Report to Congress on
International Economic and Exchange Rate Policies
December 2007

This report reviews developments in international economic and exchange rate policies, focusing on the first half of 2007,[1] and is required under the Omnibus Trade and Competitiveness Act of 1988 (the "Act").[2,3] This report includes two appendices. The first discusses some broad trends in global financial activity and the second updates issues related to Sovereign Wealth Funds described in the last report.

Major Findings:

- The global economy continued to perform exceptionally well in 2007, notwithstanding recent stress in major credit markets. Global real economic growth is expected to be near five percent in 2007, the fifth consecutive year that world growth has exceeded four percent.

- U.S. economic growth strengthened in the first three quarters of 2007 from the modest pace registered in the second half of 2006. Job creation moderated but the labor market remained broadly healthy. Inflation remained contained. Declining housing activity has been a drag on the economy in each quarter since the start of 2006. Increasing U.S. net exports, on the other hand, have contributed to real GDP growth in each of the first three quarters of 2007.

- Beginning in August, financial markets in North America and Europe came under significant stress, reflecting primarily growing concerns about the quality of instruments backed by sub-prime mortgages. Financial market stress, which continues to be worked through, heightened uncertainty over near-term U.S. economic prospects and increased volatility in financial markets. The Federal Reserve reduced the federal funds interest rate three times since September. These and other factors contributed to increasing nominal trade-weighted dollar depreciation to 3.9 percent since August 1 compared to 3.6 percent over the year to August 1.

- There has been steady progress in the reduction of global imbalances. The U.S. current account deficit has fallen from its peak of 6.8 percent of GDP at the end of 2005 to 5.1 percent of GDP in the third quarter of 2007. However, further reduction is needed, both in the United States and abroad.

- The IMF has revised the framework with which it reviews countries' economic performance so as to strengthen its surveillance over exchange rates, a core function of the IMF. It is important that the IMF implement vigorously the new framework to maintain its relevance in the international financial system.

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[1] More recent significant developments are also discussed if information is available.
[2] The Act states, *inter alia*, that: "The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."
[3] The Treasury Department has consulted with IMF management and staff in preparing this report.

- China's imbalances, both domestic and external, continue to increase. Inflation has risen significantly, exceeding 6 percent in the August-October period. China's current account surplus continues to grow, and may reach 12 percent of GDP this year. China's foreign exchange reserves continue to rise, and now are over $1.4 trillion.

- China's exchange rate policy contributes to increasing domestic liquidity, notwithstanding repeated hikes in interest rates and reserve requirements. Other administrative measures are also being employed to control lending growth.

- To address these challenges, China needs to rebalance its economy: boosting domestic demand and consumption-led growth; reforming its financial system; and achieving greater flexibility in its exchange rate regime. Indeed, rebalancing the pattern of growth is a central economic goal of China's leadership. Despite ongoing progress and further expected gains on this front, the factors underpinning China's saving and investment dynamics are firmly in place and will change only over time.

- In the context of China's efforts to rebalance its economy, the substantial undervaluation of the renminbi (RMB) poses risks for China's economy. It contributes to an unbalanced pattern of Chinese growth, which is export, capital and resource-intensive. Inflationary pressures are evident in China's goods and asset markets. Experience around the world demonstrates that substantial expansions in liquidity in banking systems, which China is now experiencing, are often associated with lax lending standards and a rise in non-performing loans. It is also a factor contributing to China's growing trade surplus, which heightens tensions with its trading partners, at a time when global protectionism is clearly on the rise.

- China's strong economic performance has imparted vigor to the global economy. The recent modest acceleration in the pace of RMB appreciation is welcome, though still insufficient. Further, the movement in the RMB on a real trade-weighted basis has been too limited and modest, and will not contribute meaningfully to some of the pressures associated with the pattern of China's economic growth.

- Concern over China's exchange rate management is multilateral. The G7 stated in October: "We welcome China's decision to increase the flexibility of its currency, but in view of its rising current account surplus and domestic inflation, we stress its need to allow an accelerated appreciation of its effective exchange rate."

- China should significantly accelerate the appreciation of the RMB's effective exchange rate in order to minimize the risks that are being created for China itself as well as the world economy, of which China is an increasingly critical part. Treasury reinforces the need for China to rebalance growth, including reform of the exchange rate regime, with Chinese authorities at every available opportunity and will continue to do so. China's exchange rate regime has been a prominent feature of the U.S.-China Strategic Economic Dialogue (SED), G-7 discussions with China, and G20 and IMF Board deliberations.

- Treasury concluded that neither China nor any other major trading partner of the United States met the requirements for designation under Section 3004 of the Act during the period.

U.S. Macroeconomic Trends

U.S. economic growth strengthened in the first three quarters of 2007 from the modest pace logged in the second half of 2006. Job creation moderated, but the labor market remained broadly healthy with a low unemployment rate and continued real wage gains. Inflation remained contained. Partly in response to the threat of credit market disruptions and partly in response to expected economic slowing, the Federal Reserve lowered the Federal funds interest rate target by 50 basis points in September, 25 basis points in October, and another 25 basis points in December. Yields on longer-term securities rose in the spring but have since retreated.

Real GDP grew by 3.1 percent at an annual rate in the first three quarters of 2007, after increasing by just 1.6 percent over the final two quarters of 2006. Business investment strengthened, led by increased outlays for structures and a modest rebound in equipment and software spending following a small decline in the latter part of 2006. Firms began to rebuild inventories in the second and third quarters of 2007 after drawing down inventories in late 2006 and early 2007. Finally, the trade deficit narrowed substantially in the first three quarters of 2007 as exports outpaced imports. Those developments were partly offset by slower growth in household consumption, which grew 2.7 percent at an annual rate over the first three quarters of 2007 compared to 3.3 percent in the second half of 2006. Residential investment continued to decline in 2007, restraining overall GDP growth.

The downturn in the housing sector comes after an eight-year period of exceptional home price appreciation and a boom in home building. Rising residential investment helped to propel GDP growth, adding an average of about half a percentage point to GDP growth rates in each quarter from 2003 to 2005. The strong demand for housing during this period was fueled in part by ample liquidity. Easy credit took the form of increased use of adjustable-rate mortgages (ARMs), including hybrid-ARMs with low teaser rates, interest-only features, low- or no-down payments, and even negative amortization. These practices exposed mortgage holders to greater risk than that of a traditional 30-year fixed rate mortgage with a 20 percent down payment. A significant percentage of non-traditional ARMs went to sub-prime borrowers, and the sub-prime component of total lending grew from about two percent of mortgages in 1998 to nearly 14 percent in mid-2007.

The housing market began to turn in early 2006. Home price appreciation slowed as sales fell and builders cut back on new home construction. Delinquencies began to rise, especially for sub-prime loans. In the third quarter of 2007, the sub-prime delinquency rate rose to 16.3 percent and the foreclosure rate rose to 3.1 percent. Both figures are all-time highs.

Declining housing activity has been a drag on the economy in each quarter since the start of 2006 and in the second half of last year reduced real GDP growth by an average of 1.2 percentage points each quarter. Conditions in the housing sector appeared to be stabilizing in the first part of 2007, but recent data show that housing activity has weakened further. Housing starts, which had leveled off in the first half of 2007, dropped sharply over the summer and in October were close to a 15-year low. Sales of new single-family homes continued to decline and by October were 48 percent below their mid-2005 peak. In the third quarter, real residential investment reduced real GDP growth by just over one percentage point. Forward-looking indicators like

low builder confidence and high inventory levels suggest that housing activity will remain sluggish in the coming months. Recent problems in mortgage markets will also likely reduce both sales and construction in the very near term. Private analysts have revised their forecasts accordingly and now expect declining housing activity to weigh on growth through the first half of 2008.

Beginning in August, financial markets came under significant stress, triggered in large part by growing concerns about the quality of instruments backed by sub-prime mortgages. Concerns spread outside the traditional home-mortgage lending sector, especially to banks, which had extended mortgage lenders credit directly and through financing conduits. Difficulties in determining the scope of the potential losses led to a sharp reduction in liquidity, causing sharp swings in asset prices and private lending rates. Partly in response to rising financial market stress, the Federal Open Market Committee (FOMC) cut the Federal funds target rate by 50 basis points at its September meeting. The FOMC further reduced the Federal funds target by 25 basis points in October 2007 and another 25 basis points in December to 4.25 percent. The September rate cut was the first in four years and followed a 15-month period of no change. Prior to that, the FOMC raised the federal funds rate in seventeen straight hikes of 25 basis points each from June 2004 through June 2006.

Job growth moderated in the first half of 2007, with nonfarm payroll employment rising by 134,000 per month on average compared to 190,000 jobs per month in the second half of 2006. Hiring slowed further during the summer, and, in the five months ended in November, the average monthly job gain slipped to 99,000. The unemployment rate has ticked up slightly since the end of 2006 but was still relatively low at 4.7 percent in November. Workers continued to see their inflation-adjusted earnings grow in the first half of 2007, but gains more recently have been held down by rising consumer prices. Real hourly earnings for production workers eased by 0.2 percent over the 12 months ending in October. Real earnings rose 1.8 percent during 2006 after falling in 2004 and 2005.

Productivity growth has generally slowed from the very rapid growth rates from 1997 through 2003, when it averaged 3.2 percent at an annual rate. More recently, however, productivity growth improved. Output per hour in the nonfarm business sector rose 3.0 percent at an annual rate in the first three quarters of 2007, after posting essentially no gain in the second half of 2006. Since the business cycle peak in the first quarter of 2001, nonfarm business productivity has grown at a 2.7 percent average annual rate, slightly faster than the 2.5 percent annual rate between the fourth quarter of 1995 and the first quarter of 2001. Growth of unit labor costs accelerated to 3.0 percent over the latest four quarters from 2.6 percent in the year-earlier period.

Headline inflation increased in the first 11 months of 2007 as food and energy prices rose, but core inflation remained benign. Consumer prices rose 4.2 percent at an annual rate in the first 11 months of 2007, compared with a very modest 0.4 percent rise in the second half of 2006. Energy prices accounted for most of the increase; consumer energy prices rose at an annual rate of over 18 percent in the first 11 months of 2007, after falling at an annual rate of 14 percent in the second half of 2006. Food prices also jumped in the first 11 months of 2007, rising 5.3 percent at an annual rate. Core consumer price inflation, which excludes food and energy prices,

was 2.4 percent in the first 11 months of 2007 (annual rate), just above the 2.2 percent rise in the second half of 2006.

Long-term interest rates rose in the spring but have since retreated, partly on safe-haven buying in response to mid-summer developments in financial markets. The yield on the 10-year Treasury note climbed roughly 50 basis points in the first half of 2007, from about 4.8 percent at the start of the year to around 5.3 percent in June, but began to retreat in August and by early December had declined to four percent. Mortgage rates have generally moved in tandem with the 10-year Treasury yield. The average interest rate for a 30-year conforming fixed-rate mortgage rose from an average of 6.2 percent in the first five months of 2007 to 6.7 percent in mid-July but by early December had eased back to around six percent. Rates for jumbo mortgages remain elevated, however, and in early December the spread between jumbo and conforming loans was close to 100 basis points. That compares to the 20-to-25 basis-point spread in the weeks leading up to the credit market turmoil that began in early August.

The federal budget situation has improved significantly in the past two years, with the deficit shrinking by half from the FY2004 estimate a full three years ahead of the Administration's FY2009 goal. In FY2007 the deficit narrowed by $85 billion to $163 billion. The FY2007 deficit was equivalent to 1.2 percent of GDP, down from 1.9 percent in FY2006, and its recent peak of 3.6 percent in FY2004. The deficit over the last 40 years has averaged 2.3 percent of GDP. Strong receipts growth has been largely responsible for the improved near-term federal budget situation. At the same time, growth in outlays has remained relatively tame. The Administration's Mid-Session Review of the FY2008 budget sees further improvement in the U.S. government's fiscal situation over the next five years, with a return to a small surplus by FY2012.

The Administration's most recent economic forecast, prepared in November, projects growth will be lower at the end of 2007 and the beginning of 2008 than it was in the middle of the year. Real GDP is projected to grow by 2.7 percent on a fourth-quarter over fourth-quarter basis in 2007 and 2008. More recent private forecasts are somewhat less upbeat about next year's outlook. One consensus forecast from early December predicts 2.2 percent real GDP growth in 2008, with growth gradually picking up throughout the year. The Administration is projecting headline consumer price inflation of 2.1 percent over the four quarters of 2008, and the unemployment rate is expected to average 4.9 percent in 2008, up slightly from its current 4.7 percent rate. Private forecasts for inflation and unemployment are very close to Administration projections for inflation and unemployment.

The Global Economy

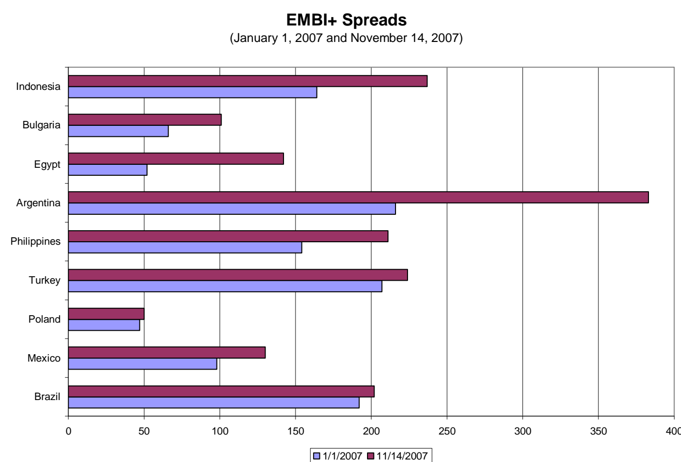
The global economy continued to perform exceptionally well in 2007, notwithstanding recent credit market stresses. Global real economic growth is expected to have been at or near five percent in 2007[4], with many forecasters projecting growth of between four and five percent in 2008. Continuation of this strong performance despite the onset of financial turbulence in large

[4] See IMF's World Economic Outlook, http://www.imf.org/external/Pubs/FT/weo/2007/02/index.htm; forecasts of aggregate world GDP growth use PPP weights.

markets reflects the solid output and demand conditions and healthy fundamentals that most economies have enjoyed.

