Report to Congress on International Economic and Exchange Rate Policies

For the period January 1, 2002 through June 30, 2002

THIS REPORT IS REQUIRED UNDER SECTION 3005 OF THE OMNIBUS TRADE AND COMPETITIVENESS ACT OF 1988 (THE “ACT”). THIS REPORT REVIEWS DEVELOPMENTS IN U.S. INTERNATIONAL ECONOMIC POLICY, INCLUDING EXCHANGE RATE POLICY.

Major Findings:

- **Countries around the world continue to use a variety of exchange rate policies, ranging from flexible rates with no intervention to currency unions and full dollarization**.

- **There was no reversal of the trend toward greater flexibility observed since the mid 1990s.** Treasury continues to monitor the exchange rate practices of major U.S. trading partners and to encourage policies that promote economic growth and economic stability.

- **No major trading partners of the United States manipulated exchange rates under the terms of Section 3004 of the Act during the period January 1, 2002 to June 30, 2002[1].**

The United States:

Current Account

The U.S. current account deficit rose in the first and second quarters of 2002, reaching 4.4% and 5.0% of GDP in the respective quarters. The current account deficit had fallen to $393 billion, or 3.9% of GDP, in 2001 from $410 billion, or 4.2% of GDP, in 2000. Imports, particularly of capital goods, increased strongly. Export growth was sluggish as the recovery in foreign markets lagged that of the United States.

Financial Flows

Net financial flows into the United States remained strong through the period, although the composition of the flows shifted. A decline in net foreign purchases of equities was offset by increased purchases of private and public sector bonds. The inflows financed the U.S. current account deficit and reflected international investors’ continued strong interest in investment opportunities in U.S. markets.

International Investment Position and Earnings

The negative net investment position of the United States at the end of 2001 widened to $2.3 trillion, when direct investment is valued on a market value basis, from a revised $1.6 trillion at the end of 2000. The U.S. nevertheless earned a net $21 billion on that position during 2001 as net receipts of $103 billion from direct investment offset net payments on portfolio investment.

U.S. Balance of Payments and Trade
($ billions. SA. unless otherwise indicated)

	2001	2001				2002	
		Q1	Q2	Q3	Q4	Q1	Q2
Balance on Currenct Account							
Billions of $	-393.4	-107.7	-99.2	-91.3	-95.1	-112.5	-130.0
Per Cent GDP	-3.9	-4.3	-4.0	-3.6	-3.8	-4.4	-5.0
Select Financial Flows							
(+=capital inflow)							
Net Bank Flows	-48.3	-97.1	44.1	23.2	-18.6	-9.3	-13.4
Net Direct Investment Flows	3.0	20.1	16.0	-27.5	-5.6	-13.1	-28.4
Net Securities Sales	342.7	101.9	37.3	77.0	126.6	73.3	117.8
Net Liabilities to Unaffiliated Foreigners							
by Non Banking Concerns	68.0	59.9	4.4	-34.6	38.4	32.4	-1.0
Memo: Statistical discrepancy	10.7	20.8	-2.5	48.3	-55.8	24.7	49.4
Trade in Goods							
Balance	-427.2	-113.0	-107.7	-105.8	-100.7	-106.4	-122.6
Total Exports	718.8	193.3	184.8	173.3	167.4	164.6	172.7
of which:							
Agricultural Products	54.9	13.6	13.6	13.6	14.0	13.8	13.5
Capital Goods Ex Autos	321.7	90.7	82.7	76.2	72.2	71.1	73.6
Automotive Products	75.4	18.3	19.3	19.3	18.6	18.5	20.1
Industrial Supplies *	160.2	42.8	41.5	38.3	37.5	36.8	39.9
Total Imports	1145.9	306.3	292.6	279.0	268.0	271.1	295.3
of which							
Petroleum and Products	103.6	29.2	28.5	25.6	20.2	19.2	27.2
Capital Goods ex Autos	298.0	84.6	75.4	69.9	68.1	69.3	72.3
Automotive Products	189.8	47.1	47.9	47.9	46.9	47.6	51.8
Advanced Technology (NSA)							
Balance	4.4	4.6	3.5	-1.2	-2.4	-2.0	-2.1
Exports	199.6	57.0	51.5	45.4	45.7	43.6	45.6
Imports	195.2	52.4	48.0	46.7	48.1	45.6	47.6

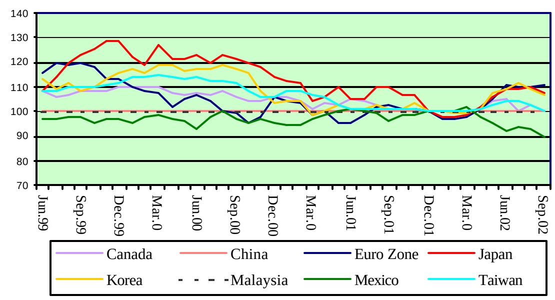
Source: BEA
* Including Petroleum & Products

1 “The period” means January 1, 2002 through June 30, 2002 in this report unless otherwise indicated.

