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2014 Pilot External Sector Report—Individual Economy Assessments

Prepared by the Research Department
International Monetary Fund

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2014 PILOT EXTERNAL SECTOR REPORT—INDIVIDUAL ECONOMY ASSESSMENTS

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

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

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

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International Monetary Fund
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INTERNATIONAL MONETARY FUND

2014 PILOT EXTERNAL SECTOR REPORT— INDIVIDUAL ECONOMY ASSESSMENTS

June 26, 2014

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INDIVIDUAL ECONOMY ASSESSMENTS

A. The External Sector Assessments

The external sector assessments use a wide range of methods, including the External Balance Assessment (EBA) developed by the IMF's Research Department to estimate desired current account balances and real exchange rates (see Box 3 of the 2014 Pilot External Sector Report, also IMF Working Paper WP/13/272 for a complete description of the EBA methodology). 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 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. 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	

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 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 3/4 percent of GDP.

D. Individual Economy Assessments—by Economy

	Australia	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The negative net international investment position (NIIP), although at around -53 percent of GDP is larger relative to many other advanced countries, has been broadly stable for many years. Debt liabilities are split equally between FDI, banks' borrowing abroad, and foreign holdings of government bonds. Looking forward, the trade balance is projected to turn positive in the near term, offset by a widening income account deficit. On net the current account deficit is expected to remain below 4 percent of GDP over the medium term, broadly stabilizing the NIIP to GDP ratio. **Assessment**. Australia's NIIP level and trajectory are sustainable and the balance sheet does not pose particular near term risks. The maturity of banks' external funding has improved since the global financial crisis, and 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. The economy as a whole has a net foreign currency asset position, implying that a nominal depreciation of the exchange rate would strengthen Australia's overall balance sheet.	**Overall Assessment**: *The external position is moderately weaker than the level consistent with medium-term fundamentals and desirable policy settings*. The gap appears to be partly driven by the strength of the exchange rate related to ample global liquidity, the relative attractiveness of highly-rated Australian assets, and an investment boom which is expected to drop sharply in the near term. **Potential policy responses**: If some of the factors accounting for the strong Australian dollar were to ease, possibly triggered by a faster-than-expected exit from unconventional monetary policies by major advanced economies, the exchange rate would likely depreciate further, supporting the transition of the economy towards more balanced growth. The government's planned fiscal consolidation should help improve the current account by boosting national savings over the medium term, and additional steps to encourage private saving such as the planned increase in the superannuation contribution rate will also help.
Current account	**Background**. Australia has run current account (CA) deficits for most of its history, with deficits averaging around 4 percent of GDP in the last three decades. The deficit is expected to remain below this level in the medium term as imports related to mining investment decline and mining export capacity comes on stream, offset by a widening income account deficit as global interest rates normalize and mining income accruing to foreign investors increases. **Assessment**. Australia's persistent CA deficits reflect a structural saving-investment imbalance with very high private investment relative to a saving rate which is already high by advanced country standards. After accounting for Australia-specific factors driving investment, the staff assessment is that the cyclically-adjusted current account is about ½ to 2 percent of GDP below the level implied by medium-term fundamentals and desirable policy settings. 1/	
Real exchange rate	**Background**. Despite the depreciation in 2013 the real effective exchange rate (REER) remains elevated and is still around 20 percent above its average over the last 30 years. There are a number of factors contributing to the current high level of the Australian dollar, including the high terms of trade, substantial capital inflows to fund the mining sector investment, and the gap between domestic and foreign interest rates. **Assessment**. Taking into account factors including the relative attractiveness of highly-rated Australian assets, staff assesses the REER as of May 2014 to be 5 to15 percent stronger than the level implied by medium-term fundamentals and desirable policy settings. 2/	
Capital and financial accounts: flows and policy measures	**Background**. The mining investment boom has been funded predominantly offshore. Net FDI inflows into this sector have partially offset the reduced need for the banking sector to borrow abroad. As investment in new mining projects winds down, related demand for imports will decrease, buffering the impact on the overall balance of payments. Australia also received large inflows in recent years into bond markets given its sound fiscal position relative to other advanced economies, owing to relatively high interest rate differentials. **Assessment**. The credible commitment to a floating exchange rate and strong fiscal position limit vulnerabilities from capital flows.	
FX intervention and reserves level	**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.	

	Australia (continued)
Technical Background Notes	1/ See Australia: Staff Report for the 2013 Article IV Surveillance, Annex 3 and 4. The EBA CA regression approach estimates a CA gap of -1.1 percent of GDP, although this estimate may not take into account Australia-specific factors such as the sharp increase over the past decade in mining-related investment. 2/ The EBA REER regression approach estimates a gap of +17 percent for the 2013 average REER, implying an overvaluation of about 15 percent at the current level of the exchange rate.

	Belgium	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) remains strong at 48 percent of GDP at end-2012, reflecting very healthy private balance sheets. Despite Belgium's decline as a financial center, gross foreign assets are large (464 percent of GDP at end-2012). Gross foreign assets of the financial sector stood at 128 percent of GDP, down considerably from the pre-crisis peak. But the gross foreign assets of the private non-financial sector have continued to grow to 320 percent of GDP in 2012, reflecting in large part the growth of inter-group corporate transactions. The net external position of the public sector was -52 percent of GDP in 2012. **Assessment**. Belgium's large gross external positions reflect its position as a center for corporate treasury units. Risk exposures on the asset side are mostly related to financial sector foreign claims. Risk exposures on the liability side are related to the external public debt (57 percent of GDP). Based on the projected current account and growth paths, the NIIP to GDP ratio is expected to decline gradually forward. The strongly positive NIIP and its trajectory do not raise sustainability concerns.	**Overall Assessment**: *The external position is weaker than the level consistent with medium-term fundamentals and desirable policy settings.* This reflects fiscal deficits and recent losses in cost competitiveness. Measures taken by the government to contain wages will help reverse some of the competitiveness loss. The strong net international investment position counters the vulnerabilities associated with the high external public debt. **Potential policy responses**: Planned steady fiscal consolidation and reductions in labor taxes will help improve competitiveness and correct the external imbalance. The impact of these policies would be enhanced by continued wage moderation and productivity enhancing structural reforms (in the labor and product markets) to restore cost and non cost competitiveness.
Current account	**Background**. The current account (CA) 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. The cyclically-adjusted CA balance has also deteriorated and is estimated at -1 percent of GDP for 2013. About ¾ of this deterioration since 2009 originates from higher government deficits, and the rest from a worsening net saving position of the private sector. **Assessment**. The EBA model estimates a CA gap of -2.3 percent of GDP for 2013. The staff assessment is similar, with the cyclically-adjusted current account weaker than the level consistent with medium-term fundamentals and desirable policy settings, by 2 to 4 percent of GDP. 1/ Projected fiscal adjustment over the medium term is consistent with a gradual convergence of the current account balance to a small surplus in the medium term, which would close most of the EBA-estimated gap.	
Real exchange rate	**Background**. Unit labor costs point to a gradual loss of competitiveness since 2005. Most of this comes from lower productivity growth, but excessive wage growth relative to trading partners also has contributed. **Assessment**. EBA model estimates which point to a real effective exchange rate (REER) which is overvalued by 5 to 10 percent. The staff assessment is of a similar REER gap, relative to the level consistent with medium-term fundamentals and desirable policy settings. 2/	
Capital and financial accounts: flows and policy measures	**Background**. Gross financial outflows and inflows grew steadily during the pre-crisis period along the expansion of banks' cross-border operations. Similarly, they have shrunk since 2007 along the bank deleveraging. Short-term debt accounts for about 40 percent of the external liabilities and financing need. The capital account is open. **Assessment**. Belgium remains exposed to financial market risks but the structure of financial flows does not point to specific vulnerabilities. The strong net international investment position reduces the vulnerabilities associated with the high public debt.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	

	Belgium (continued)
Technical Background Notes	1/ Belgium's status as a center of corporate treasury activities and its resulting large gross foreign asset and liability positions complicate the measurement of the current account, and thus are a source of uncertainty about the CA assessment. 2/ The REER gap assessment is consistent with the staff's CA gap assessment, considering the relatively high ratios of exports and imports to GDP, which tend to make the CA more responsive to the REER.

	Brazil	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Brazil's NIIP stood at -34 percent of GDP at end-2013 (with gross assets and liabilities of 34 and 67 percent of GDP, respectively), above the average of the previous decade. Almost half of external liabilities are FDI. The NIIP is projected to deteriorate moderately (by about 5-10 percent of GDP) over the coming years, partly on account of investment needs, including for developing *pre-salt* oil reserves. **Assessment**. The projected gradual deterioration of the NIIP could be reversed over the medium term if the expected export receipts from *pre-salt* oil development contribute to raising saving.	**Overall Assessment**: *Brazil's external position is moderately weaker than the level consistent with medium-term fundamentals and desirable policy settings*. FDI is expected to remain strong, but other flows could be volatile. **Potential policy responses**: Further efforts to increase national saving are needed, including by advancing with pension reform and shifting the structure of public spending away from consumption. Foreign exchange intervention, including through the use of derivatives, can be appropriate to address bouts of excess volatility in the exchange rate market arising from changes in capital flows and surges in demand for hedging, but should not be used to resist currency pressures that reflect changes in fundamentals.
Current account	**Background**. Despite subdued growth and a real depreciation since April, Brazil's current account (CA) deficit increased to 3.6 percent of GDP (2.9 percent cyclically adjusted) in 2013 on weakening terms of trade and strong consumption. Going forward the favorable effects of the depreciation since May 2013 on net exports are likely to be broadly offset by the expected recovery of investment and by soft terms of trade. Brazil's CA is vulnerable to a sharp and sustained decline in commodity prices. Higher investment could also widen the deficit unless domestic savings are mobilized. 1/ On the upside, large oil discoveries will boost exports in the longer term. **Assessment**. The CA appears weaker than the level consistent with medium term fundamentals and desirable policy settings. Estimates suggest a current account norm in the range of -2.4 (EBA CA regression approach) to -0.5 percent of GDP (to stabilize NIIP). A narrower gap range of -1 to -2.5 percent of GDP is consistent with the staff's assessment.	
Real exchange rate	**Background**. Brazil's real effective exchange rate (REER) appreciated by more than 30 percent (on average) since 2000. The REER depreciated by 14 percent from April 2013 to August 2013, but between August 2013 and April 2014 it appreciated by some 9 percent. **Assessment**. Estimates suggest that the average 2013 real effective exchange rate (REER) was some 4-21 percent overvalued (EBA CA approach, 4 percent; EBA REER approach, 7 percent; NIIP-stabilizing approach, 21 percent). Staff's assessment is that the 2013 REER was some 5-15 percent above the level implied by fundamentals and desirable policies. As of April 2014, the REER had appreciated by about 1 percent compared to its 2013 average. 2/	
Capital and financial accounts: flows and policy measures	**Background**. Brazil continues to attract sizable capital inflows, including net FDI flows of about 3 percent of GDP per annum. During 2013 strong portfolio inflows were largely offset by larger "other investment" outflows reflecting exporters' receivables. Interest differentials and the projected economic recovery will continue to attract net inflows over the medium term. External debt remains low at 14 percent of GDP. 3/ CFMs introduced in previous years to moderate inflows and influence their composition were rolled back in 2013 as global liquidity tightened. **Assessment**. The composition of flows has a favorable risk profile, but this can change quickly. Managing flows is likely to remain a challenge.	
FX intervention and reserves level	**Background**. Brazil has a floating exchange rate. Central bank intervention has been geared at reducing volatility and managing capital inflows, which resulted in a large increase of international reserves during 2006 to mid-2011. Since mid-2011, reserves have remained broadly stable. Intervention in 2013 relied on the use of foreign exchange non-deliverable forwards and foreign exchange repos; these strategies leveraged reserves without selling them in the spot market. 4/ Since August 2013, discretionary interventions were replaced by pre-announced daily auctions. **Assessment**. The flexible exchange rate has been an important shock absorber. Reserves are above adequate levels relative to various criteria including the IMF's composite reserve adequacy metric. Intervention can be appropriate if aimed at avoiding excessive FX volatility stemming from large or sudden changes in capital flows and/or demand for hedging, but should not be used to resist currency pressures that reflect changes in fundamentals.	

	Brazil (continued)
Technical Background Notes	1/ Brazil's domestic saving is low compared to other emerging economies. 2/ The estimated appreciation of the REER relative to both August 2013 and the 2013 average is calculated using revised CPI series of trading partners where applicable. 3/ Significant offshore issuances by non-resident subsidiaries (8 percent of GDP) are reflected in standard, residence-based external debt statistics when loaned back to the respective parent companies. 4/ In the forex repo, the Central Bank sells dollars with the commitment to repurchase them at a pre-determined future date. That is, the Central Bank retains a long dollar position following execution of the repo. In the non-deliverable forward, the Central Bank enters into a contract whereby it agrees to pay the onshore dollar rate on a given notional value plus the variation in the exchange rate, and to receive the SELIC rate on the BRL equivalent (at the moment of initiation) of the given notional value. The net value of these payments is redeemed in local currency. Under this mechanism, the Central bank pays the holder if the BRL depreciates by more than the difference between the SELIC rate and the onshore dollar rate, and receives payment from the holder in the opposite case. This instrument provides hedging to agents with prospective hard currency needs.

	Canada	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. After hovering at about -15 percent of GDP in 2009–12, Canada's net international investment position (NIIP) turned slightly positive by end-2013 (1½ percent of GDP) as foreign equity markets outperformed the domestic market and the currency weakened. Canada has a positive net equity position and a negative net debt position, reflecting sizable FDI and portfolio equity investment overseas. Gross external assets and liabilities are each around 150 percent of GDP. The NIIP is projected to decline gradually amid projected current account deficits. **Assessment**. Gross external debt, at 78½ percent of GDP, is low relative to other advanced economies, and is a modest vulnerability.	**Overall Assessment**: *The external position is moderately weaker than implied by medium-term fundamentals and desirable policy settings*. Non-energy export performance has been disappointing, and while the depreciation of the Canadian dollar is likely to help, boosting Canada's exports would require addressing the productivity gap with trading partners and energy export constraints. The general government (especially, provincial) fiscal position has deteriorated after the Great Recession, and the ongoing fiscal consolidation would contribute to improving the national saving-investment balance. **Potential policy responses**: Policies that could help gradually bring Canada's current account closer to the level implied by fundamentals include measures to improve labor productivity (such as budget programs aimed at improving labor skills and job matching, and fostering research and innovation); to promote investments in infrastructure to transport and export natural resources; and to further facilitate inter-provincial and international trade; as well as policies to restore stronger fiscal position (through the planned and sustained fiscal adjustment at the provincial level).
Current account	**Background**. Canada's current account (CA) shifted from a surplus of 2½ percent of GDP in 2000 to a deficit of 3.2 percent of GDP in 2013. The deterioration reflects Canada's stronger rebound from the last recession relative to the United States, but also the significant real appreciation of the Canadian dollar and weak productivity growth. At the same time, limited refining capacity and lack of transportation infrastructure curbed the positive impact on the current account from the boom in unconventional energy production. In terms of the savings-investment (S-I) balance, the current account deterioration largely matches the worsening of the general government S-I balance, while the private S-I balance is back to its slightly negative pre-recession levels. **Assessment**. The EBA CA regression approach estimates a CA gap of 3.4 percent of GDP for 2013. This, however, likely overstates the desirable external adjustment, including because it underestimates the cyclical nature of the current account deficit (given Canada's smaller output gap relative to the United States and the lower market price for Canadian oil relative to global oil prices).1/ Staff assesses that the 2013 cyclically-adjusted current account was between 1 to 2 percentage points of GDP weaker than the value implied by medium-term fundamentals and desirable policies.	
Real exchange rate	**Background**. Canada's exchange rate is correlated with oil prices, and the real effective exchange rate (REER) appreciated by 35 percent between 2000 and 2010 as energy prices surged. In recent years, the interest rate differential with the United States and safe-haven capital inflows have become increasingly important for Canada's exchange rate movements. Reflecting rising U.S. interest rates, weaker capital inflows, and flatter energy prices, Canada's REER depreciated by about 10 percent since end-2012. **Assessment**. The EBA REER regression approach estimates a REER gap of 10 percent for the 2013 average REER level. Translating staff's assessment of the CA gap suggests an average 2013 REER overvaluation of between 5 and 10 percent relative to medium-term fundamentals and desirable policy settings (down from the estimated range of 5–15 percent overvaluation reported in the previous ESR). 2/	
Capital and financial accounts: flows and policy measures	**Background**. The CA deficit of recent years has been financed primarily by net portfolio inflows. Average net portfolio outflows from 2000–07 turned into inflows of some 4 percent of GDP as relatively strong growth prospects, sound fiscal position, and high interest rates made Canada a safe-haven and carry trade destination, 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 level	**Background**. Canada has a free floating exchange rate regime, and the central bank has not intervened in the foreign exchange market since September 1998. The Bank of Canada has minimal reserves but has standing U.S. dollar and foreign currency liquidity swap arrangements with the Federal Reserve and other four major central banks (it has not drawn on these swap lines in the past). **Assessment**. Policies in this area are appropriate to the circumstances of Canada.	