Much of current global growth is coming from rapidly expanding emerging market economies which, in the aggregate, have grown more than three times as fast as the advanced economies (eight percent versus 2.5 percent). In fact, since 2000, emerging markets have grown a cumulative 58.2 percent while advanced economies have grown 16.9 percent. Faster growth from the emerging markets is to be expected as part of the "catch up" process but, unlike the 1990s when the growth advantage was about one percentage point, in recent years the advantage in favor of emerging markets has widened substantially. The economies of all emerging market regions are growing at the rate of at least five percent. Asia (ex Japan) has accounted for, by far, the largest single share of global growth, 50 percent.

The credit market squeeze that began in August 2007 has been confined principally to North America and Europe. Only minor and generally temporary repercussions have been felt in emerging markets. In emerging markets, credit spreads initially spiked, but equity markets continued to perform well. By early December 2007, the MSCI[5] emerging markets index was up 46 percent from one year earlier and up 22 percent from six months earlier. The EMBI+[6] credit spread index showed an increase of 54 basis points from a year earlier and 85 basis points from six months earlier. In addition, many, though not all, emerging market currencies have risen in value in 2007 vis-à-vis the U.S. dollar, including the currencies of Brazil, Russia, China, and India.



The impact of the financial turbulence on global capital flows is hard to measure at this point. However, according to IMF forecasts, at least in the aggregate, net private capital flows to emerging markets appear to have accelerated in 2007. In addition, emerging markets, in the aggregate, are projected to have a combined current account surplus of roughly $600 billion in 2007, about the same as in 2006 but well above the $167 billion average surplus of 2000-2005.

[5] The MSCI (Morgan Stanley Capital International) emerging market index is designed to track equity performance in emerging markets.
[6] EMBI+ is one of J.P. Morgan's expanded Emerging Market Bond Indexes (EMBIs).

In the event, emerging markets will add nearly $1 trillion in 2007 to their already burgeoning foreign exchange reserves.

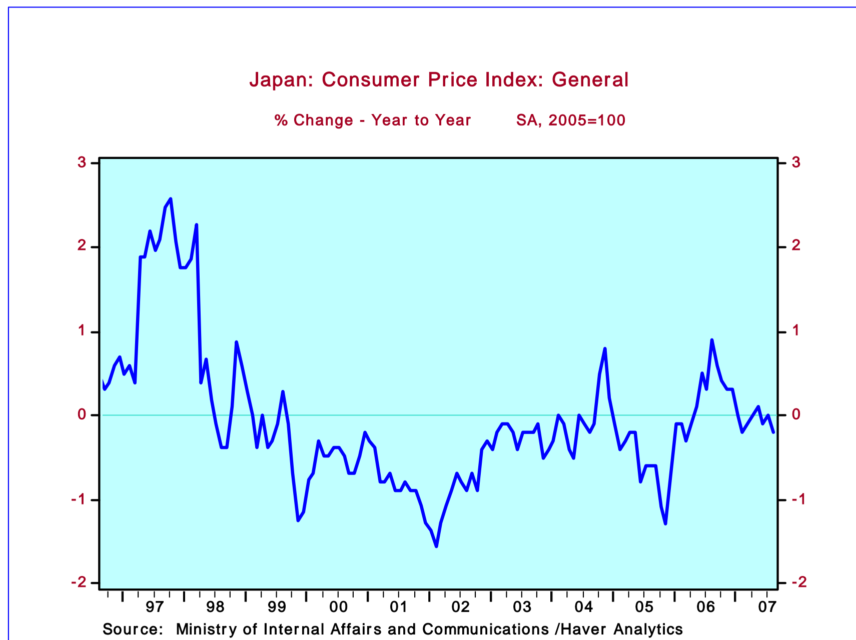
Capital Flows of Emerging Market and Developing Economies[7]

	2006	2007
Net Private Capital Flows ($ Bil)	220.9	495.4
Current Account ($ Bil)	596.0	593.3
Change in Reserves ($ Bil)	-754.2	-1,085.3

(-) Minus sign signifies an increase in reserves.
Source: IMF, *World Economic Outlook*, Fall 2007

Outside of the United States, economic growth among the advanced economies has been somewhat mixed. Europe has had generally solid growth, driven mainly by increased domestic demand growth. Germany, where fast paced growth received a significant boost from rising net exports, is a notable exception. Along with a cyclically-high manufacturing capacity utilization rate, which is now a bit above 84 percent for the Euro-area (highest since 2000), faster growth in continental Europe has reduced unemployment to a more than 20-year low.

Economic growth in Japan, on the other hand, has been erratic because of generally weak domestic demand growth. Inability to mount a robust demand-led recovery has prevented Japan from fully escaping persistent deflationary pressures. Consumer price inflation in Japan, under almost any measure, still shows no clear sign of moving into positive territory.

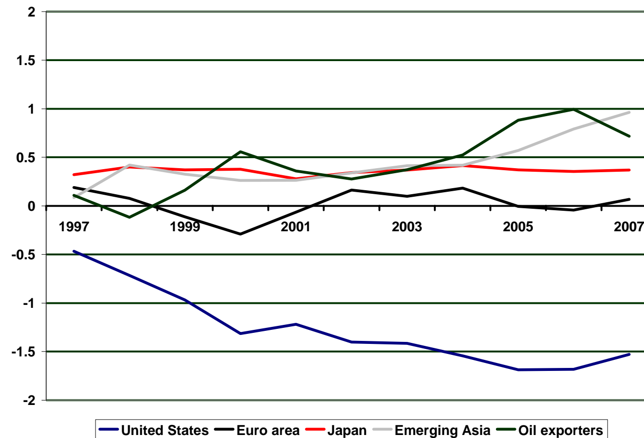


There has been some progress in the reduction of global imbalances; however, performances have been uneven. As noted in the following section, the U.S. current account deficit has fallen from 6.8 percent of U.S. GDP in the fourth quarter of 2005 to 5.5 percent of GDP as of the second quarter of 2007. Meanwhile, the combined current account of the Euro-area shows a slight surplus. (Germany's external surplus has risen sharply and is now in excess of six percent

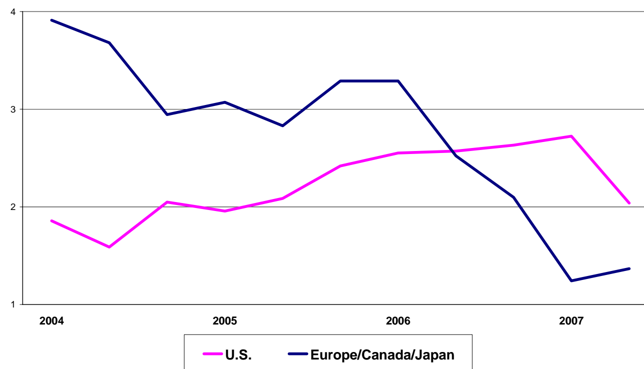
[7] Exclusive of Newly Industrialized Asian Economies of Hong Kong, Singapore, Korea, and Taiwan.

of GDP, offsetting deficits in France, Italy, and Spain.) China's external surplus also has continued to rise sharply, but the combined surplus of the oil exporting economies (Middle East plus the Commonwealth of Independent States and Mongolia) has fallen somewhat – reflecting accelerated import growth.

External Balances (percent of Global GDP)



That said, the rotation of global domestic demand growth needs to be increased on a sustained basis. Combined data on the major advanced economies (Euro-area, UK, Canada, and Japan) show some acceleration in the four-quarter moving average growth rate of domestic demand through most of 2006, but also some emerging weakness in 2007. Stronger domestically sourced demand growth also is needed in China, where the external surplus continues to rise, and among some of the oil exporting countries, to help ensure better balanced global growth.



The United States International Accounts[8]

U.S. Balance of Payments

U.S. Balance of Payments and Trade

($ billions, seasonally adjusted unless otherwise indicated)

	2005	2006	2006				2007		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
Current Account:									
Balance on Goods	-787.1	-838.3	-207.8	-211.3	-218.9	-200.3	-200.9	-204.2	-199.7
Balance on Services	72.8	79.7	18.0	18.7	19.6	23.4	23.3	25.8	26.5
Balance on Income 1/	48.1	36.6	10.5	10.7	5.9	9.7	7.5	12.7	20.5
Net Unilateral Current Transfers	-88.5	-89.6	-21.4	-23.7	-23.9	-20.7	-27.0	-23.2	-25.8
Balance on Current Account	-754.8	-811.5	-200.6	-205.6	-217.3	-187.9	-197.1	-188.9	-178.5
Balance on Current Account as % of GDP	-6.1	-6.2	-6.2	-6.3	-6.6	-5.6	-5.8	-5.5	-5.1
Major Capital Flow Components (financial inflow +)									
Net Bank Flows	11.3	1.8	-35.3	-10.2	14.6	32.7	.0	-51.0	-31.6
Net Direct Investment Flows	116.7	-54.8	-23.5	-4.7	-6.0	-20.5	-69.5	-31.4	24.9
Net Securities Sales	619.0	681.7	213.1	144.9	186.2	137.5	191.4	217.1	-48.1
Net Liabilities to Unaffiliated Foreigners by Non-banking Concerns	-7.8	152.2	36.3	10.0	40.5	65.4	45.8	16.2	142.1
Memoranda:									
Statistical Discrepancy	-18.5	-17.8	6.6	49.4	-37.1	-36.6	15.7	36.7	85.6
Change in Foreign Official Assets in the United States	259.3	440.3	125.3	120.9	108.8	85.3	152.2	70.5	39.0
Trade in Goods									
Balance	-787.1	-838.3	-207.8	-211.3	-218.9	-200.3	-200.9	-204.2	-199.7
Total Exports	894.6	1023.1	243.9	252.5	260.3	266.5	270.1	279.3	297.9
of Which:									
Agricultural Products	64.9	72.9	17.3	18.0	18.7	18.8	19.8	21.8	25.8
Capital Goods Ex Autos	362.3	413.9	99.8	102.3	103.9	107.9	107.0	107.8	114.7
Automotive Products	98.6	107.2	26.1	26.1	27.5	27.4	27.9	29.5	32.2
Consumer Goods Ex Autos and Food	116.1	130.0	31.1	31.9	33.0	34.0	35.2	35.9	37.8
Industrial Supplies and Materials 2/	233.1	276.1	64.1	69.0	70.9	72.1	72.2	77.9	81.8
Total Imports	1681.8	1861.4	451.6	463.7	479.2	466.8	471.0	483.6	497.6
of Which									
Petroleum and Products	251.9	302.4	73.4	78.7	82.8	67.6	70.9	78.1	81.9
Capital Goods Ex Autos	379.3	418.3	101.1	103.6	106.7	106.9	109.4	109.5	112.8
Automotive Products	239.5	256.7	63.7	64.2	63.6	65.2	63.4	63.1	67.1
Consumer Goods Ex Autos and Food	411.5	446.1	106.7	109.1	113.2	117.1	119.0	118.0	119.2

1/ Including compensation of employees

2/ Including petroleum and petroleum products

Source: BEA, Bureau of Census

The U.S. current account deficit was $772 billion (at a seasonally adjusted annual rate, or "saar"), or 5.7 percent of GDP, in the first half of 2007, compared with $811 billion, or 6.1 percent of GDP, in the second half of 2006. Viewed over a longer period, the U.S. current account deficit increased, as a percent of GDP, from around zero in 1991 to over four percent in the fourth quarter of 2000. Then, after a cyclically induced narrowing in 2001, it resumed increasing to reach 6.8 percent in the fourth quarter of 2005, before easing from this peak in 2006.

The U.S. surplus on services has begun to widen noticeably, reaching levels not seen for over a decade. In services, the United States exported $458 billion (saar) in the first half of 2007, a 5.8 percent increase from the second half of 2006, and imported $360 billion (saar), a 3.7 percent

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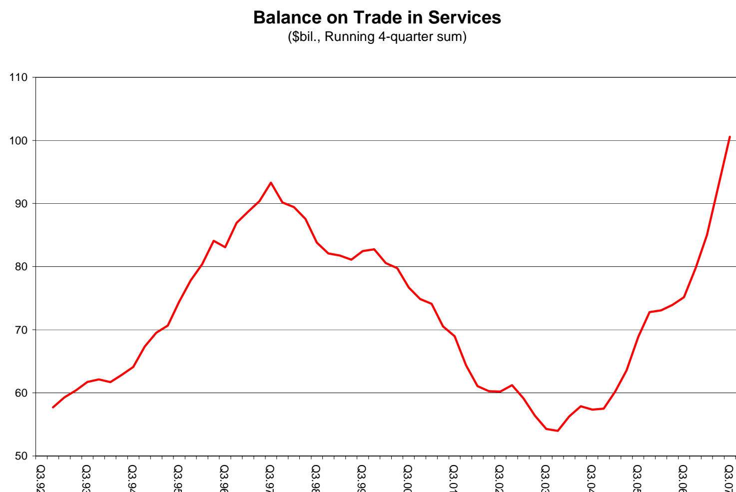
[8] The IMF annually reviews U.S. economic performance and policies through the IMF Article IV surveillance process. The last Article IV surveillance review took place in July 2007. The IMF Article IV Staff Report and the results of the IMF Executive Board's discussion of the U.S. Article IV review can be found at http://www.imf.org/external/pubs/ft/scr/2007/cr07264.pdf. In addition, the IMF discusses U.S. economic policies and performance in the context of its twice yearly World Economic Outlook reports. These can be found at http://www.imf.org/Pubs/FT/weo/2007/02/index.htm.

increase from the second half of 2006, with a resulting $98 billion surplus. Growth was particularly strong in royalties and licensing fees and in financial services. The surplus on trade in services is particularly large with South and Central America, Asia-Pacific countries (excluding China), and Canada.



