will be crucial for success
Real exchange rate	**Background**. In real effective terms the currency appreciated by around 5 percent from end 2011 through April 2013 and some 35 percent since the mid-2005 exchange rate reform. Prior to the 2005 reform, the real effective exchange rate had been depreciating , so it is only 14 percent above the level reached a decade ago, which appears somewhat below the significant increases in China's productivity relative to trading partners over the past 10 years. **Assessment**. Taking account of these developments and uncertainties in the model-based estimates, staff assesses the real exchange rate to be moderately undervalued by some 5-10 percent compared to medium-term fundamentals and desirable policies.	
Capital and financial accounts: flows and measures	**Background**. Despite a number of steps in recent years to open up its capital account, China maintains a broad range of capital controls on both inflows and outflows covering the bulk of non-FDI portfolio flows and external borrowing. However, non-FDI capital flows are comparable in size to economies with more open capital accounts. Inflows are dominated by inward foreign direct investment (equal to US$220 billion or 3 percent of GDP in 2011) limiting vulnerabilities; around one-half has gone into building manufacturing capacity. In 2012, China experienced net capital outflows of around US$100 billion, a large turnaround from the net capital inflows of the previous years. **Assessment**. Over the medium term a carefully planned and sequenced loosening of capital controls that supports and reinforces domestic financial liberalization would be appropriate. It is not clear what effect liberalization would have on the direction of capital flows, though recent staff research suggests that it could result in significant net capital outflows.	
Foreign exchange intervention and reserves	**Background**. China continues to closely manage its exchange rate and conducts intervention which has the effect, in most cases, of controlling the pace of appreciation. The pace of reserve accumulation slowed significantly in 2012, due in temporary factors, and has picked-up again in the first part of 2013 **Assessment**. Reserves are somewhat above the IMF's composite metric (161 percent at end 2012), and further accumulation would be undesirable.	
Foreign asset and liability position	**Background**. Net foreign assets amount to 30 percent of GDP and NFA has grown rapidly over the past several years. The NFA position reflects substantial and persistent current account surpluses and FDI inflows over the years while net balances on portfolio assets, trade finance, and banking are close to zero. The composition on the asset side is dominated by the accumulation of international reserves by the central bank (at end-2012 approximately 40 percent of GDP). **Assessment**. With large foreign exchange reserves and liabilities largely composed of FDI, vulnerabilities are low.	

	Euro Area	Overall assessment
Current account	**Background**. The current account balance of the euro area improved moderately in 2012 to 1.2 percent of GDP, reflecting strengthened external positions of both surplus and deficit euro area economies. The cyclically-adjusted current account (after adjusting for the output gap and terms of trade shocks) is estimated to be a surplus of 1.3 percent of GDP. **Assessment**. Building from a view of external positions in individual euro area economies as well as previous staff recommendations, the 2012 cyclically-adjusted current account is broadly in line with the estimated value from medium-term fundamentals and desirable policy settings.	The euro area external position is now broadly in line with its equilibrium level implied by medium-term fundamentals and desirable policies. Although only modest adjustment is needed for the euro area as a whole, more substantial adjustment is desirable for individual euro area economies on internal rebalancing and improving competitiveness. **Potential policy responses** Euro area economies need to improve their public and private debt positions, as appropriate. Improvements in competitiveness are particularly important for deficit economies, which need to lower costs and shift resources to tradable sectors. Increasing productivity in the non-tradable sector in the surplus countries could improve disposable incomes in these economies and lead to higher external demand. This would require strengthening the implementation of ongoing structural reforms, e.g., labor and product market reforms in deficit economies, and product market reforms in surplus ones. At the euro area level, a targeted implementation of the Services Directive would help reduce barriers to entry in protected professions, and improve productivity and living standards.
Real exchange rate	**Background.** The euro REER has declined by 10-15 percent from its peak since end-2009 and it is currently close to the long-run average (from the inception of euro). **Assessment**. Building from a view of external positions in individual euro area economies and staff estimates, the real exchange rate (in 2012 average) is close to equilibrium as suggested by medium-term fundamentals and desirable policy settings. Differences across euro area economies have remained roughly the same as in previous staff evaluations: real exchange rates seem moderately undervalued in surplus economies, while remain overvalued in most deficit economies. By early April 2013 the real effective exchange rate is estimated to have risen by about 2½ percent from its 2012 average.	
Capital and financial accounts: flows and measures	**Background**. The current account surplus in 2012 was matched by financial outflows. In particular, the financial account deficit was largely driven by FDI and other-investment outflows, while mitigated by resumed portfolio inflows to the euro area. **Assessment**. The path for financial flows depends crucially on the resolution of the euro area crisis including the long-term vision to complete the architecture of the EMU—failure to deliver previously agreed policy commitments will undermine market confidence and likely mean that "real money" flows will not readily return.	
FX intervention and reserves	**Assessment**. The euro has the status of a global reserve currency. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	
Foreign asset and liability position	**Background**. The net international investment position of the euro area has deteriorated through the crisis, to nearly -17 percent of GDP in 2008, but has since recovered to -7½ percent in 2012, reflecting both improved current account and valuation effects. Estimates of the cyclically-adjusted current account suggest that NFA position is likely to improve modestly going forward. **Assessment**. External vulnerabilities largely come from the market perception of some deficit countries to service their debts, since financial market stress could easily re-intensify if expectations of strong policy implementation were disappointed.	

	France	Overall assessment
Current account	**Background**. Over the past decade, the current account has deteriorated from a surplus of 1.2 percent of GDP in 2002 to a deficit of about 2½ percent in 2012 (the cyclically-adjusted deficit is estimated at just over 2½ percent of GDP). **Assessment**. Model estimates suggest that the cyclically-adjusted current account is some 1- 3 percent of GDP weaker than the value implied by medium-term fundamentals and desirable policy settings. The current account deficit is expected to narrow over the medium-term, which would help close this gap.	The external position appears moderately weak compared to medium-term fundamentals and desirable policies. Domestic policy settings contribute only to a small degree to the econometric findings. To improve competitiveness, the labor tax wedge has been reduced by the equivalent of 3 percent of total labor costs (with full effect in 2014) and a broad labor market reform has increased flexibility to renegotiate labor contracts and has mitigate judicial uncertainty in the event of dismissals **Potential policy responses** Wage moderation (especially minimum wage), continued reform of the labor market and productivity-enhancing reforms (increasing competition in product markets and regulatory simplification) would help restore profit margins and promote investment to into higher value added production.
Real exchange rate	**Background**. The trend deterioration in the external position and unit labor costs indicators point to a loss of competitiveness, but evidence based on price competitiveness is less clear, as firms appear to have squeezed profit margins to retain price competitiveness. **Assessment**. Structural rigidities and rising unit labor costs relative to France's main trading partners in the euro area have contributed to loss of competitiveness and an estimated overvaluation of between 0 and 5 percent.	
Capital and financial accounts: flows and measures	**Background.** Capital account movements since the early 2000s have been volatile but do not seem to demonstrate a discernible pattern that contributes to the imbalances. The capital account is open. **Assessment**. Based on data available through 2011, France's net international investment position has deteriorated since the start of the financial crisis in 2008, mainly on account of a retrenchment in portfolio investment (including adverse valuation effects).	
FX intervention and reserves	**Assessment**. The euro has the status of a global reserve currency. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	
Foreign asset and liability position	**Background**. The external debt to GDP ratio has risen in recent years due to rising public and private debt. Given France's gross external position, size, and tight financial and trade links, stability of the French debt market is an important element of euro-zone financial stability. The cyclically-adjusted current account points to a deteriorating net international investment position. **Assessment**. The net international investment position is close to balance (-16 percent of GDP in 2010). Gross assets stand at around 300 percent of GDP with exposure to the euro area periphery as the main vulnerability.	

	Germany	Overall assessment
Current account	**Background**. The current account (at 7 percent of GDP in 2012, around 8 percent of GDP cyclically adjusted) has been in surplus since 2002, peaking at 7½ percent of GDP in 2007. Sizeable surpluses were also common in the period preceding the 1990 German reunification. **Assessment**. Model analysis points to a cyclically-adjusted current account balance that is 5–6 percentage points of GDP stronger than that the value implied by fundamentals and desirable policies or 4–5 percentage points of GDP stronger than the actual current account observed in 2012. This would be consistent with a medium-term reduction in the current account balance by 2-3 percent of GDP over and above the natural rebalancing process.	Germany's external position is substantially stronger than implied by medium-term fundamentals and desirable global policy settings. **Potential policy responses** Staff projects some rebalancing in the medium term due to the relatively stronger wage growth than in the past, somewhat higher inflation and higher domestic demand. In the medium term, the most sustainable approach to durably rebalance the German economy and support euro area recovery is to raise potential growth, reinvigorate domestic demand and allow relative price adjustment with other euro area members. Staff's preliminary analysis suggests that policy levers such as making the tax structure more growth-friendly within the fiscal envelope and reforming the financial sector could be beneficial in this regard, consistent with the recommendations of the Article IV staff report.
Real exchange rate	**Background**. At the end of 2012, the real effective exchange rate was on average about 8 percent below its historical average. **Assessment**. Various methodologies indicate a range of estimates from an undervaluation of about 2 percent to 10 percent suggesting that the real exchange rate in Germany is moderately undervalued relative to the value consistent with medium-term fundamentals and appropriate policies.	
Capital and financial accounts: flows and measures	**Background**. Germany exported private capital matching its surpluses prior to the crisis, with financial investments primarily by banks driving the outflows, while FDI comprised only a small portion. However, private capital flows since the crisis have reversed course, reflecting a retrenchment from cross-border interbank markets, unwinding of investment positions, and safe haven flows, At the same time, outflows associated with the payment system of European central banks (Target 2) have increased significantly, but have declined noticeably from the peak in August 2012. This has resulted in considerable accumulation of liquidity in the German financial system. **Assessment**. Exposure to the European Monetary System reflects the failure to resolve stresses in the euro area, which are a threat to global stability.	
FX intervention and reserves	**Assessment**. The euro has the status of a global reserve currency. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	
Foreign asset and liability position	**Background**. The dent in Germany's net international investment position caused by reunification led to an almost balanced position at the beginning of the millennium, IIP recovered by the mid-2000s. It further increased in the past five years (to about 40 percent of GDP at end 2011 of which over one half are net claims on the Eurosystem (Target 2 balance). It is projected to continue to improve, suggesting a strong external position German firms and individuals hold a large positive net international investment position (46 percent of GDP) while monetary and financial institutions hold a small net surplus (4 percent of GDP), but large gross positions. The Bundesbank has also accumulated large net claims on the Eurosystem (almost 25 percent of GDP) and holds some reserves (7 percent of GDP) These positions are offset by the large negative IIP position of the general government (40 percent of GDP). **Assessment**. Safe haven status limit risks from gross liabilities of over 224 percent of GDP.	