The Dollar in Foreign Exchange Markets

The dollar depreciated modestly, on a trade-weighted basis, over the period. The Federal Reserve Board's broad nominal dollar index indicated that the dollar depreciated by 2.7%, on a trade-weighted basis, over the six-month period, with most of the decline occurring in May and June.

Exchange Rates in Dollars
(December 2001 = 100)



A closer examination reveals a dichotomy in the dollar's performance against the component currency groupings in the broad index: the world's major currencies[2] and the currencies of the other important trading partners[3] (OITP) of the United States. During the six-month period the dollar depreciated 7.4% against the Federal Reserve Board's trade-weighted index of the world's seven major currencies. But over the same period, the dollar actually rose 3.2% against the Federal Reserve Broad's OITP trade-weighted index of the currencies of the United States' 19 important emerging market trading partners.

The appreciation of the dollar against the OITP currencies was largely due to currency depreciation in Latin America over the first half of 2002. The 22.5% depreciation of the Brazilian real, which carries a 4% weight in the OITP index, and the 9.6% depreciation of the Mexican peso, which carries a 22.9% weight in the index, more than offset significant appreciation of the currencies of several of the United States' emerging Asia trading partners.

During the period, G-7 Finance Ministers and Central Bank Governors referred to exchange rates among the major currencies in two communiqués (February 9 and April 20, 2002) each time saying: "We will continue to monitor exchange markets closely and cooperate as appropriate."

The United States did not intervene in foreign exchange markets during the period.

Major Industrial Economies

Euro Zone Countries

The Euro Zone current account surplus narrowed to 0.2% of GDP sa during the period from 0.4% of GDP in the second half of 2001. Dollar-denominated Euro Zone exports rose 3% in the period from the second half of 2001, while Euro Zone imports increased 0.2%. Increasing income and transfer payments offset the gain in the merchandise trade balance.

The euro appreciated 10.7% against the dollar, while the index of the euro's real effective exchange rate appreciated 4.6%, over the period.

Japan

The yen strengthened 10.3% against the dollar in the period, rising to 119.5 ¥/$ at the end of June 2002 from 131.8 ¥/$ at the end of December 2001. In real trade-weighted terms, the yen depreciated 1.8%. Japan's current account surplus rebounded in the period to $59 billion (3.1%/GDP) from $47 billion (2.3%/GDP) in the second half of 2001, reflecting an expanding merchandise trade and services surplus. The merchandise trade surplus reached $46.7 billion reflecting export growth of 2.4% and a 4.7% decline in imports. The U.S. bilateral trade deficit with Japan in the period narrowed slightly to $33.1 billion from $34.6 billion in the second half of 2001.

During the first half of 2002, Japan intervened eight times in the foreign exchange market (between late May and late June), selling $32.7 billion equivalent of yen. These interventions did not appear to have a lasting effect on the yen exchange rate, which continued to appreciate, from 124 ¥/$ at the time of the first intervention to 119.5 ¥/$ at the end of the intervention period.

Canada

In the period, the current account surplus fell to 1.8% of GDP from 2.8% of GDP in all of 2001. The current account balance has been below 2% for four consecutive quarters.

[2] Defined by the Federal Reserve Board as currencies used broadly outside their country of issue. The major currencies account for 54.6% of the weight in Federal Reserve Board's Broad Index.

[3] The OITP are the important trading partners of the United States, whose currencies are not used broadly outside their country of issue. The OITP currencies account for 45.4% of the weight in the Fed's Broad Index.

