U.S. Department of the Treasury

Report to Congress on International Economic and Exchange Rate Policies

For the Period January 1, 2001 through June 30, 2001

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, DURING THE PERIOD OF JANUARY 1, 2001 THROUGH JUNE 30, 2001.

EMBARGOED:
FOR RELEASE AT 4:30 P.M., EDT, OCTOBER 24, 2001

Table of Contents

Summary

Major Findings

- **The pace of U.S. economic growth continued to slow over the period of January 1, 2001 through June 30, 2001.** Real investment in equipment and software dropped sharply. Unemployment edged upward. Productivity, however, rebounded strongly in the second quarter, providing evidence of continuing long run strength.

- **Global growth also continued to slow, leading to a contraction of U.S. exports in the first half of 2001.** U.S. import growth, however, declined at a more rapid pace than exports and the current account deficit fell in both quarters of the reporting period.

- **U.S. acquisition of foreign assets and foreign acquisition of U.S. assets both declined markedly in the second quarter of 2001 after surging in the first.**

- **Treasury determined that no major trading partners of the United States manipulated exchange rates under the terms of Section 3004 of the Act during the period under consideration.** We continue to monitor the exchange rate practices of major U.S. trading partners and encourage their taking further steps toward more flexible exchange rate regimes where appropriate.

Policy Priorities

- **Pursue sound economic and financial policies in the United States.** The Administation's tax relief program and planned fiscal actions, along with Federal Reserve actions this year, represent significant steps toward revitalizing the domestic economy. Economic fundamentals and growth potential remain strong.

- **Encourage policies abroad that promote strong global growth.** A healthy global economy requires that economies raise productivity and perform at their full potential.

- **Pursue efforts to expand world trade, which is critical to U.S. economic success.**

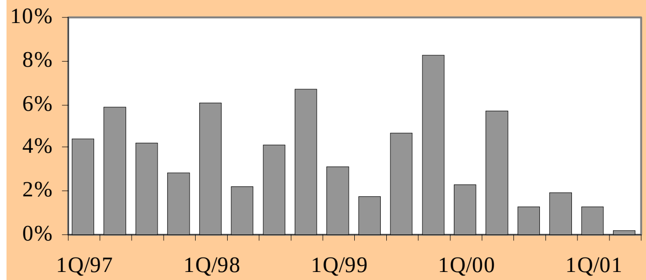
- **Encourage closer monitoring of economic and financial developments, and prompt policy action to prevent financial crises.**

- **Combat money laundering and terrorist financing.** Strengthened efforts are critical to cut off terrorists' access to financing and to strengthen the integrity of the international monetary system.

U.S. Economy

<u>Overview of the U.S. Economy</u>

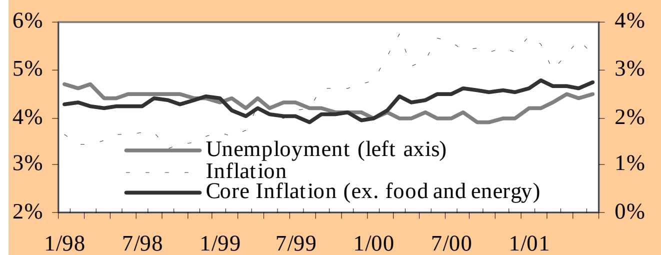
U.S. Real Gross Domestic Product. 1997-2000
% change over previous quarter, SAAR



Source: Bureau of Economic Analysis (BEA)

The U.S. economy has been slowing since the third quarter of 2000 and managed only a 1.3 percent annual rate of growth in the first quarter of 2001 and a 0.3 percent rate in the second, the slowest pace since the first quarter of 1993. Capital spending, particularly in the high-tech sector, has been one of the primary factors that has held growth down. Real investment in equipment and software dropped sharply in the second quarter for the third quarterly decline in a row, and investment in new structures fell as well.

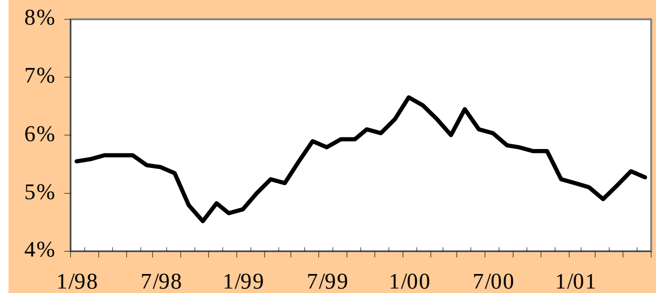
U.S. Civilan Unemployment Rate and Inflation Rate
Unemployment (left axis); Inflation (y/y % change in prices, right axis)



Source: Bureau of Labor Statistics

The household sector has provided the main support to the economy. Consumer spending continued to rise in the second quarter, up at a favorable 2.5 percent annual rate (saar), and housing demand remained high due to low mortgage interest rates. Advanced tax refunds pumped roughly $40 billion into the economy in the third quarter.

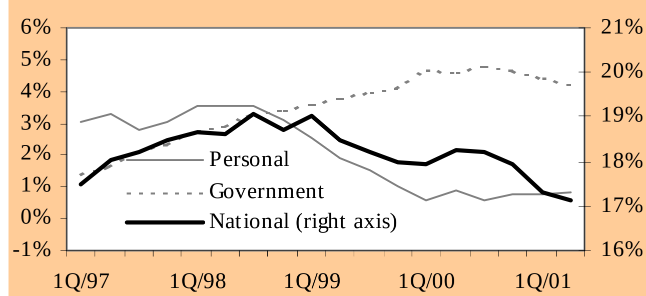
U.S. Interest Rates
% (10 year Treasury, constant maturity)



Source: U.S. Treasury

The weakness in the economy since the middle of last year has translated into reductions in employment. Private sector payroll jobs have declined by 150,000 through the first six months of the year, and the unemployment rate rose from 4.0 percent in December 2000, to 4.5 percent in June 2001. Manufacturing has borne the brunt of the employment decline, losing 592,000 jobs through the first six months of this year and nearly 800,000 since a recent peak in July 2000.