	Hong Kong SAR	Overall assessment
Current account	**Background**. Hong Kong's current account surplus has fallen substantially in the period following the global financial crisis reaching a low point of 5.4 percent of GDP in 2010 and is projected to have declined further to 2.3 percent of GDP in 2012. At current levels of the real exchange rate, the current account surplus will remain below 3 percent of GDP in 2013–15 before rising again over the medium term to around 5 percent of GDP (as global growth recovers and integration with the Mainland deepens). **Assessment**. The cyclically-adjusted current account position is broadly consistent with medium-term fundamentals and desirable policies. A cyclically-adjusted current account surplus of around 7 percent of GDP is consistent with Hong Kong's status as an international financial center, characterized by structurally high savings and low levels of investment in physical capital.	The external position appears broadly consistent with medium-term fundamentals and desirable policy settings. **Potential policy responses** The currency regime is well supported by robust and proactive financial regulation and supervision, a strong fiscal position, and significant external resources. In addition, the currency board has broad-based support among the public and remains the most appropriate exchange rate arrangement for Hong Kong SAR.
Real exchange rate	**Background**. The Hong Kong system has repeatedly shown itself to possess very strong self-equilibrating tendencies (due to very flexible goods, factor, and asset markets which adjust through both inflation and deflation) making it unlikely that misalignment will be large or persistent. **Assessment**. The real exchange rate is broadly consistent with medium-term fundamentals and desirable policies. A number of empirical methodologies confirm this assessment, with analysis pointing to a range of under/overvaluation of -15 to +7 percent.	
Capital and financial accounts: flows and measures	**Background**. Gross inflows and outflows are over 100 percent of GDP, largely comprising banking flows as well as portfolio assets. Over the past year, Hong Kong has experienced sizable net private outflows, mainly the result of portfolio outflows. Notable also was significant loan flows to Mainland China, largely a result of tightening financial conditions on the Mainland. Hong Kong SAR has a fully open capital account and no capital controls. **Assessment**. Large financial resources limit the risks from volatile banking capital flows.	
FX intervention and reserves	**Background**. Hong Kong SAR has a currency board arrangement. International reserves have been built up in a non-discretionary way as a result of a long-standing commitment to the peg. **Assessment**. Currently reserves are adequate for precautionary purposes, and future accumulation should be limited to that required by the automatic adjustment of the currency board system. Hong Kong SAR holds significant fiscal reserves, held offshore and built up through a track record of strong fiscal discipline.	
Foreign asset and liability position	**Background**. Both external financial assets and liabilities are very high, at 1330 percent and 1052 percent of GDP, respectively, reflecting Hong Kong's status as a major international financial center with considerable cross-territory investment. The NFA position is expected to rise gradually over time given the persistent current account surplus, suggesting if anything a strong external position. **Assessment**. Very large gross financial assets and liabilities could pose some vulnerability, but this is mitigated by large official reserve holdings (117 percent of GDP).	

<table>
<tr><th></th><th>India</th><th>Overall assessment</th></tr>
<tr><td>Current account</td><td>Background. The current account deficit (CAD) has widened, reaching 5.1 percent of GDP in 2012 (around 3.8 percent of GDP cyclically-adjusted). While a current account deficit of 3 to 3½ percent of GDP would be broadly consistent with India's high growth and low capital-to-worker ratio, the recent deterioration of the current account has increased India's medium-term vulnerabilities to foreign interest rate and liquidity shocks, as well as to sudden stops in capital inflows. The CAD is expected to narrow slightly in the near term as supply-side bottlenecks (which elevate imports and constrain manufacturing exports) ease, and exports should recover with global growth.

Assessment. The cyclically-adjusted CAD is broadly consistent with medium-term fundamentals and desirable policies, although the near term rise in the deficit has increased external stability risks.</td><td rowspan="5">From a medium-term perspective, India's external position is broadly in line with medium-term fundamentals and desirable policies. Recently, the external position has deteriorated and calls for further tightening of fiscal policy and addressing the economy's supply-side constraints, to reduce overall external vulnerability.

Measures have recently been put in place to ease supply bottlenecks (including expediting project approvals through the Cabinet Committee on Investment; liberalizing diesel prices; and relaxing FDI norms), and additional measures are envisaged.

Potential policy responses

Under current policies, India's general government budget deficit is expected to decline by less than 1 percent of GDP by 2017/18. Alternatively, to reach the authorities' goal (3.5 percent of GDP deficit reduction) would require additional measures. Easing domestic supply bottlenecks would also be key to help lower the current account deficit.

Reserve adequacy indicators have deteriorated but reserve levels are broadly adequate. The flexible exchange rate policy followed by the RBI is welcome, and the current policy of smoothing exchange rate volatility is appropriate.

Capital controls should be gradually liberalized with further liberalization of FDI inflows and portfolio debt flows. This should be accompanied by policies to develop financial markets.</td></tr>
<tr><td>Real exchange rate</td><td>Background. The real effective exchange rate has been broadly stable over the last two decades, but has been volatile more recently. After a 21 percent appreciation in 2009 and 2010, the real exchange rate depreciated rapidly in late 2011 and in April–June 2012. Since then it has appreciated by 9 percent (in the period up to March 2013).

Assessment. The real effective exchange rate is some 3 percent above the average of the last 20 years. Despite nominal depreciation since July 2011, the real exchange rate has appreciated somewhat due to India's large inflation differential with its trading partners. The real exchange rate is broadly consistent with medium-term fundamentals and desirable policies.</td></tr>
<tr><td>Capital and financial accounts: flows and measures</td><td>Background. India's financial account is dominated by portfolio equity and FDI flows. Though capital flows are holding up, there has been a shift in the financing mix of the current account deficit (more debt flows and less FDI flows). FDI inflows finance only a quarter of the CAD in 2012; in contrast, they generally exceeded the CAD before 2007/08. Debt flows, particularly short-term and in the form of non-resident Indian (NRI) deposits, have increased. Similarly, external commercial borrowings (by Indian corporates) increased by more than 60 percent since 2008.

Assessment. Portfolio equity flows have been volatile and the exchange rate has been sensitive to these flows and changes in global risk aversion. Restrictions on external commercial borrowing have affected the composition of debt flows, but have not impeded arbitrage of domestic and foreign interest rates. The widening of the CAD when growth and investment are weak, along with increased reliance on debt financing, have increased concerns about external vulnerabilities.</td></tr>
<tr><td>FX intervention and reserves</td><td>Background. The rupee is consistent with a floating arrangement, and the authorities have recently intervened only to prevent abrupt movements in the exchange rate (the magnitude of intervention has remained small relative to the size of the FX market). Reserve coverage has fallen, especially import cover, which dropped from 11 months of projected imports in 2007/08 to under 6 months in March 2013.

Assessment. Reserves stand at 166 percent of the IMF's composite metric and 170 percent of short-term debt covering about 6 months of imports. As such, reserve levels are broadly adequate for precautionary purposes.</td></tr>
<tr><td>Foreign asset and liability position</td><td>Background. Gross assets and liabilities have grown steadily, but the net International Investment Position (IIP) has deteriorated because of the relatively rapid increase in liabilities since 2007/08. The bulk of external assets are FDI and official reserves. Gross liabilities include portfolio equity and FDI, and increasingly short-term liabilities (trade credits and other loans). While reserves are broadly unchanged in U.S. dollars compared with November 2010, they have declined by US$30 billion since the recent peak of August 2011.

Assessment. The growth of near term gross liabilities (particularly debt) is a key external vulnerability.</td></tr>
</table>