	Canada (continued)
Technical Background Notes	1/ First, the EBA may overestimate the CA norm for Canada as the adjustment for the business cycle is done using Canada's output gap relative to the world (GDP-weighted average) output gap, while a more relevant measure for Canada is the gap relative to the United States. As the latter is currently larger, EBA likely underestimates Canada's CA improvement as the U.S. output returns to potential. Second, the oil trade balance and the terms of trade variables are both likely to be biased upward for Canada, as the EBA uses the WEO global oil prices rather than the lower market price for Canadian oil, particularly, heavy crude oil from western Canada's oil sands (the lower price reflects lower quality, transportation costs, and more recently also the impact of limited pipeline and refinery capacity). To the extent the difference is due to infrastructure bottlenecks, adding transportation capacity over the medium term should help close the CA gap. 2/ Staff's REER assessment refers to 2013 and so does not take into account the depreciation of around 5 percent (as of May 2014) relative to the 2013 average REER level.

	China
Foreign asset and liability position and trajectory	**Background**. Gross foreign assets, at 64 percent of GDP at end-2013 are dominated by foreign reserves, while gross liabilities, at 43 percent of GDP, mainly represent FDI liabilities. Net IIP was 21 percent of GDP at end 2013; this ratio has been declining since the global financial crisis in light of much reduced current account surpluses, valuation change in foreign reserve, and still fast growth of GDP. Net portfolio and other investments are near balance. **Assessment**. The NIIP to GDP ratio is expected to rise only gradually over the medium term, with a modest rise of the current account amid strong GDP growth, Vulnerabilities are low with large foreign exchange reserves and FDI-dominated liabilities.
Current account	**Background**. The current account (CA) surplus has fallen from its peak of over 10 percent of GDP in 2007 to 1.9 percent of GDP in 2013 (2.3 percent of GDP cyclically adjusted). Smaller surpluses have been driven mostly by strong investment growth, and cyclical weakness in major advanced economies. A trend widening of the services deficit, mainly due to strong outbound tourism and education spending, has contributed to smaller current account surpluses. **Assessment**. The cyclically-adjusted CA is about 1-3 percent of GDP stronger than implied by fundamentals and desirable policies (a range of +/- 1 percent around the EBA CA gap estimate of 1.6 percent of GDP, with the range including uncertainty about the cyclical adjustment). The CA gap is mainly attributed to social spending and reserve accumulation. Reforms, if successfully implemented, will lower private saving, and reduce the CA gap.
Real exchange rate	**Background**. The REER has been on a generally appreciating trend since the 2005 exchange rate reform, gaining an average of 5 percent a year during 2006–13. In 2013 the average REER appreciated by 6 percent, similar to the 2012 appreciation. By May 2014, the REER was at about the same level as its 2013 average. **Assessment**. The REER appreciation has been consistent with changing fundamentals (especially faster productivity growth than in trading partners) but not sufficient to eliminate moderate undervaluation. Taking account of EBA model-based estimates (the REER regression points to undervaluation of 12 percent; the CA regression estimates translate to undervaluation of 4-12 percent) and macroeconomic and financial developments, staff assesses undervaluation at 5-10 percent. 1/
Capital and financial accounts: flows and policy measures	**Background**. China has been gradually liberalizing its capital account, but restrictions remain broad-based. Inward FDI and its liquidation is subject to approval, while outward FDI has been largely liberalized. Portfolio flows are channeled through QDII, QFII, and RQFII programs which are subject to quotas and approvals. External borrowing is strictly regulated. Inflows are dominated by inward foreign direct investment (US$ 253 billion or 3.1 percent of GDP in 2012) limiting vulnerabilities; on average around one-half has gone into building manufacturing capacity during 2006 to 2013, although with a declining trend. In 2013, net capital inflows were around US$ 250 billion, a turnaround from the US$ 100 billion of net capital outflows in 2012. Offshore renminbi markets have developed rapidly. In Hong Kong SAR, the largest offshore renminbi market, renminbi deposits grew by 43 percent in 2013 to a total of RMB 860 billion (equivalent to 12 percent of total Hong Kong SAR deposits, or 0.8 percent of onshore renminbi deposits). **Assessment**. Over the medium term, a well-sequenced loosening of capital controls that supports domestic financial liberalization would be appropriate. The net impact of full liberalization is uncertain. The interest rate differential and expectation of RMB appreciation could attract net inflows in the short run, which, however, could be offset by outflow reflecting domestic savers' desire for portfolio diversification.
FX intervention and reserves level	**Background**. China continues to manage closely its exchange rate and conducts intervention on a regular basis, which has been asymmetric, closely controlling and smoothing the pace of appreciation. The pace of reserve accumulation slowed significantly in 2012 but picked-up again in 2013 against the backdrop of large capital inflows induced by interest rate differentials, the relatively high real return of capital in China and expectations of continued RMB appreciation. **Assessment**. Reserves are about 160 percent of the IMF's composite metric; further accumulation is unnecessary from a reserve adequacy perspective. Intervention should be reduced over time to support the move to a more flexible exchange rate regime. 2/

Overall Assessment

Overall Assessment:

The external position is moderately stronger compared with the level consistent with medium-term fundamentals and desirable policy settings.

External balances have been reduced considerably since the global financial crisis. Meanwhile, continued rapid investment underscores the priority of rebalancing the domestic economy toward more consumption. Given the systemic nature of the Chinese economy, successful domestic rebalancing over the medium-term would help foster global economic and financial stability.

Potential policy responses:

The transition to more balanced and sustainable growth 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 rate band, liberalizing interest rates, continuing gradually to open the capital account, and strengthening the social security system. However, more progress is needed. The priorities include improving financial intermediation to foster better risk pricing and resource allocation; strengthening the fiscal framework; improving resource pricing; opening markets to more competition, and improving the social safety net.

The authorities are committed to achieving these goals. This was reaffirmed by the Third Plenum's comprehensive blueprint of reforms to be completed by 2020. If well implemented, these reforms would move China to a more inclusive, environment-friendly, and sustainable growth path.

	China (continued)
Technical Background Notes	1/ Based on staff estimated CA gap of 1-3 percent and elasticity of 0.25. 2/ Taking into account the outward controls on capital flows in China, however, the level of M2/GDP in China may not be indicative of capital that is at risk of an outflow. A lower weight on M2/GDP in calculating the Fund's composite metric would suggest that China's reserves are more than 160% of the adequate level. M2/GDP weight will become more important over time as China liberalizes its capital account.

	Euro Area	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) of the euro area deteriorated through the crisis, to -17 percent of GDP in 2008, but has since rebounded to around -12 percent by end-2013, as a result of improved current accounts, modest nominal GDP growth, and valuation effects. Going forward, a more stable outlook and projections of the current account suggest that the NIIP to GDP ratio will continue to improve at a moderate pace, rising to about 0 percent over the medium-term. **Assessment**. Despite recent improvements, external vulnerabilities persist due to market perceptions of the capability of some euro area countries with sizable net foreign liabilities to service their debts. Financial market stress could easily re-intensify in the event of stalled or incomplete delivery of national and euro area policy commitments.	**Overall Assessment**: *The external position of the euro area is broadly consistent with the level implied by medium-term fundamentals and desirable policies*. However, imbalances remain at the national level, complicated by worryingly low inflation, high unemployment, and persistent financial fragmentation. Further adjustment is needed for both surplus and deficit member states on rebalancing. **Potential policy responses**: Within the euro area, external imbalances persist and policy actions are needed by both surplus and deficit economies to boost demand and make the recovery more sustainable. Large fiscal consolidations already took place in the economies worst hit by the crisis, but they have also faced a steep loss of output and large increases in unemployment. To replace lost output and move towards full employment, further relative price adjustments are needed, which could also be supported by product and labor market reforms. Euro area economies with strong external positions should aim to boost domestic demand and investment which would support growth in the euro area and also help reduce their external imbalances. More monetary easing—motivated by the need to raise the prospects of achieving the ECB's price stability objective and to support demand, in the event of continued very low inflation for the euro area as a whole—would also support adjustment efforts at the national levels.
Current account	**Background**. The current account (CA) balance improved in 2013 to 2.3 percent of GDP, reflecting some competitiveness gains and the still-weak domestic demand in the euro area. The cyclically-adjusted current account (after adjusting for the output gap and commodity terms of trade) is estimated to be a surplus of about 2.2 percent of GDP. **Assessment**. Building from a view of external positions in individual euro area economies included in the EBA analysis, staff's assessment is that the 2013 cyclically-adjusted current account is broadly consistent with the level implied by fundamentals and desired policy settings, with a CA gap ranging from -0.5 to 1 percent of GDP. 1/ 2/	
Real exchange rate	**Background**. On an annual average basis, the euro strengthened by 5 percent in 2013 from its average level in 2012, but it is still close to the long-term average (from the inception of euro). By May 2014, the euro had appreciated about 2 percent relative to its 2013 average. **Assessment**. Building from a view of external positions in individual euro area economies and staff estimates, the euro in 2013 was broadly consistent with fundamentals with no obvious distortion from euro area policies. In addition, differences between real effective exchange rates (REER) and underlying fundamentals at the national level have narrowed: real exchange rates remain undervalued in surplus economies, but they are less overvalued in several deficit economies. Taking these factors and the EBA REER model estimates into account, and consistent with the staff assessment of the current account, staff assesses that the 2013 euro area REER gap lies between -5 to 0 percent.	
Capital and financial accounts: flows and policy measures	**Background**. The rising CA surplus in 2013 was mirrored by financial outflows on a net basis. 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 trend of financial flows has followed closely developments in the current account and was supported by easing financial conditions in the euro area. Looking ahead, the return of capital flows would depend crucially on growth prospects of the region, external conditions, and institutional reform efforts including the long-term vision to complete the architecture of the EMU.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by euro area economies are typically low relative to standard metrics, but the currency is free floating.	

	Euro Area (continued)
Technical Background Notes	1/ The IMF EBA analysis for the euro area covers 11 euro area members, which are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, and Spain. The assessments of CA and REER gaps for the euro area are derived from GDP-weighted averages of the assessments of the individual countries listed above, as well as from estimates for the euro area as a whole. 2/ When applying GDP-weighted aggregation for the euro area, the CA is corrected for reporting discrepancies in intra-area transactions, as the CA of the entire euro area is about ½ percent of GDP less than the sum of the individual 11 countries' CA balances (for which no such correction is available).

	France	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. After averaging near balance in the five years before the global crisis, the net international investment position (NIIP) deteriorated, to around -20 percent of GDP, reflecting current account deficits and valuation losses. Gross asset and liability positions grew steadily in the pre-crisis period, in parallel with the expansion of French banks' balance sheets. Since the crisis, the gross asset position has grown more moderately and stood at 307 percent of GDP in 2012, with large exposures to Italy and Spain. Public external debt accounts for about one third of the gross liability position, which came to almost 330 percent of GDP in 2012. Stability of the French public debt market is an important element of euro-zone financial stability. Current account projections, which include achieving a small surplus over the medium term, point to a slight deterioration and eventual stabilization of the NIIP to GDP ratio over the medium term. **Assessment**. The net external position is negative but its size and trajectory do not raise sustainability concerns. However, there are vulnerabilities due to large exposures to Italy and Spain on the asset side, and to the external public debt on the liability side.	**Overall Assessment**: *The external position is weaker than the level consistent with medium-term fundamentals and desirable policy settings*. This reflects a still significant fiscal deficit, and is also consistent with a gradual loss of cost competitiveness. To improve cost competitiveness, the labor tax wedge has been reduced by the equivalent of 3 percent of total labor costs, and additional tax cuts have been announced for 2015-17. Measures have been taken to improve non-cost competitiveness, including labor market reforms, regulatory simplification and support to SMEs. **Potential policy responses**: Wage moderation (especially of the minimum wage), continued reform of the labor market, and productivity-enhancing reforms (increasing competition in product markets and further regulatory simplification) would help restore competitiveness. Along with the planned gradual elimination of the fiscal deficit over the medium term, these measures should help correct the external imbalance (as well as promote growth).
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 1.3 percent in 2013 (the cyclically-adjusted deficit is estimated at 1.4 percent of GDP). Two-thirds of this deterioration originates from a worsening net saving position of the private sector, the remaining third owes to higher government deficits. **Assessment**. The staff assesses the 2013 current account to be 1 to 3 percent of GDP below its cyclically-adjusted norm. This is consistent with the EBA model estimate that the cyclically-adjusted current account is 1.8 percent of GDP weaker than the value consistent with medium-term fundamentals and desirable policy settings. Based on projected policies, notably gradual elimination of the fiscal deficit, the current account is projected to converge to a small surplus over the medium term, which would close the EBA-estimated gap.	
Real exchange rate	**Background**. The trend deterioration in unit labor costs (9 percent cumulative appreciation of the ULC-based real effective exchange over the last 10 years) points to a loss of competitiveness consistent with the assessment of an imbalance in the current account. However, such loss of competitiveness is less evident based on relative price indicators, such as CPI-based real effective exchange rate (REER), as firms appear to have squeezed profit margins to retain price competitiveness. Indeed, the EBA REER regression model estimates only a slight (2 percent) overvaluation of the CPI-based REER for 2013. The EBA CA regression estimate implies an overvaluation of about 10 percent. **Assessment**. Considering also the evidence based on labor costs, the staff assesses the real exchange rate in 2013 to be 5 to 10 percent overvalued, consistent with the current account assessment. The lack of evidence of a competitiveness problem at the level of retail prices masks a squeeze of profit margins.	
Capital and financial accounts: **flows and policy measures**	**Background**. The current account deficit has been financed mostly by debt inflows (portfolio and other investment), while outward direct investment was generally higher than inward investment. Flows in financial derivatives have grown sizably on both the asset and liability side since 2008. The capital account is open. **Assessment**. France remains exposed to financial market risks but the structure of financial flows does not point to specific vulnerabilities.	

	France (continued)
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.

	Germany	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Germany's positive net international investment position (NIIP) was reduced to close to balance in the years following reunification. Since the beginning of the millennium, the NIIP recovered and reached 48 percent of GDP at end-2013. The composition of NIIP has also been evolving: in terms of instruments, other investments positions (including Target 2 claims) are now larger than loans, currency and deposits. Looking ahead, and in line with historical developments, the pace of NIIP growth is projected to be about one half of what would be implied by cumulated current account surpluses. German firms and households have a large positive NIIP (49 percent of GDP), while the general government—in part reflecting Germany's safe haven status—has a large negative position (35 percent of GDP). During the crisis, the Bundesbank accumulated large net claims on the Eurosystem, which currently stand at 19 percent of GDP. **Assessment**. Safe haven status and gross assets of over 240 percent of GDP limit risks from gross liabilities of just under 200 percent of GDP, and bolster Germany's strong external position.	**Overall Assessment**: *Germany's external position is substantially stronger than implied by medium-term fundamentals and desirable policy settings.* Staff projects some rebalancing due to stronger wage growth relative to euro area trading partners and higher domestic demand. **Potential policy responses**: Policies which focus on boosting growth potential, including higher public and private investment as well as service sector reform, would raise domestic demand and lower the German current account surplus, as well as would have beneficial spillovers to the rest of the European Union.
Current account	**Background**. The current account has been in surplus since 2002, with an average surplus over the last decade exceeding 6 percent of GDP. In 2012, all sectors ran surpluses. The saving-investment balance of households continues to hover around its historical average of about 5 percent of GDP. The corporate sector contributed strongly to the increase in the current account surplus during the 2000s as the rise in corporate saving exceeded investment, while fiscal consolidation played an important role in the last two years. The current account surplus was 7½ percent of GDP in 2013, corresponding to an estimated cyclically adjusted surplus of around 8¼ percent of GDP. While the surplus remains large, its regional composition has changed: the surplus vis-à-vis the euro area periphery has fallen from 2 percent of GDP in 2007 to ⅔ percent in 2013, but this decline has been more than offset by larger surpluses vis-à-vis Asia and other economies outside of Europe. **Assessment**. The cyclically-adjusted current account balance is 3–6 percentage points of GDP stronger than the value implied by fundamentals and desirable policies. While the cyclically-adjusted current account balance is 5¾ percentage points above the EBA-estimated norm (2½ percent of GDP), staff assesses the norm at 2¼–5¼ percent of GDP taking into account that part of this gap may reflect structural factors not fully captured by the EBA model, such as EMU and rapid population aging. 1/	
Real exchange rate	**Background**. At the end of 2013, the real effective exchange rate (REER) was about 6 percent below its historical average (1979-2013). **Assessment**. Staff's assessment is of a REER undervaluation of 5–15 percent. This assessment takes into account the current account gap, and that the EBA REER regression model performs poorly in the case of Germany, while various other metrics indicate a broad range of estimates of the appropriate exchange rate. 2/	
Capital and financial accounts: flows and policy measures	**Background**. Before the crisis Germany exported capital primarily in the form of banks outflows. During the crisis, capital flow reversals particularly affected portfolio investment. In 2013, the composition of the financial account normalized with a resumption of private capital outflows and a corresponding decline in the stock of Germany's net (Target2) claims on the Eurosystem from a peak of €750 billion in August 2012 to €510 billion at end-2013. **Assessment**. Lower exposure to the Eurosystem and a resumption of private capital outflows are associated with abating euro area financial stress and a partial reversal of euro area financial fragmentation.	
FX intervention and reserves level	**Background**. The euro has the status of global reserve currency. **Assessment**. Reserves held by Euro area countries are typically low relative to standard metrics. The currency is freely floating.	

