

External Balance Assessment: A Successor to the CGER Methodology

A Project of the IMF's Research Department

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“EBA” methodology as a successor to the well-known CGER

- Today: an introduction to EBA
- Ancestry: CA regression literature; CGER
- EBA is a project of the IMF Research Department, comprising:
 - a research effort to better understand CAs, and
 - development of an approach to evaluating CAs in a normative sense

EBA is also about real exchange rates...



EBA's new goals, relative to CGER

- Focus on **current accounts** as much as on exchange rates
- Distinguish **normative** and **descriptive** analyses
- Add focus on impact of **policies**

EBA also aims at...

- taking explicit account of cyclical (higher-frequency) influences
- a more explicit treatment of uncertainties

Recall the CGER approach:

Panel regression of current account balances:

$$CA/gdp = B(X) + e$$

X regressors: demographics, per capita income, relative growth rates, oil trade balance, fiscal balance, lagged CA

How to interpret the **e residuals**? As deviations from fitted values interpreted as a CA norm. What's a norm?

- Careful interpretation: “CA level implied by fundamentals”
- Temptation: “equilibrium” and/or appropriate level. An implied normative judgment?



Why enhance CGER?

Issues of CGER interpretation:

- Residuals are sizable... reflect ignorance, not distortions?
- Unclear mix of descriptive analysis and normative assessment [example: fiscal]
- Assessment sounds normative, but doesn't provide a clear link to role of policies, policy implications

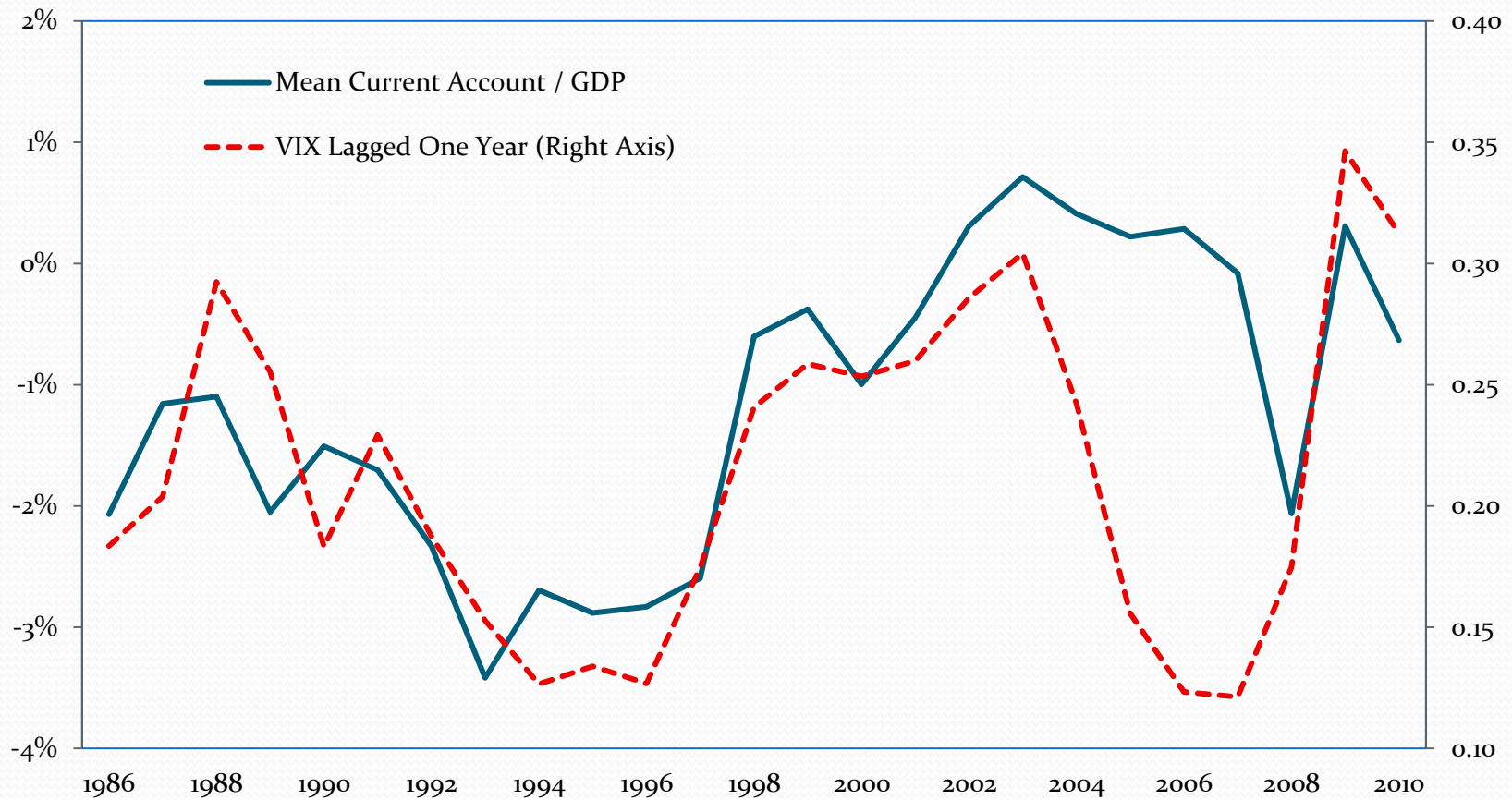
Why enhance CGER?