The Canadian dollar rose 4.8% against the U.S. dollar during the period while the JP Morgan Broad Real Trade-Weighted Index of the Canadian dollar rose 2.7%. The Bank of Canada has identified movements in real non-energy commodity prices as a significant factor in explaining movements in the U.S.$/C$ exchange rate, and a price index tracking these commodities rose 3.3% during the period. The Canadian dollar floats freely. A 1998 study by the Bank of Canada of its foreign exchange intervention concluded that its prior policy of regular intervention had very limited impact. Canada has not intervened in foreign exchange markets since 1998, except to make a small contribution to the brief G7 intervention in support of the euro in September 2000.

Latin America

Access to international capital markets suffered from a decline in investor confidence: net bond issuance in the first half of the year was just $10 billion, compared to $33 billion in the same period in 2001. While the overall EMBI+ sovereign bond index started and ended the period at 799 bps over comparable U.S. Treasuries, it ranged from a mid-April low of 585 to a high of 843 in late June. Brazil's sub-index widened nearly 700 bps at its greatest and Mexico's rose as much as 321 bps after hitting a low of 230 bps in April. Pressure also increased on countries with floating exchange rates, while those with fixed exchange rate regimes experienced a significant depletion of international reserves. In June, Uruguay responded to these pressures by floating its currency.

Argentina

Significant economic, financial, and political turmoil erupted in Argentina at the end of 2001, culminating in a default on external obligations and an end to foreign exchange convertibility (pegging the peso to the dollar at 1:1) in January 2002. Following the decision to float, the peso depreciated from an initial level of 1.4 pesos per dollar to a low of 3.86 pesos per dollar in late June 2002. From July through mid-September, the peso was largely stable at about 3.6 pesos per dollar due in part to additional foreign exchange restrictions and seasonal export receipts. The Government imposed comprehensive deposit controls in early December 2001 that remain in place as of October 2002.

Argentina had a trade surplus of $8.2 billion in the first half of 2002, largely due to import compression, compared to a surplus of $6.3 billion for all of 2001. The current account balance registered a surplus of $1.5 billion in the first quarter of 2002, compared to a deficit of $3.1 billion in the first quarter of 2001. Foreign exchange reserves fell from $14.9 billion at end-December 2001 to $9.6 billion at end-June 2002.

Despite the economic crisis, the Merval stock index rose by 16% between the beginning of the year and end-August as investors looked to equities as a store of value. EMBI+ spreads widened by 2,000 bps end-December to end-August, to 6,435. Talks between Argentina and the IMF to reach agreement on an IMF program continued throughout the period.

Brazil

Although financial market sentiment continued to be favorable through the first quarter of 2002, investor confidence in Brazil began to deteriorate in the second quarter in the face of election uncertainty. In the first semester of 2002, EMBI spreads widened 696 bps and the currency depreciated 20%.

The substantial nominal exchange rate depreciation in the period, as well as the carryover effects of high inflation in late 2001, continued to apply upward pressure on prices. Consumer price inflation year-over-year was 7.7% in June 2002, the same level as in December 2001, despite the declining inflation targets of the Central Bank. The monetary authorities increased reserve requirements to control the growth in liquidity, and intermediation spreads widened restraining credit growth. However, the Central Bank did not increase sales of dollar-linked debt in net terms and refrained from substantial intervention in the spot foreign exchange market.

Higher trade surpluses due to the weaker real helped reduce Brazil's current account deficit to $8.3 billion, compared with $13.3 billion for the same period in 2001. More than fully financing the current account deficit, foreign direct investment (FDI) was $9.6 billion for the first six months of 2002 compared with $9.9 billion for the same period in 2001.

Net international reserves (net of IMF funds as reported by the Central Bank) decreased by $500 million during the period to $27.3 billion. Short-term external debt by residual maturity was 230% of net reserves.

Mexico

Although Mexican peso and sovereign bond spreads were affected in the first half of the year by emerging market turbulence and technical factors, economic fundamentals pointed to a modest recovery as real growth rose to 4.7% saar in the second quarter. The depreciated peso did not lead to significantly increased inflation, with the June y/y change in the CPI holding at 4.9%, compared with 4.4% in December 2001. The Bank of Mexico eased its monetary policy stance in April after a February tightening in response to unanticipated increases in energy and transportation costs.

In the first half of the year, foreign direct investment is estimated to have covered roughly two-thirds of the current account deficit, which narrowed to an estimated 2.5% of GDP. In the same period, net international reserves grew by $800 million, reaching $45.6 billion by end-June. This was equivalent to three-quarters of the gross external financing requirement, estimated at $61 billion, for 2002 and covered 125% of short-term debt.