	Germany (continued)
Technical Background Notes	1/ The EBA CA regression model explained Germany's CA fairly well through about 2000, but has tracked only a small part of the subsequent rise of the CA. Most of the EBA-estimated gap for 2013 reflects the regression's residual, rather than gaps in the policies included in the EBA model. 2/ The EBA REER regression model has an unusually poor fit for Germany, predicting a depreciating trend that has not occurred. The result for 2013 is an estimate of *over*valuation (of 11 percent) that has been discarded from the assessment as implausible, including in light of the assessment that the CA is too strong. In contrast, deviations from historical averages using alternative price/cost metrics (CPI, GDP deflator, total sales deflator, or ULC) or sample periods imply a REER *under*valuation of 0–10 percent.

	Hong Kong SAR	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Hong Kong SAR has a significant net international investment position (NIIP) of around 260 percent of GDP as of Q3-2013. Both external financial assets (1300 percent of GDP) and liabilities (1076 percent of GDP) are high, reflecting Hong Kong's status as a major international financial center with considerable cross-territory investment. The NIIP to GDP ratio is projected to follow a trend that gradually converges to levels broadly in line with the average prior to the global financial crisis. The trend decline mainly reflects the projected improvement in current account surpluses (mainly net investment income) growing at a slower pace than nominal GDP over the medium term. Given the large gross assets and liabilities, annual fluctuations in the NIIP due to valuation changes have been sizable, making projections on the NIIP highly uncertain. **Assessment**. The net external position is expected to stay very strong over the medium term. The ratio of NIIP to GDP is projected to remain high despite a gradual decline to about 250 percent of GDP over the medium-term.	**Overall Assessment**: *The external position is broadly consistent with medium-term fundamentals and desirable policy settings.* **Potential policy responses**: Macroeconomic policies are broadly appropriate. Robust and proactive financial supervision and regulation, prudent fiscal management, flexible markets, and the Linked Exchange Rate System have worked well to keep the external position broadly in balance. Continuation of these policies, therefore, will help keep the external position broadly in line with medium-term fundamentals.
Current account	**Background**. Hong Kong SAR's current account (CA) surplus has fallen considerably since the global financial crisis, reaching a low of 2¾ percent of GDP in 2012. The surplus is estimated at around 3 percent of GDP in 2013 and projected to rise to 5 percent of GDP in the medium-term as global growth recovers and integration with the Mainland deepens. As a small and highly open economy that is both a trading hub and financial center, the CA projections are subject to uncertainty. Hong Kong SAR has large gross exports of goods and services, with a large surplus in the services account offsetting a corresponding deficit in goods. **Assessment**. The CA is consistent with medium-term fundamentals and desirable policies. Based on quantitative estimates from CGER-like methods and consideration of the variability of the current account in an international trading and financial center, the staff assesses no clear CA gap, nor major distortions to the saving and investment rates, but uncertainties would suggest a wide gap range from -3 to +3 percent of GDP.	
Real exchange rate	**Background**. The real effective exchange rate (REER) appreciated by about 3.5 percent in 2013 relative to its average value in 2012. The Hong Kong SAR Linked Exchange Rate System (LERS) system possesses strong self-equilibrating tendencies, thanks to flexible goods, factor, and asset markets. Wages and prices, therefore, have adjusted to keep the REER broadly in line with changing fundamentals. **Assessment**. The real exchange rate is broadly consistent with medium-term fundamentals and desirable policies. Based on empirical CGER-like estimates and factoring in the uncertainties and variability of an offshore trading and financial center, the exchange rate is assessed to be from -10 to 10 percent different from the level consistent with medium-term fundamentals and desirable policies.	
Capital and financial accounts: **flows and policy measures**	**Background**. Gross inflows and outflows are over 100 percent of GDP, largely comprising portfolio flows and cross-border lending and deposits. In 2013, Hong Kong SAR experienced net private outflows, mainly as the result of portfolio outflows. Hong Kong SAR has a fully open capital account. **Assessment**. Large financial resources and proactive financial supervision and regulation limit the risks from volatile banking capital flows.	

	Hong Kong SAR (continued)
FX intervention and reserves level	**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 Linked Exchange Rate System. The stock of reserves was equivalent to around US$311 (about 114 percent of GDP) at end-2013. **Assessment**. Currently reserves are adequate for precautionary purposes and should continue to evolve in line with the automatic adjustment inherent in the currency board system. Hong Kong SAR also holds significant fiscal reserves built up through a track record of strong fiscal discipline.

	India	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. India's net international investment position (NIIP) deteriorated to -17 percent of GDP in FY2012/13, from -12 percent in FY2010/11, driven by current account deficits financed in good part by rising corporate external borrowing. Gross foreign assets and liabilities are relatively modest, at 26 and 43 percent of GDP, respectively. The bulk of assets are in the form of FDI and official reserves. Liabilities include FDI, portfolio equity, and increasingly debt. Reserves (at US$312 billion), having dipped during the period of exchange market turmoil in mid-2013, are back above May 2013 levels. 1/ **Assessment**. With current account deficits of under 3 percent of GDP projected for the medium term, the NIIP-to-GDP ratio will be broadly stable. India's external debt at about 23 percent of GDP is moderate compared to some other emerging market economies, but growth of short-term debt liabilities in recent years is a concern.	**Overall Assessment**: *The external sector position is broadly consistent with medium-term fundamentals and desirable policy settings*. India's low per capita income, favorable growth prospects, and development needs justify running CA deficits, but too great reliance on debt financing and portfolio inflows would create significant external financing vulnerabilities. **Potential policy responses**: To reduce external vulnerabilities and reach the authorities' fiscal deficit goal of 3 percent of GDP by FY2017/18, sustainable fiscal consolidation is needed, including by passage of a goods and services tax and comprehensive subsidy reforms. Easing domestic supply bottlenecks would also be key to containing the CA deficit. Current reserve levels are adequate. The flexible exchange rate policy followed by the Reserve Bank of India is sound, and the current policy of at times smoothing exchange rate volatility is appropriate. The CA financing mix would be improved by enhancing the environment for FDI. However, given the potential risks to corporate balance sheets, further relaxation of limits on ECB (especially for sectors without natural hedges) should be implemented cautiously.
Current account	**Background**. The current account (CA) deficit narrowed sharply from a record 4.7 percent of GDP in FY2012/13 to about 1.7 percent of GDP in FY2013/14 as exports improved, and importantly higher import duties and quantitative restrictions discouraged gold imports. Non-oil, non-gold imports also declined with weaker domestic demand (due in part to ongoing fiscal consolidation). While some of these effects are likely temporary, the CA deficit is expected to stabilize at about 2½ percent of GDP over the medium term as domestic mining constraints ease, external demand improves, and the effects of depreciation are fully realized. **Assessment**. The EBA CA regression estimates a norm of -3.9 percent of GDP. 2/ However, in staff's judgment, global financial markets could not be counted on to reliably finance a deficit of that size in light of India's current (but reduced) vulnerabilities. Given the risks with global financial market volatility, staff judges that a smaller deficit of about 2½ percent is a more appropriate norm. This level is very close to the estimated underlying CA of -2.6 percent of GDP in FY2013/14. 3/ The staff assesses the CA gap to be in a range of -1 to +1 percent of GDP. 4/	
Real exchange rate	**Background**. The REER appreciated by about 10 percent over the last decade, reflecting large inflation differentials between India and its trade partners. The REER depreciated by about 13 percent in June-August 2013, before rebounding by about 8 percent through May 2014. **Assessment**. The EBA regression approach estimates a slight gap of about +2 percent for the 2013 average REER. As of May 2014, the REER was near that same level. The staff assesses the REER gap to be in a range of -5 to +5 percent.	
Capital and financial accounts: flows and policy measures	**Background**. India's financial account is dominated by portfolio equity and FDI flows. However, the composition of CA financing has shifted toward more debt flows and away from FDI recently. Debt flows, particularly in the form of non-resident Indian (NRI) deposits, external commercial borrowings (ECB) by Indian corporates and trade credits, have increased. Net portfolio flows have been very volatile in the past and more recently in response to global financial market volatility. Restrictions on foreign investment in government and corporate fixed income rupee assets have limited the development of bond markets and skewed inflows towards equity and ECBs (mostly syndicated loans). **Assessment**. Portfolio debt flows have been volatile and the exchange rate has been sensitive to these flows and changes in global risk aversion. In the past year, the authorities have taken multiple steps to bolster the available supply of external finance, including: liberalizing caps on FDI inflows; relaxing restrictions on ECB; offering FX swaps to banks to attract more NRI deposits and increase banks' ability to borrow; and working with the IFC in its US$1 billion bond program directed at offshore investors.	
FX intervention and reserves level	**Background**. The evolution of the rupee is consistent with a floating arrangement and central bank intervention has been limited in recent years. The authorities intervened to prevent disruptive movements in the exchange rate, and check any self-fulfilling momentum divorced from exchange rate fundamentals, during the period of "taper turmoil" in mid-2013, but halted intervention later in the year. Reserve coverage has fallen, notably import cover (down from 10⅓ months of prospective goods and service imports in 2007/08 to just above 6 months in 2013/14), but remains at comfortable levels. **Assessment**. Reserve levels are adequate for precautionary purposes. International reserves stand at around 6¼ months of import cover, representing 150 percent of short-term debt and above 150 percent of the IMF's composite metric.	

	India (continued)
Technical Background Notes	1/ India's NFA (at -25 percent of GDP in 2012) is lower than NIIP, mainly due to differing valuation of portfolio equities. 2/ The EBA ES (external sustainability) approach would give a CA norm of about -1½ percent of GDP for India, as the CA consistent with holding the NFA-to-GDP ratio at its current level. Such a norm is of little interest, however, as India's net external position is only moderately negative and is not on a deteriorating trend. 3/ The estimated underlying CA here incorporates the EBA-estimated cyclical adjustment and also takes account of the temporary impact of the recently-implemented restrictions on gold imports. 4/ See IMF (2014), *India: Staff Report for 2014 Article IV Consultation*, IMF Country Report No. 14/57, for additional model-based estimates of the CA deficit norm in India.

	Indonesia	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. At end 2012, Indonesia's net international investment position (NIIP) position stood at -41 percent of GDP, with reserves, net FDI and equities, and net debt and other liabilities at +13, -34, and -20 percent of GDP, respectively. At end 2013, the gross external debt-to-GDP ratio was 30 percent, with short-term debt at 6 percent of GDP. External debt increased by 2 percentage points of GDP in 2013 mainly due to the depreciation of the exchange rate (at a constant exchange rate, gross external debt ratios would have stayed unchanged). **Assessment**. The EBA external sustainability approach suggests a current account (CA) deficit of 2.6 percent of GDP would stabilize the NIIP at its current level. The level and composition of the NIIP and gross external debt indicate that Indonesia's external position is sustainable. Non-resident holdings of rupiah debt could be affected by global volatility, but currently they amount to only 3 percent of GDP.	**Overall Assessment**: *The external position is moderately weaker than implied by medium-term fundamentals and desirable policies.* However, policy actions taken since mid 2013 (mainly monetary policy tightening and a subsidized fuel price increase, supported by increased exchange rate and bond yield flexibility and capital flow management and macro prudential measures) are expected to improve the external position. Larger fiscal deficits than in other countries make Indonesia's current account gap smaller than would otherwise be the case, while faster aging and growth make it larger. External financing appears sustainable but could be affected at times by heightened volatility in global financial markets. **Potential Policy Responses**: Monetary policy should remain focused on bringing inflation back within the target band and further narrowing the CA deficit. Fiscal policy can support monetary policy to promote external adjustment and contain borrowing costs by aiming for a small structural deficit, while phasing out energy subsidies. Continued flexibility on the exchange rate and treasury bond yields would help the economy adjust to shocks. Structural reforms should aim to ease trade and investment restrictions, expand public infrastructure and domestic energy production, deepen financial markets and access, and improve the labor market.
Current account	**Background**. Despite negative import growth, Indonesia's CA deficit rose to 3.3 percent of GDP in 2013 from 2.8 percent of GDP in 2012. The main causes were a 10 percent decline in average commodity prices (affecting 45 percent of goods exports) and a 0.5 percent of GDP increase in the net oil and gas trade deficit (owing mainly to import demand). With a sizable rupiah depreciation since mid 2013, tightening of monetary policy, and moderate slowdown in growth expected in 2014, staff projects the deficit will fall slightly to 3.0 percent of GDP in 2014. **Assessment**. The EBA CA regression approach estimates a gap of around -2 percent of GDP in 2013 (based on a cyclically adjusted CA balance of -2.4 percent of GDP and a norm of -0.2 percent of GDP). Taking uncertainties into account, staff believes a norm of -1½ percent of GDP (± 1 percent of GDP) more accurately reflects Indonesia's significant investment needs. This suggests a CA gap of -2 to 0 percent of GDP (the same as in 2012). The CA gap reflects both domestic policy gaps in social spending and capital account controls, as well as policy gaps in partner countries.	
Real exchange rate	**Background**. After a sizable nominal effective depreciation in the second half of 2013, the average real effective exchange rate (REER) was 5 percent weaker in 2013 than in the previous year. Despite a nominal appreciation in the first four months of 2014, the REER (as of May 2014) was about 6 percent below its 2013 average. **Assessment**. The EBA REER regression approach estimates a gap of about 2 percent. Despite the depreciation in the REER in 2013, this estimated gap is about the same as for 2012, raising a concern about its plausibility given the CA deficit and suggesting that the REER approach is less accurate than the CA regression approach. Using a CA gap estimate of -2 to 0 percent of GDP and standard elasticities, staff's assessment is that the REER would be overvalued by 0 to 10 percent for 2013. The recent depreciation of the REER should help close the gap. However, the impact may be offset partially by falling commodity prices over the medium term and export restrictions on certain mineral ores implemented in January 2014 to encourage domestic processing. Staff recommends continued exchange rate flexibility to adjust to external shocks and structural reforms to strengthen competitiveness.	
Capital and financial accounts: flows and policy measures	**Background**. On a gross basis, Indonesia's external financing requirement in 2013 was 9.5 percent of GDP, with the CA deficit and amortization comprising 3.3 and 6.3 percent, respectively. The financing requirement was met by FDI and new borrowing—equal to 2.1, and 7.5 percent of GDP, respectively. On capital controls, Indonesia ranks as more restrictive than other countries in the sample. **Assessment**. Net and gross financial flows appear sustainable, but could dissipate or reverse in the event of domestic or external shocks. The government's frontloading of foreign exchange and rupiah debt issuance in 2014 should provide a cushion. More predictable policies and a better business climate would help sustain capital inflows in the medium term.	

	Indonesia (continued)
FX intervention and reserves level	**Background**. Since mid 2013, Indonesia has shifted towards a more flexible exchange rate policy framework, with a floating regime better facilitating adjustments in exchange rates to market conditions. As of May 2014, reserves were adequate at US$107 billion (equal to 150 percent of IMF's reserve adequacy metric—assuming a floating exchange rate—and 6 months of imports of goods and services). In addition, the government has in place swap lines equivalent to around US$65 billion. **Assessment**. Continued external deficits or disruptions to capital flows could cause reserves to decline significantly. Intervention should aim primarily at smoothing volatility, while allowing the exchange rate to adjust to external shocks.