In the first half of 2007, in goods, the United States exported $1,099 billion (saar) and imported $1,909 billion, with a resulting $810 billion deficit. Exports of goods increased 4.3 percent in the first half of 2007 compared to the second half of 2006, while imports increased 0.9 percent. Imports are sufficiently large relative to exports that the gap between imports and exports narrowed only marginally, even with the weak growth in imports.

Non-automotive capital goods constituted 39.1 percent of merchandise exports in the first half of 2007. Consumer goods constituted 24.8 percent, and non-automotive capital goods constituted 22.4 percent, of merchandise imports. Petroleum and petroleum product imports accounted for 15.6 percent of merchandise imports. The value of petroleum and petroleum product imports as a percentage of total merchandise imports has risen from 8.2 percent in the first half of 2002 to 15.6 percent in the first half of 2007. The rise in the U.S. oil bill has been an important factor in the growth in the U.S. trade and current account deficits.

Canada, Mexico, China, Japan, Germany, and the U.K. remain the largest trading partners of the United States. Of U.S. exports of goods, Canada purchased 21.7 percent, Mexico 12.0 percent, Japan 5.6 percent, China 5.5 percent, and the U.K. 4.7 percent in the first half of 2007. Of U.S. imports of goods, Canada accounted for 16.6 percent, China 15.8 percent, Mexico 10.8 percent, Japan 7.7 percent, and Germany 4.9 percent in the first half of 2007.

Country	Exports Jan07-Jun07	Country	Imports Jan07-Jun07
Total, All Countries ($Bil)	**560.4**	**Total, All Countries ($Bil)**	**953.9**
	Percent of Total		**Percent of Total**
Canada	21.7	Canada	16.6
Mexico	12.0	China, Mainland	15.8
Japan	5.6	Mexico	10.8
China, Mainland	5.5	Japan	7.7
United Kingdom	4.7	Germany	4.9
Germany	4.3	United Kingdom	2.9
Republic of Korea	3.0	Republic of Korea	2.6
Netherlands	3.0	France	2.1
France	2.5	Taiwan	2.0
Singapore	2.3	Venezuela	1.8
Taiwan	2.2	Italy	1.8
Memo		**Memo**	
Euro Area	16.0	Euro Area	13.8
OPEC	3.8	OPEC	8.2

Source: Bureau of the Census

In historical perspective the growth of both U.S. exports and imports of goods strengthened significantly in 2004, with the acceleration of world economic activity. The growth in imports exceeded that of exports until 2006. During 2006, however, the growth of imports of goods fell off significantly while the growth of exports continued at a rapid pace. In the 12 months ending September 2007 exports were 12.6 percent higher than in the preceding 12-month period while imports were only 4.1 percent higher. Several geographic areas contributed to the expansion of exports. The fastest export growth is often to small economies with a small base, contributing relatively minor amounts to the increase in the dollar value of exports. The greatest increase for major economies or economic areas in terms of dollar value was in exports to the Euro-area, followed by exports to South/Central America and exports to North America.

U.S. Exports of Goods

(Period: October 2006 - September 2007)

	Growth over previous period (%)	Change from previous period ($ bil)	Level most recent period ($ bil)
South/Central America	21.3	17.7	101.2
Oil Exporters	18.8	8.5	54.1
China	18.3	9.5	61.8
Euro Area	16.3	24.6	175.2
Asia: NICS	13.6	12.6	105.6
Japan	6.0	3.5	62.1
North America	4.7	16.8	376.3

Asia NICS: Hong Kong, Korea, Singapore, and Taiwan.
North America: Canada & Mexico
Oil Exporting Countries: Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Norway, Qatar, Russia, Saudi Arabia, United Arab Emirates and Venezuela.

Prices of imported goods (not seasonally adjusted or "nsa") increased 1.8 percent in the year through the second quarter of 2007. Non-petroleum import prices rose 1.8 percent over this period, while petroleum import prices decreased 1.5 percent. Export prices rose 4.7 percent over this period. The most recent trough in import and export price inflation occurred roughly at the

beginning of 2002. Since then, non-petroleum import prices have risen 11.3 percent and export prices have risen 18.6 percent.

Foreign demand for U.S. financial assets remains strong. A major item financing the U.S. current account deficit has been net private foreign purchases of long-term U.S. securities, which totaled $1,066.7 billion in the 12 months ending October 2007.

- *Net International Investment Position*

The U.S. Net International Investment Position (NIIP), with direct investment valued at current cost, widened from minus $2,238.4 billion (18.0 percent of GDP) at the end of 2005 to minus $2,539.6 billion (19.2 percent of GDP) at the end of 2006. Financial flows, roughly the financial counterpart to the current account deficit, widened the NIIP by $833.2 billion over 2006. Valuation changes, however, moderated this influence significantly. Dollar depreciation offset $220.7 billion of financial flows while equity and other asset price changes offset another $347.6 billion.

Although the NIIP with direct investment valued at current cost widened in 2006, as a percent of GDP, this was only in comparison to the ratio in 2005, which had narrowed due to strong valuation effects. The ratio has been broadly stable since 2001. The NIIP, with direct investment estimated at the market value of owners' equity, has narrowed significantly since 2001. The changes in both series over the period from 2001 to 2006 reflect significant valuation changes, particularly gains from the relative appreciation of the price on U.S. holdings of foreign equity and gains on foreign currency-denominated assets reflecting appreciation of foreign currencies against the dollar.

Year-end	NIIP (% GDP) estimated at	
	Current Cost	Market Value
2000	-14.1	-16.1
2001	-19.0	-23.1
2002	-19.9	-23.4
2003	-19.5	-21.3
2004	-19.6	-20.5
2005	-18.0	-17.2
2006	-19.2	-16.2

The United States currently earns approximately the same amount on its foreign investments that it pays out on foreigners' investments in the United States, even though the value of foreigners' U.S. assets is around $2.5 trillion greater than the value of the U.S.-owned foreign assets. (In fact, net earnings have yet to turn negative.) Net earnings on direct investment have been large enough for many years to offset outflows of income payments on other forms of international investment, but the difference between the two has been narrowing.

- *The U.S. Current Account in Historical Perspective*

A surplus on the capital and financial accounts is, by balance of payments accounting definition, the counterpart of a current account deficit. These flows finance that part of net capital

formation that is equal to its excess over domestic saving. The growth of the U.S. current account deficit over more than a decade has been linked to high levels of domestic U.S. capital formation compared to domestic U.S. saving. There are counterpart developments throughout the world that are necessarily linked to this process, since the rest of the world must be running an aggregate current account surplus, or a deficit on its capital and financial accounts, when the United States is running a deficit on its current account.

Slowing U.S. growth, which was lower than that of our major trading partners during most of the most recent four quarters, and a continuation of the effects of the dollar's real effective exchange rate over the past two years contributed significantly to the narrowing of the current account deficit. Over the longer-run, sustained strong productivity growth, sound U.S. economic performance, a welcoming U.S. investment climate, and the deepest and most liquid capital markets in the world have all combined to attract foreign investment. In turn, sustained external demand for U.S. assets has allowed the United States to achieve levels of capital formation that would have otherwise not been possible, and robust growth in investment has been critical to non-inflationary growth of production and employment.

The U.S. Dollar

In the first half of 2007, the dollar depreciated against the euro by 2.5 percent to $1.3541 and appreciated against the yen by 3.5 percent to ¥123.04. On a nominal trade-weighted basis, the dollar depreciated 2.8 percent in the first half of 2007; on a real trade-weighted basis it depreciated 0.3 percent

Subsequently, into the third and fourth quarters, the dollar dropped further as volatility increased in all asset classes and credit market conditions deteriorated. Concerns about credit exposures, large write-offs by several major financial institutions, and tightness in funding markets induced reassessments about U.S. economic prospects, which in turn influenced foreign exchange market developments. In particular, markets remained concerned that earnings reports in the financial sector portended further adverse effects from sub-prime mortgage exposure. By early December the dollar had extended its earlier decline.

Euro/dollar exchange rate movements in the first half of 2007 primarily reflected improvement in Euro-area economic fundamentals and a narrowing of interest rate differentials between euro and dollar-denominated instruments, which led to expectations of better relative returns on European assets. These expectations were reinforced by market impressions of strong momentum in Euro-area growth for the second half of 2007. On the other hand, dollar/yen exchange rate movements in this period reflected expectations that returns on Japanese assets would remain low relative to those on U.S. and other foreign assets. This prompted continued Japanese investor interest in purchases of foreign assets (i.e., capital outflows) and widespread yen borrowing by global investors to finance positions in higher-yielding assets. In late February/early March, there was a temporary, but sharp, reduction in risk exposure that was marked by active covering of short yen positions and an upward spike in yen exchange rates versus other major and emerging market currencies. There was also a spike in volatility across all asset classes.

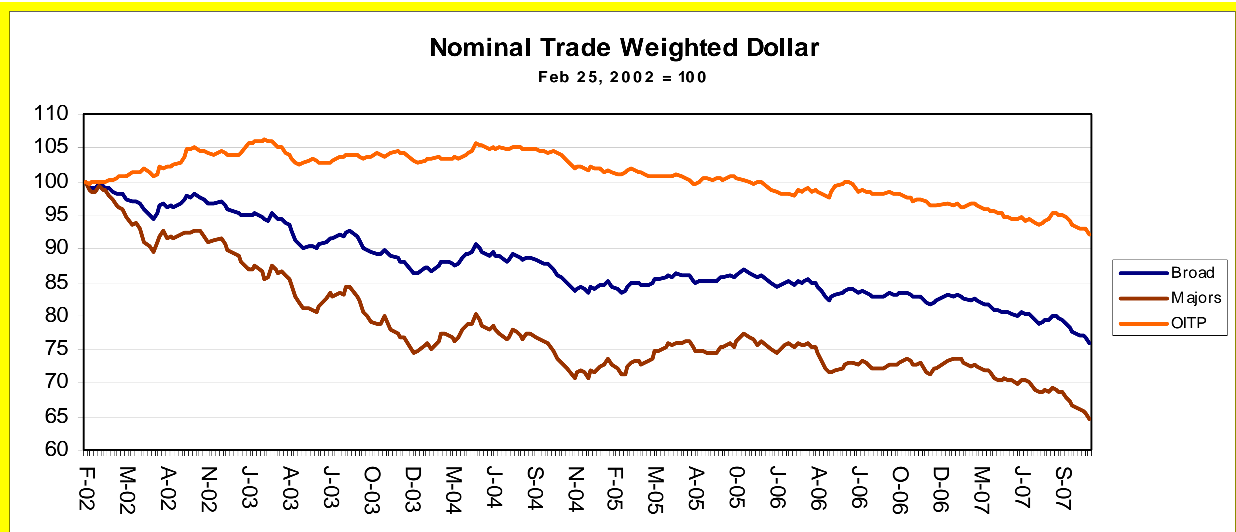
Market views on the U.S. growth outlook temporarily improved in spring 2007, and returns on U.S. assets improved relative to assets elsewhere. Subsequently, however, market concern about sub-prime mortgage credit and the continued downtrend in the housing sector prompted a downgrading of the U.S. outlook. There was no further change in the Fed funds target until a 50 basis point reduction in September 2007. This was followed by two additional 25 basis point cuts in October and December.

The Bank of Japan (BOJ) raised its overnight call money target by 25 bps to 0.50 percent in February. Market expectations shifted toward an early, additional BOJ rate hike but did not price in a more extended series of rate hikes. However, yields in Japan were expected to remain quite low relative to yields overseas, and Japanese investors' demand for foreign assets remained strong. After the yen short covering that occurred in the risk reduction episode of late February/early March, there was evidence of renewed accumulation of short yen positions in the second quarter. This reflected demand for foreign assets by Japanese investors and the re-establishment of risk positions by global investors in the second quarter of 2007. Currency market volatility settled back down near historically low levels during the second quarter – encouraging risk positions in higher-yielding currencies – notwithstanding an increase in volatility in other asset classes that re-emerged in June. Volatility has increased again early in the fourth quarter but has remained well below the levels reached in mid-August.

The European Central Bank (ECB) raised its re-financing rate by 25 basis points to 3.75 percent in March and by a further 25 bps to 4.00 percent in June. Its continued emphasis on vigilance against inflation risks reinforced market expectations of further interest rate hikes in the second half of 2007. Improvements in Euro-area labor market conditions and business sentiment supported this view. After the end of the half, increased market volatility and deteriorating conditions in global credit markets led eventually to a reduction in market expectations for further ECB monetary tightening this year. Interest rate markets are now pricing in a zero probability of a rate hike this year and only about a one in four probability of a 25 basis point rate hike in the first quarter of 2008.

Most other foreign central banks also raised their interest rates one or more times before the end of the first half of 2007, and well into the second half in a substantial number of cases. The increases reinforced the impression that a divergence of growth and monetary policy cycles in the United States and in other countries would further reduce support for the dollar. There were a few notable exceptions, such as Brazil, Turkey, and a number of Southeast Asian countries – where interest rates were reduced. Midway through the third quarter, as concerns about credit quality mounted, market expectations for further interest rate increases – notably in the Euro-area – moderated.

By early November, for the year the dollar had fallen 11 percent against the euro and by nine percent against the yen. Against a basket of the major global currencies, the dollar had depreciated by 11 percent, whereas, against a basket of "other important trading partners" currencies, the dollar had fallen by four percent.



Country Analyses

Argentina

Argentina intervenes frequently in the foreign exchange market to manage the value of the peso against the dollar, and to build international reserves. Since repaying Argentina's entire $9.9 billion in IMF obligations in January of 2006, the Argentine central bank has more than rebuilt its stock of foreign reserves. At end-June 2007, reserves stood at $43.2 billion, an increase of $11.2 billion from the end-December 2006 level of $32.0 billion. Despite this 26 percent y/y increase in reserves to June 2007, reserve holdings came under pressure during this past summer's tighter global liquidity conditions, and fell to $43 billion at end-October from the July peak of $44.2 billion as the central bank sold dollars to support the peso.