	Indonesia	Overall assessment
Current account	**Background**. Indonesia's current account balance declined by 3 percent of GDP in 2012 to a deficit of 2.7 percent of GDP (a deficit of 2.3 percent of GDP, cyclically adjusted). The main factors were weaknesses in major export commodity prices and a trend decline in net oil and gas exports (Indonesia became a net importer in 2011). Going forward, projected declines in commodity prices, continued solid domestic demand, and a further deterioration in the oil and gas balance are expected to contribute to a widening of the current account deficit in 2013. **Assessment**. A relatively young labor force, the need for sustained growth in public and private investment, and general import compression suggest that a modest current account deficit in the range ½-2½ percent of GDP is in line with medium-term fundamentals and desired policies. Therefore, the cyclically-adjusted current account is in the range 0-2 percent percentage points of GDP weaker than the estimated norm, compared with a point estimate of 2 percentage points of GDP stronger in the Pilot ESR. The change has been driven mostly by the sharp decline in the cyclically adjusted current account.	The external position appears moderately weaker than implied by medium-term fundamentals and desirable policies. While reserves are currently adequate, the ongoing reliance on foreign financing and still-volatile capital flows indicate a need to maintain reserves near current levels. **Potential policy responses** Steps should be taken to address the widening of the current account deficit. These include maintaining the current small structural fiscal deficit while eliminating energy subsidies, tightening monetary policy, and allowing exchange rate flexibility so the rates can adjust in line with developments in commodity prices and the current account. Broader efforts to reform the economy and improve the trade regime and investment climate would complement these policies.
Real exchange rate	**Assessment**. In 2012, the real effective exchange rate depreciated by a modest 2 percent. The model estimates suggest the real exchange rate is in line with medium-term fundamentals and desirable policies. Going forward, greater exchange rate flexibility would help the economy better absorb external shocks and facilitate necessary adjustment, supported by appropriate macro-financial policies and growth-oriented structural reforms.	
Capital and financial accounts: flows and measures	**Background**. Indonesia remains an attractive destination for investment. In 2012, FDI hit a new high and net debt issuance rebounded somewhat from 2011. Going forward, FDI is expected to remain at about 2½ percent of GDP, with net debt issuance amounting to about 1½ percent of GDP. However, capital flows could slow or reverse if there is an increase in global risk aversion, an unwinding in global monetary accommodation, or a weakening of investor sentiment—this last factor due to uncertainty regarding policy direction or the investment climate in Indonesia. About one-third of rupiah government debt is held by nonresidents. **Assessment**. FDI and debt inflows appear sustainable given strong growth prospects, but are susceptible to domestic and external shocks. In view of the need for stable foreign funding to finance the current account, Indonesia should improve its investment climate, refrain from unexpected changes in policy, and continue exercising fiscal constraint.	
FX intervention and reserves	**Assessment**. At end-2013, reserves are projected to be adequate at around 125 percent of the IMF's composite metric. With a sustained current account deficit projected over the medium term, this level of reserve cover could help to reduce risks associated with increasing reliance on foreign financing. Given volatile capital flows, some foreign exchange intervention may be warranted to smooth currency fluctuations.	
Foreign asset and liability position	**Background**. Indonesia's NFA position at end-2011 stood at -36 percent of GDP, comprised of reserves of 13 percent of GDP, net FDI and equities of about -30 percent of GDP, and net debt and other liabilities of -18 percent of GDP. The gross external debt-to-GDP ratio is low at about 25 percent of GDP and has been on a declining trend. Short-term debt is only 6 percent of GDP. Given the level and composition of debt and NFA, Indonesia's net external position appears sustainable. **Assessment**. The main external vulnerability is nonresident holdings of government rupiah debt. While the government's fiscal position is sustainable, these holdings could be affected by changes in global risk aversion or a reversal in global monetary accommodation. But, the current level of reserves substantially mitigates this risk.	

	Italy	Overall assessment
Current account	**Background**. Italy has typically run moderate current account deficits (1–3 percent of GDP); reflecting a broadly balanced trade account and trend deficits for services, income, and (EU) transfers. In 2012, however, the trade balance improved sharply, owing principally to subdued imports (the multilaterally consistent cyclically-adjusted current account deficit is estimated at just less than 1 percent of GDP). **Assessment**. Despite the recent improvement, model results suggest that the cyclically-adjusted current account is still around [0-2 percentage points of GDP weaker than the value implied by medium-term fundamentals and desirable policy settings.	Italy's weak productivity and competitiveness indicators point to an external position moderately weaker than suggested by medium-term fundamentals and desirable policy settings. Part of this may reflect its weak competitive position within the euro area, where relative price effects may be magnified by the existence of a common currency. **Potential policy responses** Continued progress in medium-term fiscal consolidation will be key in closing the competitiveness gap and maintaining investor confidence. In addition, implementation of structural reforms will also be central to improving competitiveness and ensuring a rebound in growth. Combined, these measures should help narrow the cyclically-adjusted current account deficit toward a level broadly consistent with fundamentals.
Real exchange rate	**Background**. Structural rigidities and increasing unit labor costs have resulted in a gradual appreciation of the real effective exchange rate. Since joining the euro area, ULC in Italy has increased by around 10 percent relative to the euro area average. **Assessment**. Various approaches suggest a real effective depreciation of 0-10 percent, would be appropriate.	
Capital and financial accounts: flows and measures	**Background**. Portfolio and other-investment inflows have typically financed the current account deficit, and a modest net FDI outflow, without much difficulty. Over 2011-12, however, banks had difficulties raising funds in international markets, resulting in an increase in euro system refinancing and TARGET2 liabilities, which have now stabilized. **Assessment**. Italy is vulnerable to a downturn in investor sentiment, owing to the large refinancing needs of the sovereign and banking sectors.	
FX intervention and reserves	**Assessment**. The euro has the status of a global reserve currency. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	
Foreign asset and liability position	**Background**. As a percent of GDP, Italy's net international investment position is relatively modest and has been broadly stable—with net liabilities reaching 24½ percent of GDP in 2012. **Assessment**. Italy is vulnerable given the relatively large stock of government debt and the large share held by non-residents.	

	Japan	Overall assessment
Current account	**Background**. The current account surplus declined to 1 percent of GDP in 2012 (around 1¼ percent of GDP cyclically adjusted), reflecting sluggish external demand, an increase of energy imports (following the Great East Japan Earthquake) and a strong yen through most of the second half of 2012. Following the depreciation of the yen, our baseline forecast is that the current account will improve with a lag. Fiscal consolidation will help improve the current account over time but the higher costs of energy and intermediate-goods imports is likely to negatively affect the trade balance in 2013. The investment income account surplus (nearly 3 percent of GDP in 2012) is expected to remain sizable, supported by large net foreign assets and higher returns on assets than on liabilities. **Assessment**. Before the recent sharp depreciation of the yen, the cyclically-adjusted current account was estimated to be about 2¼ percent of GDP weaker than the value implied by fundamentals and desirable policies. However this calculation pre-dates the adoption of new macroeconomic policies, which affect the norm through their impact on growth, inflation and the desirable policy mix. Taking into account the impact of higher energy imports in lowering the trade balance and the lagged impact of depreciation since mid 2012, the estimated current account gap ranges from 1 percent of GDP weaker to 2 percent of GDP stronger than implied by fundamentals and desirable policies.	The assessment of the external position is subject to an unusual degree of uncertainty in light of a major shift in the overall macroeconomic framework that has taken place since 2012.The external position appears moderately stronger than implied by fundamentals (and the exchange rate is moderately undervalued), due to the near-term effects of the monetary easing designed to secure an exit from deflation. Over the medium-term, if comprehensive fiscal and structural reforms are implemented in a credible manner, the external position would be expected to move to a position broadly consistent with fundamentals. As of mid-2013, the exchange rate and current account developments yield mixed signals about the external position. The new monetary framework and the reversal of safe haven effects have led to a sizable depreciation of the yen, while the current account has not, as yet, responded to the depreciation. **Potential policy responses** Policy gaps for Japan are more of an issue of internal rather than external sustainability. Fiscal consolidation to close the policy gap would raise national savings above our baseline forecast, more than offsetting the decline in private saving from aging, and raise the current account surplus. Ambitious structural reforms including liberalizing trade through the TPP could partially offset this by boosting productivity, domestic income, and imports.
Real exchange rate	**Background**. The yen remained strong against major currencies through most of 2012, then began a steady depreciation in November 2012 reflecting several factors, including the new monetary framework, the reversal of safe haven effects—potentially contributing 5-10 percent to the depreciation since the fall of 2012—and a structural weakening of the trade balance from higher energy imports. Since the last assessment in May 2012, the exchange rate has, by June 2013 depreciated by about 18-19 percent in real effective terms, reversing much of the appreciation since the global financial crisis. **Assessment**. Relative to medium-term fundamentals and desirable policies, the sharp depreciation since 2012 implies moderate undervaluation, with estimates ranging from ranging from a 20 percent undervaluation to a 10 percent overvaluation as this assessment is subject to greater than usual uncertainty given market volatility. The exchange rate is expected to move in line with fundamentals over the medium-term assuming the implementation of comprehensive and credible fiscal and structural reforms.	
Capital and financial accounts: flows and measures	**Background**. An important part of the capital flows in the 2000s was the yen carry trade and it's unwinding after the Lehman shock. The appreciation of the yen since the global financial crisis and the recent depreciation have not been associated with notable capital in- or outflows. Instead, the main driver of exchange rate movements appears to be the derivative position, reflecting hedging as well as speculative positions. The scale of the new monetary easing policy could result in some spillovers, notably a larger flow of capital to the region's other economies. **Assessment**. Safe haven flows imply limited vulnerabilities to global financial instability.	
FX intervention and reserves	**Assessment**. Reserves are higher than other reserve asset issuers (about 20 percent of GDP) on legacy accumulation. The level of the yen is market determined. Isolated fx interventions during safe haven periods appear to have reduced short-term exchange market volatility, while having ambiguous effects on the exchange rate level.	
Foreign asset and liability position	**Background**. The net foreign asset position has risen from about 35 percent of GDP ten years ago to over 50 percent of GDP in 2012. Most assets and liabilities are portfolio equity and debt securities, rather than FDI. **Assessment**. Vulnerabilities are limited as Japan's positive net position generates sizable investment income (that averaged about 3 percent of GDP over the past five years) and offset the goods trade deficit in 2012. Risks on assets and their returns are also diversified geographically and in terms of investment type.	

<table>
<tr><th></th><th>Korea</th><th>Overall assessment</th></tr>
<tr><td>Current account</td><td>Background. The current account (CA) surplus widened to 3.8 percent of GDP in 2012 (from 2.3 percent in 2011), but remained at 4½ percent in cyclically-adjusted terms. It is projected to narrow as domestic demand strengthens over the medium term. The authorities have forecasted in the context of the G-20 Mutual Assessment Process that the CA surplus would narrow.

Assessment. In line with last year's assessment, the cyclically-adjusted CA balance is assessed to be some 1-4 percent of GDP above the value suggested by fundamentals and desirable policies. This reflects the need for fiscal adjustment in many advanced economies and higher public spending, in particular social spending, in Korea.</td><td rowspan="5">The external sector position appears stronger than that implied by medium-term fundamentals and desirable policies (including in partner countries).

The real exchange rate is assessed to be moderately undervalued.

Potential policy responses

The current account gap would further narrow with fiscal rebalancing in advanced economies as well as higher public spending, in part due to higher social spending in Korea. Policies have already been put in place to enhance social protection (e.g. subsidies for child care) and further measures are envisaged.

The exchange rate should continue to be market determined with intervention limited to smoothing excessive volatility. In the event of a capital flow surge, existing macropudential measures can be further tightened as a supplement to macroeconomic policy adjustments, particularly the exchange rate and monetary policies.