The Mexican peso, which the government allows to float freely, depreciated 8.6% against the dollar over the period. Labor productivity rebounded during the first half of 2002 while unit labor costs moderated, consequently improving competitiveness. The real effective exchange rate (based on consumer prices) appreciated just 2% in the year to May.

Central and Eastern Europe

Countries in this region experienced very different exchange rate pressures. A recovery in oil prices early in 2002 again placed upward pressure on Russia's exchange rate during the period. While the ruble depreciated from 30.14R/$ at the end of 2001 to 31.4 R/$ at the end of June 2002, the ruble's real effective exchange rate was little changed in the period from the beginning of the year, compared to a 7% appreciation in 2001. Intervention in the foreign exchange market helped boost reserves $6 billion to $42.5 billion at end-June 2002. In Ukraine, the hryvnia remained stable in both nominal and real terms during the period, strengthening slightly from 5.4/$ to 5.32/$.

In the key Central European economies, the prospect of future EU membership and inflows of capital in the form of privatization payments and FDI have resulted in a continued, albeit slower, strengthening of the currencies in real terms. Both the Polish zloty and the Hungarian forint were relatively stable against the euro in the period, while strengthening somewhat against the dollar. In the Czech Republic, the main policy preoccupation during the period remained concern with continued crown appreciation in the face of the inflow of privatization receipts and EU accession-related funds, but the government did not undertake any significant steps to limit the strength of the crown. The strengthening of these three currencies helped to continue to control inflation in the region, with the average inflation rate in Poland falling to under 1.8%, while in the Czech Republic inflation was only 1.2% at the end of the period. Consumer price inflation in Hungary fell to 4.9% y/y in June 2002 and is expected to continue to decline through the rest of the year.

Asia

Asian economies showed significant recovery in the first half of 2002. Exports increased substantially throughout the region, especially information technology exports. Stronger domestic demand boosted imports as well, moderating improvements in current account balances.

Improved economic and financial prospects, as well as declining U.S. dollar interest rates relative to rates on local currency assets, made foreign investment in regional economies more attractive. This, in addition to the overall improvement in current account balances, added support to regional currencies. For those economies with fixed exchange rates, balance of payments surpluses led to an increase in reserves.

With inflation close to zero in many economies, those with floating but managed exchange rates intervened to slow the pace of exchange rate appreciation in order to reduce the risk of deflation. As a result, nominal exchange rates remained stable versus the dollar during the first quarter of 2002, while those not pegged to the dollar for the most part appreciated moderately in the second. Indonesia and Korea, which appreciated roughly 20% and 10% respectively, were exceptions. On the other hand the real effective value of Asian currencies typically depreciated as a globally weakening dollar carried currencies with nominal dollar parities or modest appreciation against the dollar along with it.

China

China's exports accelerated to 35% y/y growth, up from 5% y/y in the previous half-year. But imports also accelerated (to 28% y/y growth from 3% y/y in the previous period), so China's balance of trade in goods (FOB-CIF) rose only marginally to 2.5% of GDP from 2.4% in the previous half and 1.6% a year earlier. The current account surplus is estimated at roughly 2.0% of GDP, also marginally higher than in the previous half year. U.S. data show China's merchandise trade surplus with the U.S. was $43 billion in the period, compared to $37 billion in the same period a year earlier, as inputs from other emerging Asian countries are increasingly routed through China for assembly for export principally to the U.S. China has a significant deficit with nearly all its Asian trading partners, and half its exports come from coastal foreign-funded operations. Reported capital inflows also increased significantly during the reporting period as a result of stronger FDI inflows, which grew 21% y/y to $35 billion for the half-year period.

China maintains a *de facto* currency peg to the dollar, which it has kept within a tight band since 1995. As a result of the higher current account surplus and reported capital inflows, gross foreign reserves grew $31 billion to $243 billion. Gross reserves were 830% of short-term external debt (residual maturity) at end-December 2001. At the time of publication, similar data for end-June 2002 are not available. In real effective terms, the renminbi depreciated roughly 6% during this period, as the U.S. dollar weakened globally. China continues to maintain wide-ranging controls on both capital outflows and inflows.