The peso depreciated 0.3 percent y/y in June 2007 against the dollar, with the peso/dollar rate rising to 3.09 in June 2007 from 3.08 in June 2006, but this rate of depreciation increased to 1.9 percent y/y in October. However, the typical day-to-day percent change against the dollar is less than 0.3 percent in either direction, and suggests that the exchange rate is tightly managed in both directions. Meanwhile, the real effective exchange rate depreciated by 0.7 percent y/y in June 2007, and 1.7 percent y/y in October 2007.

In the first half of the year, the Argentine central bank continued actively to buy dollars in the foreign exchange market, and then partially sterilize these purchases through the issuance of central bank paper.[9] The average weekly U.S. dollar purchase by the central bank increased to $385 million in the first half of 2007 compared to the $224 million average for all of 2006. Despite these sterilization efforts, the growth of the broad monetary aggregate M2 increased to 25.1 percent on an annualized basis at end-June 2007 from 19.1 percent at end-2006.

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[9] Sterilized intervention means that the change in a monetary authority's net foreign currency assets arising from an intervention are offset by a corresponding change in the monetary authority's net domestic currency assets, so that its monetary liabilities remain unchanged.

Capital controls remain in effect on both local and foreign U.S. dollar inflows. Local residents are limited in the amount of dollars they can bring freely into the country, and foreigners are required to keep dollar inflows in the country for a minimum of one year, with 30 percent held on deposit in an interest-free account at the central bank. Foreign direct investment is required to remain in Argentina for at least 365 days. Argentina maintains these capital controls to limit potential volatility in the foreign exchange market and to help limit the amount of potential foreign exchange market intervention the central bank must engage in to maintain dollar/peso stability.

Despite strong economic growth along with accommodative monetary and fiscal policies, official inflation rates declined. However, even though official inflation rates moderated to 8.8 percent y/y in June 2007 compared to 11.1 percent y/y in June 2006, independent estimates of current inflation range from 15 to 20 percent. Administrative price controls on 70 percent of the items in the CPI basket are one reason for the year-on-year decline in "measured" inflation, but systematic underreporting of CPI inflation is widely suspected by market analysts. Meanwhile, nominal interest rates on central bank repo transactions increased by 125 basis points in the first half of 2007, to 9.5 percent from 8.25 percent at end-December 2006, suggesting that real interest rates were negative and, therefore, unlikely to restrain rising underlying inflationary pressure.

Argentina's economy continued its rapid expansion in the first half of 2007, driven by strong real growth in private consumption (8.4 percent y/y in the second quarter) and investment in durable equipment (22.7 percent y/y in the second quarter). Real GDP grew by a seasonally adjusted rate of 8.0 percent y/y in the second quarter, down slightly from 8.6 percent y/y growth seen in 2006. Also, Argentina's current account surplus decreased to a seasonally adjusted $2.7 billion, or 2.2 percent of GDP, in the first half of 2007 from $4.8 billion, or 4.2 percent of GDP, in the last six months of 2006. The U.S. bilateral trade surplus with Argentina increased to $541 million (nsa) in the first half of 2007 from a surplus of $214 million in the first half of 2006.

Brazil

Brazil has a flexible exchange rate and conducts monetary policy on the basis of an inflation targeting regime that was adopted in 1999. During the first half of 2007, the Brazilian real appreciated by 9.6 percent in nominal terms (from 2.13 to 1.93 per dollar) and by 8.7 percent in real effective terms. From its low point in October 2002 to October 2007, the real has appreciated by cumulative 111 percent against the dollar. The real's strong appreciation in the first half of 2007 reflects a combination of favorable domestic and external developments, including faster growth in Brazil, a rising trade surplus, and a relatively benign outlook for inflation.

Notwithstanding the real's real effective appreciation, Brazil's trade surplus rose to a seasonally adjusted (or "sa") $47.8 billion in the 12 months through June 2007 from $46.4 billion in the 12-month period through December 2006. Its 12-month accumulated current account surplus rose to $15.5 billion (sa), or 1.4 percent of GDP, from $13.6 billion, or 1.3 percent of GDP, over the same period. The U.S. cumulative bilateral trade deficit with Brazil was $1.2 billion (nsa) in the

first six months of 2007 compared to a $3.3 billion deficit in the six months to December 2006. In the first half of 2007, Brazil also experienced a sharp increase in FDI inflows, with 12-month accumulated inflows amounting to $32.2 billion compared to 12-month accumulated inflows of $18.8 billion through December 2006.

The central bank has been actively accumulating foreign exchange reserves in an attempt to smooth what it views as excessive volatility associated with short-term capital inflows, but also to reduce its external vulnerability should these short-term flows ebb or reverse. Specifically, capital inflows saw a very large increase in the first half of 2007 compared to the same period in 2006, rising to $60 billion from $6 billion. As of October 2007, reserves totaled $171 billion, an increase of $90 billion or 116 percent over the level one year earlier. This increase in reserves pushed the ratio of reserves to short-term external debt by residual maturity well above one, a ratio thought to be more than prudent for a flexible exchange rate regime. However, the accumulation of reserves came at a substantial fiscal cost, since the increase was largely sterilized and since there remains a large difference between domestic and foreign interest rates.

On the positive side, exchange rate appreciation has helped to temper rising inflationary pressures. At the end of June 2007, Brazil's CPI inflation rose by 3.8 percent y/y, up from 3.3 percent y/y at the end of December 2006. By the end of October 2007, inflation had risen further to 4.2 percent. Despite this rise, inflation remains well below the midpoint of the central bank's inflation target range (4.5 percent ± two percent). In June of 2007, Brazil's National Monetary Council announced that the 4.5 percent midpoint inflation target would remain unchanged through 2009. Brazil's favorable inflation environment has allowed its monetary policy decision-making committee (COPOM) to continue the monetary easing cycle it started in September 2005. Between December 2006 and June 2007, the targeted overnight interbank interest rate fell from 13.25 percent to 12.0 percent, and this rate was cut further to 11.25 percent in September 2007.

Mexico

Mexico has a flexible exchange rate. While the Mexican peso fluctuated on a daily basis in the first six months of 2007, the peso finished June 2007 at 10.9 pesos per dollar, roughly where it was at the end of December 2006. The J.P. Morgan real trade-weighted effective exchange rate index for the peso remained unchanged during this period. Despite rising oil prices in the first half of 2007 and further oil-price increases in the second half of 2007, peso appreciation has been limited to a large extent by Mexico's close trading and financial ties to the U.S. economy.

In particular, the slowdown in the U.S. economy caused some growth deceleration in the first quarter, but economic activity rebounded in the second quarter of 2007. Real GDP increased at annual rates of 1.2 percent and 5.7 percent during the first and second quarters of 2007, respectively. At the same time, supply shocks on certain key food items (mainly corn and tortilla) have caused inflation to rise above the Bank of Mexico's three percent target. Year-on-year headline inflation was 4.0 percent to December 2006, and remained at this level in June 2007.

During the first half of the year, rising oil prices contributed to a modest increase in international reserves, with reserves increasing by $2.3 billion to reach $69.9 billion by the end of June. Pemex, the state-controlled Mexican oil company, is obligated by law to sell its foreign currency earnings to the Bank of Mexico to service the country's foreign debt. Reserves accumulate, therefore, when the foreign currency obtained by the Bank of Mexico is greater than foreign debt payments. On this point, it is worth noting that, while Mexico's international reserves have actually fallen by $8.8 billion from their recent peak of $78.7 billion in June 2006, the gross external debt position of the public sector has also fallen by $15.2 billion over the same period, suggesting reduced vulnerability to external shocks.

The current account deficit increased to 1.1 percent of GDP in the second quarter of 2007 versus a deficit of 0.5 percent of GDP in the second quarter of 2006. The deterioration in the current account can be explained by strong import growth, and falling oil export volumes and remittances flows, down 3.2 percent y/y in June, resulting from the contraction in the U.S. residential construction sector. The bilateral trade surplus with the United States for the first half of 2007 was $33.8 billion, up from $31.3 billion in the first half of 2006. Mexico is the second largest supplier of oil to the United States, and the rise in the bilateral U.S. trade deficit reflects higher oil prices.

Mexico does not maintain controls on most external capital inflows and outflows. It does, however, maintain some restrictions against certain types of foreign investment, such as the establishment of foreign bank branches within Mexico.

Venezuela

Venezuela maintains a pegged exchange rate to the dollar. The official nominal exchange rate was held at 2,147 Bolivars to the dollar at end-June 2007, unchanged since end-December 2005. This is one of the longest periods in Venezuelan history with a stable nominal exchange rate. On January 1, 2008, the currency will be redenominated by dividing current Bolivars by 1,000. The newly denominated currency will be called the 'strong Bolivar.' The government has indicated that it will not adjust the exchange rate during the redenomination process.

Despite the stable nominal exchange rate, inflation rose to 19.4 percent by the end of June 2007, and this has propelled the real effective value of the Bolivar 5.8 percent higher during the first half of 2007 and 10.4 percent higher since end-June 2006. High inflation is primarily due to an accommodative monetary policy, with the 90-day deposit rate of 10 percent on an annualized basis, i.e., a negative real rate, and the monetary base growing by 70 percent y/y in June 2007.

The Venezuelan government maintains tight controls on capital movements as a means of managing its exchange rate. Purchases of foreign exchange in Venezuela are subject to approval by CADIVI, the government's foreign exchange authority. However, CADIVI's supply of foreign exchange to the market has not kept up with demand, leading to a parallel exchange rate that has depreciated to 4,100 Bolivars to the dollar as of end-June from 3,415 Bolivars to the dollar at end-2006, a 16.7 percent depreciation. As of October 31, the parallel exchange rate had depreciated to 6,800 Bolivars to the dollar, a 39.7 percent depreciation since end-2006.

The growing gap between the official rate and the parallel rate suggests that the official pegged rate is overvalued. This assessment is supported by booming import growth and almost no growth of Venezuelan non-oil exports. Also, the $12.2 billion decrease in central bank reserves during the first half of 2007 suggests that the nominal exchange rate is under growing downward pressure. Venezuela's stock of central bank reserves had fallen to $19 billion by end-August 2007 compared to $37.4 billion at end-2006.

Similarly, the overvalued exchange rate has cut into Venezuela's current account surplus, which fell to $8.6 billion (sa) in the first half of 2007 from $15.8 billion (sa) in the first half of 2006. Moreover, the willingness of the government to spend its extra oil revenue quickly led to continued strong import growth in the first half of 2007. A significantly lower price for Venezuelan oil in the first quarter of this year also reduced export revenues. The bilateral U.S trade deficit with Venezuela fell to $12.1 billion (nsa) during the first half of 2007, down from $14.5 billion in the first half of 2006. The slightly lower bilateral trade deficit reflects both lower price of oil and improved U.S. export competitiveness vis-à-vis Venezuela and other exporting countries.

High oil prices account for much of the continued strong growth performance and current account surpluses, although oil prices did ease somewhat in early 2007. Oil accounts for about one third of Venezuelan GDP, 90 percent of the country's exports and close to half of government revenues. Real GDP rose by 10.3 percent in both 2005 and 2006, driven primarily by strong growth in government non-interest expenditure (about 40 percent real growth) and private consumption (18.8 percent real growth) in 2006 as the government sought to disburse the benefits of additional oil revenue. Real GDP growth in the first half of 2007 slowed to 7.8 percent y/y.

The Euro-area

The value of the euro is market-determined, and the European Central Bank (ECB) has not intervened in the foreign exchange market in the last seven years. On a real effective basis, at the beginning of November, 2007, the value of the euro was about 3.2 percent above its average of the last three years. The value of the Euro-area's international reserves decreased slightly by approximately $728 million during the first half of 2007, reaching $473 billion.

Following an acceleration in Euro-area economic growth, ECB interest rate hikes in 2006 and 2007, and a narrowing of the dollar/euro interest rate spread, the euro appreciated 2.5 percent in nominal terms against the dollar during the first half of 2007, from $1.317 to $1.351 per euro. Over the same period, the euro appreciated 1.9 percent in real effective terms.[10] Since June, the euro continued to appreciate against the dollar and reached a new record high of $1.49 on November 23. The ECB has not raised its target interest rates since September. The ECB's primary monetary policy target is an annual rate of inflation of close to, but less than, 2.0 percent.

The Euro-area's current account balance moved to a surplus of $20.5 billion (0.35 percent of GDP) in the first half of 2007 compared with a deficit of $8.3 billion (0.16 percent of GDP)

[10] Source: The ECB's, CPI-based, trade-weighted index of the real value of the euro.

during the same period in 2006. Euro-area exports continued to grow robustly, rising 10.1 percent (measured in euros) in the year ending in the third quarter of 2007 compared to a 5.6 percent increase in imports. The Euro-area's trade surplus with the U.S. declined 13 percent to $39.4 billion during the first half of 2007 compared with the same period in 2006.

Recent growth in the Euro-area has been broad-based with net exports, investment and private consumption all making significant contributions. Unemployment has been falling since 2004, reaching an all-time low of 7.3 percent (sa) in September. Expanding employment should support private consumption growth in the medium-term. However, due to a strengthening euro, expected weaker growth in the U.S., and rising petroleum prices, the European Commission's 2008 growth forecast for the Euro-area has been reduced to 2.2 percent from 2.6 percent.

Germany

Germany is part of the Euro-area and does not conduct an independent monetary policy. Germany's current account surplus increased to $94.6 billion (or 5.9 percent of GDP) in the first half of 2007 compared to $56.6 billion, (4.0 percent of GDP) during the same period in 2006, largely due to strong demand from Russia and Asia for capital goods. Germany's trade surplus with the U.S. declined 12.8 percent, to $21.3 billion, during the first six months of 2007 compared with the same period in 2006.

Strong export performance has underscored accelerated German annual growth, which for 2006 more than tripled to 3.1 percent. Strong investment growth (7.5 percent in second half of 2006 and 6.6 percent in first half of 2007, y/y) continues to support improved domestic demand growth (1.5 percent in the second half of 2006 and 1.4 percent in the first half of 2007).