And issues in CGER regression specification, including:

- What does lagged CA pick up ? Sustained distortions?
- Some plausible stories for S and I behavior are not captured by the CGER regressors (e.g., social insurance, shifts in capital markets)

Cycle in Global Risk Aversion, Cycle in EM Current Accounts

VIX and Mean Current Account of Emerging Market Economies



What is the EBA approach?

EBA panel regression aims to better understand the CA:

$$CA/gdp = B_1 (\text{Structural}) + B_2 (\text{Policies}) + B_3 (\text{Cyclical}) + v$$

Want a tight fit (small **v residuals**) to reduce uncertainty of analysis.

But a small CA residual does not give a clean bill of health !

EBA strategy: identify policy gaps and their contributions to CA

EBA is not easy. Challenges:

- Need to quantify “policy gaps”...
- ...and some policies are difficult to measure in the first place
- Can improve fit but can't eliminate residuals, uncertainty



EBA's CA regression specification (preliminary, work by Luis Catao and others)

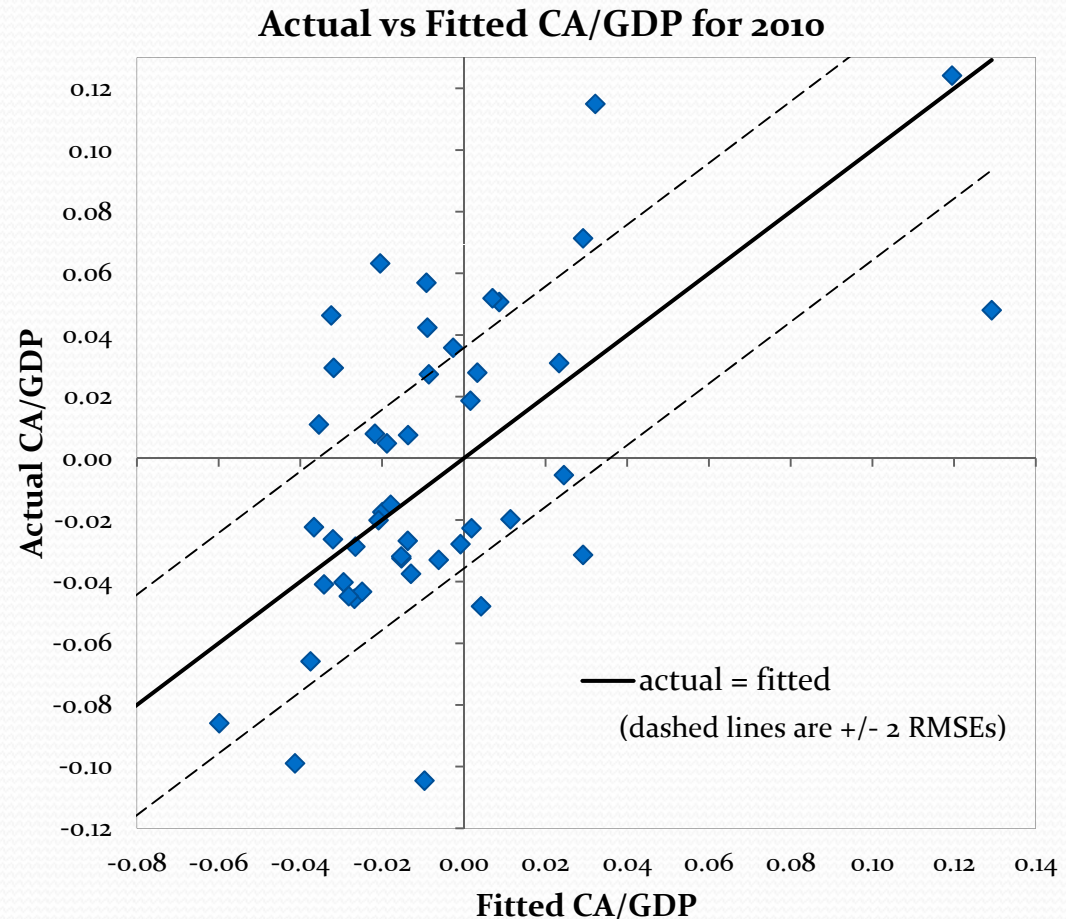
- Has traditional regressors: demographics, relative income, relative growth, net oil exports, NFA
- But no lagged CA. No country dummies.
- Adds new variables, of 3 kinds:
 - *cyclical and exogenous*: terms of trade cycle; global capital market conditions (with differential effects)
 - *cyclical and policy-influenced*: output gap (proxy for demand shock), real interest differential
 - *policies*: fiscal balance; public health expenditure, social protection index, polity, controls on capital inflows
- Signs as expected, most significant

How well does the CA regression work, as a descriptive tool?

Std. error = 1.8% GDP.
Improved fit, even with annual data, no dummies, no lagged CA.

Yet some residuals are very large. For 2010:

- Largest negative residual: Greece
- Largest positive residuals: Malaysia, Sweden, Thailand