Korea

Due to a boom in consumer credit supporting domestic demand, and a larger services deficit (despite Korea's hosting of the World Cup), the current account surplus as a percentage of GDP declined to 1.6%, down from 3.2% in the first half of 2001. Korea's merchandise trade surplus with the U.S. declined slightly to $6.1 billion from $6.4 billion during the same period in 2001. Korea had a small capital account surplus of 0.3% of GDP in the first half of 2002, as an increase in foreign currency borrowings by deposit banks and a reduction in foreign currency loans offset significant portfolio outflows. In May 2002, the Bank of Korea, concerned about potentially higher oil prices, a real estate boom, and strong domestic demand, raised its target policy rate by 25 basis points, which attracted further capital inflows.

Korea maintains a floating exchange rate, intervening only to curb what it views as excessive volatility. The won appreciated 9.3% against the U.S. dollar (on a nominal basis) and appreciated 4.7% (on a real effective basis.). Official intervention was modest. Gross reserves increased by $9.6 billion (9.4%) during the reporting period to $112.4 billion (26% of GDP) at the end of June, in part as a result of interest earnings and valuation adjustments as the dollar depreciated against other reserve currencies during this period. As of June 2002, reserves were approximately 235% of short-term external liabilities (residual maturity basis), a decrease from 263% at end-2001. Korea maintains relatively few restrictions on capital flows.

Malaysia

After falling 10% in 2001, export growth was flat over the first half of 2002 compared to the corresponding period in 2001. Meanwhile, expansionary fiscal policy and low interest rates provided a strong boost to domestic demand and hence imports. As a result, Malaysia's trade surplus contracted by 11.7% over the reporting period compared to the first half of 2001. The current account surplus, at 7.5% of GDP, fell from 8.3% of GDP in the first half of 2001. Malaysia's bilateral trade surplus with the United States rose to $6.0 billion in the period from $2.6 billion in the first half of 2001, reflecting increased U.S. demand for Malaysia's electronics exports.

Malaysia has maintained a fixed peg to the dollar since September 1998, when it also imposed capital controls. Controls have since been relaxed, but offshore trading of the ringgit remains prohibited and foreign portfolio investment by residents continues to be restricted. The Malaysian authorities have steadfastly maintained the peg despite alternating periods of downward and upward pressure on the ringgit. On a real trade-weighted basis, the ringgit depreciated 1.2% during the period, reflecting broad-based weakness of the U.S. dollar. Since the introduction of the peg, however, the ringgit has appreciated 16.7% in real trade-weighted terms. At the end of the period, reserves stood at $33 billion, equal to 275% of short-term external debt (residual maturity), up from $30 billion, or 258% of short-term external debt, at the end of 2001.

Taiwan

Taiwan's current account surplus grew to 9.6% of GDP in the period from 5.2% in the first half of 2001. However, the increase in Taiwan's global trade surplus was driven by the growth of exports to the region, especially Hong Kong (China). Taiwan's merchandise trade surplus with the U.S. declined to $6.7 billion from $7.5 billion during the same period in 2001.

As U.S. dollar interest rates fell relative to rates on New Taiwan dollar (NT$) assets, Taiwanese depositors shifted a greater share of their holdings to NT$ accounts. This led to a large net financial account inflow (6% of GDP) in the period. This, along with the large current account surplus, caused the NT$ to appreciate 3.7% on a nominal basis against the U.S. dollar and 0.4% on a real trade-weighted basis. Monetary authorities intervened significantly. Official reserves grew by US$26 billion in the period to US$148 billion, i.e., roughly 500% of total external debt.

Taiwanese authorities were reluctant to allow a sharp currency appreciation in the period, given macroeconomic conditions and policy constraints. Due to the openness of Taiwan's economy, exchange rate changes have relatively large impacts on inflation, inflationary expectations and real output. With inflation near zero, Taiwanese officials were concerned that a sharp appreciation could lead to an undesirable deflationary cycle. M2 was, in fact, within the Central Bank of China's 3½% to 8½% target range throughout the period. Tensions with China and lack of access to IMF resources may have also encouraged the accumulation of foreign exchange reserves.

<u>Summary</u>:

This report reveals a wide variety of exchange rate policies used by the major trading partners of the United States. Based on a broad review Treasury concluded that no major trading partners of the United States manipulated exchange rates under the terms of Section 3004 of the Act during the period. [4]

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[4] Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 requires the Treasury to analyze annually the exchange rate policies of foreign countries, in consultation with the IMF, and to consider whether countries manipulate the rate of exchange between their currency and the dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. The Secretary of the Treasury is required to undertake negotiations with those manipulating countries that have material global current account surpluses and significant bilateral trade surpluses with the United States, unless such negotiations would have a serious detrimental impact on vital national economic and security interests.