Reserves are in line with the IMF's composite metric. There is no precautionary need to increase reserves, although a slow increase in line with rising liabilities would be reasonable.</td></tr>
<tr><td>Real exchange rate</td><td>Background. During the 2012 ESR, the real effective exchange rate (REER) was assessed to be moderately undervalued, in the range of around 0-10 percent. Since then, it appreciated by 7 percent in 2012, followed by depreciation of around 1½ percent between end-2012 and April 2013.

Assessment. The REER is assessed to be around 2-8 percent below the level that is consistent with medium-term fundamentals and desirable policies, i.e. moderately undervalued, though less than during the last ESR round.</td></tr>
<tr><td>Capital and financial accounts: flows and measures</td><td>Background. Capital flows remained volatile in 2012, in particular equity and other flows with no significant net capital inflows overall. This reflects a combination of Korea-specific factors—e.g., North Korea risks and macro prudential measures on the negative side; and strong policy fundamentals as well as appreciation expectations on the positive side—and global push factors, particularly higher risk appetite. After the global financial crisis, Korea introduced an array of macroprudential measures aimed at containing banks' FX funding risks. It also reinstituted the withholding tax on bond investments. In 2012, some of these measures were tightened.

Assessment. While Korea faces the risk of volatile capital flows, its financial system has become more robust. There is also no evidence of unsustainably large capital inflows. It should therefore remain open to capital flows and continue to allow its exchange rates to move freely; it can further strengthen existing macroprudential measures if faced with a surge in capital inflows. Macroprudential measures should continue to be targeted at mitigating financial stability concerns and reducing excessive volatility rather than affecting the level of the exchange rate. Official communication should be clear on these intentions.</td></tr>
<tr><td>FX intervention and reserves</td><td>Background. Reserves grew by 1 percent of GDP (US$ 21 billion) in 2012, broadly in line with external liabilities.

Assessment. Reserves are adequate at 180 percent of short-term external debt and 130 percent of the IMF's composite metric, within the 100–150 percent recommended range. Including forward positions, the reserve coverage looks more comfortable. Therefore, there is no need for further reserve accumulation for precautionary purposes although going forward, a slow increase in line with rising liabilities would be reasonable. Continued nominal exchange rate flexibility would be desirable with intervention limited to smoothing volatility.</td></tr>
<tr><td>Foreign asset and liability position</td><td>Background. At -9 percent of GDP, Korea's net international investment position is modest and improving, given CA surpluses. Net debt, which is relatively small (16 percent of GDP), is more than covered by reserve assets (28 percent of GDP). Korea's short-term external debt is largely held by banks, which are bound by prudent net open position limits. About 16 percent of listed government bonds outstanding are held by foreign investors, exposing the government to some interest rate and rollover risk, however, little exchange rate risk as most of the debt is in local currency.

Assessment. There are few risks to external debt sustainability.</td></tr>
</table>

	Malaysia	Overall assessment
Current account	**Background**. The current account surplus declined to 6.1 percent of GDP in 2012 from 11 percent in 2011 and 17 percent in 2008, reflecting increasingly domestic demand-driven growth. While the goods trade balance dominated the decline, the income and service balance have also turned increasingly negative. **Assessment**. Model analysis (EBA) suggests that the cyclically-adjusted current account is stronger (by about 7 percentage points of GDP) than the level consistent with medium-term fundamentals and desirable policies. However, Malaysia's current account surplus mainly reflects structural factors that are not well captured in the EBA; in particular: insufficient social safety nets (not fully captured by health spending), which drive up the actual and optimal rates of saving; bottlenecks to investment, resulting in relatively low private investment rates (despite the recent increase). Taking these factors and the uncertainty surrounding model estimates into consideration, we assesses the CA gap to be of the order of 2-5 percentage points of GDP.	The external position appears stronger than that consistent with estimates of medium-term fundamentals and desirable policies. However, the current account and real exchange rate gap likely reflect most structural factors, such as inadequate social protection and investment bottlenecks. **Potential policy responses** The ongoing external rebalancing of Malaysia's economy is substantial and is expected to continue during the medium term. Structural reforms to strengthen social protection and improve the investment climate, together with population aging, would contribute to reduce the savings-investment gap. Significant progress has been made to improve the business climate but skill gaps and low labor force participation present challenges. Recent reforms to the pension system are welcomed but the risk-sharing characteristics of the current scheme could be further enhanced. Introduction of employment insurance would further strengthen the safety net and reduce precautionary savings. These measures should be complemented by continued two-way exchange rate flexibility with intervention limited to dampening excessive volatility, which should allow the currency to appreciate in real terms over the medium term.
Real exchange rate	**Background**. After a strong appreciation in September 2009–April 2010, the real effective exchange rate has since fluctuated around a fairly horizontal trend. **Assessment**. Estimates based on EBA suggest that the exchange rate is undervalued relative to medium-term fundamentals and desirable policies by about 17 percent. However, as noted above, the model-based methodologies do not fully capture Malaysia's structural characteristics and there is a broad range of uncertainty around such estimates. We assess the REER to be undervalued by about 5-15 percent.	
Capital and financial accounts: flows and measures	**Background**. Malaysia has typically recorded net capital outflows, driven by net foreign direct investment and non-portfolio investment. In 2012, net outflows were about 2.4 percent of GDP, with portfolio inflows (about 6.3 percent of GDP) largely offset by non-portfolio outflows. **Assessment**. Malaysia has experienced volatile capital flows over the past few years reflecting both push and pull factors, including shifting global risk aversion, low policy rates in advanced economies and Malaysia's strong fundamentals. But, a healthy financial sector has limited the impact on the overall economy. The authorities have continued to liberalize FX administration, including via greater flexibility for resident companies to undertake foreign direct investment abroad and obtain loans from related resident and non-resident companies.	
FX intervention and reserves	**Assessment**. Official reserves are about 128 percent of the IMF's composite reserve adequacy metric, and cover about 280 percent and 32 percent of short-term external debt and broad money, respectively. Therefore, current reserve levels are adequate and there is no need for additional accumulation for precautionary purposes. BNM intervention seeks to limit excess exchange rate volatility and has generally been two-sided. Thus, during the global financial crisis foreign reserves fell by about 33 percent between August 2008 and March 2009, and a decline was again recorded in August–September 2011.	
Foreign asset and liability position	**Background**. While gross liabilities are substantial (118 percent of GDP at end-2011), they consist primarily of FDI and portfolio equity. External debt is relatively low at about 27 percent of GDP in 2012, of which about 63 percent is medium and long-term debt. Short-term external debt is well-covered by foreign reserves. **Assessment**. The international investment position is not a major source of risk with a moderate surplus (4.3 percent of GDP at end-2011) and is projected to rise, suggesting a strong external position.	

	Mexico	Overall assessment
Current account	**Background**. The current account deficit was less than 1 percent of GDP in 2012 (and less than 0.5 percent of GDP cyclically adjusted), and it will increase slightly over time due to a weaker oil balance over the medium term. **Assessment**. Models suggest that Mexico's cyclically-adjusted current account balance seems to be close to the value implied by medium-term fundamentals and desirable policies.	Mexico's external position is consistent with medium-term fundamentals and desirable policy settings. **Potential policy responses** Mexico's present macro policy stance is broadly appropriate. Medium-term challenges include the need to mobilize fiscal resources to compensate for the expected decline in oil revenues, and fiscal pressures from population aging.
Real exchange rate	**Background**. The flexible exchange rate has been a key shock absorber in the context of a volatile external environment. Since the reference period, Mexico's real exchange rate is estimated to have appreciated about 10 percent, displaying substantial volatility associated with the bouts of global risk aversion. **Assessment**. A range of metrics and methodologies suggest that the current level of Mexico's exchange rate is broadly in line with medium-term fundamentals and desirable policy settings.	
Capital and financial accounts: flows and measures	**Background**. Annual net capital inflows have been in the order of 4 percent of GDP over the 2010-2012 period. Most of the inflows have been purchases of domestic currency government paper by non-residents, and reflect push and pull factors. The inclusion of Mexico in the WGBI (which led to a portfolio stock adjustment) played an important role. Capital inflows are expected to continue in coming years, associated with prospective structural reforms. **Assessment**. Foreign investors hold a large share of Mexican financial assets, which entails potential vulnerabilities from contagion.	
FX intervention and reserves	**Background**. Mexico's central bank remains committed to a flexible exchange rate, and to gradually build its reserve buffers through rules-based intervention. **Assessment**. The current level of foreign reserves is adequate according to a range of standard reserve coverage indicators, at the middle of the range of the IMF's composite adequacy metric. Going forward, there is the case for a gradual increase in reserves consistent with the expected gradual rise in foreign-held liabilities. The Fund FCL arrangement has been an effective complement to international reserves against global tail risks.	
Foreign asset and liability position	**Background**. The NFA position (about -40 percent of GDP) is comfortable, and is projected to remain broadly stable. **Assessment**. The external position is broadly consistent with fundamentals, but gross foreign portfolio liabilities—at nearly 30 percent of GDP—represent a material risk and could be a channel of contagion.	