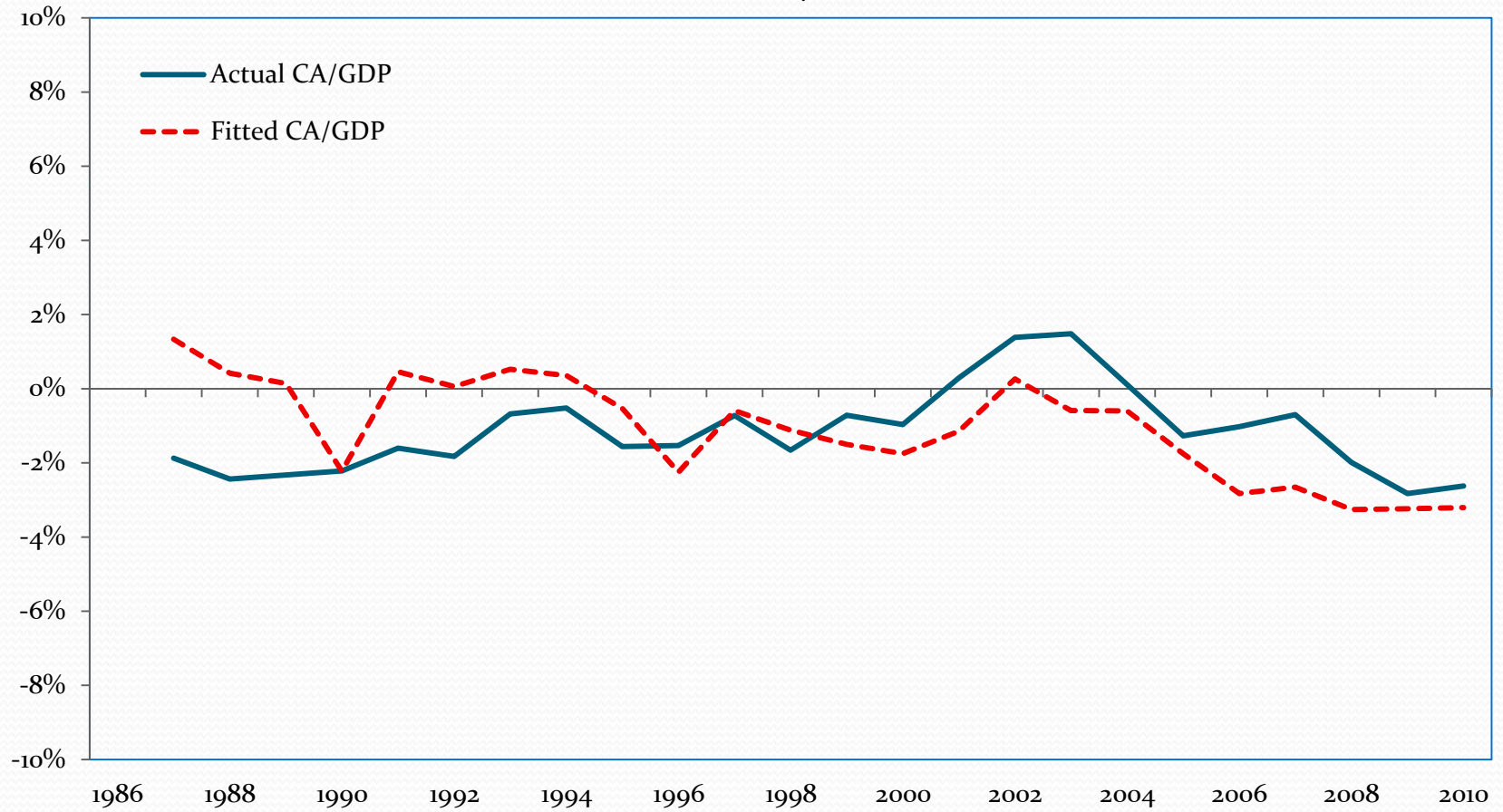
What do panel regression results mean *for an individual country*?

For countries with small CA residuals, we ask:

- what are the key drivers of the CA balance?
- is the well-fitted CA driven by inappropriate policies? And is the CA sustainable?
 - Example: prelim. regression suggests that CA deficit of Turkey comes in part from a weak fiscal balance.
 - For countries with large CA surpluses, what are the estimated contributions of policies?

