Report to Congress on
International Economic and Exchange Rate Policies
December 2006

This report reviews developments in international economic and exchange rate policies, focusing on the first half of 2006,[1] and is required under the Omnibus Trade and Competitiveness Act of 1988 (the "Act").[2, 3] This report also updates the special Appendix to the May 2006 Report on International Economic and Exchange Rate Policies and includes two additional appendices highlighting key issues in the evaluation of currency misalignment and foreign exchange reserve accumulation.

Major Findings:

- The U.S. economy has continued to grow at a healthy pace, although moderating in the most recent quarters. The Administration's economic forecast for the FY2008 budget projects continued moderate growth over the next four quarters, and the labor market is expected to remain strong with little change in employment growth or the unemployment rate. The Administration forecast is similar to the consensus of private economic forecasters.

- The world economy grew by 4.9 percent in 2005, and the IMF projects growth of about five percent in 2006 and 2007, which would make the 2004 to 2007 period the fastest growing in over 30 years. Growth in developing Asia has been particularly strong, exceeding 8.5 percent this year.

- Global imbalances remain a key issue on the international economic agenda. They arise because of large growth disparities in major countries, differences in the relative attractiveness of investment in their economies, and divergent patterns of saving and investment. Reducing global imbalances, in a manner that sustains global growth, is a shared responsibility requiring complementary actions by a large number of countries.

- Europe and Japan each need to achieve higher rates of growth of domestic demand on a sustained basis. The pace of domestic demand growth in the Euro-area has firmed over the last year. However, the pace of domestic demand growth in Japan has slowed sharply in 2006, and was negative in the third quarter. For a global rebalancing of growth to occur, higher rates of domestic demand growth are needed on a sustained basis.

- The largest oil exporters can help ensure that robust global growth is sustained in several ways, such as: (1) by increasing expenditure on oil production capacity, (2) by judiciously increasing expenditure that enhances their economic potential and diversifies their

[1] More recent significant developments are also discussed if information is available.
[2] The Act states, among other things, 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.

economies, and (3) where appropriate, strengthening their macroeconomic tools and monetary policy implementation including by moving toward more flexible exchange rates.

- The United States already has made substantial progress to reduce the federal fiscal deficit, which has fallen from 3.6 percent of GDP in FY 2004 to 1.9 percent of GDP in FY 2006, a net improvement of 1.7 percent of GDP in two years. But further progress is needed. Personal saving, which moved into negative territory in 2005, needs to rise as well.

- China is the world's third largest trading nation and a global economic leader. It also has a very high saving rate, a growing dependency on exports to drive economic growth, and a very large and growing current account surplus. China's economy needs a more balanced pattern of growth that is more consumption-based, with a flexible exchange rate regime and a modernized financial sector.

- Secretary Paulson and China's Vice Premier Wu Yi, chaired the first Strategic Economic Dialogue in Beijing on December 14 and 15. The agreed goals of the dialogue include balanced, sustainable growth in China, without large trade imbalances, which will aid China's successful integration into the global economy. Important pieces of that equation include exchange rate flexibility, intellectual property rights protections, increasing the role of consumption in the economy and opening up the service sector. China's currency policy is a core issue in the China - United States economic relationship.

- In the first half of 2006, China continued with modest capital account liberalization, *inter alia*, of the programs that allow Chinese investors to make portfolio investments overseas and foreign investors to make portfolio investments in China. In addition, China has taken further steps to strengthen and reform its financial sector to accommodate currency and interest rate fluctuations.

- During the first half of 2006, the authorities took further steps to reform the currency market and RMB flexibility increased compared to the last six months of 2005. This increased flexibility, however, is considerably less than is needed.

- China's cautious approach to exchange rate reform continues to exacerbate distortions in the domestic economy and impede adjustment of international imbalances. Clamping down on exchange rate fluctuations has increased pressures in other parts of the economy.

- The Department of the Treasury concluded that no major trading partner of the United States met the technical requirements for designation under the terms of Section 3004 of the Act during the period under consideration.