	The Netherlands	Overall assessment
Current account	**Background**. The current account (at 8.3 percent of GDP in 2012) has been in surplus since 1981, peaking at 10.1 percent of GDP in 2011. However, the persistent current account surpluses have not led to a commensurate accumulation of net foreign assets. **Assessment**. Persistently large surpluses, even after allowing for biases created by being a financial center and an energy exporter (but not taking into account the specificities of the Dutch pension system), with a cyclically-adjusted surplus estimated at 8 percent of GDP, point to a cyclically-adjusted current account 1–3 percent of GDP stronger than the value implied by medium-term fundamentals and desirable global policy settings.	The external position is stronger than the level consistent with medium-term fundamentals and desirable global policy settings. **Potential policy responses** Domestic policy settings are broadly appropriate and no policy measures are needed.
Real exchange rate	**Background**. The REER has depreciated somewhat in recent years, following appreciation between 2006–09, as a result of decelerating wage and price pressures. It is slightly lower than its historical averages. **Assessment**. Relative profitability in manufacturing has been broadly stable, and a range of approaches suggest a moderate undervaluation of 0–5 percent.	
Capital and financial accounts: flows and measures	**Background**. Net FDI outflows dominate and appear to be stimulated by the investment of corporate profits abroad. On average, gross FDI outflows largely match corporate profits. **Assessment**. The strong external position limits vulnerabilities from capital flows. The financial account is likely to remain in deficit as long as the corporate sector continues to sustain substantial investments abroad.	
FX intervention and reserves	**Assessment**. The euro has the status of a global reserve currency. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	
Foreign asset and liability position	**Background**. Both assets and liabilities have increased at a rapid pace since 2008, with assets growing faster. The net international investment position turned positive in 2008 and is projected to continue to increase, suggesting a strong external position. Direct investment net assets are considerable at 50 percent of GDP, while portfolio investments are in net liability of approximately 10 percent of GDP. **Assessment**. Net foreign assets of 50 percent of GDP and a safe haven status limit risks from liabilities close to 470 percent of GDP, including significant gross debt.	

	Poland	Overall assessment
Current account	**Background**. The moderate current account deficit largely reflects income repatriation by multinational companies' domestic affiliates and a structural fiscal deficit. It has improved to about 3.5 percent of GDP (around 3 percent of GDP cyclically adjusted), after rising to a peak of 6 percent of GDP in 2007–08. **Assessment**. The cyclically-adjusted current account position is broadly consistent with medium-term fundamentals and desirable policies.	The external position appears broadly consistent with medium-term fundamentals and desirable policies, including fiscal consolidation. Reserves are broadly adequate, and the FCL arrangement provides an added buffer. **Potential policy responses** Fiscal consolidation should continue over the medium term, in line with the authorities' goal of achieving their medium-term objective. Continued. vigilance with respect to funding activities (including foreign exchange swaps) of foreign bank subsidiaries is warranted, including through ongoing preparedness to extend fx liquidity in the face of external shocks.
Real exchange rate	**Background**. The real effective exchange rate appreciated modestly in 2012 as global risk aversion receded. **Assessment**. Model-based estimates suggest the exchange rate is broadly consistent with medium-term fundamentals and desirable policy settings.	
Capital and financial accounts: flows and measures	**Background**. EU regulations do not allow use of capital controls **Assessment**. Capital inflows are increasingly centered on portfolio (notably government bonds), as net FDI inflows slowed and the country experienced other investment outflows (notably external deposits to the banking sector) in 2012. Historically high foreign holdings of government bonds suggest some potential vulnerabilities.	
FX intervention and reserves	**Assessment**. Reserves are broadly adequate, standing at about 140 percent of the IMF's composite reserve adequacy metric, but are less than 100 percent of short-term debt at remaining maturities plus the current account deficit. The Fund FCL arrangement helps as a buffer to external shocks. The zloty has floated freely.	
Foreign asset and liability position	**Background**. Substantial net IIP liabilities have stabilized at 66 percent of GDP. **Assessment**. Vulnerabilities exist, but are mitigated to some degree as much of this represents well-diversified FDI liabilities and associated inter-company lending. Implementation of the planned reduction in the structural fiscal deficit over the medium term would also help improve the net IIP position. Broadly adequate reserves, and the FCL arrangement, also help to mitigate risks that may arise from the high net IIP liabilities.	

	Russia	Overall assessment
Current account	**Background**. The current account surplus declined in 2012 (estimated at around 3½ percent of GDP in cyclically adjusted terms), amid strong import demand and real appreciation of ruble. The current account surplus is expected to decline gradually over the medium term, reflecting a moderating oil price and growing imports. **Assessment**. Model-based estimates as well as an analysis of demographics and the exhaustibility of natural resources suggest that the cyclically-adjusted current account was in line with the value implied by medium-term fundamentals and desirable policy settings.	The external position appears in line with the value consistent with medium-term fundamentals and desirable policy settings. **Potential policy responses** The nonoil fiscal deficit remains significantly higher than its long-term sustainable level (estimated at 4.7 percent of GDP). However, the newly-adopted oil price-based fiscal rule envisages considerable medium-term adjustments, and the remaining gap is relatively small, compared with other countries' adjustment need. The increased flexibility of the exchange rate should help maintain appropriate external balances.
Real exchange rate	**Background**. The real effective exchange rate (REER) has appreciated considerably during 2011–12, due mostly to higher inflation in Russia than in trading partners. **Assessment**. A model-based approach points to a real exchange rate undervaluation of 0–10 percent. However, alternative competiveness indicators, such as estimates of equilibrium dollar wages of the manufacturing sector using broad cross-country panel data, suggest that ruble is broadly in line with medium-term fundamentals, consistent with the current account assessment.	
Capital and financial accounts: flows and measures	**Background**. Capital outflows continued in 2012 (US$54 billion), albeit at a slower pace, which, with limited foreign exchange interventions, broadly mirrored current account developments. **Assessment**. Capital outflows are expected to decline this year. While Russia is exposed to risks of accelerated capital outflows and sudden stops of external funding, the flexible exchange rate and large international reserves would help Russia to better handle such shocks.	
FX intervention and reserves	**Assessment**. Reserves, which include National Wealth Fund savings, were around 172 percent of the IMF's composite adequacy metric at end-2012. Reserves assets are adequate, and there is no need for further reserve accumulation for precautionary purposes. Over time it would be appropriate to invest oil reserve fund assets in less liquid and higher-yielding instruments, limiting the costs of reserve holdings. The exchange rate has shown greater flexibility, and interventions have been limited since early 2011.	
Foreign asset and liability position	**Background**. The net international investment position is in surplus (US$138 billion at end-2011), and the improvement will slow gradually. **Assessment**. A significant proportion of gross liabilities consist of FDI and equities. Total external debt has fallen from about 40 percent of GDP in 2009 to 27 percent in 2012, but vulnerabilities remain in the face of unanticipated events.	

<table>
<tr><th></th><th>Saudi Arabia</th><th>Overall assessment</th></tr>
<tr><td>Current account</td><td>Background. Increased current account surpluses in 2011-12 were driven by higher oil prices and increased oil production as Saudi Arabia acted to help offset supply shocks in the global oil market (higher oil prices and exports boosted export revenues by 19 percent of GDP between 2010 and 2012). In recent years, the share of Saudi non-oil exports in global non-oil exports has increased, but is still less than 1/3 of 1 percent. Oil prices are anticipated to decline over the medium term while oil export volumes are expected to adjust as supply conditions normalize, implying significantly reduced current account surpluses going forward. Errors and omissions are large and consistently negative (average of 7.5 percent of GDP in 2011–12). Over the long term, the current account will be determined by the development strategy chosen—in particular the balance between saving oil revenues overseas to create an income stream for future generations versus investment (public and private) in Saudi Arabia.
Assessment. Using various methodologies designed to reflect the circumstances of large oil exporters, estimated current account norms (reflecting the following medium term fundamental determinants: the non-oil and gas fiscal balance, oil and gas reserves, old-age dependency ratio, population growth rate, initial net foreign assets net of external debt, oil trade balance, growth rate of real per capita GDP, and relative income) vary between 6 and 15 percent of GDP. On current policies, the structural current account balance is within the range of model estimates.</td><td rowspan="5">The external position is in line with medium-term fundamentals and desirable policies, although a large degree of uncertainty around specific estimates should be acknowledged.
Higher oil prices and volumes, as Saudi Arabia fulfilled its commitment to adjust production to stabilize the oil market, pushed the current account surplus higher in 2011 and 2012. With the reversal of these temporary supply shocks and the forecast trend decline in oil prices, the current account is projected to converge to a level broadly consistent with long-term fundamentals.
Potential policy responses
Fiscal spending increased sharply in 2011 and 2012 and is currently above the level implied by intergenerational equity models. Increased government investment on infrastructure and education is appropriate, but it is important to ensure that the composition of spending does not generate permanent increases in entitlements that would be difficult to reverse, particularly given the continued heavy dependence on oil revenues.</td></tr>
<tr><td>Real exchange rate</td><td>Background. Saudi Arabia has maintained a fixed exchange rate against the US dollar without realignment since 1986. The real effective exchange rate is primarily influenced by oil price dynamics and movements in the US nominal exchange rate vis-à-vis major trading partners. While there is little direct impact of oil prices on the domestic price level—domestic oil prices are adjusted very infrequently—oil prices affect prices through government (and therefore consumer) spending.
Assessment. Empirical models linking the real effective exchange rate to the real price of oil suggest that the rate is broadly in line with fundamentals.</td></tr>
<tr><td>Capital and financial accounts: flows and measures</td><td>Background. Inflows are dominated by foreign direct investment, while outflows are largely portfolio investment. Capital account restrictions and underdeveloped domestic capital markets continue to limit portfolio and investment inflows, while higher oil export revenues tend to boost portfolio and investment outflows. Steps to remove some of the barriers to portfolio inflows are under consideration.
Assessment. There are no immediate risks or vulnerabilities associated with capital flows.</td></tr>
<tr><td>FX intervention and reserves</td><td>Background. Saudi Arabia does not have a Sovereign Wealth Fund. The government's foreign assets are held at the central bank within the international reserves. International reserves have increased to approximately 90 percent of GDP or 34 months of import coverage. This value reflects the dual role of reserves in Saudi Arabia—for both precautionary motives and as savings for future generations.
Assessment. Reserve assets are more than adequate for precautionary purposes (measured by traditional metrics); foreign assets accumulation is consistent with the intergenerational transfer of oil revenues.</td></tr>
<tr><td>Foreign asset and liability position</td><td>Background. Assets of both public and private sectors are substantial, with the public sector's assets dominated by the central bank's international reserves. Total external liabilities (portfolio and other investments) amounted to 7.2 percent of GDP in 2011. All external debt is private.
Assessment. There are no immediate vulnerabilities.</td></tr>
</table>