The Netherlands

The Netherlands is also a part of the Euro-area and thus does not have an independent monetary or exchange rate policy. The Netherlands has continued to post large current account surpluses; $24.5 billion (7.1 percent of GDP) in the first half of 2007, down from $26.4 billion (8.4 percent of GDP) during the first half of 2006. The Netherlands has trade and services surpluses as well as a surplus on net income flows that more than offset a deficit in transfers. Both the trade and income balances are influenced heavily by the large number of international companies based in the Netherlands that have transformed it into a major processing and trans-shipment point for Europe. For the full year in 2006, the current account surplus was 8.6 percent of GDP, up from 7.7 percent in 2005. The Netherlands had a bilateral trade deficit with the United States, which grew to $8.6 billion in the first half of 2007, up $1.7 billion from the same period in 2006.

GDP grew 2.6 percent (annualized) over the first half of 2006, driven largely by private and government consumption of 2.1 percent and 2.3 percent, respectively, and government investment, which increased 6.8 percent, all on an annualized basis. Headline inflation during the first half of 2007 was 1.8 percent while core inflation was 1.6 percent, both on a year-on-year basis.

Norway

Norway maintains a freely floating exchange rate and an inflation-targeting monetary policy regime. The Norwegian kroner appreciated 5.7 percent against the dollar during the first half of 2007 while the IMF's real effective exchange rate index for the kroner appreciated 4.8 percent. Norway's central bank reserves the right to intervene in foreign exchange markets to influence the kroner but has not done so since January 1999; however, management of the Government Pension Fund (GPF) – the custodian of Norway's oil and gas savings – influences currency developments. By investing the GPF's resources overseas, Norway reduces the upward pressure that oil and gas-related earnings inflows might have on the exchange rate. At end-June 2007, the GPF's market value was $328.6 billion (90 percent of total 2006 GDP, or 124 percent of non-oil and gas GDP) and growing rapidly.

Norway is a major oil and gas exporter and a key player in the oil services industry. Its current account surplus during first half of 2007 was $25.8 billion (14 percent of GDP), down $634 million from $26.4 billion (15.7 percent of GDP) in the first half of 2006. Excluding the oil and gas sectors, Norway had a current account deficit of 10.2 percent of GDP during the first half of 2007, down from 11.8 percent during the corresponding period in 2006. Merchandise exports in the first half of 2007 were up 7.5 percent over the same period in 2006 while imports increased 6.7 percent. Norway had a bilateral trade surplus of $2.2 billion with the United States in the first half of 2007, down $197.4 million from the corresponding period in 2006. Foreign exchange reserves declined $184 million to $56.6 billion during the first half of 2007.

By law, the return on the GPF's investments abroad can be used for current government consumption while the principal remains as a retirement fund for future generations. However, some of the GPF is already being used to service retirement benefits through the current government budget. Oil production is expected to peak in 2008 and halve by 2030, and revenue accruing to the GPF is inadequate to meet the needs of a rapidly aging population. Consequently, there is increasing pressure to reform the pension system to avoid the need to draw down GPF principal.

GDP increased 2.9 percent (at an annual rate) during the first half of 2007 on an annualized basis. Consumption grew by 8.1 percent during the same period while fixed investment increased 3.8 percent. Headline inflation was 0.7 percent year-on-year during the period while core inflation was 1.5 percent. Monetary policy was gradually tightened during the first half of 2007, and the key policy interest rate was raised gradually from 3.5 percent to 4.2 percent during the first half of 2007 due to concerns about economic overheating.

Switzerland

Switzerland has a freely floating exchange rate and an inflation-targeting monetary policy regime. The Swiss franc depreciated 0.5 percent against the dollar while its real effective exchange rate[11] depreciated 1.3 percent during the first half of 2007.

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[11] Source: International Financial Statistics.

Switzerland has a large and persistent current account surplus equal to 18 percent of GDP. The surplus is driven by robust exports, services income (mostly banking fees derived from its role as an international banking center) and income from overseas investments that support the financial sector. In the first half of 2007, the current account surplus was $33.3 billion, up from $31.5 billion (15.7 percent of GDP) in the same period in 2006. The U.S. trade surplus with Switzerland reached $1.7 billion in the first half of 2007 compared to $66 million in the corresponding period in 2006. Goods exports increased by 13 percent in the first half of 2007 over the corresponding period in 2006, while imports grew by 9.5 percent. The counterpart to the current account surplus is largely net portfolio investments abroad, which are estimated to have been $25.5 billion in the first half of 2007, down from $39 billion during the corresponding period in 2006.

Switzerland is a small open economy heavily influenced by conditions in the Euro-area, Switzerland's largest trading partner. In the first half of 2007, Swiss authorities tightened monetary policy by raising the policy interest rate from 2.1 percent at the end of 2006 to 2.7 percent in June 2007 – a hike which mirrored rate increases by the ECB. However, because Swiss interest rates are low relative to those of other major currency countries, including those of the Euro-area, the Swiss franc continues to be a significant funding source for "carry trades" in the region. This tends to place downward pressure on a currency and helps explain why the Swiss franc depreciated despite a large external surplus. Foreign exchange reserves remained unchanged at $38 billion during the first half of 2007.

GDP growth was estimated to be 2.6 percent (annualized) during the first half of 2007. Consumption and fixed investment grew 2.2 percent and 5.6 percent, respectively, on an annualized basis, while exports grew 13.3 percent, and imports grew 9.5 percent. During the first half of 2007, headline inflation was 0.6 percent y/y, while core inflation was 0.5 percent y/y.

Russia

The exchange value of the Russian ruble is managed by the Central Bank of Russia against a reference basket of the U.S. dollar and euro. The U.S. dollar's and euro's shares in the basket are 55 percent and 45 percent, respectively. The central bank continues to manage closely the exchange rate in an effort simultaneously to meet inflation targets and to limit real exchange rate appreciation. The ruble was allowed to appreciate 2.2 percent against the dollar and 1.3 percent against the basket during the first half of 2007. The Central Bank's nominal trade-weighted index of the ruble depreciated by 0.3 percent in the first half of 2007 while Russia's relatively higher inflation caused its real trade-weighted index to appreciate by 3.3 percent. According to the IMF's Article IV report on Russia, published in October, the ruble's real exchange rate remains undervalued by as much as 20 percent. In the second half of 2007 through mid-November, the ruble appreciated 5.3 percent against the dollar and 0.8 percent against the dollar-euro basket.

The Central Bank of Russia's intervention to moderate nominal exchange rate appreciation accelerated in the first half of 2007, and helped to contribute to an increase in Russia's total international reserves to $406 billion as of end-June from $303 billion at the end of 2006.

Reserve accumulation slowed in the third quarter of 2007 (increasing by $20 billion), but appears to be accelerating once again in the fourth quarter.

Strong growth in imports pushed Russia's current account surplus down from $55.5 billion (nsa), or 12.8 percent of GDP, in the first half of 2006 to $39 billion (nsa), or 7.2 percent of GDP, in the first half of 2007. Russia's bilateral trade surplus with the United States decreased to $5.9 billion in the first half of 2007 compared to $7.5 billion in the first half of 2006. Net inflows of private sector capital rose sharply, fueled by external borrowing by Russian corporations as well as increased foreign direct investment into Russia. As a result, the financial accounts in the balance of payments, exclusive of changes in reserves, posted a surplus of $62 billion during the first half of 2007 compared to a $10 billion surplus in the first half of 2006.

In the last several years, commensurate increases in households' demand for rubles have helped mitigate the inflationary impact of the sizeable increases in domestic monetary aggregates related to large inflows of foreign exchange. This was reflected in a sustained decline in foreign currency deposits in the banking sector. However, as of June 2007, foreign currency deposits have reached just 13 percent of total deposits, suggesting that further scope for inflation mitigation through "de-dollarization" is limited. The possibility that "de-dollarization" has to a considerable degree played itself out also helps to explain recent inflation developments. M2 growth continued to accelerate during the first half of 2007, increasing 53 percent y/y in June, compared to 44 percent in June 2006. Measured on a year-on-year basis, disinflation continued through March of 2007, before inflation rose to 8.4 percent in June (compared to 9.1 percent in June of 2006). More recently, M2 growth has moderated slightly (down to 48 percent as of end-September 2007), but inflation has continued to rise to 9.4 percent y/y in September -- well in excess of the Central Bank's year-end target of 6.0-8.5 percent. A loosening of fiscal policy and the recent liquidity injections by the Central Bank to calm volatile financial markets also appear to have exacerbated inflation pressures.

Real GDP continues to grow robustly, running at 7.5 percent in the second quarter of 2007 compared to seven percent growth in the second quarter of 2007. Output growth has been supported by strong household spending and fiscal easing as the government is spending a larger share of Russia's rapidly growing revenues ahead of the 2007-2008 election cycle.

South Africa

The South African central bank states that it intervenes in the foreign exchange market only to increase gradually the level of its reserves. The South African rand/U.S. dollar exchange rate was at virtually the same level at the end of June, 2007, as it was at the end of December, 2006, although it experienced modest fluctuations over the period. The JPMorgan nominal effective index of the rand, however, depreciated 2.7 percent over this period. The central bank continued to add to its foreign exchange reserves rapidly. Reserves increased 11 percent to $26 billion from end-December 2006 to end-June 2007. Foreign exchange reserves represented 150 percent of short term debt at the end of 2006. The rand appreciated three percent against the dollar over the period from the end-June to late November 2007 although reserve accumulation continued.

Strong consumer demand and increased capital expenditure continued to fuel a current account deficit that reached an annualized 7.8 percent of GDP in the fourth quarter of 2006,[12] though dropping to an annualized average of 6.7 percent for the first two quarters of 2007. (The current account deficit averaged 6.5 percent of GDP in 2006.)

South African growth eased somewhat in the first half of 2007 to 4.7 percent in the first quarter and 4.5 percent in the second quarter compared with 4.5 percent in the third quarter and 5.6 percent in fourth quarter of 2006. Average growth of South African GDP has been close to five percent over the past three years, and, by the second quarter of 2007, South Africa had experienced thirty-one quarters of uninterrupted expansion.

In April, inflation breeched the official inflation target range (3-6 percent)[13] at 6.3 percent and remained above target in May and June (6.4 percent each month). Inflation has largely been driven by food and fuel prices and strong household consumption demand. Responding to continued inflationary pressure, the central bank raised interest rates in June, to 9.5 percent, resulting in a cumulative 250 bps increase over 12 months. The central bank forecasts above-target inflation for the remainder of 2007 and into the first quarter of 2008, predicting that inflation will fall within range thereafter as rate hikes feed through to consumer demand and the National Credit Act results in a more rigorous credit screening process.

Egypt

Egypt abandoned its formal peg of the Egyptian pound to the U.S. dollar in late January 2003, and launched an interbank foreign exchange market in late 2004. However, Egypt maintained a de facto peg against the dollar from January 2005 through mid-2007, with the pound only gradually appreciating from 5.8 to 5.7 pounds per dollar. From June through November, the pound appreciated around three percent against the dollar. In nominal terms, the trade-weighted index of the pound appreciated by 0.7 percent in the 12 months ending June 2007. However, Egypt's relatively high inflation rate did cause the real effective exchange rate to appreciate by 2.1 percent y/y to June.

Between end-June and late November 2007, the pound appreciated by a further three percent against the dollar, a greater appreciation in the pound-dollar exchange rate than at any time since the introduction of the de facto peg in January 2005. This trend suggests the Central Bank of Egypt (CBE) may be gradually shifting from the de facto peg towards an exchange rate regime that allows greater scope for market forces. However, the typical day-to-day percentage change against the dollar is less than 0.3 percent in either direction, suggesting that the exchange rate remains tightly managed in both directions.

Egypt's current account surplus rose to an estimated 1.4 percent of GDP in the year ending June 2007 from 0.8 percent of GDP in the year ending June 2006. This surplus came mainly from the strong surplus on the services balance, including Suez Canal fees and tourism receipts. By contrast, Egypt's merchandise trade deficit was 12.4 percent of GDP. Egypt's bilateral deficit in

[12] The South African Reserve Bank (SARB) attributes the current account deficit spike in the fourth quarter of 2006 to oil import timing.
[13] The SARB's inflation target corresponds to CPIX inflation, which is CPI minus mortgage interest.

trade in goods with the United States grew to $2.4 billion in the 12 months ending September 2007, compared to $1.3 billion in the same period in 2006. The CBE's gross reserves grew to $27.2 billion at end-June 2007, covering over six months of imports, from $21.7 billion at end-June 2006. Reserves are more than adequate compared to short-term external debt, with reserves about eight times larger than short-term external debt.

Structural reforms since 2004, along with a robust regional economy, helped Egypt's economy to grow by 7.1 percent in the year through end-June 2007. Egypt has also received a large influx of foreign capital, driven in part by privatizations of state-owned firms and the sale of a license for a cellular phone network; FDI reached an estimated 10.5 percent of GDP in the year ending June 2007, compared to 6.0 percent of GDP in the same period a year earlier.

Rapid economic growth has been accompanied by rising inflation. The CPI rose by 8.6 percent y/y at end-June 2007, compared to 7.2 percent at end-June 2006. The rise in prices was due to increases in government-controlled fuel prices, and pressure on wages and building materials. However, strong growth in the monetary base (15.6 percent y/y to end-June 2007) and in broad money, M2 (18.3 y/y percent to end-June 2007), suggests that excess liquidity is the overall driver of rising inflationary pressure.

The Gulf Cooperation Council

Six countries make up the Gulf Cooperation Council (GCC): Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. With the exception of Kuwait, the exchange rates of GCC countries are pegged to the U.S. dollar (Kuwait dropped its peg in May 2007 in favor of a basket of currencies). GCC countries have benefited significantly from the robust global economy of the last several years and particularly from the sharp rise in the price of oil, which has boosted the value of their oil exports and significantly expanded government revenues. Notwithstanding the sizable and favorable increase in the terms of trade that has benefited GCC countries and their burgeoning external surpluses, their real effective exchange rates are lower today than in 2002. Given their pegs to the U.S. dollar but disproportionate dependency on imports from Euro-area countries, this has tended to boost import prices to GCC countries. Higher import prices, rising domestic liquidity and increased domestic spending have accelerated the pace of domestic inflation. Notwithstanding some real effective exchange rate appreciation, rising inflationary pressures have intensified discussion in the region as to whether GCC countries should revalue their currencies or adjust their exchange rate regimes. However, there was no mention of exchange rate or anti-inflation developments coming out of the GCC's most recent summit on December 3-4, 2007.