U.S. National Saving and Selected Components
% of GDP (personal/gov't on left axis; national on right axis)



Source: BEA

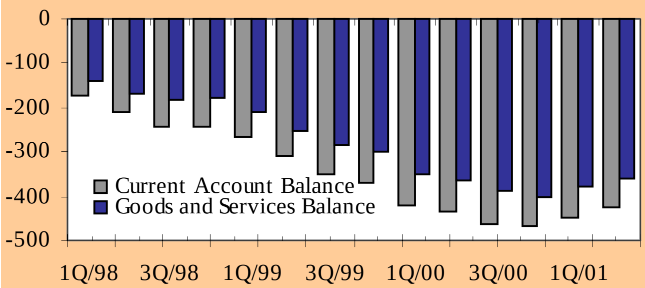
Core consumer inflation (excluding food and energy) rose at a 3.1 percent annual rate over the reporting period, and energy prices 11.3 percent. Energy prices have fallen in recent months and 12 month increases in core inflation have leveled off around a 2-3/4 percent rate. Productivity rebounded in the second quarter to a strong 2.1 percent rate, however, suggesting that despite cyclical influences, structural productivity is very sound. That increase was only slightly below the 2.4 percent trend rate of growth since 1995, a remarkable performance since productivity usually declines when business slows.

The Federal Reserve responded to the weakening economy, reducing interest rates six times in the first six months of this year, bringing the target for the federal funds rate down from 6.5 percent at the end of last year to 3.75 percent at the end of this reporting period.

The Current Account

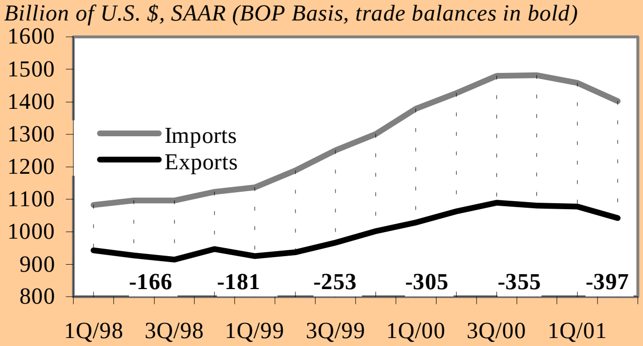
The deceleration in the U.S. economy has sharply curtailed imports, particularly that of capital goods, with a resulting reduction in the current account deficit. The current account deficit fell to $447 billion (saar), or 4.4% of GDP, in the first quarter of 2001 and to $426 billion, or 4.2 % of GDP, in the second quarter, compared with a deficit of $465 billion, or 4.6 percent of GDP, in the fourth quarter of 2000. The decline was more than accounted for by the decline of the merchandise trade deficit from $474 billion (saar) in the final quarter of 2000 to $450 billion in the first quarter and $431 billion in the second quarter of 2001.

U.S. External Balances
Billions of U.S. $, SAAR (Balance of Payments, BOP, Basis)



Source: Bureau of Economic Analysis, Bureau of the Census

U.S. Trade in Goods and Services
Billion of U.S. $, SAAR (BOP Basis, trade balances in bold)



Source: Bureau of Economic Analysis, Bureau of the Census

U.S. Trade in Goods and Services
Billions of U.S. $ (BOP basis, SAAR)

	Exports		Imports	
	Level	Change	Level	Change
1Q/99	925.3	-8.7%	1,136.8	5.1%
2Q/99	936.7	5.0%	1,188.2	19.4%
3Q/99	966.4	13.3%	1,250.9	22.9%
4Q/99	1,001.1	15.2%	1,300.9	17.0%
1Q/00	1,029.0	11.6%	1,378.3	26.0%
2Q/00	1,063.3	14.0%	1,426.4	14.7%
3Q/00	1,090.0	10.4%	1,479.3	15.7%
4Q/00	1,080.5	-3.4%	1,481.7	0.6%
1Q/01	1,077.2	-1.2%	1,457.3	-6.4%
2Q/01	1,042.3	-12.3%	1,401.8	-14.4%

Source: Bureau of the Census

U.S. Bilateral Merchandise Trade Balances
Billions of U.S. $ (nsa, Census basis)

	China	Japan	Canada	Mexico	South America	EU
1Q/99	-13.6	-16.3	-6.8	-5.7	1.1	-5.6
2Q/99	-15.7	-17.2	-6.8	-6.5	-.3	-10.6
3Q/99	-20.1	-19.4	-9.4	-6.3	-2.5	-13.8
4Q/99	-19.3	-20.4	-9.4	-4.2	-1.7	-13.3
1Q/00	-16.7	-19.1	-10.8	-5.5	-3.9	-12.3
2Q/00	-19.4	-20.7	-12.2	-6.3	-3.5	-13.0
3Q/00	-25.0	-20.3	-13.8	-6.3	-3.6	-14.8
4Q/00	-22.8	-21.5	-15.2	-6.5	-3.1	-14.9
1Q/01	-18.0	-18.2	-14.6	-6.4	-3.4	-13.3
2Q/01	-19.0	-16.2	-13.9	-8.1	-1.8	-14.8

Source: Bureau of Economic Analysis, Bureau of the Census

The slowing global economy reduced U.S. exports over the first half of 2001 even as U.S. imports declined. Exports of goods and services (saar) were 3.5% lower, while imports were 5.4% lower, in the second quarter of 2001 than the final quarter of 2000. Imports of capital goods excluding automobiles (sa) declined 16.1 % from the final quarter of 2000 to the second quarter of 2001 while exports declined 9%.

U.S. net investment income payments (sa), $3.7 billion in the first quarter of 2001 and $4.2 billion in the second, are much smaller than the size of the U.S. net international investment position might suggest. This results from the higher rate of return that U.S. investors secure on their foreign assets relative to what foreigners secure on their U.S. assets. In particular, the net income on foreign direct investment is significantly positive even though the value of foreigners' direct investment in the United States exceeds that of U.S. residents abroad. In the first two quarters of 2001 the net income on direct investment (sa), at $22.7 billion and $23.1 billion, was significantly greater than it was in comparable quarters of 2000. This nearly offsets the net payments to foreign residents on U.S. Government assets (s.a.), which totaled $26.1 billion in the first quarter of 2001 and $25.6 billion in the second quarter.

Financial Flows:

U.S. residents' acquisition of foreign assets, and foreign investors' acquisition of U.S. assets declined markedly in the second quarter of 2001 after surging in the first quarter. Foreign direct investment flows (sa) to the United States fell to $120 billion compared to $127 billion in the first half and $161 billion in the second half of 2000. Net U.S. foreign direct investment flows abroad (sa) were $77 billion in the first half of 2001 compared to $72 billion in the first half and $81 billion in the second half of 2000.

After modest, $0.7 billion, net purchases of Treasuries in the first quarter of 2001, non-official foreigners resumed their net sales to US residents in the second. Net sales, on the other hand, of non-Treasury securities remained very strong, non-official foreigners purchasing $148.8 billion in the first quarter and $132.7 billion in the second. These levels are significantly above the levels of corresponding quarters of 2000.