U.S. Macroeconomic Trends

The U.S. economy continued to grow at a healthy pace during the four quarters ending in the third quarter of 2006, although growth slowed somewhat in the most recent quarter. Job gains also moderated through the first 11 months of 2006, but the unemployment rate remained low by historical standards. Inflation – both in the headline numbers and in core measures – has started to ease. Energy prices dropped significantly in the late summer and early fall, and there were associated declines in retail gasoline prices. The Federal Reserve held its short-term interest rate target unchanged from July through December after raising the federal funds rate at every policymaking meeting since mid-2004. With the economy moderating and inflation stabilizing, yields on longer-term securities eased, and in the third quarter of 2006, the yield on 10-year U.S. government securities was noticeably below the Federal Reserve's policymaking rate. The Administration's economic forecast for the FY2008 budget projects continued moderate growth over the next four quarters, and the labor market is expected to remain strong with little change in employment growth or the unemployment rate. The Administration forecast is similar to the consensus of private economic forecasters.

Real GDP grew at an annual rate of 3.4 percent over the first three quarters of 2006, matching the pace recorded over the three years ending in 2005. Growth moderated in the third quarter of 2006 to a 2.2 percent seasonally adjusted annual rate after rising at a 2.6 percent annual pace in the second quarter of the year. The pace of expansion was restrained by a sharp decline in residential investment. However, consumer spending growth rose to 2.9 percent in the third quarter of 2006 from 2.6 percent in the second quarter. A jump in purchases of durable goods, chiefly motor vehicles, contributed to the pickup. Nonresidential investment also strengthened notably in the third quarter.

Housing starts fell about 15 percent in October of 2006 to a seasonally-adjusted annual rate of 1.486 million, and were 27.4 percent below October 2005. Building permits issued for future construction also declined, and were down 5.2 percent in October 2006 to 1.553 million units. That was the weakest permits figure in six years. New home sales were off 25.4 percent in October from a year earlier and readings on housing market sentiment on the part of homebuilders as reported by the National Association of Home Builders are weaker. As measured in the GDP accounts, residential investment decreased 11.1 percent at an annual rate in the second quarter of 2006 and fell an additional 18.0 percent in the third quarter.

Other types of investment have strengthened, however. Real business investment in equipment and software rebounded in the third quarter of 2006, rising at an annual rate of 7.2 percent after dipping by 1.4 percent in the previous quarter. Real business fixed investment in structures rose at a 16.7 percent pace on top of a rapid 20.3 percent annual rate gain in the second quarter 2006.

Nonfarm payroll employment increased by 132,000 in November, and job growth so far this year is averaging nearly 150,000 per month, down from 165,000 in 2005. Since the employment trough in August 2003, the economy has generated more than 6.2 million jobs, or 160,000 per month. The unemployment rate edged up from a 5-1/2 year low of 4.4 percent in October to 4.5 percent in November, and the labor force participation rate rose slightly to reach its highest level in nearly 3-1/2 years.

Consumer price inflation started to slow following large energy-led increases earlier in the year. Headline consumer prices fell for a second straight month in October, bringing the twelve-month change to 1.3 percent – the smallest year-over-year increase since mid 2002. Energy prices, which were largely responsible for recent declines, were down 11.3 percent in October 2006 compared to October 2005. Core consumer prices (excluding the volatile energy and food categories) have also started to ease but still increased 2.7 percent over the twelve months ended in October 2006 compared to 2.1 percent a year earlier.

At its most recent meeting, in December 2006, the Federal Open Market Committee (FOMC) maintained the federal funds target interest rate at 5.25 percent, its highest level since March 2001. The pause occurred after 17 straight hikes of 25 basis points each in the current cycle of monetary tightening, which began in late June 2004 when the federal funds rate was at one percent. Despite the magnitude of that tightening, the level of the Treasury ten-year yield remained relatively stable over this period. After dipping slightly below four percent in June 2005, the yield fluctuated in a slightly higher range of about 4.5 percent through the remainder of 2005 and into early 2006. It rose to as high as 5.25 percent in late June, and has since trended lower, to about 4.5 percent currently.

The federal budget deficit in FY2006 was $248 billion, about $71 billion less than in FY2005. The July 2006 Mid-Session Review Budget projects the deficit will continue to shrink, down to $127 billion in FY2011, or 0.7 percent of GDP.

The Administration's most recent economic outlook, prepared in November, is close to the consensus economic forecasts of professional forecasters and shows continued strength in the economy in the coming year. Real GDP is projected to rise 3.1 percent and 2.9 percent during 2006 and 2007, respectively. That is similar to the U.S. historical average over the last 20 years. More recent private forecasts also suggest moderating growth in the near term.