Saudi Arabia

The Saudi riyal has been unofficially pegged to the dollar since 1986 (officially since 2003), so interest rates largely follow those in the United States. However, the Saudi Arabian Monetary Agency (SAMA) did not follow the Federal Reserve's 50 basis points interest rate cut in mid-September, which increased speculation that Saudi Arabia might revalue or possibly depeg from the dollar. The GCC has set a goal of establishing a formal monetary union by 2010, and SAMA has previously stated that its exchange rate would remain pegged to the dollar until a common GCC currency was formed.

Saudi Arabia is one of the most oil-dependent economies in the world, with oil accounting for around 50 percent of GDP, almost 90 percent of export earnings, and around 85 percent of government revenue. With high and rising oil prices over the past few years, real GDP growth has averaged close to six percent, with average nominal GDP growth around 15 percent. Despite strong economic growth, official CPI inflation was initially contained to less than one percent y/y on average over 2002-2005, but since 2006 it has increased, reaching 4.4 percent y/y in August 2007 on the back of strong food price inflation, which posted a 6.7 percent y/y increase that month.
High and rising oil prices over the last few years are the main cause of the country's high growth, large current account surplus, and rapidly accumulating net foreign assets. Real depreciation of the riyal has added to rising inflationary pressures coming from the huge surge in oil export revenue. In October 2007 the JP Morgan real trade-weighted index of the riyal showed a 3.7 percent depreciation since December 2006 and a 25.4 percent depreciation since February 2002. By comparison, OPEC's reference basket price of oil saw more than a three-fold increase over the same time frame, rising to $79.7 per reference barrel from $18.9 per barrel.

Saudi Arabia's current account surplus has soared over the past few years, reaching a peak of 28.5 percent of GDP (or $90.1 billion) in 2005, but has started to ebb due to strong import growth of 29 percent in 2006. This strong import growth led the current account surplus to fall as a percent of GDP to 27.4 percent (or $95.5 billion) in 2006. Whether this trend will continue will depend on whether import growth is able to outpace increases in oil export revenue associated with much higher oil prices at the end of 2007. The bilateral trade surplus with the United States was $10.7 billion for the first six months of 2007 compared with $12.2 billion for the first six months of 2006. The decline in the bilateral surplus reflects a combination of modest declines in the volume and price of Saudi Arabian petroleum exports to the United States and a modest increase in United States exports to Saudi Arabia.

The robust balance of payments position is also reflected in the net foreign assets of the SAMA, which rose to $260 billion in September 2007, providing almost two years of import cover, from $150 billion at end-2005. However, SAMA official reserves less gold rose by a much smaller amount over the same period to $27.9 billion from $23.7 billion. The government's fiscal position remains very strong as well, although the IMF estimates that the Saudi fiscal surplus will fall to 18.2 percent of GDP in 2007 from 21.4 percent of GDP in 2006 due to increased spending on social and infrastructure projects.

Singapore

The Monetary Authority of Singapore (MAS) uses the exchange rate as its operational monetary policy tool for maintaining price stability. Singapore is a highly open economy, with exports and imports of goods totaling more than 350 percent of GDP. The MAS manages the Singapore dollar (SGD) against an undisclosed basket of currencies of its major trading partners, and since April 2004 has had a policy of "modest and gradual" nominal appreciation against this basket.[14]

[14] The MAS manages the exchange rate within an undisclosed band and can choose to (1) change the midpoint of the band to allow for a one-off adjustment, (2) change the band's gradient to signal a possible turning point in the monetary policy cycle, or (3) widen the band.

On October 10, 2007, the MAS reaffirmed its exchange rate policy but "slightly" increased the slope of the policy band in response to incipient inflationary pressures.

In the first half of 2007, the SGD appreciated 0.3 percent against the U.S. dollar, while JP Morgan's real trade-weighted index of the SGD appreciated 5.2 percent. CPI inflation rose to 1.0 percent (y/y) in the second quarter of 2007, up from 0.5 percent in the previous quarter. The economy continued to expand briskly, with growth at 14.4 percent (saar) in the second quarter of 2007 following 8.8 percent (saar) in the first quarter. The expansion was broad-based, with the manufacturing, construction, and "other services" sectors all performing well.
High and increasing saving rates, accompanied by falling rates of domestic investment, have led to large and widening structural current account surpluses. Singapore's current account surplus was 31 percent of GDP in the first half of 2007, an increase from 27.5 percent of GDP in 2006. The current account surplus has exceeded 10 percent of GDP since 1994 and 20 percent of GDP since 2003. The trade surplus was 34.0 percent of GDP in the first half of the year, compared with 34.5 percent of GDP in the same period a year ago. Nonetheless, Singapore continues to run a bilateral trade *deficit* with the United States, amounting to $3.6 billion in the first half of this year, up from $2.7 billion from the same period in 2006.

Singapore's gross national saving rate of about 47 percent of GDP in the first half of 2007 was among the world's highest, and reflects extremely high corporate saving and persistent budget surpluses. Gross capital formation, meanwhile, fell from a high of 39 percent of GDP in 1997 to 16 percent of GDP in 2003, before stabilizing at around 20 percent of GDP the past several years. Although Singapore does not have capital controls, and residents are free to invest abroad as well as at home, the country had a net private capital inflow in the first half of the year. However, because of net official outflows totaling 31 percent of GDP – largely a result of overseas investment by Singapore's Government Investment Corporation (GIC) and Temasek – Singapore recorded a capital account deficit of 19 percent of GDP in the first half of the year.

Singapore's official foreign reserves increased $8 billion in the first half of 2007, reaching $144 billion or 76 percent of broad money.[15] Furthermore, as of end-2006 the MAS had a net forward position of $60 billion, which constitutes an obligation to buy foreign exchange in the future. In addition to the MAS' official foreign exchange interventions, GIC purchases additional foreign assets with proceeds from surplus fiscal funds and compulsory social security savings (Central Provident Fund). Temasek, originally a holding company for Singapore's state-owned enterprises, now makes significant investments abroad, largely in other Asian companies. Its total portfolio is valued in excess of $100 billion.

In order to maintain domestic money growth within reasonable ranges, Singapore's sterilization operations – through foreign exchange swaps, direct borrowings, and repos – are significant. In the first half of 2007, the MAS' foreign reserves increased by $8 billion, while reserve money increased by just $1 billion.

Although Singapore's prices are strongly influenced by export prices – through an exchange rate mechanism that keeps domestic inflation slightly below U.S. levels – the country's large current

[15] Conventional minimum levels of the foreign reserves to M2 (broad money) ratio are 5-20%.

account surplus is at least partially attributable to the government's national savings decisions. These savings may exceed levels that Singapore's public would choose for itself.

India

India's exchange rate arrangement is a managed float. The Reserve Bank of India (RBI) describes its monetary objectives as "maintaining price stability and ensuring adequate flows of credit to productive sectors." These objectives are implemented by adjusting market liquidity through repurchase and reverse repurchase agreements, open market operations, and the cash reserve ratio applied to banks. The RBI also intervenes in the foreign exchange market to impact the nominal exchange rate, thereby providing the RBI with another tool to meet its monetary objectives.

The rupee appreciated just over eight percent against the dollar in the first half of the year. In real effective trade-weighted terms as calculated by JP Morgan, the rupee appreciated by 8.8 percent over the same period. The rupee has continued to appreciate against the dollar since June 30 bringing nominal appreciation to around 10 percent for the year through November. In response to strong capital inflows, the RBI made U.S. dollar purchases totaling $26.7 billion in the first half of 2007, contributing to an overall increase in foreign exchange reserves of $36.1 billion to $213.4 billion as of June 30. RBI made dollar purchases totaling another $25.1 billion in July through September, bringing foreign exchange reserves to $247.8 billion. By comparison, the RBI purchased $15.6 billion in the first half of 2006, and foreign exchange assets increased by $25 billion.

India's economy grew 10.5 percent on a seasonally-adjusted annualized basis in the first half of 2007, driven by continued strong activity in all sectors, including agriculture (4.9 percent growth), manufacturing (13.3 percent) and services (11.9 percent). Inflation moderated over the first half of 2007. The wholesale price index, which increased 5.8 percent y/y in December 2006, increased 4.3 percent y/y in June 2007. The inflation moderation is due to a combination of a high 2006 base effect, fiscal measures including cutting domestic fuel prices, monetary tightening, and an appreciating rupee. The RBI twice increased its policy interest rate by 25 basis points, in February and March, and raised the cash reserve ratio by 1.5 percentage points over a series of six moves between January and May.

India's rapid growth has been driven by domestic demand, while increasing net imports of goods and services have continued to put a drag on growth. In 2006, net imports were one percent of GDP; in the first half of 2007, they were three percent of GDP. The current account deficit was a seasonally adjusted $8.0 billion (1.7 percent of GDP) in the first half of 2007 compared with $7.8 billion (2.0 percent of GDP) in the first half of 2006. The U.S. bilateral trade deficit with India was $5.4 billion in the first half of 2007, which is slightly smaller than in the same period one year earlier.

Capital inflows remained strong, covering the current account deficit and funding additional reserve accumulation. Direct investment (FDI) inflows for the first half of 2007 were $8.2 billion while portfolio inflows jumped to $9.2 billion for the same period, already exceeding the $7 billion in portfolio investment from the previous fiscal year. Indian commercial borrowings

abroad remained robust, at $14 billion for the first half of 2007, compared with roughly half that amount for the same period in 2006.

Japan

Japan's economic recovery continues into its sixth year, but the pace remains moderate and the economy has yet to decisively exit price deflation. Despite the recovery in real activity, the yen value of GDP remains below its 1997 peak. Real GDP expanded 2.2 percent in 2006, and increased 2.0 percent y/y in the first half of 2007. GDP contracted in the second quarter of 2007 but rebounded to a 2.6 percent annualized growth rate in the third quarter. Consumer prices, which rose 0.2 percent y/y in 2006 after nearly seven years of deflation, began to decline once again at the start of 2007. In the first half of 2007, the CPI fell 0.1 percent y/y or 0.6 percent excluding food and energy. In September, the CPI declined 0.2 percent y/y, or 0.3 percent excluding food and energy.

After ending its zero interest rate policy in July 2006, the Bank of Japan (BOJ) raised overnight interest rates by an additional 25 basis points to 0.50 percent on February 21, 2007. The BOJ has left the overnight interest rate unchanged in the period since, over a span of eleven monetary policy committee meetings.

In the past year, Japan's current account surplus has expanded sharply, rising to $100.7 billion (4.7 percent of GDP) in the first half of 2007 from $81.5 billion (3.7 percent of GDP) in the first half of 2006. In the third quarter, the current account surplus was $53.8 billion, or about 4.8 percent of GDP. Less than half of the current account surplus is due to trade in goods and services. Rather, net income inflows from Japan's overseas direct and portfolio investment account surged to swell the external surplus. Japan's trade surplus also increased over the first nine months of 2007, as export growth accelerated and import growth held steady. Net exports contributed one percentage point, or just under half of overall GDP growth for the first three quarters of 2007. The U.S.'s bilateral deficit with Japan, however, narrowed by $3.0 billion to $53.4 billion in the first nine months of the year compared with the same period in 2006.

Gross flows of private capital surged in the first half of 2007, with the net outflows (the sum of net domestic and foreign outflows) rising to $96.0 billion over January-June compared to outflows of $54.4 billion over the first six months of 2006. Net outflows remained strong over the July-September period, totaling $52.9 billion. Japanese investor outflows reached $98.0 billion in the third quarter of 2007, supported by what may be a structural shift in household portfolios towards overseas bonds and equities.[16] The so-called "yen carry trade", in which investors borrow yen at a low interest rate to invest in higher return foreign currency assets, has also contributed to Japan's net outflows.

The yen weakened 3.5 percent versus the dollar over the January to June 2007 period, closing at ¥123.18 on June 29. The yen began to appreciate in July, however, reaching ¥108 in late November before depreciating to above ¥110. Over the past 10 years the BOJ's index of the yen's real effective exchange rate depreciated by 33 percent from its strongest point in December

[16] Japanese households hold a relatively low share – less than 5 percent as of the end of the second quarter of 2007 – of foreign financial assets compared to households in other developed economies.

1999 and now stands near a 22-year low. The BOJ real exchange rate index depreciated 7.4 percent over the first half of 2007, and was 10.4 percent weaker compared to June 2006. More recently, the real effective yen exchange rate has strengthened, appreciating some four percent through October compared to end-June 2007.

Japan's foreign exchange reserves continue to rise, reflecting interest earned on reserves and valuation effects. Gold and foreign exchange reserves totaled $913.6 billion at the end of June 2007, up from $895.3 billion at end-December. By the end of October, reserves had risen to $954.5 billion.

Japan maintains a floating exchange rate regime. Japanese authorities have not intervened in the foreign exchange market since March 2004. The yen has fluctuated between ¥123.90 and ¥107.42 since the start of 2007. At the same time, the yen exchange rate is followed closely, and is occasionally the subject of comments by Japanese officials and politicians. There were few official statements about the yen during the first half of 2007. However a sharp appreciation of the yen in November (the yen strengthened 5.5 percent in 12 days) led to comments by a number of Japanese officials, mostly about the speed of the appreciation.[17] The yen foreign exchange market is huge, with daily transactions estimated to be $500 billion. Attempts to estimate the effect of direct official intervention on the yen exchange rate have been mixed, and even those who find an impact estimate intervention's effects to be temporary. Treasury does not believe that indirect intervention in the form of official comments on exchange rates, absent actual intervention in the exchange markets, has any lasting effect, if it has an effect at all. However, such comments may introduce additional volatility in exchange markets, and therefore are unhelpful.