U.S. Financial Flows

*Millions of U.S. $ s.a.**	Q2/99	Q3/99	Q4/99	Q1/00	Q2/00	Q3/00	Q4/00	Q1/01	Q2/01
Net Financial Flows	**106,573**	**55,923**	**119,771**	**59,358**	**154,986**	**114,613**	**115,542**	**103,329**	**126,784**
Net Portfolio Flows	**-1,371**	**57,678**	**108,664**	**124,897**	**36,560**	**100,258**	**98,114**	**194,696**	**35,909**
U.S. acquisition of foreign assets**	-98,984	-55,970	-29,610	-102,802	-69,130	-47,714	-69,135	-92,602	-34,807
Foreign acquisition of U.S. assets	97,613	113,648	138,274	227,699	105,690	147,972	167,249	287,298	70,716
Foreign Official	-736	12,721	27,402	22,498	6,447	12,247	-3,573	4,898	-22,430
Private***	98,349	100,927	110,872	205,201	99,243	135,725	170,822	282,400	93,146
Net Banking Flows	**-6,936**	**-2,808**	**-21,890**	**-63,659**	**61,378**	**-20,057**	**-28,209**	**-102,899**	**59,314**
Assets	-36,016	-10,476	-52,808	-56,234	7,455	-18,147	-71,574	-109,789	9,191
Liabilties	29,080	7,668	30,918	-7,425	53,923	-1,910	43,365	6,890	50,123
Net Direct Investment	**114,880**	**1,053**	**32,997**	**-1,880**	**57,048**	**34,412**	**45,637**	**11,532**	**31,561**
U.S. direct investment abroad	-36,474	-49,750	-30,631	-38,388	-33,346	-41,634	-39,070	-40,940	-35,602
Foreign direct investment in the United States	151,354	50,803	63,628	36,508	90,394	76,046	84,707	52,472	67,163

Source: Bureau of Economic Analysis

* Details may not add to totals due to rounding.

** Net private claims on foreigners by nonbanks plus net private U.S. purchases of foreign securities.

***Net purchases of U.S. Treasury securities, net nonbank liabilities to foreigners, net purchases of gov't non-Treasury securities, and net U.S. currency flows.

U.S. Exchange Rate Developments

The January 1 - June 30, 2001 reporting period was characterized by sustained foreign investment flows into U.S. assets, notably corporate debt securities. This demand for U.S. assets was evident in an appreciation of the dollar against most other major currencies. The yen depreciated from around ¥115 per dollar at the start of the period to over ¥120 at the end of it, and the euro depreciated from $0.94 to $0.83. There was no foreign exchange market intervention in the major currencies during the period.

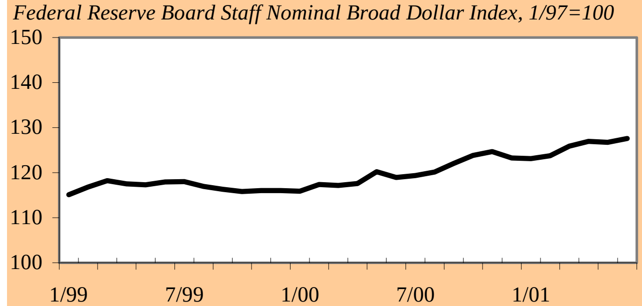
The Federal Reserve Board staff's broad nominal dollar index indicated that the dollar appreciated 3.5% on a trade-weighted basis during the period covered by this report, after a 3.6% appreciation in the second half of 2000. The real dollar appreciated 4.5% during the first half of 2001, after a 3.0% appreciation during the second half of 2000. Dollar movements have reflected continued foreign interest in investing in the United States, despite slowing economic activity.

During the reporting period, January 1, 2001 through June 30, 2001, G-7 Finance Ministers and Central Bank Governors referred to exchange rates among the major currencies in two communiqués (February 22, 2001 and April 28, 2001), each time stating:

"We discussed developments in our exchange and financial markets. We reiterated our view that exchange rates among major currencies should reflect economic fundamentals. We will continue to monitor developments closely and to cooperate in exchange markets as appropriate."

Currency Movements: United States

Federal Reserve Board Staff Nominal Broad Dollar Index, 1/97=100



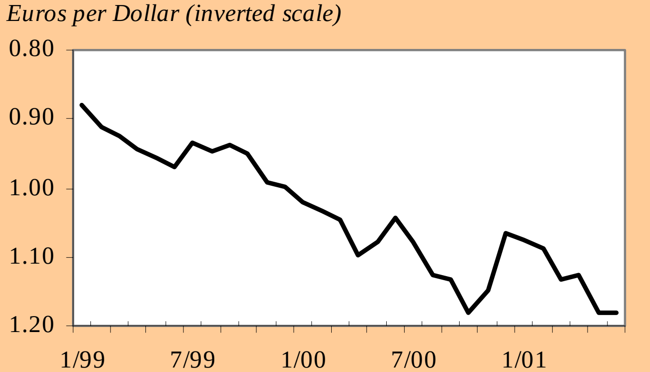
Economic and Currency Market Developments in Other Major Economies

Overview of Other Major Economies

Economic activity in the major industrial countries weakened perceptibly in the first half of 2001, influenced by the slowdown in the U.S. economy, which began in the second half of 2000. The slowdown also reflected the continued weakness in Japan. In Europe, which experienced the best growth rate in a decade in 2000, the pace of activity slowed far more than expected and to a considerable degree in view of more potent global transmission effects than anticipated. On balance no major economy escaped the synchronous slowdown in the first half of 2001. Recent data indicate further weakening across all the major countries. With the slowing of activity, inflation pressures appeared to be contained in the major economies and indeed waned over the period, while deflationary pressures remained firmly entrenched in Japan. These developments permitted an overall easing of monetary conditions in the major countries led by the vigorous actions of the Federal Reserve. Foreign interest in acquiring U.S. assets remained strong throughout the period, reflecting the relative attraction of investment in the United States and major currencies depreciated modestly against the dollar.

Euro Zone Countries. Euroland's 3.4% growth last year was the best in 10 years. This year, aggregate growth will probably fall below 2%. Early confidence that the Euro Zone could withstand the effects of economic slowing in the rest of the world now seems overly optimistic. GDP growth was only 0.2% (saar) in the second quarter: Germany, Italy, and Belgium had negative growth; France and Spain had positive, but sharply lower, growth. The area-wide unemployment rate has reached 8.3%, a ten-year low, but slowing growth will likely reverse this in the second half of this year. Headline inflation spiked above 3% in the late spring from a combination of food price increases and continued high oil prices. Core price inflation edged just above 2%.