World Economic Conditions

The world economy grew by 4.9 percent in 2005, and the IMF projects growth of about 5 percent in 2006 and 2007, which would make the growth from 2004 through 2007 period the fastest growing three-year period in over 30 years.[4] The IMF also expects some rebalancing of growth across advanced countries, even though growth rates in developing and emerging market economies are expected to remain above seven percent. In developing Asia, the IMF expects economic growth to exceed 8.5 percent this year and next. Against this positive backdrop in emerging countries, U.S. growth is expected to moderate, as discussed above, while growth in Europe rises from its relatively low level over the last few years. This modest rebalancing of growth, to the extent it materializes, would represent a favorable development that would likely stimulate U.S. export growth and help maintain strong global growth in the coming year. However, it is not certain that the growth acceleration in Europe will be maintained beyond

[4] See the IMF's *World Economic Outlook*, http://www.imf.org/external/pubs/ft/weo/2006/02/index.htm; forecasts of aggregate GDP growth use PPP weights.

2006. Japan is already decelerating in 2006. Some recent forecasts project modest deceleration in both Japan and the Euro Area in 2007.[5]

Core inflation measures, which exclude food and energy prices, are running at less than three percent, and recent declines in oil prices have pushed headline inflation below core inflation. Non-energy commodity prices remain at or near all-time highs, with October metals prices rising by 80 percent y/y, but the IMF expects these price increases to moderate going forward.[6]

Financial conditions have tightened this year with the Federal Reserve, European Central Bank (ECB), and Bank of Japan (BoJ) raising short-term interest rates. But conditions remain generally supportive for continued global growth. For example, after the recent volatility in emerging markets in May and June, the spread that emerging market countries paid on their external debt over 10-year U.S. Treasuries temporarily rose to 240 basis points in late June before retreating to 200 basis points in late November.[7] Also, many successful emerging market countries have used benign global liquidity conditions to reduce debt generally, relying more on local currency debt, and increasing reserve holdings (reserves covered about 70 percent of yearly imports in 2005 compared to 50 percent in 2001).[8] Moreover, financial markets expect further tightening by the ECB and BoJ to be gradual and contingent on inflation developments going forward.

Nevertheless, some analysts remain concerned that the benign global liquidity conditions described above will subside, and that greater risk aversion will cause a global economic slowdown. The moderation in the U.S. housing market is attracting attention overseas because analysts question whether U.S. consumers will spend less generally, and whether slower consumption growth will negatively impact other countries' exports and slow economic growth overseas. At this point, it is difficult to determine how much of any slowdown in U.S. consumption growth will be offset by higher growth in investment spending and exports, thus sustaining overall U.S. economic growth, and how much reduced consumption growth will lead to reduced imports from other countries.