South Korea

Although the authorities intervened periodically over the reporting period, South Korea's exchange rate exhibited a high degree of flexibility on both a day-to-day basis and over time. The won depreciated modestly (by 0.3 percent) from end-December 2006 to end-June 2007, but, at KRW923.6 per U.S. dollar, was still approximately 30 percent stronger versus the dollar compared to five years earlier. The won depreciated sharply during the credit market turmoil in August, along with other high-yielding currencies as carry trades were unwound, reaching KRW946.9 versus the dollar, but has strengthened in the period since, closing at KRW913.6 on November 14, an appreciation of slightly more than one percent since end-June. In real effective terms, the won depreciated slightly over the first half of 2007, and was 1.7 percent y/y weaker in October.

Foreign exchange reserves increased $11.8 billion (4.9 percent) over the first half of 2007, the smallest half-year change since the second half of 2005. Aggregate foreign exchange reserves rose to $250.2 billion, almost equal to South Korea's total foreign debt of $286.1 billion as of the first quarter of 2007. Reserves rose to $259.7 billion at the end of October. Korea does not

[17] In an interview in the *Financial Times* published on November 12, Prime Minister Yasuo Fukuda said the yen is appreciating "too fast," and, "In the short term, yen appreciation would certainly be a problem. Any kind of sudden change in exchange rates would not be desirable." Also in mid-November, Finance Minister Fukushiro Nukaga said that the G-7 shares the view that excessive volatility in the foreign exchange market is undesirable.

publish data on its foreign exchange market interventions. The increase of reserves over the reporting period thus reflects the combination of exchange market intervention, interest earnings on existing reserves, and any valuation changes stemming from changes in USD exchange rates of any non-dollar currencies held in Korean reserves.

South Korea's economy continues to perform well, with real GDP expanding 2.6 percent over the first half of 2007 compared to 2.2 percent in the previous half year. Consumer price inflation – at 3.0 percent in October 2007 – is currently within the central bank's target range.

The Bank of Korea (BOK) has used inflation targeting since 1998, and its current inflation target for the 2007-2009 period has been set at a three-year average of 3.0±0.5 percent. The overnight call rate is the principal monetary policy instrument of the BOK, and the Bank has been raising the overnight rate since October 2005. The BOK raised interest rates in July and August, pushing the overnight call rate to 5.0 percent. Steady won appreciation since 2003 has contributed to containing inflation, and does not appear to have had a significantly negative impact on export growth. Exports grew by close to 15 percent in 2006, and expanded at the same rate over the first 10 months of 2007.

Over the first nine months of 2007, the trade surplus increased by $5.4 billion to $14.0 billion. Korea's bilateral trade surplus with the United States, however, fell to $6.2 billion from $6.8 billion over the same period as growth in imports outpaced growth in exports. Although South Korea runs an overall surplus in merchandise trade, it has a substantial and growing deficit in services. Driven by a rising net outflow of tourists and students, Korea's services deficit reached a record $18.8 billion in 2006 and totaled $14.7 billion during the January-September 2007 period. As a result, South Korea's current account surplus fell sharply in 2006 to $6.1 billion (0.7 percent of GDP), and has narrowed further in 2007. Over the first half of 2007, the current account surplus was just $1.1 billion or 0.2 percent of GDP.

China

China's growth rate has accelerated since the beginning of 2007, with a growing trade surplus making a strong contribution. Real GDP growth was 11.9 percent y/y in the second quarter, the highest quarterly growth rate in 12 years, and China's provisional real GDP growth rate was 11.5 percent y/y for the first three quarters of 2007. There were also signs of increasing inflationary pressures during the first part of 2007. Consumer prices climbed from 2.2 percent growth y/y in January to 6.5 percent in August, led by rapid increases in the food component of the price index. The government has implemented administrative controls on price increases for the remainder of the year, though allowing increases in fuel prices to counter widespread shortages in early November. Inflationary pressures are clearly visible in asset markets. At its peak in mid-October, the Shanghai Composite Index of equity prices had increased by 244 percent in one year, and by 128 percent year-to-date in 2007. With price gains and large IPOs on the Shanghai exchange (notably PetroChina), market capitalization grew by $3.2 trillion from January to November to $4.5 trillion. Low bank deposit interest rates, combined with recent equity market reforms, enticed individuals to open 14.6 million new stock trading accounts from January through September of 2007.

China's merchandise trade surplus of $185.8 billion in the first three quarters surpasses the 2006 *annual* surplus, possibly indicating an even greater contribution from net exports to economic expansion in 2007. China exported $878.3 billion worth of goods through the first three quarters of 2007, up 27 percent y/y, while importing $692.5 billion, up 19 percent y/y. This expansion comes off of annual growth of 27 percent for exports and 20 percent for imports in 2006. China's current account surplus continued to expand as a share of GDP. The current account surplus for the first half of 2007 came in at $162.8 billion (12 percent of GDP), 78 percent higher than in the first half of 2006, largely due to expansion of net exports of goods and services. Inflows increased on the financial account as well, with foreign direct investment inflows of $58 billion and other investment inflows of $43 billion netted against outward direct investment of $7 billion.

The RMB appreciated against the dollar by 2.5 percent in the first half of 2007, and by 3.2 percent from June 30 to December 11, 2007. Since the beginning of the new currency regime in July 2005, the RMB has appreciated by 12.1 percent. Its cumulative gains against other currencies have been smaller; on a nominal effective exchange rate basis incorporating all major trading partners, the RMB has appreciated about 3.8 percent since July 2005.[18]

Although the official daily fluctuation band was widened from 0.3 to 0.5 percent for intraday trading, intervention by the People's Bank of China (PBOC, China's central bank) has limited daily fluctuations of the RMB to an average of 0.1 percent since the beginning of 2007. The greatest fluctuation in daily trading came on October 26, 2007, when the RMB weakened 0.31 percent.

China's exchange rate policy and the slow adjustment of the RMB exchange rate to date create several challenges for macroeconomic management and maintaining long term growth. Foreign exchange intervention to manage the exchange rate leads to large increases in the domestic RMB money supply. These must be re-absorbed, or sterilized, in order to restrain inflation and credit growth. The numerous steps that the People's Bank of China has taken to sterilize foreign exchange inflows are described in Box 1.

Box 1: Challenges to Domestic Monetary Policy from Foreign Exchange Inflows

The PBOC achieves strict management of the RMB exchange rate versus the dollar through persistent and heavy intervention in the foreign exchange markets, and through controls on capital movements and currency holdings. In the first half of 2007, the PBOC bought approximately $266 billion in reserves, and a total of $367 billion of reserves by the end of September. From September 2006 to September 2007, the PBOC's foreign exchange reserves grew by $446 billion.

In order to stem the liquidity created by this intervention, or sterilize the impact of intervention, the central bank issued $473 billion (gross) of its own debt from January through September,

[18] The J.P. Morgan, the IMF and the Bank for International Settlements (BIS) indices of the RMB real effective exchange rate show appreciation of 5.9 percent, 8.8 percent, and 6.0 percent, respectively from July 2005 to July 2007. Differences in the domestic price indexes used in constructing the indexes lead to differences in these estimates.

about 25 percent more than over the same time period in 2006. At the end of June, $500 billion in PBOC sterilization debt was outstanding, which was 38 percent of the stock of foreign exchange reserves. Issuance yields on one-year bills rose from 2.8 percent at the end of 2006 to 3.3 percent at the end of June, narrowing the interest rate differential between the PBOC's foreign currency holdings and domestic rates and increasing the costs of sterilization in RMB terms, given the expected appreciation of the RMB. As the cost of issuing debt rose, increases in banks' required reserves, which pay 1.89 percent, became a more attractive option for liquidity absorption. The PBOC hiked the required reserves ratio on six occasions by a total of three percentage points in the first half of the year. By doing this it effectively sterilized more foreign exchange purchases than it did via bill issuances, according to the PBOC.

The PBOC's sterilization activities have helped to limit growth of monetary aggregates in the face of massive foreign exchange market intervention; however growth in M1 and M2 picked up in the latter part of the first half of 2007. Increases in banks' required reserves led to reserve money growth of 31 percent y/y in the first half of 2007, though the PBOC estimates that reserve money growth would have been lower than 10 percent y/y without the increase in reserve requirements. Booming asset markets and a strong investment climate led depositors to prefer demand deposits over time deposits. Consequently, M1 growth accelerated to near 20 percent y/y in the nine months until September. M2 growth crept up from 16 percent y/y in January to about 18 percent y/y in September, above the PBOC's target growth rate of 16 percent y/y. Estimates of M3 indicate rapid growth, implying a growing pool of slightly less liquid financial assets.

The central bank continued to take measures to control credit growth, in order to slow monetary expansion and economic activity. The PBOC also continued with "window guidance" consultations with banks, encouraging them to abide by a 15 percent loan growth target for the year. On three occasions the PBOC issued a total of RMB 303 billion in "special" bills to targeted banks with excessively fast loan growth. The central bank also increased interest rates several times. In the first half of 2007, the PBOC raised the floor on lending interest rates for one-year loans from 6.12 percent to 6.84 percent. Deposit rates for one-year deposits were increased from 2.52 percent to 3.33 percent. Despite these hikes, real deposit rates are negative. The government remains concerned that increasing interest rates may attract speculative capital inflows, creating further demand for RMB.

Paired with measures to liberalize the capital account (see appendix below), the authorities have also tightened some capital controls to reduce inflows of foreign exchange. In March 2007, the State Administration of Foreign Exchange (SAFE) ordered domestic banks to reduce short-term foreign debt in stages to 30 percent of their 2006 quota by the end of March 2008. Foreign-owned banks and all non-bank financial institutions in China were ordered to cut their short-term foreign debt to 60 percent of their 2006 quota by the same deadline

Not only does China's exchange rate policy have implications for short-term macroeconomic policy, but it also influences the pattern of China's growth over the medium term. The shift toward greater reliance on export growth and investment in powering China's growth continued during 2006 and 2007. Rising net exports accounted for 19.5 percent of growth in 2006, up from 1.0 percent in 2003. China's National Statistics Bureau estimates that, in the first nine months of

2007, net exports and investment contributed 21 and 43 percent, respectively, of China's real GDP growth, with consumption contributing only 37 percent. The share of consumption in GDP has fallen from 62 percent in 2000 to 50 percent in 2006.

The high dependence of GDP growth on exports and investment has been identified by the Chinese authorities as a serious imbalance that must be addressed to assure sustainable growth, Chinese authorities have announced plans to move the economy away from relying on exports and investment and more towards consumption, in an effort to "rebalance" growth. Notably, these goals are identified in China's 11th Five-Year Plan. In his report to the 17th Party Congress, on October 15, President Hu reiterated these objectives, noting, "We must promote the transition of economic growth from a major reliance on investment and export-orientation toward a combined reliance on consumption, investment, and export-orientation." President Hu also emphasized, "We should adopt comprehensive measures to maintain a basic equilibrium in the balance of payments." However, the imbalances the Chinese authorities intend to correct show little improvement to date in 2007.

The high share of investment and exports and the low share of consumption in China's growth reflect a sparse social safety net and limited availability of financial services to Chinese households, as well as the growth of retained earnings by Chinese enterprises. But China's monetary and exchange rate policies are also obstacles to faster rebalancing of the components of aggregate demand. China's current macroeconomic policy mix is characterized by a slowly moving and undervalued exchange rate, low real interest rates, and a relatively tight fiscal policy. This mix of policies contributes to export-intensive, capital-intensive, and resource-intensive growth. China's efforts to rebalance growth towards consumption, services, labor-intensive sectors, and interior provinces will achieve limited success unless prices, including the exchange rate, are allowed to change significantly to direct resources to their most productive use.

China states that it pursues exchange rate reform in a "self-initiated, controllable, and gradual" manner, as reiterated in the central bank's recent Monetary Policy Report for the third quarter of 2007.

Box 2: Chinese Actions to Develop the Foreign Exchange Market

While the introduction of increased currency flexibility has been restrained, China's foreign exchange market infrastructure has improved and market participants are using more currency derivatives to hedge risk. In the first half of 2007, spot trading of eight currency pairs on China's foreign exchange trading system grew by 25 percent, to $46.4 billion. In the same period, the use of currency forwards increased by 70 percent y/y to reach $10.7 billion and currency swap transactions turnover reached $133.4 billion, 2.6 times the total of the last nine months of 2006. (Swaps were introduced in April 2006.)

China has also taken further steps to reduce capital controls. In January, the annual limit for purchases of foreign exchange by individuals was raised from $20,000 to $50,000. In May, authorities expanded the scope of overseas investments for qualified commercial banks beyond fixed income investments to include equities. In July, brokerages and fund management firms were allowed to invest foreign currency deposits in overseas fixed income securities, stocks, and derivatives. Also in July, the percentage of assets that insurance companies can invest abroad, including in equities, was raised from 5 percent to 15 percent. At the second session of the SED, Chinese authorities agreed to increase the quotas for foreign investment in Chinese stocks from $10 billion to $30 billion. In August, China scrapped the limit on the amount of current account foreign exchange earnings that firms can hold. Also in August, SAFE announced plans for an individual investor scheme allowing mainland investors to buy Hong Kong stocks, but implementation of the plan has since been postponed for further study.

Despite the progress that China has made and the continued public commitment to reform, China's exchange rate is undervalued against the U.S. dollar and on a trade-weighted basis, even in the judgment of many domestic observers. Prolonged, one-way intervention in foreign exchange markets by the central bank, unprecedented foreign exchange reserve accumulation, and a steadily expanding current account surplus are clear indicators of renminbi undervaluation. While China has taken some steps to increase the flexibility of the renminbi, the pace of appreciation that the authorities have allowed is much too slow and should be quickened.