	Italy	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Italy's net international investment position (NIIP) has deteriorated by 16 percent of GDP since joining the Euro area, with net liabilities of 29 percent of GDP (September 2013) as compared with 13 percent at end 2000. 1/ Modest current account surpluses forecast over the medium-term will gradually shrink Italy's net liability position as a share of GDP. At 123 percent of GDP, Italy's external debt is in line with the Euro area as a whole; however the composition of external debt, of which 40 percent is owed by the government, underscores the vulnerabilities related to the high level of public sector debt. 2/ **Assessment**. In light of the current account's shift into small surplus, overall external sustainability is not a concern; however, some further strengthening of balance sheet is desirable. Italy is vulnerable to financial contagion given its large stock of government debt and the large share held by non-residents.	**Overall Assessment**: *The external position is broadly consistent but likely still weaker than suggested by medium-term fundamentals and desirable policy settings*. This assessment is supported by Italy's weak productivity and competitiveness indicators. In particular, stronger growth, consistent with reducing high unemployment and public debt, while strengthening the external balance sheet, would require a modest weakening of the real effective exchange rate. Part of the needed adjustment may reflect Italy's weak competitive position within the Euro area, where relative price effects may be magnified by the existence of a common currency. **Potential policy responses**: Implementation of structural reforms will be critical to improving competitiveness and boosting potential growth. Continued progress in medium-term fiscal consolidation will also help close the competitiveness gap and maintain investor confidence. Combined, these measures will support growth and employment over the medium-term.
Current account	**Background**. Italy's current account (CA) averaged a deficit of 2 percent of GDP over the past decade, and moved into balance starting in 2012. In 2013, the current account registered a surplus of 1 percent of GDP. The improvement in the current account reflects a modest trade surplus starting in 2012 (growing to more than 2 percent in 2013), owing both to higher exports and subdued imports, while the deficit in incomes and (EU) transfers continued. In terms of saving and investment, declining investment accounted for about three-fourths of the improvement in the current account, while increased public saving more than offset lower private saving. **Assessment**. With the recent improvement in the current account, the EBA model suggests the cyclically-adjusted level was very near balance (0.3 percent of GDP) in 2013, essentially matching the EBA-estimated norm implied by medium-term fundamentals and desirable policy settings. Given the need for stronger growth to reduce the high public debt and unemployment over the medium term, while improving the external balance sheet, staff assesses a gap of -1.5 to 0 percent of GDP.	
Real exchange rate	**Background**. Stagnant productivity and rising labor costs have resulted in a gradual appreciation of the real effective exchange rate (REER) since joining the Euro area, both in absolute terms and relative to the Euro area average. A comparison of price-based indices suggests misalignment on the order of 0 to 10 percent, with labor-based indicators showing a much wider gap than other price-based measures. **Assessment**. The EBA methodologies provide estimates of REER gaps of +3 percent (overvaluation, from the REER regression method) to -1 percent (undervaluation, from the CA regression method). On balance, and consistent with the staff assessment of the CA, a real effective depreciation of 0-5 percent would support further adjustment and address economic imbalances over the medium-term.	
Capital and financial accounts: flows and policy measures	**Background**. Portfolio and other-investment inflows typically have 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 increased reliance on euro system refinancing. As conditions in the Euro area stabilized starting in late-2012, TARGET2 liabilities have declined. Foreign investment in portfolio debt securities turned positive in 2013, following two consecutive years of outflows, led by investment in government securities. **Assessment**. Italy remains vulnerable to a loss in market confidence, owing to the large refinancing needs of the sovereign and banking sectors, and tight credit conditions from financial fragmentation.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	

	Italy (continued)
Technical Background Notes	1/ The NFA position is somewhat more negative, at about -34 percent of GDP in 2012, than the NIIP position of about -28 percent of GDP in that year. While not very negative in relative terms, a stronger NIIP position would help reduce vulnerabilities to financial contagion. 2/ Total gross external liabilities are about 152 percent of GDP (2012), of which external debt represents about fourth-fifths.

<table>
<tr><th></th><th>Japan</th><th>Overall Assessment</th></tr>
<tr><td>Foreign asset and liability position and trajectory</td><td>Background. The net international investment position (NIIP) position has risen to over 60 percent of GDP in 2013 (from 35 percent ten years ago). In the medium term, despite likely valuation effects, it is projected to stabilize around 70 percent of GDP, in light of the outlook for the current account, as private saving declines with aging.
Assessment. Vulnerabilities are limited. Japan’s positive NIIP generates sizable investment income (average 3 percent of GDP over the past five years). Risks on assets and their returns are also diversified geographically and in terms of investment type.</td><td rowspan="5">Overall Assessment:
The external position is broadly consistent with medium-term fundamentals and desirable policies. However, a large degree of uncertainty around specific estimates must be acknowledged.

Potential policy responses:
Policy gaps for Japan are primarily of internal rather than external sustainability. Full implementation of the fiscal and structural reform arrows of Abenomics is needed to close the policy gaps. Fiscal consolidation would raise national savings above the 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 approval of trade agreements could partially offset this by boosting productivity, domestic income, and imports.</td></tr>
<tr><td>Current account</td><td>Background. The 2013 current account (CA) surplus narrowed to 0.7 percent of GDP (0.8 percent cyclically-adjusted). Despite the yen depreciation, exports recovered only sluggishly due to a combination of a higher share of overseas production, competitiveness problems in traditional strongholds such as consumer electronics, and slow pass-through of the depreciation to lower export prices. Imports remained elevated as a result of temporarily high demand for fossil fuels and greater import penetration in certain areas, such as handsets. In 2014, the current account is projected to rise to 1.2 percent of GDP as exports recover and the fiscal deficit declines, although energy imports are likely to remain high in the near-term.
Assessment. Correcting for temporarily higher energy imports, delayed effects of depreciation on the trade balance, and elevated rush demand for imports ahead of the 2014 consumption tax hike, staff estimates the underlying, cyclically-adjusted CA to be about 1-1 ¼ percentage point higher than estimated by the EBA CA regression model. Adjusting for the full impact of the new macro policy framework under Abenomics and structurally lower export elasticities, staff estimates the CA norm to be 2 percent of GDP, just under 1 percentage point lower than the EBA estimate (see notes 1,2,3 in technical background). Staff assesses the underlying CA to be in line with fundamentals and desirable policies (compared to the EBA estimated gap: 2 percent). Uncertainties around the assessment suggest a wide range of +/-1½ percent of GDP around a midpoint of zero (see note 4, in technical background).</td></tr>
<tr><td>Real exchange rate</td><td>Background. After having depreciated by close to 20 percent between 2012 and 2013, the real effective exchange rate (REER) depreciated by another 5 percent by May 2014 relative to the average value in 2013. This is in part due to a sustained trade deficit and widening long term interest rate differentials relative to the U.S. (related to asynchronous stances of the U.S. Federal Reserve and the Bank of Japan).
Assessment. The EBA REER regression model assesses the 2013 average REER to be 14 percent weaker compared to the level consistent with fundamentals and desirable policies, primarily from a large unexplained residual while the policy gap is close to zero (the specification does not include fiscal P*). The EBA REER model however does not capture e unusual factors affecting the REER – large short speculative positions against the currency used to hedge long equity exposures in the domestic stock market, temporarily higher energy imports, and a sudden widening of long-term sovereign spreads relative to other advanced economies. There is therefore a high degree of uncertainty in the model estimates. Instead, using the CA gap range as reference, staff assesses a midpoint of zero with indicative ranges of -15 percent undervaluation to +15 percent overvaluation for 2013 (see notes 4 and 5 in technical background).</td></tr>
<tr><td>Capital and financial accounts: flows and policy measures</td><td>Background. The appreciation and recent depreciation of the yen since the global financial crisis 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.</td></tr>
<tr><td>FX intervention and reserves level</td><td>Background. Reserves are higher than in other reserve asset issuers (about 20 percent of GDP) on legacy accumulation. The exchange rate is free floating and the level of the yen is market determined.
Assessment. Staff assesses isolated foreign exchange interventions during safe haven periods as directed toward reducing short-term volatility, with ambiguous effects on the level of the exchange rate.</td></tr>
</table>

	Japan (continued)
Technical Background Notes	1/ The new macro policy framework under Abenomics will translate into higher domestic demand, inflation, and productivity, which lead to a smaller required fiscal adjustment than under the EBA CA model – i.e. the policy gap is smaller than estimated by EBA. 2/ Export elasticities are structurally lower because offshoring of production and a higher share of intermediate goods exports makes Japanese exports less sensitive to yen fluctuations than in the past. 3/ The norm is positive because of high corporate saving in excess of domestic investment opportunities, low residential investment, and a sizable income account owing to the large NFA position and favorable return differential on assets relative to liabilities. 4/ Large bands around the CA midpoint estimate are the result of three factors, each contributing about ½ a percent of GDP to the +/- 1.5 percent of GDP range: (i) varying estimates of the reversal of temporary effects on the underlying current account balance, in particular fossil fuel imports; (ii) difficult to quantify CA implications of Abenomics policies via higher growth and productivity and the effects on fiscal adjustment needs; and (iii) uncertain long-run trade balance effects of structural changes, such as increased overseas production and reduced competitiveness of tradables in some sectors. Ranges around these adjustments to the CA balance are assumed to be symmetric and not correlated with each other. 5/ This large range for the REER gap is associated with a narrow range for the CA gap because lower trade elasticities have reduced the sensitivity of the CA to REER changes.

	Korea	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Korea's net international investment position (NIIP) increased from -7.5 percent of GDP in 2012 to -2.5 percent in 2013. Its net return declined to -3¾ percent in 2013. This negative influence on NIIP dynamics is offset, however, as the current account as a whole is in strong surplus. . The net external debt position was -14.2 percent of GDP in 2013. **Assessment**. The NIIP position and dynamics present little risk to external sustainability.	**Overall Assessment**: *The external position is substantially stronger than that implied by medium-term fundamentals and desirable policies.* The extent of the assessment of excessive strength is subject to uncertainty related to the challenge of interpreting the recent combination of a rising current account and strengthening exchange rate. **Potential policy responses**: While the current account gap would further narrow with fiscal rebalancing in advanced economies, there is also a need to close Korea's social spending gap. The authorities' ongoing efforts to increase social spending will help. More flexible management of long-term fiscal space would help in this regard. The exchange rate should continue to be market determined and intervention should be limited to smoothing excessive volatility, in both directions. Macroprudential measures should continue to be targeted at mitigating financial stability concerns. Recent real appreciation has been consistent with some reduction in the external imbalance going forward. Reserves are in line with the IMF's composite adequacy metric. There is no precautionary need to increase reserves.
Current account	**Background**. The current account (CA) surplus rose from 4.3 to 6.1 percent of GDP in 2013 (7 percent cyclically adjusted, compared to 4½ in 2012), reflecting both higher exports and lower imports. Based on a CA norm estimate of 2 percent of GDP, EBA estimates a CA gap of 4.9 percent of GDP. **Assessment**. The 2013 CA balance is assessed to be about 2¾ to 4¾ percent of GDP above the value suggested by fundamentals and desirable policies. The lower bound reflects that part of the EBA residual (3.3 percent of GDP) may reflect factors not fully captured by EBA (e.g. the impact of weak oil price and a lag in the response of exports to the won's stronger value against the Japanese yen). About half of the CA gap is explained by Korea's own social spending gap (1¼ percent of GDP) and the fiscal policy gaps of other countries (0.7 percent).	
Real exchange rate	**Background**. The EBA method based on a real effective exchange rate (REER) regression estimates that the 2013 average REER is undervalued by 8 percent—of which 3 percent is accounted for by identified policy gaps, notably in social spending—reflecting an updated social spending norm, larger than in the previous year's analysis. The assessment puts more weight on the REER undervaluation implied by the staff's assessment of the 2013 CA gap, which is 11 to 19 percent. More recently, as of May 2014, the REER has appreciated by about 7 percent relative to the 2013 average. 1/ **Assessment**. The assessment of the current (May 2014) REER level is centered on an undervaluation of around 6 percent.	
Capital and financial accounts: flows and policy measures	**Background**. While portfolio capital continued to flow in (1½ percent of GDP) in 2013, the overall net capital flow deficit increased significantly to 4¾ percent of GDP (3 percent in 2012), driven by the expansion of banks' short-term external assets (2½ percent of GDP) and residents' overseas portfolio investment (2¼ percent of GDP). No new macroprudential measures or capital flow measures (CFM) were introduced in 2013. **Assessment**. Korea's macroprudential measures and CFMs are appropriately aimed at financial stability concerns.	
FX intervention and reserves level	**Background**. Korea has a floating exchange rate. Reserves have increased in dollar terms but remain at around 130 percent of the IMF's composite reserve adequacy metric. The Bank of Korea's (BOK) forward position increased by US$12 billion during 2013. The authorities continued actual and verbal intervention during bouts of high appreciating pressures, with the stated goal of stemming one way bets. **Assessment**. Intervention should be limited to smoothing excessive volatility. It should not be used to hamper movement of the exchange rate toward equilibrium. There is no need for further reserve accumulation relative to the range of IMF's metrics.	

	Korea (continued)
Technical Background Notes	1/ A few private sector analyses suggest the won is no longer undervalued and may even be overvalued—however, unlike EBA, they do not seek to *assess* where the REER should go to bring the CA to the norm but merely to *predict* its path.

	Malaysia	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) was –2 percent of GDP at end 2012. Gross liabilities (including both ringgit- and foreign currency-denominated liabilities) were about 132 percent of GDP at end 2012. Foreign currency denominated external debt is relatively low, estimated at about 29 percent of GDP in 2013, of which about 18 percent is medium- and long-term debt. 1/ **Assessment**. The NIIP is not a major source of risk; it is projected to rise in the medium term reflecting the projected current account surpluses.	**Overall Assessment**: *The external position is stronger than that consistent with medium-term fundamentals and desirable policy settings.* **Potential policy responses**: The external rebalancing of Malaysia's economy is substantial. Looking ahead, over the medium-term, increased public sector saving will be offset by sustained private consumption and investment activity and is expected to result in a current account surplus of 3-4 percent of GDP over the medium-term. Staff views any remaining current account and real exchange rate gaps as reflecting inadequate social protection (beyond that captured by public health expenditure), the need to improve the risk sharing characteristics of the pension system, investment bottlenecks, infrastructure gaps, labor force skill mismatches, and rigidities in the labor market. Consistent with the authorities' intentions, stronger social safety nets and efforts to remove bottlenecks to investment would help to further moderate the current account surplus.
Current account	**Background**. Malaysia's current account (CA) surplus has declined by almost 8 percentage points since 2011 to 3.8 percent of GDP in 2013. From a saving-investment perspective, about two thirds of the CA adjustment was due to a strong surge in private investment and ETP-related investment projects, which bodes well for medium term growth. **Assessment**. The EBA CA regression approach estimates that the cyclically-adjusted CA is stronger (by about 4.5 percent of GDP) than consistent with medium-term fundamentals and desirable policies. That estimated gap comprises net policy gap contributions of 1.8 percent of GDP and a residual requiring interpretation. However, Malaysia's CA surplus partly reflects factors that are not well captured in the EBA. In particular, insufficient social safety nets (not fully captured by public health spending), which drive up saving rates; bottlenecks to investment, resulting in relatively low private investment. It is difficult to separate the above factors into slow-moving structural ones (that are given in the short run and add to the gap) and controllable policy variables that explain the gap. Taking these factors and the uncertainty surrounding model estimates into account, staff assesses the CA gap to be 1½ to 3½ percent of GDP in 2013.	
Real exchange rate	**Background**. Over the past year, the real effective exchange rate (REER) has fluctuated more widely than in 2010–2012. The ringgit depreciated during the capital outflow episode around mid-2013, however, the nominal and real depreciation was short-lived and, overall, the REER moved around a fairly horizontal trend. 3/ **Assessment**. The EBA REER regression estimates Malaysia's REER to be 22 percent below levels warranted by fundamentals and desirable policies, though most of the gap is an unexplained residual. Staff's preferred estimation of the REER undervaluation is less than 10 percent, based on staff's view of the CA gap and the semi-elasticity of the current account with respect to the REER, estimated at 0.29 and takes into account Malaysia's trade openness and commodity exports. Staff assesses the REER in 2013 to be undervalued by about 5 to 10 percent.	
Capital and financial accounts: flows and policy measures	**Background**. Malaysia has typically recorded net capital outflows. Although net FDI flows are generally small, there are large gross foreign direct investment flows. In 2013, net outflows were about 1.5 percent of GDP, with portfolio outflows accounting for 1.1 percent of GDP, and other outflows accounting for 0.4 percent of GDP. 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. **Assessment**. The authorities have continued to liberalize FX administration, including via greater flexibility for resident companies to undertake FDI abroad and obtain loans from related resident and nonresident companies.	
FX intervention and reserves level	**Background**. While Malaysia maintains a flexible exchange rate regime, BNM intervention seeks to limit excess volatility and generally has been two-sided. 4/ **Assessment**. At end-2013, official reserves were about 117 percent of the IMF's composite reserve adequacy metric, and about 240 percent and 32 percent of short-term external debt and broad money, respectively. Reserves are adequate and there is no need for additional accumulation for precautionary purposes.	