	Singapore	Overall assessment
Current account	**Background**. The current account surplus declined by 6 percentage points to around 18½ percent in 2012 (with a similar decline in the structural balance), as an appreciated real exchange rate and weak external demand dragged on goods exports. Singapore's large surplus reflects the strong goods balance that is partially offset by modest remittance outflows and a small negative income balance (with the latter resulting from income payments on the large stock of inward FDI exceeding income receipts, including from official-sector assets held abroad). The current account surplus reflects the high rate of private and public sector saving as well as Singapore's status as a financial center. **Assessment**. A range of estimates suggest a current account surplus that is stronger than the level consistent with medium-term fundamentals and desirable policies. While non-standard factors (see real exchange rate assessment below) make a quantitative assessment of the current account difficult, a sizable structural decline (on the order of 3-5 percent of GDP) is appropriate. The structural balance is expected to moderate further over the medium term on increased aging-related and other social spending and slower absorption of foreign workers.	The external position appears to be stronger than what is consistent with medium-term fundamentals and desirable policies. In addition to the strength induced by large fiscal deficits in major advanced economies, the strong external position is driven by structural factors and policies that boost the private and public saving rate. **Potential policy responses** From a multilateral perspective, and consistent with the authorities' current policies, increased public spending, a more-even distribution of consumption across generations, and recourse to slower foreign worker inflows would help to further moderate the current account and slow accumulation of foreign assets.
Real exchange rate	**Background**. The 27 percent appreciation of the real effective exchange rate (REER) since 2005—9 percentage points of which occurred since end 2011—has increased the REER above its previous peak in the late 1990s. **Assessment**. While non-standard factors (Singapore is a very small, very open economy that serves as a regional financial center) make quantitative assessment difficult, the real exchange rate appears around 0−10 percent weaker than warranted by medium-term fundamentals (including rapid population aging) and desirable policies.	
Capital and financial accounts: flows and measures	**Background**. The financial account deficit tends to co-move with the global financial cycle (i.e. outflows are larger when global financial activity is strong). This reflects in part reinvestment abroad of income from the foreign assets of the official sector (the largest contributor by sector to net financial flows). Financial flows also encompass sizable net inward FDI and smaller but more volatile net bank-related flows (the result of considerably larger gross inflows and outflows, reflecting Singapore's role as a financial center). The nonbank corporate sector (which includes some SWF-related activities) is generally associated with net outflows. Large reserves, a high sovereign investment rating and strong banks support Singapore's status as a safe haven. **Assessment**. The financial account is likely to remain in deficit as long as income from NFA (recorded in the current account) is reinvested abroad.	
FX intervention and reserves	**Assessment**. With the nominal effective exchange rate as the intermediate target, intervention is undertaken as required to achieve monetary policy's inflation and output goals. At end-2012, official reserves covered 26 percent of short-term external debt, but are much higher than thresholds for other traditional adequacy metrics. Reserves are also a larger share of GDP than in most other financial centers, but this may reflect in part that most other financial centers are located in reserve-currency countries or currency unions. While non-standard factors warrant generous reserve buffers, current levels appear adequate and there is no clear case for further reserve accumulation for precautionary purposes.	
Foreign asset and liability position	**Background**. Available data indicate that as of 2012, net IIP stood at a positive 223 percent of GDP, rising 76 percentage points of GDP since 2008. Assessment. The international investment position is not a major source of risk. Very large short-term gross non-FDI liabilities of 436 percent of 2012 GDP, predominantly deposit taking by banks' Asian Currency Units, could nonetheless pose some vulnerability, although this is mitigated by large official reserve holdings (92 percent of 2012 GDP) and other official liquid foreign assets.	

<table>
<tr><th></th><th>South Africa</th><th>Overall assessment</th></tr>
<tr><td>Current account</td><td>Background. The current account deficit widened sharply to 6.3 percent of GDP in 2012 (5.8 percent of GDP cyclically adjusted), reflecting flat export volumes, a pick-up in imports and softer terms of trade. The export stagnation partly reflected disruptions from labor unrest as well as South Africa’s competitiveness problems.

Structurally, low saving coupled with robust public infrastructure investment is expected to keep the current account deficit elevated over the medium term and despite the planned fiscal consolidation.

Assessment. Model-based estimates suggest that the cyclically-adjusted current account is 2-4 percentage points of GDP weaker than implied by medium-term fundamentals and desirable policy settings.</td><td rowspan="5">The current account deficit has widened sharply, financed to a large degree by portfolio debt flows. The external position appears weaker than consistent with medium-term fundamentals and desirable policy settings. Though the real depreciation in 2013 should help reduce the gap, structural problems underlie the large current account

Low savings relative to investment buoyed by large infrastructure projects also imply substantial current account deficits over the medium term.

Although external debt is still moderate and about half denominated in local currency, external vulnerabilities have risen.

Potential policy responses

Implementation of the authorities’ National Development Plan would help improve competitiveness over the medium term, but additional labor and product market reforms that increase competition and bring domestic costs in line with productivity growth are essential.

The planned fiscal consolidation can help improve the sustainability of the current account. Some tightening of macro-prudential measures to reign in rapid growth of personal loans to households could help encourage household savings. But a substantial increase in household saving will require faster growth in household incomes through much faster employment growth which in turn requires structural reforms.

Building reserves would strengthen the country’s ability to deal with FX liquidity shocks.</td></tr>
<tr><td>Real exchange rate</td><td>Background. After appreciating in 2009–10, the REER depreciated in 2011 and 2012, as the NEER weakened, By April 2013, the REER was 9 percent below its 10 year average. On the other hand, ULC-based measures of the REER, which reflect differences in domestic costs of production more accurately, suggested that the REER was stronger than its 10-year average. Since April, the rand has depreciated amidst high volatility.

Assessment. Direct approaches to estimating the equilibrium exchange rate are complicated by structural changes since 1994 and the high volatility exhibited by the REER.

Model-based estimates suggest that the CPI-based REER was slightly undervalued as of 2013 Q1. However, several indicators of external competiveness, including South Africa’s declining share on world’s exports and the ULC-based REER, point in the opposite direction. Applying mechanically trade elasticities to close the current account gap suggested an overvaluation of 10-15 percent by the first quarter of 2013. Although the rand depreciation since then should help reduce the current account gap, structural factors will likely keep the external position weaker than justified by fundamentals and desired policies.</td></tr>
<tr><td>Capital and financial accounts: flows and measures</td><td>Background. Portfolio inflows, particularly foreign purchases of local currency government bonds, have accounted for a large and increasing share of the CAD financing in recent years. South Africa benefits from its relatively large share in major EM indices and its 2012 inclusion in the WGBI.

Assessment. The risks posed by portfolio flows and large nonresident financial holdings are mitigated by the free-floating exchange rate, the fact that the inflows go into long-term, local currency bonds, the large share of index tracking investors, and the large domestic institutional investors’ base. Nevertheless, a slow down or sudden stop of capital inflows would complicate the financing of the twin deficits, possibly prompting disorderly adjustments.</td></tr>
<tr><td>FX intervention and reserves</td><td>Background. South Africa’s exchange rate regime is one of the most flexible among EM. SARB intervention is rare.

Reserves cover 5 months of imports about 80 percent of the gross external financing requirement, but are expected to be slightly below the lower bound of the IMF’s composite adequacy metric. Gold reserves account for about 12 percent of reserves.

Assessment. Some reserve accumulation is desirable.</td></tr>
<tr><td>Foreign asset and liability position</td><td>Background. Gross external debt is modest (at 36 percent of GDP), but is expected to rise gradually over the medium term. Short-term external debt is also relatively low. More than half of the external debt is denominated in rand. Nevertheless, a sudden stop of portfolio inflows is an important vulnerability.