Taiwan

Taiwan operates a managed floating exchange rate regime. According to the central bank's official policy statement, the exchange rate is market-determined except in instances when "the market is disrupted by irregular factors" and the central bank intervenes. Throughout the first half of 2007, the Taiwan dollar (NT$) remained within the 31-35 NT$/USD trading range in which it has fluctuated for more than five years. After ending 2006 at 32.59/USD, the NT$ depreciated 0.79 percent to end the first half of 2007 at 32.85/USD. Since then, the NT$ has appreciated by 1.4 percent, ending October 2007 at 32.40/USD.

Since the second half of 2005, Taiwanese residents have increased their holdings of foreign assets while foreign investor demand for Taiwan dollar assets has eased, reducing upward pressure on the exchange rate. Certain types of capital inflows are subject to administrative transaction costs, helping to limit foreign demand for the NT$. At the same time, low domestic

interest rates, weak domestic demand, and a relatively stable currency have all helped to drive increasing capital outflows. Structural factors have also led to an increase in Taiwanese households' appetite for international asset diversification; these include increased concerns within an aging Taiwanese population about the robustness of the public pension system, as well as increased financial sector competition leading to an increase in the types of savings instruments available to households.[19]

Net accumulation of foreign exchange reserves, which averaged nearly $29 billion a year from 2001 to 2005, has consequently slowed, falling to $6 billion in the second half of 2006. Total foreign reserves stayed constant at $266 billion in the first half of 2007 and remained at this level at the end of October. A $5 billion drop in foreign reserves in August marked the largest monthly decline in more than a decade and the second largest monthly decline on record. The drop was attributed to foreign capital outflows amidst concerns about the U.S. subprime mortgage situation.

Broad money supply (M2) grew 1.8 percent from the end of 2006 to the end of June 2007. The central bank raised interest rates in March and June 2007, with the discount lending rate in June set at 3.125 percent, up from 2.75 percent at the end of 2006. Effective August 1, 2007, all foreign currency deposits are now subject to reserve requirements. To the extent that the costs of the new policy are passed onto depositors in the form of lower yields, Taiwanese investors will have an added incentive to invest in foreign currency deposits abroad rather than at home.

Taiwan has experienced sluggish domestic demand growth and low inflation or falling prices since a sharp decline in fixed investment spending led to a short recession that began in the fourth quarter of 2000. However, strong export growth has allowed Taiwan to achieve annual real GDP growth rates of between three and six percent since the recession ended in late 2001. Growth in Taiwan has been highly dependent on global market growth and demand for Taiwan's exports.

Real GDP growth improved slightly from 4.6 percent at an annual rate in the last half of 2006 to 4.7 percent in the first half of 2007. Net export growth slumped in 2006 but increased 21.9 percent in the first quarter of 2007, only to fall slightly in the second quarter. Taiwan's exports are heavily concentrated in sales of electronics to China, Japan, and the United States, meaning that small fluctuations in either overall demand within these three large economies or global demand for electronics can create significant changes in Taiwan's income from net exports.

Inflation remained very low, with prices falling by some measures, throughout 2006 and the first half of 2007. Consumer prices, excluding food and energy, rose by 0.7 percent y/y in the first half of 2007, while Taiwan's GDP deflator rose by 0.82 percent during that same period. Inflation has since accelerated, rising from 3.1 percent y/y in September to 5.3 percent y/y in October, reflecting increases in food prices caused by damage from typhoons Wipha and Krosa.

Taiwan's current account surplus fell slightly from 6.7 percent of GDP ($24.6 billion) at the end of 2006 to 6.4 percent of GDP at end-June 2007, after rising to 8.3 percent of GDP during the first quarter of 2007. The drop in the current account surplus between the first and second

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[19] The new savings instruments available to Taiwanese households include foreign currency deposits.

quarters of 2007 reflects a narrowing surplus in goods trade, a widening deficit in services trade, and growth in the income surplus.

Malaysia

Malaysia continues to move in the direction of increased currency flexibility, taking steps to relax foreign exchange controls while the daily fluctuations in the exchange rate increase. A persistent gap between saving and investment remains, however, which was reflected in a continued large current account surplus and continued accumulation of foreign exchange reserves in the first half of 2007.

Bank Negara Malaysia, the monetary authority, states that it does not have an explicit target band or basket, but rather intervenes to smooth out excessive volatility in the ringgit. Intervention in the foreign exchange markets has, in fact, been in both directions – buying the ringgit to limit depreciation and accumulating foreign reserves to fend off upward pressure. Since the initial 1.4 percent revaluation in July 2005, the ringgit has appreciated an additional 6.6 percent in 2006 and 2.2 percent in the first half of 2007 in nominal terms, for a total appreciation of 10.2 percent through the end of June. The appreciation over the past year has been driven by strong portfolio flows into the local stock market. Ringgit movement has not been uniform, depreciating from late May 2007 into August due to the recent global credit market conditions and risk reappraisal. Since August, the ringgit has appreciated steadily, reaching a yearly high of 3.34 ringgit/dollar at the end of October. Bank Negara Malaysia's easing of restrictions on foreign exchange transactions in April and October of 2007[20] points to a more flexible currency regime, but offshore trading of the ringgit remains prohibited, a restriction put in place during the Asian financial crisis.

Real GDP grew 5.9 percent y/y in 2006 and 5.6 percent y/y in the first half of 2007. Economic growth was driven by domestic consumption and public investment spending, while external demand remained sluggish. For the first half of 2007, private consumption grew 10.8 percent y/y and public consumption increased 8.8 percent y/y, followed by total capital investment growth of 8.2 percent y/y. Domestic consumption was supported by improved consumer sentiment, a steady increase in disposable income, a more stable labor market and stronger commodity prices. Capital spending was led by the disbursement of development expenditures under the Ninth Malaysia Plan, which included projects in agriculture and rural development, and upgrading of transportation infrastructure and public utilities.

Exports increased by only 2.5 percent y/y in the first half of 2007, primarily due to sluggish demand for electronics and electrical products. The economy continues to be highly dependent on exports (110 percent of GDP) and remains closely tied to the global electronic product cycle and particularly to U.S. demand. Imports grew only 2.4 percent y/y in the first half of 2007 due to slower demand growth in imported inputs for manufactured exports.[21]

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[20] Effective April 1, Bank Negara Malaysia eased limits on foreign currency asset holdings for local residents, companies and fund managers. Simultaneously, foreigners were given greater access to local currency bonds and properties. In October, five registration requirements were lifted on ringgit transactions and deadlines for non-residents on forward foreign-exchange contracts were abolished.

[21] Inputs for export manufacturing comprise 70 percent of Malaysia's total imports.

Consumer price inflation for the first six months of 2007 slowed to 2.1 percent, down from 3.6 percent in 2006, the highest rate since 1998. Despite the risk of higher food and commodity prices, inflationary pressure is benign, due in part to the government's fuel subsidy scheme and ringgit appreciation. The central bank has kept its overnight policy rate at 3.5 percent, unchanged since April 2006.

Malaysia's current account surplus in first half of 2007 totaled $12.7 billion, or 15.4 percent of GDP. This level is almost the same as in 2006, when the annual total was $25.6 billion, over 16 percent of GDP. While significant capital outflows have partly offset the large surplus, with the exception of Singapore, Malaysia runs the highest current account surplus as a percentage of GDP among emerging market countries in Asia. The massive current account surplus reflects a significant savings-investment gap, with total investment yet to recover to pre-Asian financial crisis levels. Although foreign capital inflows recovered to a 10-year high in 2006, domestic capital outflows increased as well. As a result, gross fixed capital formation was 21 percent of GDP in the first quarter of 2007, similar to 2006 levels, but much lower than the average of almost 40 percent over the 1990-1994 period, before the Asian financial crisis. As a net oil exporter, Malaysia also continues to benefit from sustained high oil prices, further contributing to the double-digit current account surpluses run since 2003.

International reserves increased by $15.9 billion in the first half 2007, as compared to a $3.7 billion increase in the second half of 2006. As of the end of September 2007, reserves totaled $98.2 billion, a 19.1 percent increase in the year-to-date figure and equivalent to roughly nine months of imports, or eight times short-term external debt. The increased accumulation mostly reflects higher portfolio inflows, in addition to the structural trade surplus.

Australia

The Australian dollar has strengthened substantially over the past six years, including a nine percent appreciation against the U.S. dollar over the year through June 2007. Since hitting its weakest point this decade of over two Australian dollars per U.S. dollar in March 2001, the Australian dollar has strengthened more than 70 percent, ending June 2007 at a rate of A$1.1774 to the U.S. dollar. The Australian dollar weakened during the financial market turmoil starting in August, but has since appreciated beyond its levels earlier this year, closing November 14 at A$1.1107. In real, trade-weighted terms, the Australian dollar appreciated 7.1 percent y/y through the second quarter of 2007, strengthened a further 1.0 percent through the end of third quarter of 2007 and now stands near its strongest level since the early 1980s.

The appreciation of the Australian dollar reflects the surge in the terms of trade as well as strong capital inflows encouraged by interest rate differentials. The so-called "yen carry trade", in which investors borrow yen at a low interest rate to invest in higher return foreign currency assets, including Australian dollar-denominated assets, contributed to net inflows and Australian dollar appreciation. Net portfolio inflows totaled A$44.9 billion in the first half of 2007 compared to A$38.7 billion in the first six months of 2006.

The Reserve Bank of Australia (RBA) allows the Australian dollar to float, however, the RBA does intervene when it believes the exchange rate has overshot. In mid-August, in response to "thin and disorderly conditions in the foreign exchange markets", the RBA intervened by purchasing Australian dollars. The RBA acknowledged that it had purchased Australian dollars for the first time since 2001, but did not disclose the size of its intervention. Net foreign exchange reserves have grown steadily over the period, rising to $29.8 billion at the end of September 2007 from $27.3 billion at the end of June 2007 and $24.3 billion at end-December 2006.

Australia has experienced more than 15 years of continuous economic growth. The long expansion has brought the economy close to full employment, but is also generating inflationary pressures. The consumer price index rose 1.9 percent y/y in third quarter of 2007, but the Reserve Bank of Australia (RBA) expects annual inflation to accelerate to above 3.0 percent by first quarter of 2008. The RBA has been tightening monetary policy since May 2002, raising the policy rate most recently in November 2007 by 25 basis points to 6.75 percent.

Real GDP surged 4.2 percent y/y in the first half of 2007, after a more moderate 2.5 percent expansion in 2006. Growth has been stimulated by the most favorable terms of trade on record and strong demand for Australia's commodity-rich exports. External demand, in turn, has helped support strong business investment growth, as have high corporate profits and high rates of capacity utilization. Household consumption has been firm despite moderation in the pace of home price appreciation and modest wage growth.

Rapid investment growth, in addition to a strong Australian dollar, helped push the current account deficit to 5.9 percent of GDP in the first half of 2007 compared to 5.5 percent in the first half of 2006. A widening income deficit – to 4.5 percent of GDP in the first half of 2007 from 4.0 percent in the first half of 2006 – also contributed to the external imbalance. Australia's persistent current account deficit drove net external liabilities to 67 percent of GDP at the end of the second quarter of 2007.

New Zealand

The New Zealand dollar has exhibited a high degree of flexibility since it was floated in 1985. The Reserve Bank of New Zealand (RBNZ) did not intervened in the currency market from 1985 until June 2007. In June, the RBNZ declared that the level of the New Zealand dollar was "exceptionally high and unjustified" and intervened in the foreign exchange market. The RBNZ sold NZ$736 million (about US$556 million) in June, NZ$1.5 billion in July and NZ$138 million in August. Official foreign currency reserves at the RBNZ rose to US$12.6 billion at the end of June from US$10.9 billion at the end of December 2006. By the end of September, reserves had fallen to US$12.5 billion (or about 10 percent of GDP).

The intervention was prompted by the strength of the New Zealand dollar, the capital inflows driving appreciation, and the impact both were having on the domestic economy. The New Zealand dollar gained 27 percent against the U.S. dollar from June 2006 through June 2007, standing at NZ$1.2942 per U.S. dollar, compared to NZ$1.6407 the year before. The New Zealand dollar has shown broad-based strength; it appreciated 13.2 percent y/y in real, trade-

weighted terms through June, putting it well above its long-term average. Although it weakened in August during the global financial market turmoil, it began to appreciate again in September, closing at NZ$1.3059 on November 14.

Much of the New Zealand dollar's strength has been a product of capital inflows that stem from relatively high interest rates in New Zealand, making New Zealand an attractive destination for the so-called "carry trade" investors. In the first half of 2007, New Zealand recorded a surplus on its financial account of US$3.471 billion, up slightly from the first half of 2006, but down from the massive inflow recorded in the second half of 2006 (US$5.625 billion).

The current account deficit narrowed from 9.7 percent of GDP in the second quarter of 2006, but still remained significant at 8.5 percent of GDP as of the end of the first quarter of 2007. The bulk of this deficit reflected a wide gap in the income account, due mostly to earnings on the large stock of inward foreign direct investment, valued at US$69.8 billion at the end of the second quarter of 2007. At the end of the second quarter of 2007, New Zealand's net foreign liabilities stood at 87.6 percent of GDP. In the first half of 2007, New Zealand posted a small surplus in goods and services trade (US$443 million) and a large income deficit (US$4.2 billion).

New Zealand's aggregate real trade balance has widened over recent quarters, and falling net exports reduced real GDP growth by 0.7 percent in the first quarter of 2007 and 0.8 percent in the second quarter. Nevertheless, over the first two quarters of 2007, real GDP expanded 3.7 percent y/y compared to 1.7 percent in the first half of 2006, with solid growth in domestic demand underpinned by strong labor and housing markets.

Domestic demand growth, in turn, has been spurred by income gains due to favorable terms of trade. The RBNZ has been in a monetary policy tightening cycle since early 2004, raising the official cash rate most recently 25 basis points to 8.25 percent in July. Headline CPI inflation has remained within the RBNZ's medium-term inflation target of 1-3 percent since the end of 2006, in large part due to an appreciation-induced decrease in the prices of tradable goods.[22]

[22] Tradable goods prices fell in the third quarter (-0.3 percent y/y) while non-tradable goods prices rose 3.7 percent y/y in the period.