	Malaysia (continued)
Technical Background Notes	1/ Gross assets are 130 percent of GDP, of which about one-third are direct investment assets. Short-term foreign-currency denominated external debt has risen in the last few years, largely due to banking sector activity, it is matched by an increase in short-term external assets and is well-covered by foreign reserves. Ringgit-denominated debt held by nonresidents, about 23 percent of GDP at end 2013, increased rapidly since the global financial crisis. 2/ The non-oil current account deficit widened from -0.6 percent in 2012 to -2.4 percent in 2013. 3/ Since 2000, movements in the REER have been driven almost entirely by the nominal exchange rate rather than inflation differentials. 4/ During the global financial crisis foreign reserves fell by about 28 percent between August 2008 and March 2009, but then registered a strong increase in early 2011; a decline was again recorded in August–September 2011 and in June 2013. During June 2013, reserves fell by in US$5 billion suggesting intervention.

	Mexico	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Mexico's NIIP is about -40 percent of GDP (gross foreign assets and liabilities are roughly 40 percent and 80 percent of GDP, respectively). Foreign-held portfolio liabilities (particularly of peso government bonds) are about 38 percent of GDP. With projected current account deficits averaging less than 2 percent of GDP, the NIIP to GDP ratio is projected to remain broadly stable over the medium term. **Assessment**. While the NIIP is sustainable, gross foreign portfolio liabilities could be a channel of vulnerability to global financial volatility, especially through the domestic sovereign bond market.	**Overall Assessment**: *Mexico's external sector position is broadly consistent with medium-term fundamentals and desirable policy settings*. For 2013, the staff assesses the current account as having been only slightly on the strong side, and correspondingly the REER to have been slightly on the weak side. The FCL provides an added buffer against global tail risks. **Potential policy responses**: As the external sector position is broadly consistent with medium-term fundamentals, there is no reason to alter the current and planned policy settings. The authorities have committed to reducing the public sector borrowing requirement from 4.1 percent of GDP in 2014 to 2.5 percent of GDP in 2017, which will require expenditure restraint. The central bank will set monetary policy to ensure that the inflation converges towards the 3 percent permanent target within the horizon at which monetary policy operates, while maintaining a flexible exchange rate policy.
Current account	**Background**. The current account (CA) deficit widened to 2.1 percent of GDP in 2013 (-1.7 percent cyclically adjusted), amid larger net factor payments. The deficit is projected to rise to about 2 percent of GDP, on the back of imports associated with increased FDI in the energy and telecom sectors. Investment is projected to rise by almost 2 percentage points of GDP over the medium term, supported by an increase in public and private saving. **Assessment**. Mexico's CA appears to be slightly stronger than the level consistent with medium term fundamentals and desirable policy settings. The EBA model estimates a cyclically-adjusted current account norm of -1.9 percent, implying a positive CA gap of +0.2 percent of GDP (including the upward influence on the CA of fiscal policies of other countries). The staff assessment is similar, within a gap range centered on that estimate plus or minus 1 percent of GDP. The small projected increase in Mexico's CA deficit is consistent with fundamentals, desirable policy settings, and the expected effects of the growth-enhancing structural reforms on FDI.	
Real exchange rate	**Background**. The floating exchange rate has been a key shock absorber in an unsettled global environment. 1/ In 2013, the peso became the most widely-traded emerging market currency. As such, it often serves as a port-of-call for investors taking positions in other EM currencies with less liquid markets or capital account restrictions. **Assessment**. The EBA REER regression estimates a small undervaluation of about 6 percent in 2013; this is also consistent with the EBA estimate that the current account is slightly on the strong side. The staff assesses Mexico's real effective exchange rate to be broadly consistent with fundamentals and desirable policy settings (slightly undervalued with a gap centered on -5 percent, in a range of 0 to -10 percent).	
Capital and financial accounts: flows and policy measures	**Background**. Large gross capital inflows by non-residents in the period following the global crisis were broadly offset by large purchases of assets abroad, particularly by the resident private sector. 2/ Net capital inflows are expected to continue to be in excess of the external current account deficit; since 2010, a large share of these flows have been purchases of government paper and other portfolio investments by non-residents. 3/ Going forward, the structural reforms could raise overall inflows and FDI. **Assessment**. While the local currency denomination and long duration of sovereign debt reduces the exposure of government finances to depreciation, the large presence of foreign investors leaves Mexico exposed to a reversal of capital flows and a sustained increase in risk premia. The authorities have refrained from capital flow management measures, in line with their view that an open capital account reduces policy uncertainty and supports long-term growth.	
FX intervention and reserves level	**Background**. The central bank remains committed to a floating exchange rate, using rules-based intervention only to prevent disorderly conditions. The central bank did not conduct any discretionary foreign exchange intervention in 2013; it will continue to build its reserve buffer through purchases of the net foreign currency proceeds of the state oil company. **Assessment**. The current level of foreign reserves is adequate for normal times according to a range of standard reserve coverage indicators, and falls in the lower end of the 100-150 percent range of the IMF's composite adequacy metric. The current policy of reserve accumulation is broadly consistent with the expected gradual rise in foreign-held portfolio liabilities. The Fund FCL arrangement has been an effective complement to international reserves against global tail risks.	

	Mexico (continued)
Technical Background Notes	1/ Following the tapering announcement by Ben Bernanke in May 21, 2013, Mexico's currency experienced one of the sharpest depreciations across emerging markets, falling by nearly 8.4 percent by end-June 2013. Since then it has been on an appreciating trend, and by the end of April 2014 it had depreciated 6 percent with respect to May 21, 2013—significantly less than for other emerging market countries. 2/ The large gross capital inflows by non-residents in the period after the global crisis did not lead to a significant widening of the current account deficit. Rather, they translated (in a BOP accounting sense) into a strong accumulation of hard-currency assets abroad, particularly by the private sector. Outward FDI, foreign bond and equity purchases, deposits abroad and domestic banks' loans to non-residents represented two-thirds of the economy's foreign asset accumulation over this period. 3/ In the second quarter of 2013, gross capital inflows from non-residents, especially portfolio investment, fell sharply from a peak in the first quarter. Residents helped cushion the effects of this shift by repatriating part of their assets invested abroad, thus leading to a smaller decline in overall net capital inflows. Portfolio inflows bounced back strongly in the second half of 2013.

	The Netherlands	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The growth in foreign assets has been driven by large FDI outflows, while liabilities have increased owing to portfolio investments, mainly equities. The net international investment position (NIIP) turned positive in 2008 and is estimated to have reached 53 percent of GDP in 2013, indicating a strong position. Direct investment net assets are considerable at 48 percent of GDP, while portfolio investments are in net liability of approximately 4 percent of GDP. **Assessment**. The Netherland's sizeable foreign assets, amounting to 495 percent of GDP, and safe haven status limit the risks from foreign liabilities that are 442 percent of GDP. In light of projected continued sizable current account surpluses, the ratio of NIIP to GDP is likely to continue rising.	**Overall Assessment**: *The external position is stronger than the level consistent with medium-term fundamentals and desirable policy settings*. However, the external assessment is subject to relatively large uncertainty, including because of the Netherlands' role as a trade conduit and financial center. **Potential policy responses**: Structural reforms to raise the productivity of smaller, domestic firms and progress in repairing household balance sheets and strengthening the banking system will support domestic demand and contribute to reducing external imbalances. A slower pace of fiscal consolidation and shift towards more productive investment will also help in the rebalancing.
Current account	**Background**. The current account has been in surplus since 1981, reaching 10.4 percent of GDP in 2013. The current account surpluses are explained in large part by savings of the corporate sector and institutional pension held by households and reflect Netherland's status as a trade and financial center and natural gas exporter. The large corporate savings have been used to finance substantial FDI outflows by global firms in the Netherlands. The rise in household savings since 2008 also reflects deleveraging in response to the sharp declines in housing prices. **Assessment**. After accounting for the Netherlands' status as a financial center and energy exporter, the EBA model results suggest that the cyclically-adjusted current account surplus (estimated at 9.3 percent of GDP) is stronger than the value implied by medium-term fundamentals (a current account norm estimated at 5.1 percent of GDP). The current account gap is likely to be smaller due to the following country-specific factors: (i) unlike many other advanced economies, the Netherlands has a fully funded pension system which has increased household saving rates; (ii) following a real estate collapse, household deleveraging has also kept saving rates high, and (iii) statistical issues related to the income measurement of large FDI flows. Taking account these factors, the staff assessment of the current account gap is in the range of 0-4 percent of GDP. 1/	
Real exchange rate	**Background**. After depreciating during the period 2008–12, both the ULC and CPI based REERs appreciated somewhat in 2013 and are now slightly above their historical averages. **Assessment**. The EBA REER model estimates a gap of -1 percent, while the translation of the EBA CA regression estimate to REER terms yields a gap of -7 percent. Considering in addition the staff's CA assessment, and taking into account that trade elasticities tend be larger for members of monetary unions and for economies with high trade shares, the staff's assessment is that the real exchange rate is below the level consistent with fundamentals and desirable policy settings by 0–10 percent.	
Capital and financial accounts: flows and policy measures	**Background**. Net FDI and portfolio outflows dominate the financial account. FDI outflows are driven 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 investment substantially abroad.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the Euro area are typically low relative to standard metrics, but the currency is free floating.	

	The Netherlands (continued)
Technical Background Notes	1/ The larger external balance sheet, presence of large international corporations, and issues related to the measurement of the current account add uncertainty to this assessment.

<table>
<tr><th></th><th>Poland</th><th>Overall Assessment</th></tr>
<tr><td>Foreign asset and liability position and trajectory</td><td>Background. A large negative net international investment position (NIIP) has stabilized and stood at 69 percent of GDP in 2013 (gross assets were 42 percent of GDP and gross liabilities were 111 percent of GDP). Amid projections for a moderate widening of the current account (CA) deficit, which will be financed largely by EU transfers, the NIIP is projected to decline to around 50 percent of GDP by 2019.
Assessment. Vulnerabilities exist, but sustainability concerns surrounding the large negative NIIP position are mitigated by well-diversified FDI liabilities and associated intra-company lending (over 40 percent of foreign liabilities are FDI investments) and the projected decline in the NIIP under the baseline. Broadly adequate reserves, and the Flexible Credit Line (FCL) arrangement, also help to mitigate liquidity risks that may arise from the large negative NIIP.</td><td rowspan="5">Overall Assessment:
The external position is broadly consistent with medium-term fundamentals and desirable policies.
These policies include continued modest fiscal consolidation. Reserves are broadly adequate. The FCL arrangement provides an added buffer.

Potential policy responses:
Modest fiscal consolidation in Poland, and in the rest of the world, should continue. Vigilance with respect to bank funding (including foreign exchange swaps) is warranted including by standing ready to extend FX liquidity in the event of external shocks. Modest additional reserve accumulation would be appropriate to further bolster buffers. The exchange rate should be allowed to play its appropriate cushioning role.</td></tr>
<tr><td>Current account</td><td>Background. The CA deficit declined from around 5 percent of GDP in 2010-11 to 1.3 percent of GDP in 2013. The moderate CA deficit in 2013 largely reflects income repatriation by multinational companies' domestic affiliates and a trade surplus of 1.9 percent of GDP.
Assessment. The CA is close to that suggested by fundamentals and desirable policies. The EBA CA regression approach estimates a gap of around 0.4 percent of GDP, reflecting the sum of offsetting domestic and trade partners' policy gaps (a further reduction in Poland's structural fiscal deficit will be needed to reduce its domestic policy gap) and a residual. The cyclically-adjusted CA and CA norm are both estimated at about -1 percent of GDP. The staff assessment is similar, with a CA gap range centered on 0 within a range of plus or minus 1 percent of GDP.</td></tr>
<tr><td>Real exchange rate</td><td>Background. The average real effective exchange rate (REER) appreciated modestly in 2013 relative to its average level in 2012.
Assessment. The various EBA model approaches suggests a modest undervaluation of between 0 and 8 percent (there is no estimated undervaluation using the current account norm; the estimated undervaluation using the ES estimate of the REER gap is 8 percent; and the estimated undervaluation using the REER regression approach is 5 percent). Based on these inputs, and the assessment of the CA, staff assesses Poland's real exchange rate in 2013 to be broadly consistent with fundamentals and desirable policy settings, with a REER gap range of -5 to +5.</td></tr>
<tr><td>Capital and financial accounts: flows and policy measures</td><td>Background. In recent years, inflows in the financial account have been centered on portfolio flows (notably government bonds), as net FDI inflows slowed and the country experienced other investment outflows (notably external deposits to the banking sector). However, this did not continue in 2013, when Poland experienced portfolio outflows. The capital account is dominated by EU structural fund inflows. Portfolio inflows recovered in early 2014 and Poland was only moderately affected by the emerging market turmoil this year.
Assessment. Historically high foreign holdings of government bonds suggest potential vulnerability. Pension modifications, which further increase the share of foreign investors in the domestic government bond market (by shifting pension fund's holdings of government bonds to the public sector), may exacerbate the vulnerabilities from large foreign holdings of government bonds</td></tr>
<tr><td>FX intervention and reserves level</td><td>Background. Reserves have increased substantially in recent years—from 93 billion in 2010 (77 percent of ST debt plus the current account deficit) to 106 billion in 2013 (90 percent of ST debt plus the current account deficit). The zloty has floated freely.
Assessment. Reserves are broadly adequate, standing at about 126 percent of the IMF's composite reserve adequacy metric and are at 100 percent of short-term debt at remaining maturities (and at 90 percent plus the current account). Nonetheless, modest additional reserve accumulation would be appropriate to further bolster buffers. The FCL arrangement with the Fund also provides insurance against external risks.</td></tr>
</table>

	Poland (continued)
Technical Background Notes	1/ Poland has a total current account gap of 0.4 percent. Reasons are twofold: domestic policy gaps are close to zero (except for the fiscal policy gap); and a combination of offsetting domestic and trading partner policy gaps. The domestic fiscal policy gap is -0.8, but its impact on the current account is offset by fiscal gaps in trading partners that result in a total contribution of -0.1 of fiscal policies on the current account gap. In addition, Poland's other gaps (health spending and capital controls) are small but of opposite sign to the fiscal gap. 2/ The various EBA model approaches suggests a modest undervaluation of between 0 and 8 percent (there is no undervaluation using the EBA current account regression approach; 8 percent is the extent of undervaluation estimated using the ES estimate; and 5 percent undervaluation is estimated is using the REER regression approach).