Global Imbalances

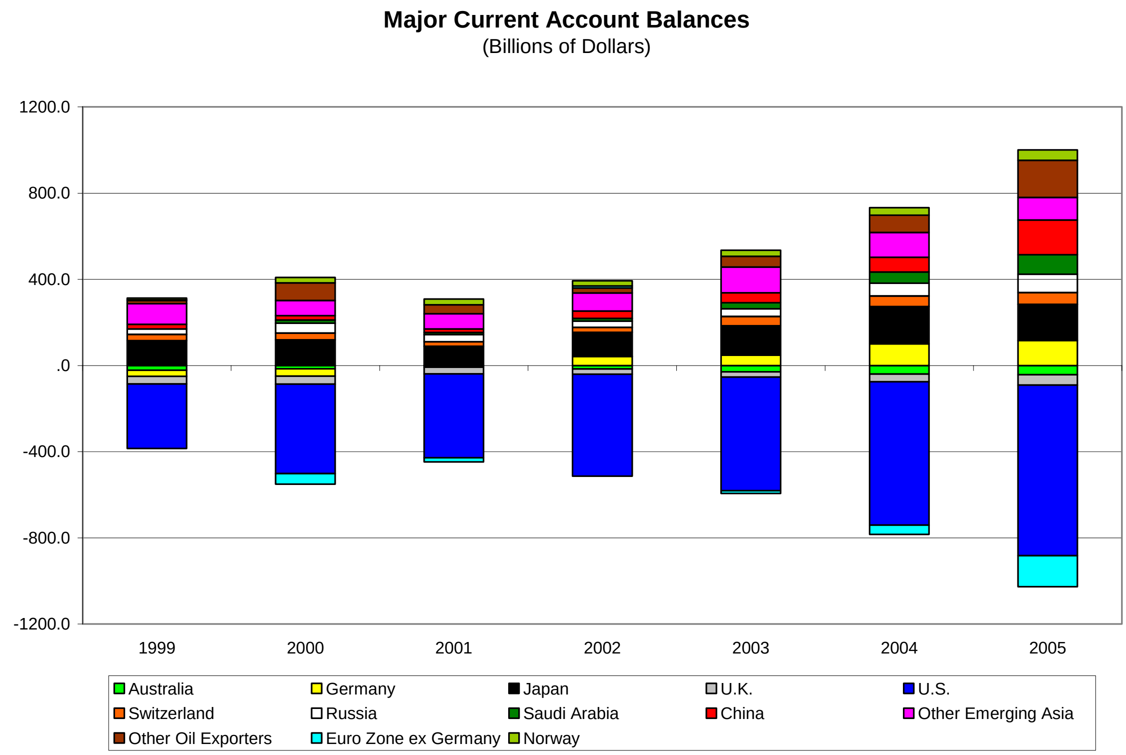
Much has been written about the large U.S. current account deficit, which through the first three quarters of 2006 totaled $656 billion or 6.7 percent of GDP.[9] The U.S external deficit has been growing since 1991, with about half of the increase occurring in the 1990s (3.6 percent of GDP) and the other half occurring since 2000 (3.1 percent of GDP).

A variety of views has been put forth as explanations for the growth in the current account deficit, including: the persistence of more rapid growth of domestic demand in the United States

[5] For example, OECD Economic Outlook, November 28, 2006.
[6] CRB metals index (sub-index of five markets): copper scrap, lead scrap, steel scrap, tin and zinc
[7] As measured by JP Morgan EMBIG+ spread.
[8] See Table 35, page 248 in the Statistical Annex of the IMF's *World Economic Outlook*, and see also Annex 1.1 of it's the IMF's *Global Financial Stability Report* that discusses the nature of financial flows to developing countries.
[9] The U.S. current account deficit for all of 2005 was $791.5 billion or 6.4 percent of GDP.

than in major trading partners and other G7 economies;[10] weak consumption and high saving rates in Asia with the excess of saving over investment channeled mainly to the United States; the comparative attractiveness of U.S. financial markets with respect to instrument depth and liquidity and market execution which has influenced the behavior of asset prices and consumption/saving patterns; and rising oil and other commodity prices which have resulted in large wealth transfers. Throughout the 1990s and the current decade, the U.S. current account deficit has risen during times of both an improving and a deteriorating fiscal situation.

The counterpart to a growing U.S. current account deficit is growing current account surpluses in other parts of the global economy. The economies with the largest external surpluses in 2005 were the oil exporters[11] ($325 billion), followed by Japan ($167 billion), China ($161 billion), and Germany ($ 113 billion). The surpluses of oil exporters and China continued to rise in 2006, while those of Japan and Germany stabilized. A reduction in the U.S. current account deficit, by definition, implies an equivalent reduction in one or more countries' external surpluses or an increase in one or more countries' external deficit. There cannot be change in the United States without a corresponding change elsewhere. For this reason, the United States and G7 partners have emphasized the "shared responsibility" for the adjustment of global external imbalances, as well as the importance of ensuring that global growth is not jeopardized in the adjustment process.



[10] Over the period 1995-2005, domestic demand grew an average 3.7 percent annually in the United States. Average growth of domestic demand in Japan over the same period was 1.2 percent and in the Euro-area was 2.0 percent. Average growth of domestic demand in key U.S. export markets, weighted by export shares, was 3.2 percent.

[11] Defined as the top seven oil exporters: Saudi Arabia, Russia, Norway, Iran, Venezuela, the UAE, and Kuwait.

With respect to "shared responsibility", Europe and Japan each need to achieve higher rates of growth of domestic demand on a sustained basis. The good news is that over the past year the pace of domestic demand growth in the Euro-area has firmed. However, for a global rebalancing of growth to occur, rates of domestic demand growth in Japan and Europe need to be elevated and sustained. Current projections for 2007 or 2008[12] raise questions about whether this is happening. Doubts also remain over how much, if at all, past structural reforms in Europe and Japan have translated into meaningful changes in their respective long-term potential growth rates. One key will be Germany's future investment pattern. Germany's investment/GDP ratio fell from 22 percent in the early 1990s to 17 percent in 2005 – the fall in the ratio translates into a very large $140 billion difference in current German investment.