Currency Movements: Euro-zone
Euros per Dollar (inverted scale)



The expectation of relatively stronger growth in the Euro Area compared to the United States buoyed demand for the euro in the fourth quarter of 2000. This advance, however, peaked in the first two weeks of January and the euro experienced a general depreciation throughout the first two quarters of this year, as evidence accumulated of European vulnerability to the global slowdown. Last year, rising domestic demand and increasing oil prices generally offset the effect of a decline in the trade-weighted value of the euro, causing a deterioration of the current account. In the first half of 2001, however, falling import demand and lower oil prices offset weak exports and the current account recovered from –0.9% of GDP in the fourth quarter of 2000 to -0.4% of GDP in the second quarter of 2001.

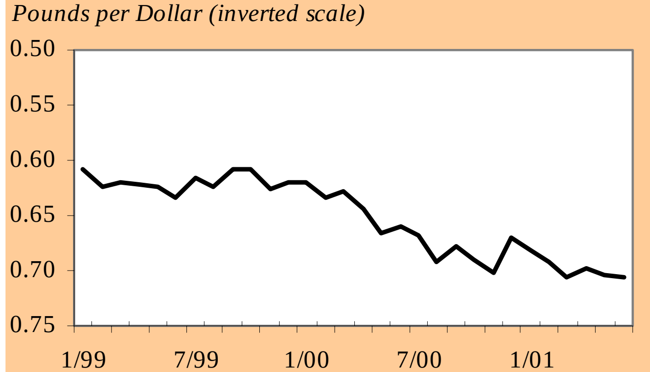
The European Central Bank cut rates by 25 basis points in May. Euro Zone stock markets declined in the first half. The German DAX declined almost 6% and the French CAC almost 12%.

United Kingdom. U.K. growth is also slowing but was, in the second quarter of 2001, the strongest in the G-7 – at 1.8% (saar) after 2.6% in the first. Growth has been sustained by strong consumption, while the relative strength of sterling hampered the competitive position of the manufacturing sector. The current account deficit (sa) fell to 0.6% and 1.6% of GDP in the first and second quarters of 2001 from its 1.9% and 2.1% levels of the third and fourth quarter of 2000.

Labor market conditions remained generally tight during the period, particularly for skilled workers. The unemployment rate fell to 3.2% in June 2001, reaching at that time a 26-year low.

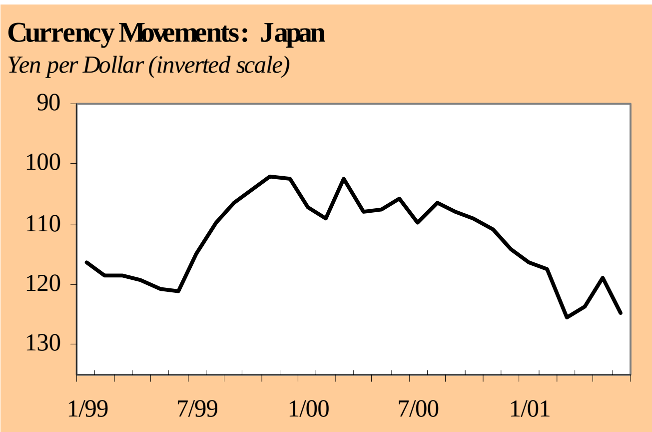
The benchmark inflation rate (retail prices excluding mortgage interest rates) was 2.4% y/y in June, up from December's 2.1% rate, but below the Bank of England's 2.5% target rate. In the first half of 2001, the BOE's Monetary Policy Committee made three 25 basis point reductions in its benchmark interest rate. This was due to greater concern about slowing growth and reduced concern about inflation.

Currency Movements: United Kingdom
Pounds per Dollar (inverted scale)



Sterling depreciated 5.9% against the dollar in the first half of 2001, following a 1.2% depreciation in the second half of 2000. In contrast to the movement against the dollar, sterling appreciated 4.2% in terms of the euro in the first half of 2001, following a 0.7% appreciation in the second half of 2000. The real trade-weighted value of the pound depreciated 0.6% in the first half of 2001 following a 0.9% appreciation in the second half of 2000.

Japan. The Japanese economy weakened in the first half of 2001, as the gradual recovery from the 1997-98 recession ran out of steam. Real GDP for the period was flat compared to the second half of 2000, as modest growth in real consumption spending was offset by declining net exports and weakening business investment. Recent data suggest that the economic weakness has deepened in the second half of the year: industrial production in July-August 2001 was down 3-1/2% from its level in the second quarter, and data on producers' inventories suggest the inventory adjustment cycle could put further downward pressure on production in coming months. Deflationary pressures remained entrenched, with core consumer prices (excluding perishables) down 0.9% y/y in June 2001.

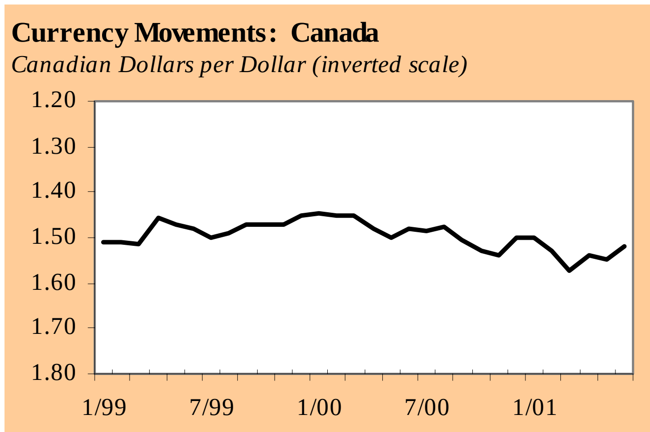


Japan needs continued progress in market-opening deregulation and structural reforms, especially in the financial sector, to raise its potential growth rate. The declining size of the work force due to Japan's aging population implies that rapid productivity gains will be needed in coming years to avoid a decline in living standards.

The yen depreciated by 7.4% against the dollar in nominal terms, 10.4% in real terms, and 6.1% in real trade-weighted terms, from December to June. Japan's current account surplus fell from a seasonally-adjusted ¥5.9 trillion ($54 billion, or 2.3% of GDP) in the second half of 2000, to ¥5.1 trillion ($42.0 billion, or 2.0% of GDP) in the first half of 2001. Japanese investors increased their holdings of foreign assets in the January-June period, recording net outflows of ¥5.1 trillion ($42.7 billion), while foreign investors reduced their holdings of Japanese assets by ¥320 billion ($2.7 billion). Japan's foreign exchange holdings increased by $1.4 billion in the first half of 2001 after posting a $17.3 billion increase in the second half of 2000.