Assessment. The net IIP position (-6 percent of GDP in 2011) is not seen as a major source of risk, but gross positions are large and the IIP position is expected to continue to deteriorate given the projected large CAD.</td></tr>
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<table>
<tr><th></th><th>Spain</th><th>Overall assessment</th></tr>
<tr><td>Current account</td><td>Background. The current account deficit stood at 1 percent of GDP in 2012, or 1.8 percent of GDP cyclically-adjusted), falling from its peak in 2007 at 10 percent of GDP.
Assessment. Although model-based estimates of current account norms do not suggest a significant gap, the overriding need to sharply improve the net international investment position (IIP) suggests that, in line with medium-term projections, a significant improvement in the cyclically-adjusted current account balances would be appropriate. Taking this into account, the 2012 current account appears to be 3–5 percentage points of GDP weaker that the value implied by medium-term fundamentals and desirable policy settings.</td><td rowspan="5">Despite the recent sharp improvement in the current account, the external position appears substantially weaker than that consistent with medium-term fundamentals and desirable policy settings.
The net IIP remains highly negative and indicators point to substantial real effective exchange rate overvaluation.
The recent labor market reform and the ongoing fiscal consolidation should help improve the current account and price competitiveness
Potential policy responses
Because the current account improvement partly reflects domestic demand compression and a sizeable output gap, attaining strong and sustainable growth and full employment would require a significantly weaker real effective exchange rate.
The authorities' current policy plans to deliver fiscal consolidation, to push further on product market reforms and to continue with bank restructuring program are in line with reducing imbalances.
Further reforms of the labor market and accelerated implementation of product market reforms would be required to speed up the adjustment by bringing down labor costs and reduce mark ups.</td></tr>
<tr><td>Real exchange rate</td><td>Background. In 2012, the CPI-based REER had declined by 4 percent from its 2008 peak. This was only a limited reversal of the almost 16 percent appreciation since euro entry. The ULC-based REER, however, shows a nearly full reversal of pre-crisis appreciation. These recent improvements significantly reflect apparent productivity gains from labor shedding and cuts in public sector compensation. Export market shares have been resilient.
Assessment. Model-based REER analysis suggests the real effective exchange rate is about 8-12 percent above the level consistent with medium-term fundamentals and desirable policies. Achieving domestic equilibrium, especially full employment, would, however, likely imply an even greater gap.</td></tr>
<tr><td>Capital and financial accounts: flows and measures</td><td>Background. Large portfolio debt outflows by non-residents took place in 2010–12, adding external financing needs to the current account deficit. Despite residents' portfolio repatriation, a private financial account deficit opened up in 2011 and 2012, compensated by increased ECB refinancing of Spanish banks (reflected in TARGET2 imbalances). Since the ECB's OMT announcement, financing conditions have eased, non-resident portfolio outflows have abated, and ECB borrowing has fallen.
Assessment. Large external financing needs both in the public and private sector leaves Spain vulnerable to changes in market sentiment. However, the ECB's OMT program has greatly helped improve sentiment and reduce risks of a liquidity crisis.</td></tr>
<tr><td>FX intervention and reserves</td><td>Assessment. The euro has the status of a global reserve currency. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</td></tr>
<tr><td>Foreign asset and liability position</td><td>Background. Large net IIP liabilities have stabilized around 90 percent of GDP since 2009. A further large improvement in the current account would be needed to reduce net liabilities, suggesting a weak external position.
High gross external debt has also stabilized close to 170 percent of GDP since 2010.
Assessment. The negative IIP and large gross financing needs from external debt are major sources of external vulnerability.</td></tr>
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<table>
<tr><th></th><th>Sweden</th><th>Overall assessment</th></tr>
<tr><td>Current account</td><td>Background. The current account surplus remained almost unchanged at 7.1 percent of GDP in 2012 (cyclically adjusted also around 7.1 percent of GDP) relative to the previous year when it represented 7 percent of GDP. This in part reflects continued strong exports in spite of the cooling in the euro area with which Sweden has tight trade and financial linkages.
Assessment. Various approaches point to a cyclically-adjusted current account that is 2–4 percent of GDP stronger than the value implied by medium-term fundamentals and desirable policies.</td><td rowspan="5">The external position appears stronger than the one consistent with medium-term fundamentals. Sweden has benefited from strong fundamentals relative to euro area, including wage moderation.
Potential policy responses
The undervaluation likely reflects some structural factors such as higher savings rates following the phased-in pension reform. Hence, current policies in place are appropriate.</td></tr>
<tr><td>Real exchange rate</td><td>Background. Safe-haven flows driven by Sweden’s strong (both in absolute and relative terms) fiscal and growth position have put upward pressures on the krona, which has appreciated in real effective terms by over 5 percent since its trough in early 2009 (and by around 25.percent against the euro), having reached a ten-year high in August 2012.
Assessment. Despite the continued strengthening of the krona, the model estimates suggest a real exchange rate undervaluation of some 3.5-8.5 percent relative to its long-run equilibrium.</td></tr>
<tr><td>Capital and financial accounts: flows and measures</td><td>Background. The surplus in the current account is balanced by a deficit in the financial account (mainly FDI and bank flows). Banks’ liquidity risk vis-à-vis a renewed EU banking crisis is a vulnerability even though banks have improved their structural liquidity measures in 2011 and 2012.
Assessment. A further rebalancing of flows, with a drop in short-term flows at the expense of longer ones, is desirable.</td></tr>
<tr><td>FX intervention and reserves</td><td>Background. While the krona floats freely, the Riksbank has decided to gradually boost its currency reserves by about one-third to around USD 55 billion (10 percent of GDP) to pre-empt possible financial sector liquidity shortages. The entire amount will be borrowed using bonds and short-term securities in foreign currencies (primarily euro and dollar) with maturities of up to five years.
Assessment. Though such pre-emptive reserve accumulation is a conservative move by the central bank, given the large gross external liabilities of banks, maintaining FX liquidity buffers—in the form of reserves and swap lines—is advisable.</td></tr>
<tr><td>Foreign asset and liability position</td><td>Assessment. The net IIP is slightly negative (-14.4 percent of GDP at 2012 Q4) and is expected to weaken slightly before turning positive in the medium term, suggesting a strong external position.
Gross liabilities (268 percent of GDP in 2012) create vulnerabilities. In particular, external debt liabilities are large, including a proportion of liquid liabilities from the banking sector.</td></tr>
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	Switzerland	Overall assessment
Current account	**Background**. Switzerland has a large current account surplus (13½ percent of GDP in 2012 according to preliminary estimates or about 14 percent in cyclically-adjusted terms) dominated by service exports and net investment income. The latter is very volatile and preliminary estimates of current account are subject to large revisions. In addition, correcting for the foreign ownership of FDI retained earnings and domestic ownership of the retained earnings of foreign multinationals could reduce the balance by 2-5 percentage points (SNB estimates for 2009-11), while accounting for cross-border shopping would further increase imports. **Assessment**. The cyclically-adjusted current account surplus in 2012 is some 0-5 percent of GDP above the level implied by medium-term fundamentals and desirable policy settings, mostly reflecting a large preliminary estimate of net investment income, particularly FDI income. Given the preliminary nature of the data and other factors discussed above, there are considerable uncertainties around this assessment.	The underlying external position is moderately stronger than the level consistent with medium-term fundamentals and desirable policy settings, but this assessment is complicated by measurement and other issues and is subject to unusual uncertainty. The real exchange rate is moderately overvalued because of safe-haven capital inflows, but the overvaluation is eroding over time given negative inflation differentials with trading partners. As a rapid real appreciation threatened to destabilize the economy with deflationary pressures, Switzerland successfully imposed a floor on the franc-euro rate, curbing further appreciation. The introduction of the floor was appropriate in light of the risk of economic contraction and deflation. In the authorities view the exchange rate is significantly overvalued. **Potential policy responses** Introducing negative interest rates on bank excess reserves at the SNB might discourage inflows if exchange rate pressures return. Once growth recovers and inflation returns to comfortable levels, the credibility of the ceiling may be called into question and the central bank should return to floating the currency to avoid stoking inflation.
Real exchange rate	**Background**. The Swiss franc appreciated by more than 30 percent in real effective terms from mid-2007 to August 2011. Since Sept 2011, the central bank has enforced a floor of 1.20 for the CHF/EUR rate and the Swiss franc has traded above that level. The REER has depreciated by 7 percent between September 2011 and May 2013 as a result of nominal depreciation and negative inflation differentials. **Assessment**. Model-based estimates suggest that the real effective exchange rate is overvalued by 5-10 percent relative to its medium-term fundamentals and desirable policy settings.	
Capital and financial accounts: flows and measures	**Background**. The large current account surpluses have led to accumulation of foreign exchange reserves and increases in the net foreign direct investment position (in large part via reinvestment of retained earnings). **Assessment**. Switzerland continues to face the risk of safe-haven capital inflows and/or reduced outflows if a tail event occurs in the euro area or problems in the euro periphery persist.	
FX intervention and reserves	**Background**. The SNB has accumulated massive foreign exchange reserves during 2009–12 following several rounds of intervention. As a result of interventions in the spring and summer of 2012 reserves increased by 175 billion (29 percent of GDP). **Assessment**. The introduction of the floor was appropriate in light of the risk of economic contraction and deflation. The credible exchange rate arrangement mitigated the need for reserve accumulation initially, but reserves are on the rise again with a large scale intervention from the SNB as a result of the intensification of the European crisis and, to a lesser extent, a continued increase in global liquidity. The central bank has access to dollar swap lines with the US Federal Reserve.	
Foreign asset and liability position	**Background**. Switzerland is a financial center and has a positive IIP position of 150 percent of GDP, and large gross foreign asset/liability positions. Valuation changes due to exchange rate movements have also had a significant effect on the IIP position. **Assessment**. A healthy asset position, policy credibility and large reserves, mitigate the risks from large and liquid gross liabilities.	

	Thailand	Overall assessment
Current account	**Background**. Thailand's current account has been quite volatile over the last decade, ranging from a 4¼ percent deficit to 8¼ percent surplus, against the backdrop of a relatively stable trend real appreciation, and volatile economic fundamentals. The current account surplus came down sharply from its peak in 2009 at 8¼ percent of GDP to 0.7 percent in 2012 (2 percent cyclically adjusted) and is expected to remain close to balance over the medium term, as large investment projects raise imports and the baht continues to appreciate in real terms. **Assessment**. Thailand's cyclically adjusted current account is close to its norm; model-based and other estimates suggest a cyclically adjusted current account that is about 0-2 percentage points, of GDP stronger than the value consistent with medium-term fundamentals and desirable policies.	The external position is consistent with medium-term fundamentals and desirable policy settings. Thailand's current account is likely to remain close to its norm and the exchange rate is assessed to be fairly valued. To the extent that higher infrastructure investment adds to the productive capacity of the economy its equilibrium real effective exchange rate is likely to appreciate. **Potential policy responses** A medium-term infrastructure investment policy is key to unlocking growth by boosting private investment, which would reduce existing current account surpluses. The authorities should allow the nominal effective exchange rate to follow fundamentals. The more-than-adequate reserves can support two-way flexibility of the baht while still providing some scope for intervention to prevent exchange rate overshooting and smoothing excessive volatility. To deal with the impact of strong capital inflows, macroprudential policies should also be considered.
Real exchange rate	**Background**. Barring the global financial crisis, the Thai baht has been appreciating in real effective terms since 2005. **Assessment**. A number of methodologies suggest that the Thai baht is consistent with medium-term fundamentals and appropriate policies.	
Capital and financial accounts: flows and measures	**Background**. While equity flows were mostly flat over 2012, bond inflows have been very large and volatile, reaching historic peaks at times, and reversing during periods of heightened domestic or external uncertainty. **Assessment**. While capital flows to banks reflect mostly hedging activities of the trade sector and therefore follow the trade balance, portfolio flows are driven by global push factors as well as the relatively better fundamentals of the Thai economy compared to advanced economies. Portfolio inflows are expected to continue, although they will increasingly be offset by outward investment as the authorities push forward with their financial account liberalization plans.	
FX intervention and reserves	**Background**. Foreign currency reserves are about 50 percent of GDP, over four times short-term debt, and at 297 percent of the IMF's composite metric. Thailand's net forward FX position (7 percent of GDP in 2012), has been increasing since mid-2012. **Assessment**. Thailand's gross reserves are more than adequate and there is no need to build up reserves for precautionary purposes. Intervention has smoothed volatility but sterilization costs have increased and there is room for more two-way exchange rate flexibility.	
Foreign asset and liability position	**Background**. Net foreign assets had been rising steadily as a percentage of GDP from the large deficit they hit following the Asian crisis until 2011, when large inflows of direct and portfolio investment raised foreign liabilities and lowered the net investment position to -9 percent of GDP. Net foreign assets are currently rising but would be expected to remain broadly stable, although further liberalization of outflows could raise both foreign assets and liabilities. **Assessment**. There are limited risks to external debt sustainability because Thailand's external debt is projected to remain low and net foreign assets (as a percent of GDP) are expected to stabilize.	