China is the world's third largest trading nation and already a global economic leader. It also has an extremely high saving rate, near 50 percent, and a growing dependency on exports to drive economic growth. In the first six months of 2006 China's current account surplus reached $92 billion, or around eight percent of GDP compared to 7.1 percent of GDP in 2005 as a whole. China needs a more balanced pattern of growth. A more consumption-based growth model that includes a modernized financial sector and a flexible exchange rate regime would contribute significantly to a global rebalancing.

The largest oil exporters have been significant beneficiaries of the robust pace of global growth the last several years. They have a large interest in helping to ensure that robust global growth is sustained. They can do so in several ways: (1) by increasing expenditure on oil production capacity, (2) by judiciously increasing expenditure that enhances their economic potential and diversifies their economies, and (3) where appropriate, by strengthening their macroeconomic tools and monetary policy implementation including by moving toward more flexible exchange rates.

And finally, the United States must continue to do its part, especially with respect to increasing national saving. The national saving rate reflects both corporate and household saving rates as well as government claims on saving (sometimes called "dissaving" when government budgets are in deficit). The United States already has made substantial progress on reducing government claims, with the federal fiscal deficit having fallen from 3.6 percent of GDP in FY 2004 to 1.9 percent of GDP in FY 2006, a net improvement of 1.7 percent of GDP in two years. But further progress is needed. Personal saving moved into negative territory in 2005, following a steady decline from a post-war peak of 11.2 percent in 1982.[13]

The United States is well positioned to participate in an upswing in foreign global growth, should it be sustained. Studies of absolute and comparative productivity growth show the U.S. manufacturing sector to be very competitive internationally, with exports increasing 18.5 percent in the 12 months through September 2006. Overall, the ratio of U.S. exports to U.S. GDP is nearing its historical high, set in 1998.

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[12] See OECD Economic Outlook, November 28, 2006.

[13] The average personal saving rate over the period 1950-2005 was 7.3 percent. The rate peaked in 1982 at 11.2 percent, then fell by four percent in 1982-87. It leveled off in 1987-92, and then resumed declining in 1993, falling eight percent further over the next 13 years.

The United States International Accounts[14]

- *U.S. Balance of Payments Data*

U.S. Balance of Payments and Trade

($ billions, SA, unless otherwise indicated)

	2004	2005	2005				2006		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
Current Account:									
Balance on goods	-665.4	-782.7	-183.3	-188.2	-198.7	-212.5	-208.0	-210.6	-218.6
Balance on services	54.1	66.0	15.2	16.2	17.0	17.7	16.8	17.5	18.3
Balance on income 1/	27.6	11.3	3.6	2.0	7.8	-2.2	-2.5	-2.2	-3.8
Net unilateral current transfers	-81.6	-86.1	-27.2	-23.2	-9.5	-26.2	-19.5	-21.9	-21.5
Balance on current account	-665.3	-791.5	-191.7	-193.3	-183.4	-223.1	-213.2	-217.1	-225.6
Current Account as % of GDP	-5.7	-6.4	-6.3	-6.3	-5.8	-7.0	-6.6	-6.6	-6.8
Major Capital Flow Components (financial inflow +)									
Net Bank Flows	44.4	-8.9	-32.5	13.0	-7.0	17.6	-48.4	41.1	-3.8
Net Direct Investment Flows	-111.0	100.7	-.7	-25.7	74.8	52.3	-16.0	-.9	-19.0
Net Securities Sales	656.6	669.2	148.7	120.5	186.3	213.8	203.6	116.1	165.4
Net Liabilities to Unaffiliated Foreigners by Non Banking Concerns	-26.8	-14.1	13.0	37.2	-9.2	-55.1	28.8	-6.1	30.2
Memoranda:									
Statistical discrepancy	85.1	10.4	57.7	44.0	-72.2	-19.1	43.4	64.9	49.7
Change in Foreign official assets in the United States	387.8	199.5	19.0	74.6	34.0	71.9	75.7	75.9	80.8
Trade in Goods									
Balance	-665.4	-782.7	-183.3	-188.2	-198.7	-212.5	-208.0	-210.6	-218.6
Total Exports	807.5	894.6	214.2	222.6	224.9	232.9	244.5	252.8	262.1
of which:									
Agricultural Products	62.9	64.9	15.6	16.5	16.3	16.5	17.4	18.3	na
Capital Goods Ex Autos	331.6	362.7	85.9	90.1	90.6	96.1	100.1	102.3	na
Automotive Products	89.2	98.6	23.6	23.7	25.2	26.1	26.4	26.2	na
Consumer Goods Ex Autos and Food	103.1	115.7	28.2	28.4	29.1	30.0	31.2	31.5	na
Industrial Supplies and Materials 2/	204.0	233.1	56.4	58.9	58.8	59.0	63.9	68.9	na
Total Imports	1472.9	1677.4	397.5	410.8	423.7	445.4	452.5	463.4	480.7
of which									
Petroleum and Products	180.5	251.9	53.2	58.3	67.3	73.2	72.1	79.3	na
Capital Goods ex Autos	343.5	379.2	90.7	95.3	95.8	97.5	101.1	103.9	na
Automotive Products	228.2	239.5	57.9	58.7	60.3	62.6	64.6	64.6	na
Consumer Goods Ex Autos and Food	373.1	407.3	100.8	101.8	101.0	103.8	106.1	107.7	na