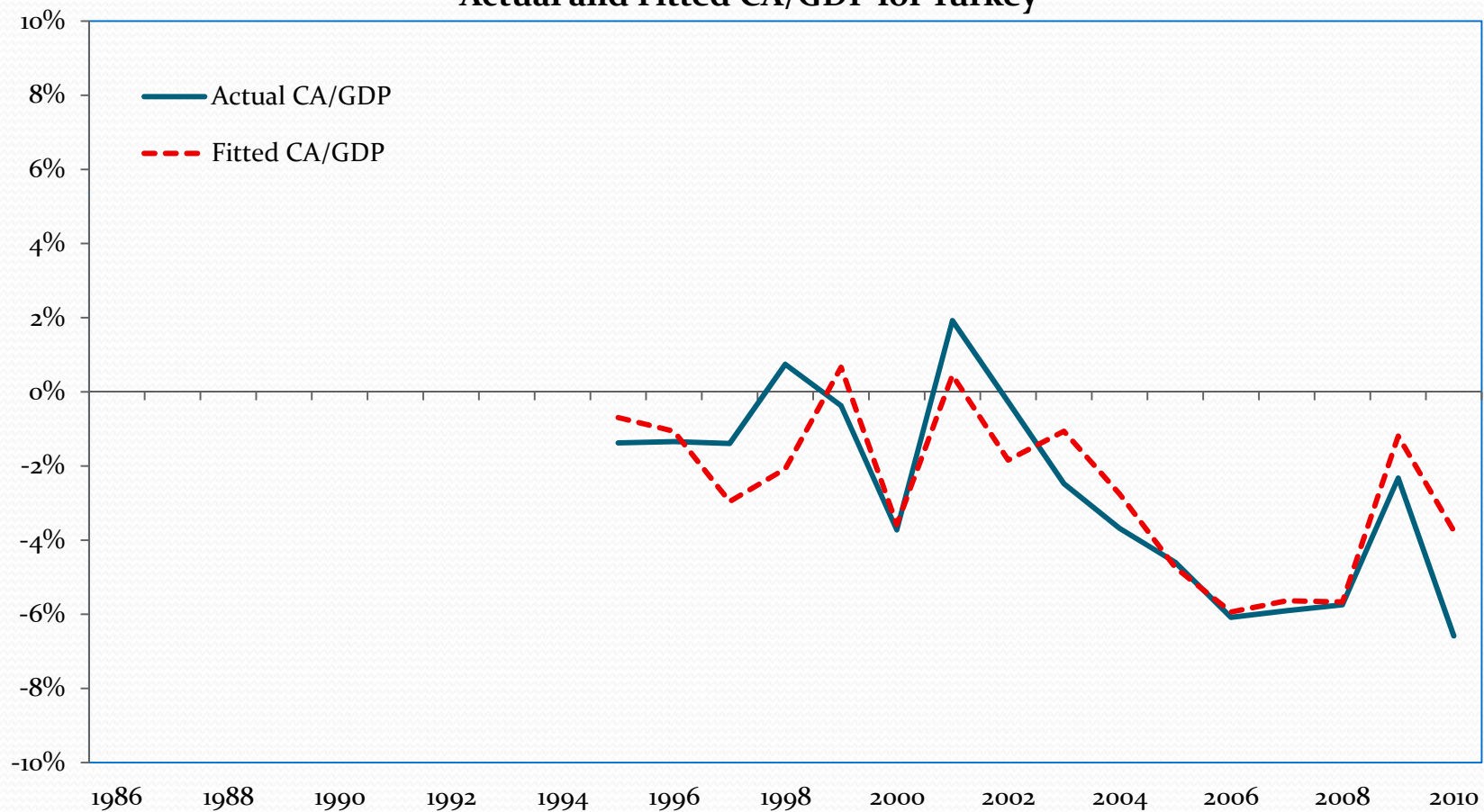
India

Actual and Fitted CA/GDP for India



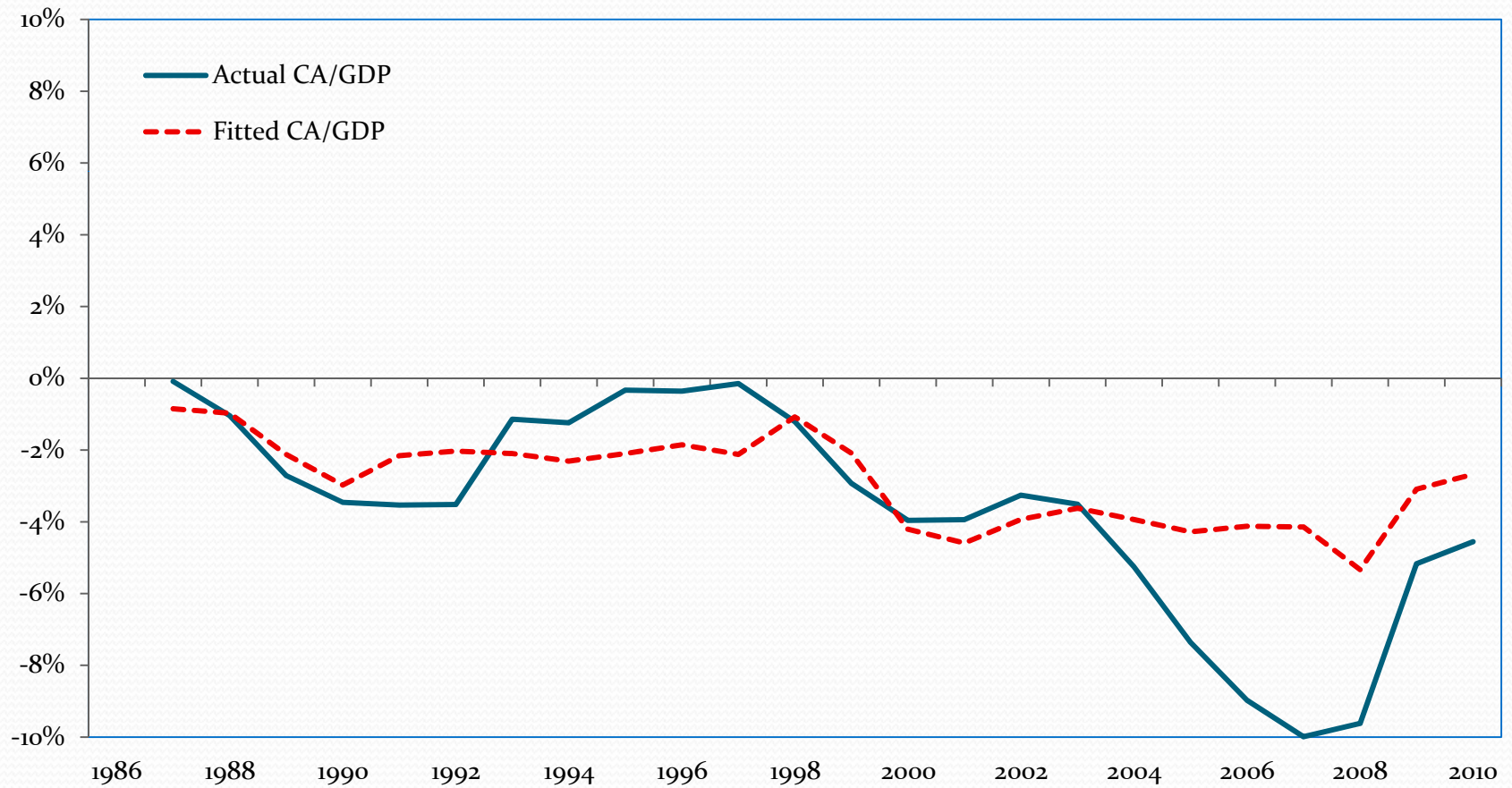
Turkey

Actual and Fitted CA/GDP for Turkey



Spain

Actual and Fitted CA/GDP for Spain