Canada. Real GDP grew 1.5% (saar) during the first six months of 2001, slowing from 3.1% in the second half of 2000. The unemployment rate was 7.0%, up from 6.8% in December 2000, but still at a 24-year low. Consumer prices were up 3.3% through June 2001 compared with 3.2% in December. Short-term government bond rates have fallen while long-term government bond rates have been relatively flat during the six-month period. Because of reduced concerns about inflation and to support flagging growth, the Bank of Canada cut its benchmark policy rate 4 times for a total of 125 basis points in the first half of 2001.

The Canadian dollar depreciated 1.2% against the U.S. dollar during the first half of 2001 following a 1.3% depreciation in the second half of 2000. The real trade weighted index of the Canadian dollar appreciated mildly in the twelve months to June 2001, falling 1.2% over the second half of 2000 and rising 1.7% over the first half of 2001.



Canada’s overall current account surplus for the first half of 2001 was $15.2 billion (sa) or 4.3% of GDP, up from 2.9% in the second half and 2.2% in the first half of 2000. Canada's surplus of goods and services with the United States fell slightly to $32.2 billion in the first half of 2001 from $32.8 billion in the second half of 2000.

Economic and Currency Market Developments in Emerging Market Economies

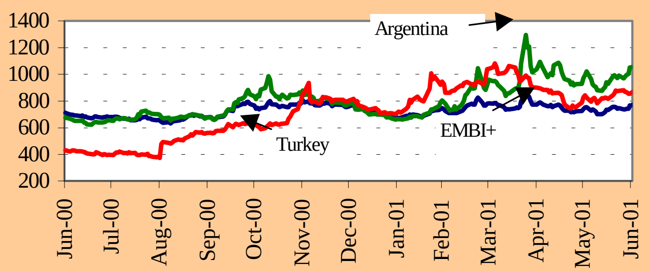
Overview of Key Emerging Markets

Credit and liquidity spreads in the first half of 2001 continued a rise that began in the second half of 2000, although at a slower pace. Spreads rose as concerns over global growth began to materialize and the potential for credit events within emerging markets increased. The yield spread over U.S. Treasuries of JP Morgan's Emerging Market Bond Index Plus (EMBI+), after reaching 784 basis points at the end of the first quarter, remained 10 basis points higher at the end of 2Q/2001 compared to 4Q/2000. This increase was due, in part, to continued concerns about the sustainability of Argentina's public debt (roughly 20% of the EMBI+ total market capitalization) and the February crisis in Turkey.

As judged by issuance, emerging market financing strength was mixed. Bond issuance recovered strongly in 1Q and 2Q/2001. As a result, large emerging market borrowers such as Brazil and Mexico were able to cover over 90% of their financing needs for the entire year. On the other hand, equity and syndicated loan issuances were well off their respective 2000 levels and closer to 1998 levels, which were abnormally low due to the Asian and Russian crises.

On a positive note, emerging markets in Asia, Emerging Europe and the Middle East made progress in reducing their vulnerability to external shocks in 2001. Short-term debt declined by roughly $40 billion to$380 billion by the end of 2000. Meanwhile, reserves declined only $20 billion to $760 billion. Notably, Latin American emerging markets increased short-term debt $10 billion to $150 billion, while reserves remained constant at $135 billion. This is largely attributable to Argentina and Brazil, whose end-2000 debt to reserve ratios increased from 180% to 190% and 120% to 130%, respectively.

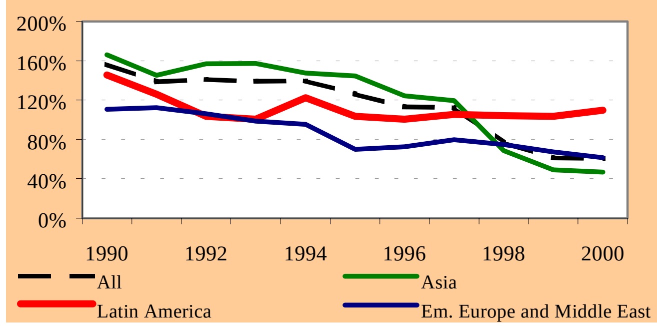
Tale of Two EMBI+ Spreads, 2000-2001
Basis point spreads over U.S. bonds (Source: JP Morgan)



Financial Developments in Emerging Markets

	1999	2000	3Q/00	4Q/00	1Q/01	2Q/01
Issuance (US$ bil.)	163.6	216.4	50.3	50.3	42.2	48.1
Bonds	82.4	80.5	21.1	9.4	26.8	27.7
Equities	23.2	41.7	8.8	12.4	2.3	5.3
Loans	58.1	94.2	20.4	28.5	13.1	15.2
Secondary Bond Markets (bps)						
EMBI+	703	756	677	756	784	766
Asia	221	489	423	489	450	397
Latin America	597	706	634	706	763	803
Em. Europe	1,762	988	852	988	957	766
Stock Market Returns (%)						
MSCI EM Free	6.4	-31.8	-13.4	-13.5	-6.2	3.1
Asia	67.6	-42.5	-22.3	-17.3	-0.1	-1.6
Latin America	55.5	-18.4	-6	-8.5	-3.5	7.1
Em. Eur./M. East	76.7	-23.4	-3.9	-14.3	-22	4.5

Emerging Markets Short Term Debt to Reserves
(S-T external debt as a percentage of gross FX reserves)