	Russia	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) was modestly positive in 2012 at about 8 percent GDP; with gross assets of 69 percent GDP and liabilities of 61 percent GDP. Historically, the NIIP position has not kept apace with the CA surpluses due to unfavorable valuation changes and the treatment of "disguised" capital outflows. 1/ The NIIP has declined from about 15 percent GDP in 2008. A significant proportion of gross liabilities consists of FDI and equities (57 percent in 2012). Total external debt increased from 32 percent of GDP in 2012 to 33 percent in 2013. **Assessment**. Projected modest current account surpluses would suggest that the positive NIIP position will not change greatly over the medium term. However, intergenerational equity concerns and signs of Dutch disease suggest that a higher portion of oil income should be saved, producing a stronger NIIP.	**Overall Assessment**: *The external position in 2013 was weaker than the level consistent with medium-term fundamentals and desirable policy settings.* While the REER gap identified for 2013 narrowed following the recent depreciation, lasting improvement in the current account would require sustained consolidation on the fiscal policy front and structural reforms. **Potential policy responses**: The nonoil fiscal deficit remains significantly higher than its long-term desirable level amid high oil prices and strong oil revenues. Greater saving of oil revenues and/or re-allocation of government current expenditure into capital spending would help address the worsening in the current account and signs of Dutch disease. Structural reforms to improve the business climate and increased flexibility of the exchange rate should help maintain appropriate external balances.
Current account	**Background**. From 2000 to 2013, the current account (CA) surplus fell from 18 to 1.6 percent of GDP despite increasing oil prices for most of the period. Non-oil exports declined by 12 percent of GDP as the non-oil fiscal balance worsened by 9 percent of GDP. An increase in domestic investment drove about a third of the CA deterioration (evenly split between private and public). The CA surplus is expected to further decline over the medium term, reflecting a moderating oil price, unless policy acts to raise the non-oil fiscal balance. **Assessment**. The EBA-estimated 2013 CA norm was 5.2 percent of GDP; the cyclically adjusted CA was 1.9 percent. 2/ The staff assessment is that the 2013 CA gap was -3 to -1 percent of GDP. This change in the assessment from the previous ESR reflects a decline in the CA in 2013, in part driven by the further deviation of the non-oil fiscal balance from the estimated sustainable level of 5 percent of GDP. In the medium term, fiscal policy should be tightened to rebuild buffers, save more of the oil wealth for future generations, and counter Dutch disease. The current account in 2014 is projected to improve on the back of recent real depreciation and projected contraction in domestic demand.	
Real exchange rate	**Background**. The sustained oil price boom and related expansion of domestic demand led to strong real effective exchange rate (REER) appreciation between 2000 and 2013. The REER depreciated in the second half of 2013 and early 2014 due to global financial turbulence and geopolitical tensions. **Assessment**. EBA estimates that the average REER in 2013 was 15 percent overvalued based on the CA regression approach and 5 percent undervalued based on the REER regression approach. However, the latter approach is less reliable in countries with large structural changes and short data spans and is discarded from the staff assessment. The sustained fall in non-oil exports suggests that the REER appreciation may be a symptom of Dutch disease. On balance, staff assesses that the REER was overvalued by 5-15 percent on average during 2013. Considering the subsequent REER depreciation in early 2014 (as of May, about 4 percent relative to the 2013 average), suggests that the REER gap has narrowed to a range of 1 to 11 percent.	
Capital and financial accounts: flows and policy measures	**Background**. Net private capital outflows continued in 2013 at about 3 percent of GDP (including net errors and omissions). They were driven by the non-bank sector. Outflows are expected to increase this year, on account of geopolitical tensions and the Fed tapering. Over the medium term, structural outflows are expected to decline if Russia improves its investment climate and oil prices moderate. **Assessment**. While Russia is exposed to risks of accelerated capital outflows (especially because of exceptional geopolitical tensions) and sudden stops of external funding, the ongoing gradual move to a flexible exchange rate and large international reserves provide substantial buffers.	
FX intervention and reserves level	**Background**. The CBR has gradually widened and moved the intervention band since October 2013, increasing the flexibility of the ruble. Following the turmoil in Ukraine and ruble depreciation, the CBR has temporarily reverted to discretion in the conduct of intervention policy and has increased considerably its FX interventions. **Assessment**. At end-2013, reserves stood at 155 percent of the IMF's composite adequacy metric. Reserve assets are adequate, but accumulation of fiscal savings in the oil funds should continue as long as oil prices are high. 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. FX interventions should be limited to episodes of market distress. The move to increased ruble flexibility should continue.	

	Russia (continued)
Technical Background Notes	1/ Unfavorable valuation changes arise because the Russian stock market has performed very well in the last 15 years as the oil price soared, boosting the valuation of foreign-owned assets. "Disguised" capital outflows include transactions such as pre-payments on import contracts where the goods are not delivered, repeated large transfers abroad that deviate from standard remittances behavior, or securities transactions at inflated prices. The Central Bank of Russia includes estimates of "disguised" capital outflows in the financial account but not in the foreign asset position of the reported NIIP. Hence, the actual NIIP position could be higher than the reported level and this treatment of "disguised" outflows may explain part of the discrepancy between accumulated CA surpluses and the reported NIIP position. 2/ The EBA estimated CA norm, calling for a sizable surplus of 5.2 percent of GDP, rests mostly on the need to save out of income from non-renewable oil exports. Staff's assessment shares this basic logic in also calling for a CA surplus for Russia, but acknowledges that such saving (i.e., refraining from consumption) would not necessarily have to take a financial form, and could in part take the form of productive investment spending, which could justify a somewhat lower CA surplus than the EBA-estimated norm.

	Saudi Arabia	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. External assets are substantial at an estimated 130 percent of GDP at end-2012, with the public sector's assets dominated by international reserves. Total external liabilities amounted to 34 percent of GDP at end-2012 (portfolio and other investments were 7 percent of GDP). All external debt is private. The net international investment position (NIIP) stood between 90 and 100 percent of GDP during 2007-2012. The average return on assets was relatively low at about 3 percent compared to a 6 percent on liabilities during the period. While details on the composition of external assets are not available, they are likely mostly invested in government securities. Projections for the current account and GDP growth suggest that the ratio of the NIIP to GDP will rise substantially over the medium term. **Assessment**. There are no immediate vulnerabilities.	**Overall Assessment**: *The external position is broadly consistent with medium-term fundamentals.* Although empirical estimates on the external position from alternative models yield different conclusions, on balance they do not point to a systematic misalignment with medium term fundamentals. The macroeconomic balance approach and the equilibrium exchange rate assessment suggest that current account and real exchange rate are broadly in line with fundamentals, while the external sustainability approach signals that the current account surplus in the medium term may be too low. Higher oil prices and volumes, as Saudi Arabia fulfilled its commitment to adjust production to stabilize the oil market, has pushed the current account surplus higher in recent years. In the absence of further negative supply shocks and with the forecast trend decline in oil prices, the current account is projected to decline over the medium term. **Potential policy responses**: The non-oil fiscal deficit remains significantly above the level implied by intergenerational equity models, and it will be important to begin narrowing the gap with the sustainable primary non-oil balance estimated from an intergenerational equity perspective. 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.
Current account	**Background**. The current account (CA) surplus in 2013 narrowed to 17.9 percent of GDP from 22.4 percent in 2012. This reflected lower oil revenue, weaker demand for petrochemical products, and increased remittance outflows. In recent years, the share of Saudi non-oil exports in global non-oil exports has increased, but is only around 1/3 of 1 percent. Oil prices are anticipated to decline over the medium term, while oil export volumes are expected to fall slightly as output in other producers increases faster than global demand, implying significantly reduced CA surpluses (projected at 7 percent of GDP in 2019). Over the long term, the CA will be determined by: (i) the development strategy chosen, in particular the balance between saving oil revenues overseas to create an income stream for future generations versus domestic investment (public and private); and (ii) the pace of oil extraction, determined by Saudi Arabia's role as the producer that helps balance global oil supply and demand. **Assessment**. Using various methodologies designed to reflect the special situation of large oil exporters, estimated CA norms range from 3-13 percent of GDP. 1/ With oil prices projected to decline, the surplus will fall further, to within this range in the next few years.	
Real exchange rate	**Background**. The real effective exchange rate (REER) is mainly influenced by oil price dynamics and the US nominal exchange rate vis-à-vis trade partners. While there is little direct impact of world oil prices on domestic fuel prices (adjusted very infrequently), oil prices affect domestic prices through government (and therefore consumer) spending. **Assessment**. Consistent with the assessment of the underlying CA, models linking the REER to the real price of oil suggest that the rate is broadly in line with fundamentals.	
Capital and financial accounts: flows and policy measures	**Background**. Inflows are dominated by FDI, while outflows are largely trade credits and portfolio investment. Capital account restrictions and underdeveloped domestic capital markets continue to limit portfolio and investment inflows, while higher oil export revenues boost portfolio and investment outflows. Steps to remove some barriers to portfolio inflows are under consideration, particularly allowing increased foreign investment in the equity market. 2/ **Assessment**. There are no immediate risks or vulnerabilities associated with capital flows.	
FX intervention and reserves level	**Background**. Saudi Arabia has maintained a fixed exchange rate to the US dollar without realignment since 1986. Saudi Arabia does not have a Sovereign Wealth Fund. The government's foreign assets are held at the central bank within international reserves. International reserves increased to about 96 percent of GDP (35 months of imports) at end-2013. This value reflects the dual role of reserves—for both precautionary motives and as savings for future generations. **Assessment**. Reserve assets are more than adequate for precautionary purposes (measured by the Fund's metrics); current account surpluses and the resulting NIIP accumulation are below what would be needed to ensure an equitable intergenerational transfer of oil revenues.	

	Saudi Arabia (continued)
Technical Background Notes	1/ EBA methodology assessments are not available for Saudi Arabia. The models considered in the staff assessment have been developed to deal more adequately with the special intertemporal considerations that are dominant in economies in which exports of non-renewable resources are a very high share of output. (For a description of these models, see International Monetary Fund, 2013, Saudi Arabia: Country Report No. 13/229). 2/ Preliminary data for 2013 suggests that improved coverage of other investment flows has led to a sizable increase in estimated financial outflows, while errors and omissions, which averaged 7.4 percent of GDP during 2005-12, have been reduced to less than 1 percent of GDP.

	Singapore	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) stood at 191 percent of GDP at end-2013, up 44 percentage points from 2008 but still lower than the pre-GFC peak of 217 percent of GDP in 2006. Valuation changes have been an important driver of changes in the NIIP, given the large assets and liabilities. Current account and growth projections imply that the NIIP to GDP ratio is likely to rise substantially over the medium term. **Assessment**. The external balance sheet is not a major source of risk. Potential vulnerabilities posed by the large and mainly short-term gross non-FDI liabilities (468 percent of GDP in 2013)—predominantly cross-border deposit taking by foreign bank branches—are mitigated by banks' large short-term external assets and the authorities' close monitoring of banks' liquidity risk profiles. Singapore also has large official reserves (92 percent of GDP in 2013) and other official liquid assets.	**Overall Assessment**: *The external position is substantially stronger than what is consistent with medium-term fundamentals and desirable policies.* However, this assessment and the size of the imbalance are subject to a wide range of uncertainty reflecting Singapore's very open economy and position as a global trading and financial center. **Potential policy responses**: From a multilateral perspective, and consistent with the authorities' current policies, increased public spending, a stronger social safety net, a more-even distribution of consumption across generations, helped by an expected slower absorption of foreign workers would contribute to further moderate the current account.
Current account	**Background**. The large current account (CA) surplus (18.3 percent of GDP in 2013) reflects a strong goods balance that is somewhat offset by remittance outflows and a negative income balance. 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 rates. 1/ In particular, precautionary saving motives (reflecting Singapore's status as a financial center and the limited scope of social safety nets), a rapid pace of aging and greater income inequality than in other countries, together with wealthier households' higher propensity to save may have played a role. 2/ 3/ **Assessment**. Singapore is a small, very open economy that has a large positive NIIP, very high per capita income and is aging at a very high speed. Such non-standard factors make Singapore an outlier; and a quantitative assessment of its CA difficult and subject to a wide range of uncertainty. Considering a range of estimates (based on EBA-like and other models) staff assesses that the CA is stronger than the level consistent with medium-term fundamentals and desirable policies, by 2 to 8 percent of GDP.	
Real exchange rate	**Background**. The 25½ percent appreciation of the real effective exchange rate (REER) since 2005—some 8 percentage points of which has occurred since end 2011—has raised the REER above its previous peak in the late 1990s. **Assessment**. While non-standard factors make a quantitative assessment difficult, staff assesses that the real exchange rate is around 4-16 percent weaker than warranted by medium-term fundamentals and desirable policies. This estimate is drawn from the CA assessment and relies on a semi-elasticity of the CA with respect to the REER of about 0.5, consistent with Singapore's high level of openness. This assessment is subject to a wide range of uncertainty reflecting the uncertainty in the underlying CA assessment and the semi-elasticity of the CA with respect to the REER.	
Capital and financial accounts: flows and policy measures	**Background**. Singapore has a fully open capital account. 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). **Assessment**. The financial account is likely to remain in deficit as long as income from NFA is reinvested abroad.	
FX intervention and reserves level	**Background**. With the nominal effective exchange rate as the intermediate target, intervention is undertaken as required to achieve monetary policy's inflation and output goals. As a financial center, prudential motives call for a large NIIP buffer, including in the form of official reserves. **Assessment**. At end-2013, official reserves covered about 27 percent of short-term external debt. However, reserves are far in excess of thresholds for other adequacy metrics. The reserves-to-GDP ratio is also larger 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.	

	Singapore (continued)
Technical Background Notes	1/ Although investment has declined considerably since the Asian crisis, Singapore has made significant progress in increasing productivity and is now close to the productivity frontier in many sectors. 2/ Non-standard factors make quantitative assessment of Singapore's external position difficult and subject to significant uncertainty. Singapore is not in the sample used to estimate the EBA models because it is an outlier along several dimensions (e.g. the NFA position, per capita income, fiscal balance and the aging speed) and nonlinearities in their impacts on the CA would not be captured in the EBA framework. That said, the EBA CA framework, appropriately adjusted for the special characteristics of Singapore, can still be informative. 3/ Applying the EBA coefficients to Singapore suggests that the CA surplus is mainly explained by the high level of productivity, the large fiscal surplus and high rate of aging, plus a dummy regressor for status as a financial center, and its large NFA position. The EBA-estimated CA gap is about 3 percent of GDP (relative to a cyclically-adjusted level of the CA of about 20 percent of GDP in 2013). Of that, two percentage points of GDP is identified as policy gaps (driven by the fiscal balance and public spending on health care) and the remaining 1 percentage point of GDP is the residual. However, that estimated CA surplus norm could be overstated, in particular if the high NFA level is interpreted as a byproduct of past excessive surpluses, and by the aforementioned nonlinearities, implying an understatement of the gap.

	South Africa	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Gross external debt has increased to 39 percent of GDP from near 25 percent in 2009, but short-term external debt (10 percent of GDP) remains manageable. About 55 percent of external debt is denominated in rand. Nevertheless, a sudden stop of portfolio inflows remains an important source of vulnerability. **Assessment**. The net IIP position (-8 percent of GDP in 2012) is not a major source of risk because it improves with depreciation. However, gross liabilities (106 percent of GDP) are large and the IIP position is expected to deteriorate given the projected large current account (CA) deficit.	**Overall Assessment**: *The external position is weaker than implied by desirable policy settings and medium-term fundamentals.* Though it has started to adjust, the CA deficit continues to be elevated and mainly financed by debt-creating flows. Real depreciation should boost net exports, but structural problems are slowing the CA adjustment. Low saving relative to investment imply substantial CA deficits over the medium term. In spite of a favorable maturity structure and currency denomination of external debt, gross external financing requirements are relatively high and vulnerabilities are elevated. A slowdown of capital inflows would complicate the financing of the CA deficit and, if severe, could induce a significant growth slowdown. **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 and monetary tightening are expected to alleviate external vulnerabilities. As financing conditions allow, a build-up of reserves would strengthen the country's ability to deal with FX liquidity shocks. Increasing household saving will require faster growth in household incomes through much faster employment growth, which in turn requires structural reforms.
Current account	**Background**. The CA deficit widened to 5.8 percent of GDP in 2013 (5.3 percent of GDP cyclically adjusted) from 5.2 percent in 2012, on the back of resilient imports and softer terms of trade. Export and import volumes have started to adjust, reflecting lagged effects of depreciation. However, South Africa's competitiveness problems and supply bottlenecks hinder the CA adjustment. Low saving coupled with robust public infrastructure investment is expected to keep the CA deficit elevated over the medium term, notwithstanding planned fiscal consolidation. **Assessment**. EBA estimates a CA norm of -2.3 percent of GDP and a gap of -3.0 percent of GDP for 2013. Staff assesses the CA to be 1½ to 3½ percentage points weaker than implied by medium-term fundamentals and desirable policy settings. 1/	
Real exchange rate	**Background**. Since end-2010, the CPI-based REER has depreciated 26 percent, ending 2013 15 percent below its 10 year average. By May 2014, the REER had further depreciated by 4 percent relative to its 2013 average level. In contrast, ULC-based measures, which reflect differences in domestic costs of production more accurately, are near 10-year averages. While the EBA REER regression estimates (which use CPI-based REERs) an undervaluation for 2013, other indicators, including the EBA CA gap estimate and South Africa's declining share of world's exports, continue pointing to overvaluation. **Assessment**. Considering the more reliable CA gap estimate, the staff assesses the 2013 REER as overvalued by 5-20 percent. 2/ Gauging the appropriate exchange rate for South Africa is challenging due to its structural changes since 1994 and high REER volatility; in essence REER history provides little guidance. 3/ Also, the sensitivity of trade flows to the exchange rate movements appears lower than implied by long-run elasticities—estimates of such elasticities are subject to high uncertainty due to structural changes. With substantial lags, the weaker rand has started reducing the CA deficit, but structural factors will likely keep the external position weaker than justified by fundamentals and desired policies over the medium term. Hence the exchange rate is still deemed overvalued, but the extent of overvaluation is difficult to pinpoint.	
Capital and financial accounts: flows and policy measures	**Background**. FDI is lower than in most of South Africa's peers, while portfolio and other investment flows, particularly foreign purchases of local currency government bonds, have accounted for most of the financing of the CA deficit up to 2012. Last year, net portfolio flows declined substantially to 0.1 percent of GDP while other investment and unrecorded transactions financed the bulk of the current account deficit. **Assessment**. The risks posed by the reliance on non-FDI flows and nonresident financial holdings are significant but mitigated by the 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 investor base. Nevertheless, a sharp slowdown or sudden stop of capital inflows would complicate the financing of the external deficit, possibly prompting a disorderly adjustment.	
FX intervention and reserves level	**Background**. South Africa's exchange rate regime is one of the most flexible among EMs. Intervention is rare. Reserves cover 5 months of imports (80 percent of gross external financing needs), but are expected to remain slightly below the lower bound of the IMF's composite adequacy metric. Gold reserves account for about 10 percent of reserves. **Assessment**. As financing conditions allow, reserve accumulation is desirable.	