	Turkey	Overall assessment
Current account	**Background**. The current account deficit adjusted to 6.1 percent of GDP in 2012 (4.7 percent of GDP on a cyclically adjusted basis), down from 9.7 percent in the previous year. **Assessment**. A substantial adjustment took place in 2012, driven by both cyclical and structural factors. However, model results suggest a cyclically-adjusted current account deficit that is 1.5-3 percent of GDP weaker than the level implied by medium-term fundamentals and desirable policy settings.	The external balance has improved vis-à-vis 2011, as have external buffers. However, the external position continues to be weaker than the level consistent with medium-term fundamentals and desirable policy settings. Turkey remains vulnerable to a large capital flows reversal. **Potential policy responses** Given the country's external imbalances, a tighter fiscal policy over the medium term and continued structural reforms to increase private savings (such as last year's changes to private sector contributions) are desirable.
Real exchange rate	**Background**. The Real exchange rate appreciated by 4 percent in 2012 largely due to higher inflation than in trading partners. **Assessment**. Model results point to a real effective exchange rate that is 10-20 percent stronger than the level that can be explained by medium-term fundamentals and policy deviations from desirable settings.	
Capital and financial accounts: flows and measures	**Background**. Turkey has received substantial capital inflows in recent years. In 2012 net inflows, including errors and omissions, amounted to some 10 percent of GDP, thereby over-financing the current account deficit and resulting in reserve accumulation. Despite improvements in the maturity composition of capital inflows, short-term debt remains the predominant financing instrument. Turkey has not resorted to capital controls on either inflows or outflows. Rather, it has used the reserve requirement ratio (RRR) and reserve option mechanism (ROM) as tools to manage liquidity. **Assessment**. Despite improvements in the current account deficit, short-term debt inflows expose Turkey's private sector to significant rollover risks. Gross external financing needs are estimated at a large 28 percent of GDP in 2013. In an environment of ample global liquidity, these risks have not thus far materialized, but continue to pose a major vulnerability.	
FX intervention and reserves	**Background**. The Central Bank has not intervened in the exchange rate since January 2012. The ROM has been the instrument of choice to accumulate reserves in the face of capital inflows, helping to alleviate pressure on the lira. **Assessment**. Turkey's gross reserves of $119 billion at end-2012 increased from $88 billion the year before. The 2012 reserves account for 115 percent of the IMF composite adequacy metric versus 99 percent in 2011. Reserves cover of short-term debt rose to 87 percent in 2012 compared with 71 percent in 2011. Reserve coverage is also adequate when using other traditional metrics. However, reserves accumulation is warranted for precautionary reasons given uncertainty in global liquidity flows.	
Foreign asset and liability position	**Background**. Turkey's net international investment position is about -53.2 percent of GDP, and it is comparable to peers. However, the NFA position has worsened by 8.4 percentage points of GDP since 2009 and the deterioration is projected to continue. The composition of NFA has also deteriorated in recent years, with short-term debt liabilities accounting for a growing fraction of total liabilities. **Assessment**. The current NFA level does not point to a solvency problem at this stage, but Turkey remains exposed to liquidity vulnerabilities.	

<table>
<tr><th></th><th>United Kingdom</th><th>Overall assessment</th></tr>
<tr><td>Current account</td><td>Background. Prior to the crisis, the United Kingdom had a substantial current account deficit due to strong domestic demand. In the aftermath of the crisis the trade and current account balances had a transitory improvement, but have reverted back to the levels observed in 2007. The cyclically adjusted current account was -3.8 percent of GDP in 2012.
Assessment. Model estimates suggest that the cyclically-adjusted current account balance (after adjusting for the output gap and terms of trade) is some 1–2 percent of GDP weaker than the value implied by medium-term fundamentals and desirable policies.</td><td rowspan="5">The external position is moderately weaker than implied by medium-term fundamentals and desirable policy settings.
From an accounting perspective, this reflects the position of public and private saving rates. More fundamentally, the external position is influenced by the lack of trade competitiveness.
Potential policy responses
Sustaining a strong and durable recovery in the UK requires a rebalancing away from public support toward private-sector led demand, along with a greater reliance on external demand.
The authorities are pursuing fiscal consolidation, which, per se, would normally be expected to improve national savings. However, given that households banks and (to a lesser extent) firms are also attempting to save more than usual, the overall effect would weaken growth. Bringing forward infrastructure spending and other growth enhancing measures, within a medium-term fiscal framework, could help bridge to a more sustained pick-up in private demand, notably investment.
The authorities have implemented some growth-friendly fiscal measures. More structural reforms (in improving infrastructure, skills, and banking competition) would help to improve competitiveness.</td></tr>
<tr><td>Real exchange rate</td><td>Background. The necessary fiscal consolidation and deleveraging of the private sector imply that the relative demand for non-tradables will be low over the medium term.
Assessment. Various methodologies suggest a decline in the real effective exchange rate of the order of 5–10 percent may be appropriate given medium-term fundamentals and desirable policy settings, although, there is uncertainty regarding the precise magnitude of exchange rate misalignment. For instance, the recent depreciation of the real exchange rate has not propelled an improvement of net exports suggested by standard trade elasticities.</td></tr>
<tr><td>Capital and financial accounts:
flows and measures</td><td>Background. Given the UK's role as an international financial center, portfolio and bank flows are the key components of the financial account.
Assessment. With safe haven inflows offset by debt outflows, and while the depth of the sterling market provide it with some cushion against idiosyncratic moves, the fickle nature of some flows into the UK is a potential vulnerability for sterling.</td></tr>
<tr><td>FX intervention and reserves</td><td>Assessment. Reserves held by the UK are typically low relative to standard metrics, but the currency is free floating.</td></tr>
<tr><td>Foreign asset and liability position</td><td>Background. The UK's net international investment position improved substantially during the crisis as the exchange rate depreciation yielded positive valuation effects. Current account deficits are worsening the net international investment position suggesting a weak external position, although net liabilities remain relatively low at about 35 percent of GDP at end-2012.
Assessment. Gross liabilities exceed 500 percent of GDP, including a high proportion of short-term debt. These are offset by large holdings of equities. Large and highly liquid gross liabilities create vulnerabilities for the UK's large financial sector, despite continuing efforts to strengthen regulation and supervision.</td></tr>
</table>

	United States	Overall assessment
Current account	**Background**. The US current account deficit narrowed from 6 percent of GDP prior to the crisis to around 3 percent of GDP during 2009–12 due to higher private saving and lower private investment (and was -3.8 percent of GDP cyclically adjusted). It is projected to worsen modestly as the output gap closes. **Assessment**. Model estimates suggest that the cyclically-adjusted current account deficit is½–1½ percentage points of GDP weaker than the value implied by medium-term fundamentals and desirable policies	The US external position is moderately weaker than implied by medium-term fundamentals and desirable policies. **Potential policy responses** Over the medium term, fiscal consolidation should aim for a general government primary surplus of about 1 percent of GDP (corresponding to a federal government primary surplus of 1¾ percent, higher than the 1 percent surplus envisaged in the President's budget and staff's projection of a very small deficit). This, together with some depreciation of the dollar would be consistent with maintaining external stability and full employment.
Real exchange rate	**Background**. The dollar appreciated in real effective terms by some 2½ percent over the summer of 2012, with an increase in global risk aversion, and subsequently depreciated by a similar amount as market confidence returned. It is currently over 10 percent below its average value over the past 2-4 decades. **Assessment**. Estimates relying on current account assessments suggest a mild overvaluation given underlying fundamentals and desirable policies. The range of direct estimates of equilibrium real exchange rates is instead centered around zero, reflecting primarily the dollar's current weakness relative to a long-run average. On balance, staff assesses that a further depreciation of the dollar in the range of 0–10 percent would be associated with a level of the dollar and a current account balance broadly consistent with medium-term fundamentals and desirable policies.	
Capital and financial accounts: flows and measures	**Background**. Both inflows and outflows are substantially lower than the levels observed prior to the Lehman crisis (including US portfolio investment overseas, despite record-low US interest rates). The US dollar reserve currency status and safe haven motives boost foreign demand for US Treasury securities during periods of market turbulence even as US overseas investments fall. Hence the outlook for capital flows in the United States will depend on global financial stability and the pace of the global recovery, as well as on the outlook for the US economy and its public finances. **Assessment**. The United States has a fully open capital account. Vulnerabilities are limited by the dollar's status as a reserve currency and the United States' role as a safe haven.	
FX intervention and reserves	**Assessment**. The dollar has the status of a global reserve currency. Reserves held by the U.S. are typically low relative to standard metrics, but the currency is free floating.	
Foreign asset and liability position	**Background**. The net IIP declined from -17 percent of GDP in 2010 to an estimated -28 percent of GDP in 2012, and would deteriorate further under staff's baseline scenario, suggesting some overvaluation. Still, given the large external imbalances of the last decade, the decline in the international investment position has been modest as the falling dollar and rising overseas equity prices raised the value of US assets overseas. **Assessment**. Risks to external stability could come from a decline in foreign demand for US debt securities (the bulk of US external liabilities), driven for example by a protracted failure to restore long-run fiscal sustainability. Still, given the dollar's reserve currency status, current vulnerabilities are limited. Most US foreign assets are denominated in foreign currency; over 50 percent are in the form of FDI and portfolio equity claims and hence tend to decline in value in periods of global growth and stock market weakness, as well as US dollar appreciation.	