1/ Including compensation of employees

2/ Including petroleum and petroleum products

Source: BEA, Bureau of Census

The U.S. current account deficit was $863 billion (at a seasonally adjusted annual rate, or "saar"), or 6.6 percent of GDP, in the first half of 2006, compared with $813 billion, or 6.4 percent of GDP, in the second half of 2005. Viewed over a longer period, the U.S. current account balance declined, as a percent of GDP, from a one percent surplus in the first quarter of 1991 to a four percent deficit in the fourth quarter of 2000. Then, after a cyclically induced narrowing in 2001, it resumed its decline to reach a seven percent deficit in the fourth quarter of 2005, before easing from this peak in the first three quarters of 2006.

Although services constitute around 30 percent of U.S. exports of goods and services and around 15 percent of U.S. imports of goods and services, the balance of trade in services is relatively small, being around a $5 billion a month surplus over the past several years, and is relatively

[14] 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 2006. 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/2006/cr06279.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/external/pubs/ft/weo/2006/02/index.htm.

stable. As a consequence, movements in the trade balance reflect in the main movements in the balance of trade in goods.

In the first half of 2006, the United States exported $995 billion (saar) in goods and imported $1,832 billion, with a resulting $837 billion deficit on trade in goods.[15] Exports of goods increased 13.9 percent in the first half of 2006 compared to the first half of 2005, while imports increased 13.3 percent. As strong as export growth has been, it has not been sufficient to narrow the gap between imports and exports. As highlighted in the May Report to Congress on International Economic and Exchange Rate Policies, U.S. exports must grow more than 50 percent faster than imports just to keep the trade deficit unchanged.

Non-automotive capital goods constituted 40.7 percent of merchandise exports in the first half of 2006. Consumer goods constituted 23.3 percent and non-automotive capital goods constituted 22.4 percent of merchandise imports. Petroleum and petroleum product imports accounted for 16.5 percent of merchandise imports. The value of petroleum and petroleum product imports as a percent of total imports of goods has risen from 10 percent in the second half of 2003. The rise in the U.S. oil bill is 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. Canada purchased 23.0 percent of U.S. exports, Mexico 13.3 percent, Japan 6.0 percent, China 5.0 percent, and the U.K. 4.3 percent in the 12 months through June 2006. Canada accounted for 17.3 percent of U.S. imports, China 14.7 percent, Mexico 10.4 percent, Japan 7.9 percent, and Germany 5.9 percent in 2005.