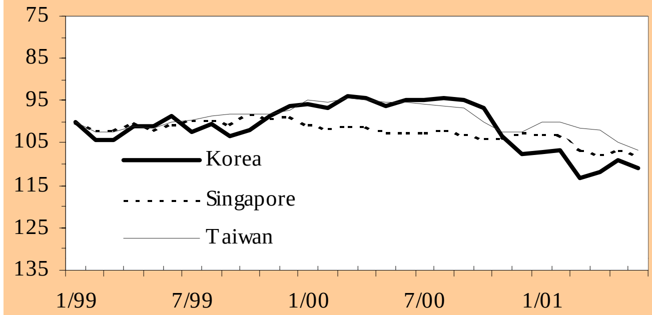


Source: IMF, World Bank, OECD, BIS External Debt Tables

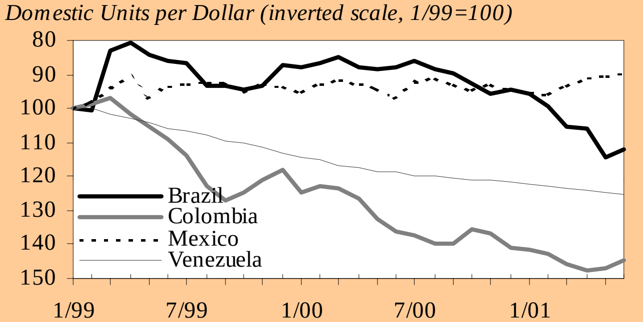
Growth in much of the Latin America weakened during the first half of 2001, due to negative external and domestic shocks. Argentina experienced negative growth in the first half of the year and Brazil and Mexico's economies slowed considerably, the former due in part to its domestic energy crisis. The U.S. and global slowdown reduced demand for exports, particularly in Mexico, and uncertainty emanating from Argentina and elsewhere reduced investor appetite for risk, raising fears about reduced capital inflows. The current account deficit for the Latin American region widened as exports slowed and interest rates rose (though lower import demand mitigated this trend). Due to concerns about the economic outlook, investment inflows have declined. New Latin American emerging market issues in the first six months of 2001 were $29 billion (not including the Argentine bond swap), down from $38 billion in the first half of 2000, according to the IMF. External bond spreads, as measured by the Latin America EMBI+ index, widened 97 bps to 803 bps during the first half of the year. Weaker exports and capital inflows have put pressure on exchange rates for those countries with floating exchange rate regimes and on international reserves for countries with fixed regimes.

Weakening global demand, particularly for high tech goods, caused real GDP in Emerging Asia (outside of China) to decline by an average rate of negative 0.8% (saar) during the first two quarters of this year, compared to annual growth of 6.8% last year. While output slowed in China as well, it remained a regional engine of growth. Given the decline in growth and relatively low inflation rates, most countries sought to boost domestic demand through accommodative monetary and fiscal policies. In some countries, under-capitalized banking systems and over-leveraged corporate sectors hampered the transmission of monetary stimulus. However, due to the drop in external demand and supportive macroeconomic policies, current account surpluses and bilateral trade surpluses with the U.S. declined in most countries during the reporting period. Along with lower current account surpluses, a decline in capital inflows due to the weaker outlook and continued capital outflows put downward pressure on most currencies and/or holdings of international reserves.

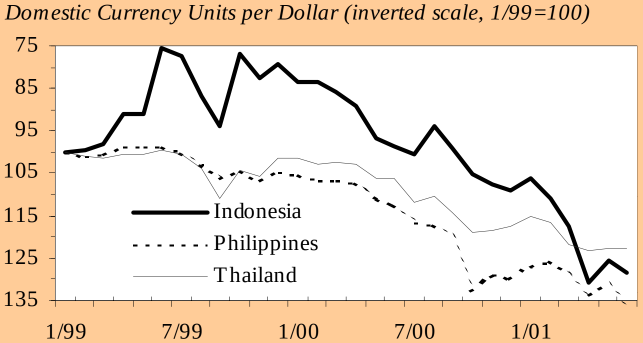
Currency Movements: NIEs (ex. Hong Kong)
Domestic Currency Units per Dollar (inverted scale,



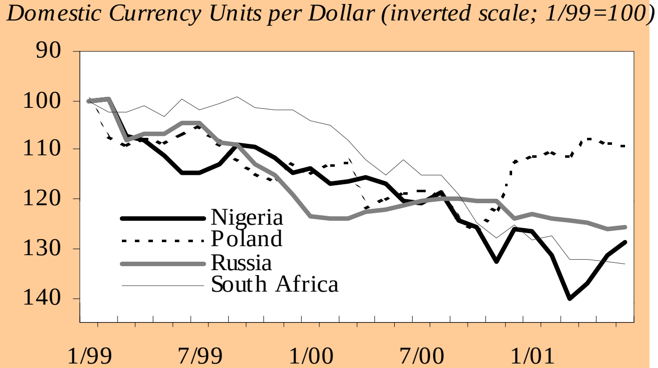
Currency Movements: Latin America
Domestic Units per Dollar (inverted scale, 1/99=100)



Currency Movements: Selected ASEAN Countries
Domestic Currency Units per Dollar (inverted scale, 1/99=100)



Currency Movements in Other Emerging Markets
Domestic Currency Units per Dollar (inverted scale; 1/99=100)



Overview of Selected Countries

Argentina. The Argentine economy contracted 0.7% q/q (saar) in the first quarter of 2001 and grew 1.1% q/q (saar) in the second quarter, after contracting 0.5% in 2000. Unemployment rose to 16% by May 2001, up from 14.4% in October 2000. Consumer prices continued to fall on the back of depressed aggregate demand, registering a deflation rate of 0.7% y/y in the first half of 2001. On the plus side, exports grew 0.6% y/y in the first half of the year, with real exports growing at a 4% rate over the same period. Weak domestic demand resulted in import compression of 12.3% y/y in first half of 2001. Export growth together with a sharp import contraction led to a narrowing of $0.7 billion in the current account deficit between 1H/2000 and 1H/2001.

Argentina maintains a currency board arrangement, with the Argentine peso pegged to the U.S. dollar at parity. Argentina's real effective exchange rate (REER) appreciated 4.8% during the first half of the year, due in large part to the decline of the Brazilian real. In the face of slippage on IMF targets, political turmoil and subsequent reshuffling at the Ministry of Economy, investors' confidence in the sustainability of public finances and government polices fell, increasing capital outflows. The spread on Argentina's component of the EMBI+ index widened 250 bps during the first half of the year to 1025 bps over U.S. Treasuries. Central Bank foreign exchange reserves fell $4 billion during the same period, while bank deposits fell $3 billion, or 3.5%.

Brazil. In the first half of 2001, the Brazilian economy slowed amid weak consumer demand, energy rationing, and continuing uncertainty about neighboring Argentina. Real GDP growth in 1Q/2001 was 0.4% q/q (saar) and 0.1% in 2Q/2001, vs. 3.6% q/q (saar) in 4Q01. The trade balance in the first half of 2001 recorded a surplus of $70 million as strong export performance was counterbalanced by substantial capital imports related to the emerging energy crisis. The current account deficit was $13.3 billion in the first half of 2001, vs.

$11.2 billion during the same period last year. FDI fell to $9.8 billion in the first half of 2001 (74% of the current account), down from $13.4 billion during the same period in 2000, and foreign investment was unable to meet Brazil's current account needs for the first time in several years.