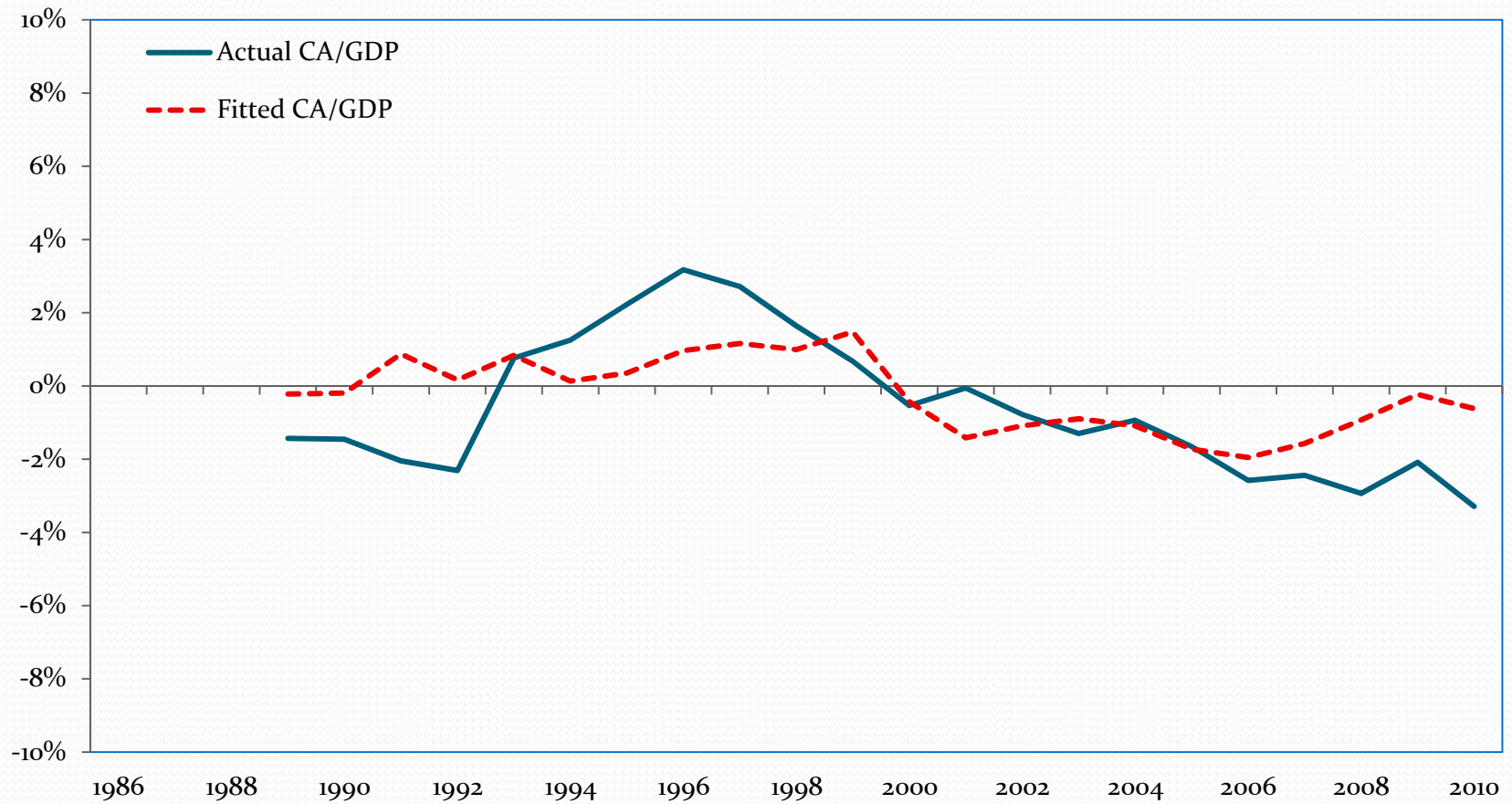
What do panel regression results mean *for an individual country*?

For countries with fairly large CA residuals, we ask:

- what do we think is missing from the regression's story, and is it a good or bad thing?
- For these countries as well, need to ask whether *fitted* values reflect policy distortions...
- ... and to consider sustainability