Country	**Exports Jul05-Jun06**	**Country**	**Imports Jul05-Jun06**
Total, All Countries ($Bil)	**967.0**	**Total, All Countries ($Bil)**	**1781.2**
	Percent of Total		**Percent of Total**
Canada	23.0	Canada	17.3
Mexico	13.3	China	14.7
Japan	6.0	Mexico	10.4
China	5.0	Japan	7.9
United Kingdom	4.3	Federal Republic of Germany	4.9
Federal Republic of Germany	3.8	United Kingdom	3.0
South Korea	3.1	South Korea	2.5
Netherlands	2.9	Venezuela	2.1
France	2.4	Taiwan	2.0
Taiwan	2.3	Malaysia	2.0
Singapore	2.2	France	2.0
Memo		**Memo**	
Euro Area	15.0	Euro Area	13.4
OPEC	3.8	OPEC	7.9

Source: Bureau of the Census

Prices of imported goods (nsa) increased 7.3 percent in the year through the second quarter of 2006. Non-petroleum import prices rose 1.5 percent over this period, while petroleum import prices increased 37.5 percent. Export prices rose 3.4 percent over this period. The most recent

[15] Sums may not be exact due to rounding.

trough in import and export prices occurred roughly at the beginning of 2002. Since then non-petroleum import prices have risen 8.2 percent and export prices 13.3 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 $884.1 billion in the twelve months ending October, 2006. (Included in these were net private foreign purchases of long-term Treasury securities amounting to $146.5 billion and net private foreign purchases of U.S. corporate bonds amounting to $435.0 billion.) Net purchases by foreign official institutions were $175.2 billion over the same period.

Foreign investors owned $2.1 trillion of Treasury securities at the end of June 2006, or 51.9 percent of the public debt not held in Federal Reserve and U.S. Government accounts. This compares with $2.0 trillion, at the end of December 2005. Foreign official institutions held $1.3 trillion in Treasury securities at the end of June 2006, as they did at the end of June 2005. There are around $20 trillion in U.S. securities of all kinds outstanding.

Net International Investment Position

The U.S. net international investment position (NIIP) widened (with direct investment valued at the market value of owner's equity) to a minus $2.5 trillion (20.4 percent of GDP) at the end of 2005, the latest date for which data are available, from $2.4 trillion (20.9 percent of GDP) at the end of 2004. A $1.1 trillion valuation adjustment, reflecting strong appreciation of foreign stocks relative to U.S. equity, offset almost all the $785 billion widening attributable to financial flows and the $394 billion widening due to exchange rate changes. The NIIP (with direct investment valued at current cost) was a negative $2.7 trillion (21.6 percent of GDP) at the end of 2005 compared to a negative $2.4 trillion (20.2 percent of GDP) position at the end of 2004.

The United States continues to earn 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' investments in U.S. assets is around $2.5 trillion greater than the value of the U.S. investment in foreign assets. Net earnings on direct investment have been large enough to offset outflows of income payments on other forms of international investment. U.S. residents earned $18 billion more on their investments abroad than they paid out on foreign investments in the United States in 2005. Net payments have turned into marginal outflows in the four quarters ended September 2006.

The NIIP is a critical measurement in analyzing the sustainability of the current account deficit. A growing negative NIIP must stabilize as a percent of national output in the long run or it would become impossible to service the external debt out of current or future production. It is generally believed that a stable NIIP as a percentage of GDP requires that the balance on trade in goods and services be close to zero.[16]

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[16] The magnitude of the balance depends, among other things, on relative rates of return. For example, U.S. residents earn a higher rate of return on their foreign assets than residents of foreign countries earn on their U.S. assets. If this were to remain the case through the indefinite future, then the NIIP could stabilize with the United States running a deficit on trade in goods and services. There is, however, no clear reason for this interest rate advantage to continue indefinitely.

- *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 to a current account deficit. These flows finance the net capital formation that is equal to the 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. Perceived high rates of return on U.S. assets, based on sustained strong productivity growth especially relative to that of the rest of the world, 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 United States 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

The dollar ended the first half of 2006 7.4 percent lower vs. the euro at $1.2795 and 2.8 percent lower vs. the yen at ¥ 114.45 than at the start of the year. For most of the first half of 2006, the exchange rates of the dollar vs. the euro and the dollar vs. the yen moved similarly.

- Initially, the market focused on interest rate differentials that remained favorable to the dollar.

- The Bank of Japan ended its quantitative easing policy and returned to its Zero Interest Rate Policy (ZIRP) in March, setting the stage for an eventual move toward removal of monetary accommodation. The European Central Bank (ECB) also raised interest rates in March.

- By mid-April, market participants increasingly looked toward the prospect of an end to the Federal Reserve's tightening cycle and an erosion of the dollar's interest rate advantage. Some took the view that adjustment of global imbalances would require substantial exchange rate changes.