	South Africa (continued)
Technical Background Notes	1/ The CA gap presented here results from the CA regression approach and the External Sustainability (ES) approach. The ES approach compares the CA balance expected to prevail in the medium term with the one that would stabilize South Africa's stock of net foreign assets at its peers' benchmark. According to this approach, to stabilize South Africa's NFA at the peers' level, South Africa's CA deficit would need to be around 2 percent of GDP, compared to staff's projection of a CA deficit between 4 and 5 percent of GDP over the medium term. The CA regression approach yields a gap for 2013 of -3 percent of GDP. Hence, the staff's gap range is centered on about -2 ½ percent of GDP. 2/Using the CA gap range and applying a long-run elasticity would suggest an REER overvaluation of about 8-18 percent. Considering the uncertainty regarding the elasticity and the possibility that it may be lower, but also the fact that CA has started to adjust and hence some deficit reduction is in the pipeline, the range here is 5-20 percent. 3/ The history of South Africa's REER divides roughly into two periods and levels: before 2000 the average level was much higher than the post-2000 average. Moreover the REER has fallen steeply over the last several years. In this context, REER regression-based models such as EBA (which uses CPI-based REERs) are very likely to point to current undervaluation, unless they can link the full downward trend of the REER to deteriorating fundamentals. It appears that the level of the REER that is consistent with a given level of the current account has declined over time, but empirical models are unable to explain this shift.

	Spain	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) liabilities dropped from -34 percent of GDP in 2000 to -97 percent of GDP in 2009, driven mainly by substantial current account (CA) deficits. High gross external debt has also stabilized around 165 percent of GDP since 2010. **Assessment**. The large negative NIIP, and the large gross financing needs from external debt, are still major sources of external vulnerability.	**Overall Assessment**: *The external position is substantially weaker than that consistent with medium-term fundamentals and desirable policy settings.* In particular, despite the strong improvement in the current account, achieving both a sufficiently declining IIP and much lower unemployment would require a substantially weaker real effective exchange rate. **Potential policy responses**: The authorities' recent reforms and policy plans to deliver gradual fiscal consolidation, further improve active labor market policies, and to advance product market reforms, are in line with reducing imbalances. Further reforms of the labor market and accelerated implementation of product market reforms would be required to speed the adjustment. More monetary easing at the euro area level—motivated by the need to raise the prospects of achieving the ECB's price stability objective and to support demand, given the weak and fragile growth, large output gaps and very low inflation for the euro area as a whole—would also support Spain's adjustment efforts.
Current account	**Background**. The CA moved into a 0.8 percent of GDP surplus in 2013 (or -0.6 percent of GDP cyclically adjusted) after a 1.1 percent deficit in 2012 and a peak deficit in 2007 of 10 percent of GDP. **Assessment**. Although the EBA model-based estimates of current account norms would not suggest a significant CA gap for 2013, the staff assessment considers the overriding need to sharply improve the NIIP and gauges the 2013 cyclically-adjusted CA to have been 1-3 percent of GDP weaker than desirable. Staff projections envisage the current account surplus will indeed rise by about this amount over the medium term; such surpluses will need to be maintained for many years until the NIIP is at sustainable levels. To the extent the output gap is larger, for example, reflecting a structural level of unemployment closer to international peers, the cyclically-adjusted current account would be lower and thus the gap with respect to the desirable level larger.	
Real exchange rate	**Background**. By 2013, the CPI-based real effective exchange rate (REER) had declined by 3 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 the appreciation has been substantially reversed since that time, largely reflecting substantial labor shedding. Export market shares have been resilient. **Assessment**. The EBA REER regression model estimates an overvaluation of 14 percent for 2013 (with reference to the CPI-based REER); other model-based and a historical REER analysis as well as other indicators (translating the CA gap to REER terms or considering the ULC-based REER) suggest the overvaluation may be smaller. On balance, staff assesses a gap of around 5 to 15 percent above the level consistent with medium-term fundamentals and desirable policies. However, as for the current account analysis, achieving significantly lower unemployment rates closer to international peers in the medium term would likely imply a larger gap.	
Capital and financial accounts: flows and policy measures	**Background**. Since mid-2012, financing conditions have greatly eased, non-resident portfolio outflows have resumed, and ECB borrowing has fallen significantly. **Assessment**. The ECB's OMT program and domestic reform progress have greatly helped improve sentiment and reduce risks of a liquidity crisis. But large external financing needs both in the public and private sector leaves Spain vulnerable to changes in market sentiment and spillovers from Europe.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	

	Spain (continued)
Technical Background Notes	1/ The EBA CA regression-based approach estimate would suggest that a small (1 percent of GDP) deficit would be appropriate for Spain. However, the empirically-based EBA norm is not an appropriate basis for a normative CA assessment for an economy with an extremely negative NIIP. The staff assessment is thus based on higher norm level that is consistent with the overriding need to substantially strengthen the external balance sheet.

	Sweden	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The Swedish net IIP is estimated to have remained at about -13 percent of GDP in 2013, roughly unchanged from the recent years' average. The net IIP would be expected to rise in the medium term, reflecting continued projected current account surpluses. However, there has been a large discrepancy between the recorded net IIP and the notional balance implied by cumulative current account balances, in part explained by negative valuation effects. **Assessment**. Gross assets are estimated at about 263 percent of GDP and gross liabilities at about 276 percent of GDP in 2013. About one-third of the latter are external debt liabilities (about 95 percent of GDP), including liquid liabilities from Sweden's large banking sector. While Sweden's safe haven status moderates risks, sizable gross liabilities create vulnerabilities.	**Overall Assessment**: *Sweden's external position is moderately stronger than the level consistent with medium-term fundamentals and desirable policies*. This comes despite an absence of obvious policy distortions affecting the current account or the exchange rate. As currently specified, EBA models suggest a lower current account norm. However, these estimates do not capture difficult-to-model structural factors, including Sweden's very large financial sector, demographic pressures, and recent structural policy reforms. **Potential policy responses**: Current account and exchange rate trends likely reflect a variety of structural factors, while clear and substantial policy distortions are absent. Hence, current policies in place are broadly appropriate.
Current account	**Background**. The current account surplus is estimated at 6.5 percent of GDP in 2013 (with a cyclically adjusted balance of about 7 percent, reflecting, among other things, the lagged impact of the strong post-crisis *krona* appreciation), down from a peak of over 9 percent of GDP in 2007. It is expected to moderately decline in the medium term, mostly reflecting stronger projected domestic demand contributions to growth. **Assessment**. The cyclically-adjusted current account is about 8 percentage points of GDP above the cyclically adjusted EBA norm estimate (of -1.4 percent of GDP). However, there are no clear and substantial policy distortions that could be pointed to, and a high saving rate is not unusual for an aging society and has been reinforced by pension and other social protection reforms since the mid-1990s, notably a phased shift to a defined contributions pension scheme and a progressive shrinkage in transfers. In addition to demographic factors, the EBA-estimated gap likely reflects other structural factors also not fully captured by the model, such as Sweden's large financial sector and its export structure. This suggests that substantial surpluses are likely to persist into the medium term. Staff assesses Sweden's adjusted current account norm to be around 2 to 6 percent of GDP, implying a current account gap in the range of -½ to 3½ percent of GDP. 1/	
Real exchange rate	**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 22 percent since its trough in early 2009 (and similarly by around 20 percent against the euro). **Assessment**. Despite the continued strengthening of the *krona*, EBA-estimates suggest a real exchange rate undervaluation of 6 percent. Consistent with staff seeing a smaller deviation of the current account surplus from the norm, the real exchange rate gap is assessed to be in the range of -10 to +2 percent.	
Capital and financial accounts: flows and policy measures	**Background**. The surplus in the current account is balanced by a deficit in the financial account (mainly FDI and bank flows). Given their size and funding model, Sweden's large banks remain vulnerable to liquidity risk stemming from global wholesale markets even though banks have improved their structural liquidity measures in recent years. **Assessment**. A further rebalancing of flows, with a drop in short-term flows in favor of longer maturities, is desirable. Macroprudential policies, including stricter capital requirements on domestic banks and raising funding stability standards, can play an important role in assisting this rebalancing process.	
FX intervention and reserves level	**Background**. While the *krona* floats freely and the Riksbank does not generally intervene in currency markets, it boosted borrowed currency reserves by about one-third to around USD 56 billion (10 percent of GDP) in early 2013 to pre-empt possible financial sector liquidity shortages. **Assessment**. Given the large gross external liabilities of banks, maintaining FX liquidity buffers—in the form of reserves and swap lines—is a helpful policy; the current level of foreign currency reserve holdings appears broadly appropriate.	

	Sweden (continued)
Technical Background Notes	1/ The EBA CA regression model leaves Sweden with an unexplained positive residual that is both unusually large and very persistent. Specifications that provide a closer fit for Sweden, including by accounting for cross-country heterogeneity and fixed effects would suggest that the CA norm should on average be about 5½ percent higher than the EBA estimate. Several factors play a role in this regard. First, Sweden's dependency ratio has persistently ranked among the highest in the EBA sample, and there is evidence that the current EBA model substantially understates the implications of this for Sweden's CA norm. Second, while Sweden currently is not classified as a financial center in the EBA model, its banking sector is very large (with assets of over 400 percent of GDP) and serves as a financial center for the Nordic-Baltic region. Taking this into account also raises the implied CA norm. And third, Sweden ranks among the countries with the largest share of merchanting trade—a business model that has been shown to lead to larger CA balances. Taking these characteristics into account would further increase the CA norm. The relative large degree of uncertainty around the CA norm is typical for large financial centers.

	Switzerland	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Switzerland is a financial center with a positive net international investment position (NIIP) of about 150 percent of GDP, and with large gross foreign asset/liability positions (610/467 percent of GDP) characteristic of such economies. Amid large valuation effects, the NIIP to GDP ratio has been volatile with a modest upward trend over the last 10 years. Current projections for the current account and GDP growth rates indicate that the NIIP to GDP ratio will rise to about 175 percent over the medium term. **Assessment**. Large foreign assets and reserves, and policy credibility mitigate risks from large liquid liabilities.	**Overall Assessment**: *The underlying external position is broadly consistent with medium-term fundamentals and desirable policy settings.* This assessment takes into account measurement anomalies in the Swiss BoPs. The real exchange rate is moderately overvalued, a legacy of the large post-crisis appreciation due to safe-haven capital inflows. As a rapid real appreciation threatened to destabilize the economy with deflationary pressures, Switzerland imposed a floor on the CHF/EUR exchange rate, curbing further appreciation. The introduction of the floor was appropriate in light of the economic contraction/deflation risks, and has helped stabilize the franc. **Potential policy responses**: Monetary and exchange rate policies should continue to be guided by the price stability objective. If the global/euro area recovery solidifies and growth strengthens, concerns about low inflation would abate and safe haven capital inflows would reverse. In this scenario, the authorities could begin to undo past intervention with a view, eventually, to returning to a free float. Introducing negative interest rates on bank excess reserves at the SNB might reduce the need for intervention if safe haven inflows return.
Current account	**Background**. Switzerland has a large CA surplus, dominated by net investment income and services exports. Preliminary estimates from the authorities indicate a surplus of 13 percent of GDP in 2013, up from 9½ percent in 2012, reflecting mainly sharply higher net investment income. However, in recent years early estimates of net investment income were revised down sharply—e .g. by 4.1 percent of GDP in 2012. Thus, staff expects the final CA surplus reading to be around 9½ percent of GDP, similar to 2012. Furthermore, correcting for net foreign ownership of FDI retained earnings could reduce the CA further.[1/] Adoption of the BPM6 methodology in 2014 is expected to lead to major changes to CA credits, debits and balance. **Assessment**. Staff assesses the CA as broadly consistent with the level implied by fundamentals and desirable policy settings, with a CA gap ranging from -3 to +3 percent of GDP. The EBA CA regression approach estimates a CA gap of around 1.7 percent of GDP, reflecting a cyclically-adjusted current account surplus of 10.1 percent of GDP) and a EBA CA regression-estimated norm of 8.4 percent of GDP. The latter is consistent with a substantial surplus given the economy's high per capita income, financial center structure, and demographics. The assessment also takes account BoP anomalies and the absence of major distortions that would cause excessive saving or insufficient investment. This assessment is subject to considerable uncertainty, in light of the special structure of the economy and potential anomalies in the BoP.	
Real exchange rate	**Background**. The REER (CPI basis) appreciated by 40 percent from mid-2007 to August 2011, overshooting the correction of an earlier undervaluation. Since Sept 6, 2011, the SNB has enforced a floor of 1.20 for the CHF/EUR exchange rate and the franc has traded in a narrow band above that level. The REER has been relatively stable since end-Sept 2011, although appreciation pressures have emerged since May 2013, as the NEER appreciated while negative inflation differentials vis-à-vis major trading partners disappeared. **Assessment**. The staff's assessment is that the REER is moderately overvalued (an amount that would have only marginal impact on the Swiss CA, given its particular structure) with a REER gap range of 0 to +10 percent of GDP. The EBA REER regression-based estimate suggests that the franc is overvalued by 7 percent relative to its fundamentals and desirable policy settings.	
Capital and financial accounts: flows and policy measures	**Background**. Significant net outward FDI (mostly reinvested earnings) has been a consistent feature of the financial account in recent years, although bank lending flows have become critical since the crisis. The SNB absorbed the very large safe haven inflows (intermediated by the banking system) in 2012 through reserve accumulation. Errors and omissions continue to be significant, and have been positive over the last six quarters. **Assessment**. Safe-haven capital inflows may return in the event of a re-emergence of euro area stress, an intensification of EM turmoil (including, due to a disorderly UMP exit by major central banks), or geopolitical risks.	
FX intervention and reserves level	**Background**. The SNB accumulated foreign exchange reserves of about 45 percent of GDP during 2009–12 in three rounds of intervention. With safe haven inflows related to euro area stress abating since mid-2012, the SNB balance sheet has stabilized at around 81 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 rose when the European euro area crisis intensified in early/mid-2012. The floor seeks to protect the Swiss economy in the event of further such stress episodes and the associated likely resumption in safe haven inflows.	

	Switzerland (continued)
Technical Background Notes	1/ Swiss multinational firms are often partly owned by foreigners through portfolio shares. Thus, a part of the retained earnings of these companies, which form a large component of Swiss current account receipts, should be attributed to foreign shareholders, rather than counted as domestic income. See T. Mancini-Griffoli and N. Stoffels, "Adjusting the Current Account to Better Capture Wealth Accumulation," mimeo, Swiss National Bank, August 2012. 2/ Because the Swiss current account is dominated by investment income, financial services and merchanting receipts, it is likely to be less sensitive to the real effective exchange rate than if it were dominated by trade in goods. Moreover, many of Switzerland's goods exports are luxury or highly specialized the demand for which tends to be price inelastic. See T. Jordan, "Reconciling Switzerland's minimum exchange rate and current account surplus", Speech Delivered at the Peterson Institute for International Economics, Washington D.C., October 2013. On merchanting, see, for example, E. Beusch, B. Döbeli, A. Fischer and P. Yesin, "Merchanting and Current Account Balances," Swiss National Bank working paper, June, 2013.