The exchange rate largely floats although the Central Bank of Brazil (BCB) sporadically intervened to support the *real* both in the spot foreign exchange market and through sales of dollar-indexed Brazilian *real*-denominated debt during the first half of the year. In addition, in response to a depreciating *real* and rising inflationary pressures, the BCB began a gradual monetary tightening, raising its target overnight interest rate by 250 bps to 18.25% over the first half of the year. Nevertheless, the *real* continued to weaken in the first half of the year, depreciating 16% against the dollar (the REER depreciated 14%) amid concerns about high gross external financing needs, uncertainty in Argentina, and the domestic energy crisis. Net international reserves (excluding dollar-linked liabilities of the BCB) increased during the first half of the year by $3 billion to $34.1 billion, and from 56% of short-term external debt (residual maturity) to 61%. As a percent of M2, net reserves increased from 21.2% to 27.6% during the same period.

Mexico. Growth slowed to 1.9% y/y in 1Q/2001 and 0.0% y/y in 2Q/2001 (compared with 5.2% y/y in 4Q/2000). The U.S. slowdown lowered demand for Mexican exports during this period, though the impact on the trade balance was somewhat mitigated on the import side by lower domestic demand and the large imported component of exports. The current account deficit was unchanged at 1.3% of GDP in the first half of the year (vs. 1.3% of GDP in the first half of 2000), with foreign direct investment of $6.8 billion covering 84% of the current account deficit. Capital inflows strengthened in the first half, as Mexico continued to distinguish itself as a safe haven among emerging market economies. The 2Q/2001 Citigroup purchase of Banamex, in particular, sent a strong positive signal to investors. This helped support the peso, which appreciated 6.2% against the U.S. dollar during the first half of this year to 9.04 pesos/$, from 9.75 pesos/$. The authorities let the exchange rate float relatively freely during this period. Mexico's REER appreciated 6.2% over the same period. Helped by low inflation numbers, the BOM eased monetary policy somewhat over the first half of 2001 to stimulate the economy Net international reserves rose $5.2 billion during the first half of 2001 to $40.8 billion. As a percent of M2, net reserves increased slightly from 13.8% to 14.3% during this time.

Indonesia. Growth slowed to 3.4% (year-on-year) during 1H/2001, from 4.8% in the previous half, due to a weakening of both external and internal demand. On the external side, lower world prices hurt oil and gas export revenues (down 17% in dollar terms) and weakening global demand hit non-oil exports (down 7%). Meanwhile, domestic demand weakened due to political uncertainty and concerns about economic policy. The current account surplus was steady at about 4% of GDP (comparing 1H/2001 and 1H/2000); the U.S. bilateral trade deficit with Indonesia expanded slightly from $3.6 billion to $3.8 billion. Reduced export revenues and low real interest rates, along with concerns about political stability, economic policy and the investment climate all weighed on the rupiah, which depreciated 6.4% in real effective terms (and 16% against the dollar in nominal terms) over the reporting period.

Indonesia maintains a floating, though at times moderately managed, exchange rate regime. While the central bank raised short-term interest rates several times during the first half of 2001 to support the rupiah and contain inflation, rising prices led to a continued decline in real interest rates. During the first half of 2001, net international reserves increased slightly from $17.8 billion to $18.3 billion, rising as a percent of M2 from 23% to 26%. As a percent of short-term external debt (residual maturity), reserves climbed from 57% to about 60%. During the first half of 2001, to support the rupiah, and limit short-selling, the central bank tightened controls on capital outflows, mainly lending rupiah to non-residents. Indonesia has relatively few controls on capital inflows.

Turkey. Turkey suffered an economic crisis beginning in February 2001, following the liquidity and banking crises it experienced in November/December 2000. The economic crisis, which included a massive drop in foreign exchange reserves, led the Turkish authorities on February 22 to abandon their "crawling peg" exchange rate mechanism and move to a float of the Turkish Lira. This crisis and its subsequent effects have led to a 8.5% contraction in GNP for the first half of 2001 (compared to 6.1% growth in 2000), with Consumer Price Index inflation accelerating to 56% for the 12 months preceding the end of June 2001 (up from 39% for 2000). The crisis also led to high real interest rates and enormously increased public sector costs for restructuring the banking sector, and in turn the net public sector debt ballooned from 57% of GNP at end-2000 to an estimated 87% at end-2001. The Turkish Lira lost 45% of its value in nominal terms from its float to end-June, and roughly 6% in real terms.

To stabilize the economy and address the causes of the crisis, the Turkish authorities have implemented a strong program of macroeconomic and structural measures. To support this effort, the International Monetary Fund approved an augmentation of its financing for Turkey of $8 billion, bringing its total financing for Turkey for the period 1999-2003 to $19 billion. Through end-June 2001, nearly $9 billion had been disbursed. The World Bank also agreed to make available $2 billion in exceptional financing for Turkey in 2001, of which half had been disbursed by end-June 2001. These efforts have brought some greater stability to Turkey's financial markets, setting the stage for a recovery in output.

Exchange Rate Regimes Assessed

Elements of Manipulation

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 there would be a serious detrimental impact on vital national economic and security interests.

- **Treasury undertook a broad review of the performance of major trading partners of the United Stated and 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 under consideration.**

In evaluating evidence of currency manipulation, Treasury looks at the following two factors:

- **Exchange Restrictions and Capital Controls.** Restrictive exchange regimes and capital controls can be a concern, particularly where the restrictions are designed to maintain a consistently undervalued exchange rate.

- **Exchange Rate Movements.** Large depreciations of exchange rates, if induced artificially rather than by market forces responding to fundamentals, could suggest an attempt to gain a competitive advantage in trade. Manipulation could also be reflected in the absence of a significant appreciation of the exchange rate when justified by fundamentals. Equilibrium real exchange rates, however, are determined by a number of factors and are therefore difficult to define.

Assessment

As the law requires, economies were examined as potential exchange rate manipulators if they had significant global current account surpluses and bilateral surpluses with the United States and maintained a fixed or actively managed exchange rate system during the reporting period. Detailed assessments are not provided for those economies where oil exports, with prices customarily denominated in dollars, clearly dominate total exports, and fluctuations in world oil prices produce at times wide swings in the trade and current account balances.

Five emerging market economies were reviewed in detail: Taiwan, China, Korea, Russia, and Malaysia.

Taiwan. Economic activity slowed substantially during the reporting period due to Taiwan's high reliance on IT exports and declining investor confidence associated with increasing signs of domestic banking problems and a continued deterioration in the traditional corporate sector. Real GDP fell 2.4% during in the second quarter of this year on a year-over-year basis, the first time real GDP fell over a 12-month period since 1975. During the reporting period Taiwan implemented increasingly accommodative monetary and fiscal policies to support domestic demand. Due to the sharp drop in domestic demand, the current account surplus rose to 5% of GDP during the reporting period compared to 1.6% during the same period last year. However, due to the sharp drop in exports to the United States, over the same period, Taiwan's bilateral trade surplus with the United States declined by $0.7 billion to $4.8 billion.