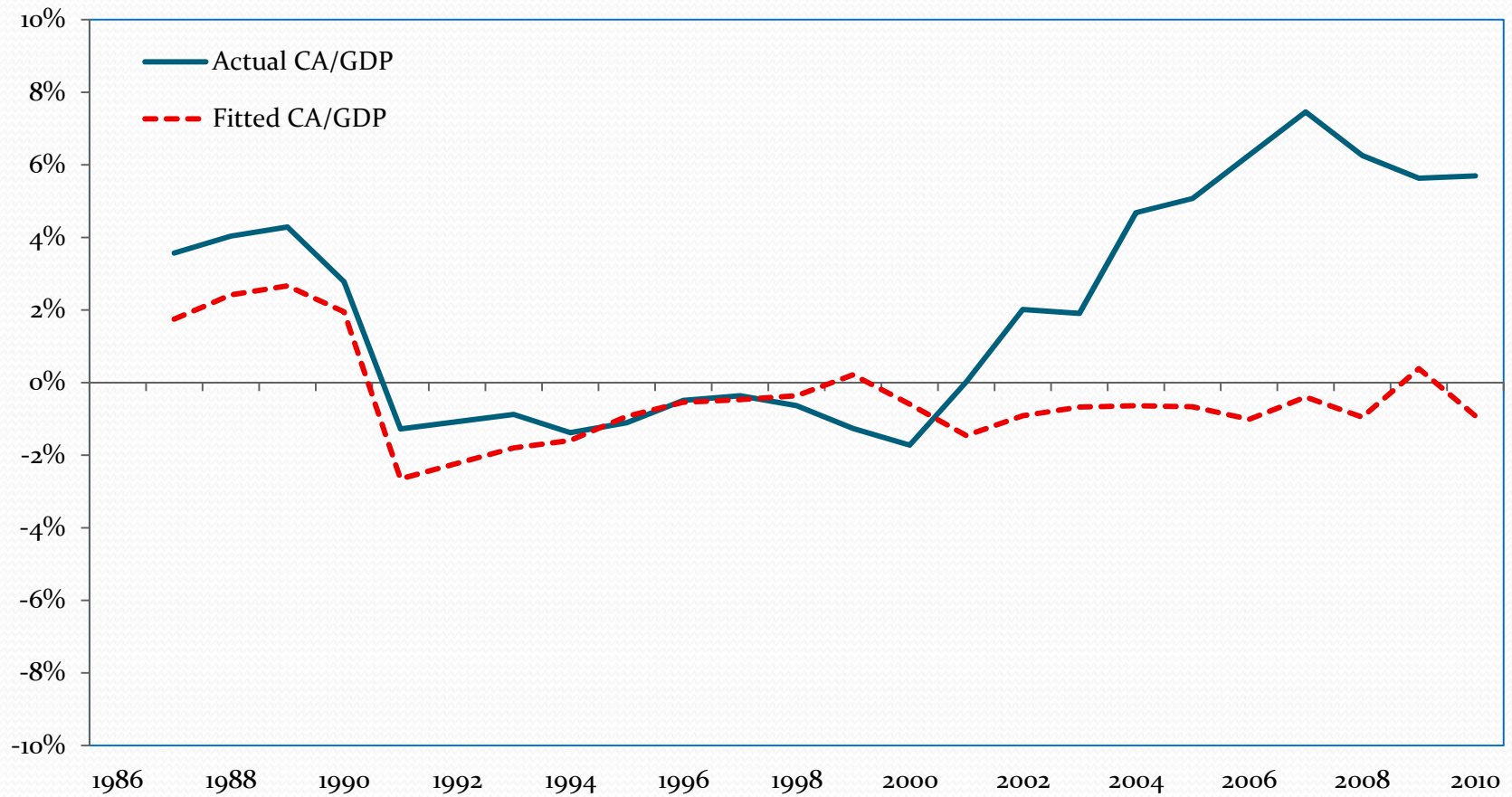
Italy

Actual and Fitted CA/GDP for Italy



Germany

Actual and Fitted CA/GDP for Germany





EBA Analysis has 3 legs:

1. **Current Account analysis**
2. **Also: Real Exchange Rate analysis**
 - Again, add cyclical and policy drivers
 - Also new: aim to assess the level of the RER (not just the level of an RER index relative to its past average)
3. **And: External Sustainability analysis**
 - Various enhancements of CGER's ES approach.
 - Hope to add new approach based on intertemporal constraint (proposed by Martin Evans)



EBA Takeaways

EBA builds on the CGER base by:

- Moving the boundary between uncertainty and what we can explain...
-by adding explicit role for policies, and by modeling responses to higher-frequency shocks
- Facilitating normative analysis and policy discussions...
-but need for informed judgment remains.