	Thailand	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) had been improving steadily from the large deficit hit following the Asian crisis (-81 percent of GDP), until 2009, when the NIIP came close to balance (-3 percent of GDP). Subsequently, large increases in direct and portfolio investment valuations raised foreign liabilities and lowered the NIIP to -24 percent of GDP in 2012. Net foreign liabilities are expected to remain broadly stable. **Assessment**. The deterioration of the NIIP during 2010–2012 appears to be due largely to valuation changes, as on average the current account was in surplus. There are limited risks to external debt sustainability because Thailand's external debt is projected to remain low and net foreign liabilities (as a percent of GDP) are expected to stabilize.	**Overall Assessment**: *The external position is broadly consistent with medium-term fundamentals and desirable policy settings.* Reserves are more than adequate. **Potential policy responses**: A medium-term infrastructure investment policy is key to unlocking growth by boosting private investment, which would justify temporarily larger current account deficits. The authorities should continue to allow the exchange rate to follow fundamentals. Ample reserves can support two-way flexibility of the baht while still providing some scope for intervention to smooth excessive volatility.
Current account	**Background**. Thailand's current account (CA) has been quite volatile over the last decade, ranging from a 4¼ percent of GDP deficit to 8¼ percent of GDP 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 2013 (a cyclically-adjusted CA balance of about 0.1 percent) and is expected to remain close to balance over the medium term. **Assessment**. Staff assesses Thailand's 2013 CA to be close to the level consistent with medium-term fundamentals and appropriate policies, within a range of -1 to +1 percent of GDP). This is supported also by the EBA CA model estimate of a gap of +0.2 percent of GDP (in cyclically adjusted terms, the EBA estimated CA norm and 2013 CA outcome are -0.1 and +0.1 percent of GDP, respectively).	
Real exchange rate	**Background**. Barring the global financial crisis, the Thai baht generally has been appreciating in real effective terms since 2005. After appreciating strongly during late 2012 and the first four months of 2013, the real effective exchange rate (REER) weakened over the remainder of 2013 (as did the REER of many other emerging economies). As of May 2014, the REER was about 4 percent weaker than its 2013 average level. **Assessment**. Staff assesses the REER to be broadly consistent with medium-term fundamentals and appropriate policies, likely within a range of -5 percent below to +5 percent above such a level. The EBA estimates do not point clearly to a REER gap (the EBA REER regression model estimates a REER slightly on the strong side in 2013, by 4 percent; the EBA CA regression model suggests a REER gap of about -1 percent).	
Capital and financial accounts: flows and policy measures	**Background**. Equity and bond flows have declined and became negative in 2013. **Assessment**. While capital flows to banks reflect mostly hedging activities of the trade sector and therefore follow the trade balance, portfolio flows benefited from the relatively better fundamentals of the Thai economy compared to advanced economies, but faced headwinds from the withdrawal of unconventional monetary policies, emerging market sell-offs and domestic political uncertainties. The authorities have allowed exchange rate flexibility to smooth capital flow volatility. 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.	

	Thailand (continued)
FX intervention and reserves level	**Background**. The exchange rate is floating with intervention at times, including in the forward market. Foreign currency reserves are about 43 percent of GDP, over three times short-term debt, and at 229 percent of the IMF's composite metric. (Thailand's net forward FX position has declined to six percent of GDP in 2013). **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 is costly and can be limited by continuing to allow two-way exchange rate flexibility.

<table>
<tr><th></th><th>Turkey</th><th>Overall Assessment</th></tr>
<tr><td>Foreign asset and liability position and trajectory</td><td>Background. Turkey’s net international investment position (NIIP) is about -48 percent of GDP, and is comparable to peers. However, the composition of foreign liabilities has also worsened in recent years, with short-term debt liabilities accounting for 16 percent of GDP.
Assessment. The current net IIP level does not point to a solvency problem at this stage; however, if the current account deficit does not narrow in the years ahead, the ongoing trend deterioration in IIP would present a challenge. Moreover, the composition of foreign liabilities exposes Turkey to liquidity shocks.</td><td rowspan="5">Overall Assessment:
Turkey’s external position is substantially weaker than the level consistent with medium-term fundamentals and desirable policy settings.
The current account deteriorated vis-à-vis 2012, as did external buffers. Net international reserves are low, and Turkey remains vulnerable to capital flow reversal.

Potential policy responses:
Given the country’s external imbalance, a significantly tighter fiscal policy over the medium term and continued structural reforms geared at increasing private sector savings are needed. In addition, monetary policy should continue to keep real interest rates solidly in positive territory. Finally, the CBRT should use any opportunity to accumulate net international reserves, limiting foreign exchange intervention to support the currency to smoothing periods of excessive volatility.</td></tr>
<tr><td>Current account</td><td>Background. The current account (CA) deficit increased to 7.9 percent of GDP in 2013, partly on the back of temporary gold restocking. The deficit is expected to decrease to 6.3 percent of GDP in 2014.
Assessment. Turkey continues to suffer from low private saving. In 2013, domestic demand-led growth widened the deficit. The EBA model estimates a 2013 CA gap of -5.7 percent of GDP. However, staff’s assessment is that the underlying CA in 2013 was some 2½ to 5 percent of GDP weaker than the level implied by medium-term fundamentals and desirable policies. Tighter fiscal and monetary policies would reduce this gap somewhat. Substantial currency depreciation in late 2013 and early 2014, combined with tighter monetary policy and supporting macro-prudential measures that are expected to reduce domestic demand, will likely lower the current account deficit. Thus a forward looking assessment for 2014, incorporating recent developments, also lowers the CA gap.</td></tr>
<tr><td>Real exchange rate</td><td>Background. The real effective exchange rate (REER) has fluctuated considerably in recent years. From a peak in 2010, the REER fell steeply in 2011 and then appreciated by 15-20 percent through early 2013; it then depreciated through the end of 2013, to near its 2011 low. In 2014, the REER appreciated again; as of May, the REER was fairly close to its 2012 and 2013 year averages.
Assessment. Analyzing the 2013 year average REER, the EBA regression model estimates a 19 percent overvaluation. Consistent with the CA assessment, the staff assessment is that the REER was 10-20 percent stronger on average in 2013 than the level consistent with medium-term fundamentals and desirable policy settings.</td></tr>
<tr><td>Capital and financial accounts: flows and policy measures</td><td>Background. Turkey has received substantial capital inflows in recent years. In 2013 net inflows (including net errors and omissions) amounted to some 9 percent of GDP, thereby over-financing the current account deficit in the context of reserve accumulation of about 1.2 percent of GDP. Short-term debt remains the predominant financing instrument. Amid shifting external financial conditions, Turkey has not made use of capital controls on inflows or outflows.
Assessment. Despite projected 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 over 25 percent of GDP in 2014. In an environment of tighter global liquidity, the likelihood of risks materializing has increased.</td></tr>
<tr><td>FX intervention and reserves level</td><td>Background. The lira exchange rate is floating, along with occasional intervention and reserve accumulation. In June 2013, the central bank started selling foreign exchange to the commercial banks through regular auctions. The cumulative total amount of these sales reached US$ 17.6 billion in 2013. This continued in 2014, with cumulative interventions reaching US$ 20.2 billion at end-January. Turkey’s gross reserves equaled 116 percent of the IMF composite adequacy metric at end-2013 versus 114 percent at end-2012. Adjusting this metric for ROM-related reserve holdings reduced it to 95 percent at end-2013. Reserve cover of short term debt declined from 83 percent in 2012 to 78 percent at end-2013. Further taking account of the current account deficit that needs to be financed, reserve cover drops to 53 percent. Thus, reserves available for intervention are significantly lower than gross reserves.
Assessment. Given Turkey’s low net international reserves, reserve accumulation is warranted.</td></tr>
</table>

	Turkey (continued)
Technical Background Notes	1/ The assessment that the current account is 2½–5 percent weaker than medium term fundamentals is based on the fact that the 5.7 gap identified by the EBA current account analysis is mainly a result of an unexplained regression residual, as well as staff's assessment that the current account deficit norm for an emerging market economy catching up to developed countries is likely to be higher than the -0.9 percent norm estimated by the EBA regression. 2/ The EBA analysis of the REER identified a 19 percent overvaluation whereas the result of the External Sustainability (ES) Approach translates into a 16 percent REER overvaluation. Given that by April 2014 the REER has depreciated by some 8 percent from the 2013 average REER and that unexplained regression residual accounts for all of the overvaluation identified in the EBA REER exercise, staff's assessment is that the REER valuation is in the range of 0-10 percent.

	United Kingdom	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) improved from -15 percent of GDP in 2012 to -2 percent in 2013, as a result of valuation effects and changes in the stock of portfolio investment. Although the net position is relatively small relative to the size of the UK economy, gross positions are about 600 percent of GDP. Staff projections for the current account and GDP suggest that the NIIP to GDP ratio would decline to about -8 percent by 2019. **Assessment**. While the net external position and sustainability issues are not a concern, fluctuations in the underlying gross positions are a source of external vulnerability to the extent that they could lead to large changes in the net position.	**Overall Assessment**: *The external position is moderately weaker than implied by medium-term fundamentals and desirable policy settings.* External deficits reflect insufficient public and private saving rates. More fundamentally, the external position is influenced by the lack of competitiveness and limited export diversification. **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 current fiscal consolidation plan implemented within a medium-term framework and an accommodative monetary policy stance contribute to the goal of external rebalancing. Further structural reforms focused on broadening the skill base and investing in public infrastructure will boost productivity, improving the competitiveness of the economy.
Current account	**Background**. Before the crisis, the UK experienced persistent current account (CA) deficits as a result of an overreliance on public and private consumption. In the aftermath of the crisis, the CA balance deteriorated primarily as a consequence of a decline in the income balance. This reflects a fall in earnings on UK's foreign direct investment abroad, notably earnings on investment exposed to the euro area. The trade balance deficit has remained stable around 2 percent of GDP, despite a 16 percent real exchange rate depreciation between 2007 and 2013. The lack of external adjustment is a result of high trade exposure to the euro area and weak growth of financial service exports. While investment declined in the aftermath of the crisis, national savings experienced an even larger contraction primarily as a result of lower public savings. More recently, the household sector savings rate has declined, also contributing to the increase in the CA deficit. **Assessment**. The EBA CA regression approach estimates a CA gap of around -2.6 percent of GDP. Based on alternative models and historical CA analysis, staff's assessment find a cyclically-adjusted CA balance that is 1-2 percent weaker than the current account norm. 1/	
Real exchange rate	**Background**. In the decade preceding the global crisis (1997-2007), the real effective exchange rate (REER) appreciated 16 percent; since 2007, the REER has depreciated by 16 percent. Moreover, the UK experienced an increase in unit labor costs (ULC) of 16 percent since 2007, the largest increase in ULC among G7 economies. Since July 2013 sterling has appreciated in real effective terms. By May 2014, the REER was 6 percent stronger than its average level in 2013. **Assessment**. The EBA exchange rate assessment implied by the EBA CA regression model indicates an overvaluation in the range 10-15 percent. The staff assesses the 2013 REER as 5–10 percent above the level consistent with fundamentals and desirable policy settings; this assessment is consistent with the staff's CA assessment. 2/ 3/	
Capital and financial accounts: **flows and policy measures**	**Background**. Given the UK's role as an international financial center, portfolio investment and financial derivatives are the key components of the financial account. **Assessment**. Large fluctuations in capital flows are inherent to financial transactions in countries with a large financial services sector. This volatility is a potential source of vulnerability.	
FX intervention and reserves level	**Background**. The pound has the status of a global reserve currency. **Assessment**. Reserves held by the UK are typically low relative to standard metrics (4 percent of GDP at the end of 2013), and the currency is free floating.	

	United Kingdom (continued)
Technical Background Notes	1/ The difference between the EBA and staff's CA gap estimate is explained by the treatment of the income balance. Staff has taken the view that recent fluctuations in the income balance are almost entirely cyclical, leading to a smaller estimate of the CA gap. 2/ The estimate from the EBA REER regression-based approach (which tends to be less reliable than the CA regression-based approach) would suggest an 2013 average REER *under*valuation (of 5 percent); this estimate is discarded as implausible, including in light of the assessment that the CA is too weak as well as evidence on competitiveness. 3/ The difference between the EBA and staff's exchange rate assessment is accounted by the alternative approaches to estimate the CA balance gap.

	United States	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) declined from -15 per cent of GDP in 2010 to -27 percent of GDP in 2013, reflecting current account deficits as well as the stronger performance of the U.S. stock market relative to global markets. The U.S. has a positive net equity position, with sizable portfolio equity and direct investment abroad, and a negative debt position vis-à-vis the rest of the world, owing to sizeable foreign holdings of U.S. Treasuries and corporate bonds. Gross assets and liabilities are about 130 and 160 per cent of GDP, respectively. Under staff's baseline scenario, U.S. NIIP would deteriorate by about 5 percentage points of GDP over the next five years. 1/ **Assessment**. Risks to external stability could arise from a decline in foreign demand for U.S. debt securities (the bulk of U.S. 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 U.S. foreign assets are denominated in foreign currency and over 50 percent are in the form of FDI and portfolio equity claims, whose value tend to decline when global growth and stock markets are weak, as well as when the U.S. dollar appreciates.	**Overall Assessment**: *The U.S. external position is broadly consistent with medium-term fundamentals and desirable policies.* The U.S. external position has improved considerably in recent years, as have assessed imbalances and fiscal policy gaps. The boom in unconventional energy production contributed to the improvement. Going forward, although there is some uncertainty on its full potential impact on the U.S. current account, the gains from increased energy independence are expected to boost national saving, partially offsetting the negative impact of stronger domestic investment. **Potential policy responses**: Over the medium term, fiscal consolidation should aim for a general government primary surplus of about 1¼ percent of GDP (corresponding to a federal government primary surplus of about 2 percent, higher than the 1½ percent surplus envisaged in the President's budget and staff's projection of a small deficit). Structural policies should be implemented to raise productivity and labor force growth including by taking steps to fully exploit the benefits of the boom in unconventional energy production. This would be consistent with maintaining external stability and achieving full employment.
Current account	**Background**. The U.S. current account (CA) deficit continued to narrow from its pre-crisis height of 6 percent of GDP to 2.3 percent in 2013, reflecting a sharp reduction in the fiscal deficit (which also helped to lower the global fiscal gap and hence the impact of U.S. policy distortions on other countries), higher private saving, lower investment in the aftermath of the financial crisis, and a stronger energy trade balance (due to the rapid increase of unconventional energy production). Going forward, the current account deficit is projected to widen to about 2¾ percent of GDP by 2019, as stronger private demand leads to a closure of the output gap but with the effect tempered by a further improvement in the energy balance. **Assessment**. The EBA model estimates a CA gap of -1 percent of GDP for 2013. The staff view is broadly similar, on balance assessing the cyclically-adjusted current account to be between 0 and 1.5 percent of GDP weaker than the level implied by medium-term fundamentals and desirable policies.	
Real exchange rate	**Background**. The real effective exchange rate (REER) appreciated by about 2 percent during 2013, but remains around 10 percent below its average value over the past two decades. **Assessment**. Indirect estimates of the REER (drawing on the EBA current account estimate and the staff's current account assessment range) suggest some overvaluation (within the 0 to 10 percent range). However, direct analyses of the REER in the EBA would suggest an undervaluation of around 8 percent in 2013. 2/ Taking into account both methodologies, and acknowledging some uncertainty associated with the boom in unconventional energy production on the US external position, staff assesses the REER to be broadly in line with medium-term fundamentals and desirable policies (with a range of -5 percent to +10 percent).	
Capital and financial accounts: flows and policy measures	**Background**. Inflows and outflows picked up in 2013 but are substantially lower than pre-Lehman levels. Portfolio inflows halved in 2013 relative to 2012 but were more than offset by stronger bank inflows (which were negative in 2012). On the outflow side, there was a large increase in U.S. portfolio investment overseas. The U.S. dollar reserve currency status and safe haven motives boost foreign demand for U.S. Treasury securities during periods of market turbulence. Hence the outlook for U.S. capital flows will depend on global financial stability and the pace of the global recovery, as well as on the outlook for the U.S. 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 level	**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.	

	United States (continued)
Technical Background Notes	1/ Forecasts of U.S. NIIP reflect mainly projected CA flows. 2/ Such REER regression models may, however, be less reliable and have difficulty explaining the REER's weakness (relative to its own history) in terms of changing fundamentals or policy distortions.