Taiwan maintains a floating, though heavily managed, exchange rate policy. During the reporting period, Taiwanese authorities, in the face of the sharp decline in growth and inflation, adopted a more accommodative monetary policy, showing less resistant to downward market pressures on the exchange rate. During the reporting period, the New Taiwan Dollar depreciated 4% against the U.S. dollar and 5.5% in real effective terms. Gross foreign exchange reserves rose by $2.4 billion during the reporting period to $109 billion, compared to a decline of $7.1 billion in reserves during the last reporting period. As a percentage of M2, reserves rose from 18.7% to 19.6%. Reserves to short-term debt rose from about 425% to 470% during the reporting period. Taiwan maintains pervasive controls on both capital outflows and inflows.

China. China's real GDP growth in 1H/2001 was 7.9% y/y, virtually unchanged from 7.8% in 2H/2000 in spite of continued weakening of 1H/2001 export growth to 8.8% y/y due largely to the slowdown in global demand. Domestic demand strengthened as fixed capital investment and urban household incomes both showed accelerated growth supported by accommodative fiscal policies. As a result, the current account surplus for 2001 is expected to decline moderately from its level of 1.9% of GDP ($20.5 billion) in 2000. China's merchandise trade surplus was $8 billion in 1H/2001, down 34% y/y as imports continued to grow faster than exports. China's bilateral trade surplus with the United States was $37 billion in 1H/2001, little changed from $36 billion in 1H/2000 but down from $47 billion in 2H/2000.

China implements a de facto currency peg to the dollar, which it has maintained within a tight band since 1995. However, given the strengthening dollar in 1H/2001, the Renminbi appreciated vis-à-vis the Japanese Yen and most other regional currencies. In real effective terms, the Renminbi showed virtually no change from August 2000 to February 2001. Gross foreign exchange reserves reached $180 billion by June 2001, about 7 times short-term external debt on a residual maturity basis, only slightly higher than at end 2000. Reserves were 10% of M2 at end-June, unchanged from end-2000. Reserve growth during 1H/2001 can be accounted for largely by the resurgence in FDI inflows associated with China's imminent WTO accession. China continues to maintain wide-ranging controls on both capital outflows and inflows.

Korea. Real GDP growth was sluggish in the first half of 2001, posting 1.2% growth in the first quarter and 2.0% growth in the second quarter (saar) as investment along with global export demand weakened. Korea's current account surplus as a percent of GDP rose to 3½ % in the reporting period compared to 2% for the first half of 2000 as imports declined more rapidly than exports due largely to the sharp drop in investment. Similarly, Korea's bilateral trade in goods and services surplus with the United States rose to $3.8 billion in the first half of 2001, up from $2.4 billion in the first half of 2000, as imports from the United States declined 20% while exports declined only 9% over the period.

Korea generally maintains a floating exchange rate regime, intervening only occasionally to curb what it views as excessive volatility. During the reporting period the won weakened by 6½ % against the U.S. dollar and 1½ % on a real effective basis. The Bank of Korea delayed loosening monetary policy out of concern that inflation was running above the 4% upper limit of the target band. Gross reserves dropped by about $2 billion in the reporting period to $94 billion, due in part to Korea's decision to repay IMF loans ahead of schedule. By March 2001, gross reserves stood at 224% of short-term external liabilities (residual maturity) compared to 227% in at the end of 2000. As a percent of M2, gross reserves were little changed at 28% in June 2001 compared to 28.3% at end-2000. Korea has relatively few restrictions on capital flows.

Russia. Russia's GDP rose 5% in the first half of 2001 compared to the first half of 2000, reflecting continued robust industrial output growth and a recovery in domestic demand. Federal revenue collections rose to 17.5% of GDP from 15.5% of GDP in the second half of 2000, while the primary surplus rose to 6.5% of GDP from 3.5% of GDP. The current account surplus slipped slightly to 15% of GDP ($21.1 billion) in the first half of 2001 compared to 18% of GDP (23.5 billion) in the second half of 2000, primarily due to the steady real appreciation of the ruble and increases in household incomes. Imports continued to rise rapidly in the first half of 2001, up 20% compared to the first half of 2000. Russia's bilateral trade surplus with the United States reached $2.3 billion in the first half of 2001.

Russia operates a managed floating exchange rate. The ruble was under strong pressure to appreciate in the first half of 2001, but the Central Bank of Russia (CBR) intervened to modestly depreciate the ruble, in nominal terms, from 28.2R/$ at the beginning of 2001 to 29.1R/$ at the end of June 2001. The ruble appreciated 15% (in real terms against the U.S. Dollar) in the first half of 2001 due to high Russian inflation. By intervening, the CBR has taken advantage of Russia's favorable balance-of-payments position to rebuild reserves from their low levels following the 1998 financial crisis. In the first half of 2001, Russia's foreign exchange reserves rose from $28 billion to $35 billion, while the ratio of Russia's short-term debt to reserves fell to 30%. Accumulation of reserves continues to fuel the growth of base money, which increased 47% year-on-year in the first half of 2001, while inflation was 23%.

Malaysia. Malaysia entered a technical recession in 1H/2001, with 2Q/2001 real GDP contracting 6.3% q/q (seasonally adjusted annualized rate) following 1Q/2001's 0.6% decline due largely to a sharp drop in exports, particularly of high-tech goods to the United States. Expansionary fiscal policy helped to mitigate the impact of the global slowdown on domestic demand. With exports stagnating, the current account surplus shrank to 10.0% of GDP ($8.2 billion) in 1Q/2001 (latest data available) from 12.9% in the first quarter of 2000. Malaysia's bilateral trade surplus with the United States fell to $2.6 billion in the first half of 2001 from $3.1 billion over the same period in 2000.

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 investments by residents continues to be restricted. To limit short-selling, ringgit borrowing by non-residents is also restricted. Substantial capital outflows, which intensified over 2H00, continued into 2001, raising concerns about the sustainability of the ringgit peg. Reserves fell to a low of $26 billion from a peak of $34.7 billion last May, but later stabilized as interest rate differentials with the United States narrowed (due to the Federal Reserve's easing), speculation of a devaluation subsided, and some portfolio investment returned. As a percent of short-term external debt (residual maturity), reserves fell from 344% at the end of 2000 to 299% by June 2001. As a percent of M2, reserves fell from 32% to 28% during this time. Due to the strengthening of the U.S. dollar, in real effective terms, the ringgit appreciated 5.4 percent over the reporting period.