In late May and early June the market's focus then shifted back to interest differentials, and talk of global imbalances faded. The euro retained much of the gains it had made in late April and early May, but the yen depreciated back to levels seen in late 2005.

- Some higher than expected U.S. economic indicators, notably on inflation, led to a resurgence in market expectations of higher interest rates. The FOMC raised interest rates at both its May and June meetings.

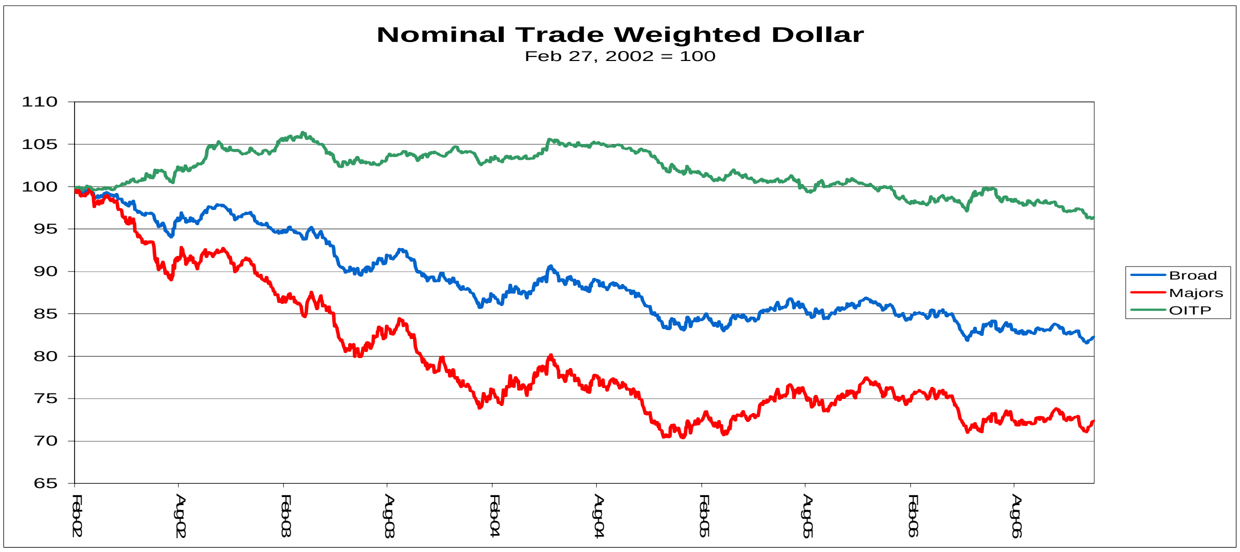
- Also concerned about inflation risks in the Euro area, the ECB raised it key policy rate in June, August, and October, narrowing the dollar's yield advantage vs. the euro. A number of other central banks, including some in emerging market countries, raised interest rates.

- Market concerns about the withdrawal of liquidity by central banks prompted a liquidation of risk positions globally in late May and June.

- The Bank of Japan maintained the ZIRP through the end of the first half and made clear that further removal of monetary accommodation would be very gradual.

On balance, the dollar largely traded in narrow ranges against the euro and yen, with low volatility, throughout most of this year, despite changing fundamentals. In recent trading (i.e., late November), however, the dollar depreciated beyond the limits of its trading range vs. the euro

The Federal Reserve's nominal trade-weighted dollar index declined by 3.2 percent in the first half of the year. The dollar depreciated by 5.4 percent vs. the major currencies component of the index and by 0.6 percent vs. the currencies of other important trading partners (OITP).



Country Analyses

Argentina

Pursuit of Argentina's goal of increasing its foreign exchange reserves to reduce external vulnerabilities has resulted in a de facto managed float.

The peso depreciated 1.8 percent nominally against the dollar during the first half of 2006, from 3.03 to 3.09 pesos to the dollar. The peso depreciated 6.9 percent from end-June 2005 to end-June 2006, from 2.89 to 3.09 pesos to the dollar. However, given current high inflation rates, in real terms, the peso appreciated by 0.8 percent from end-2005 through June 2006.

Argentina repaid its entire $9.9 billion in IMF obligations in January of 2006. Since then, the central bank has been able to rebuild its stock of foreign reserves back to pre-IMF repayment levels. At the end of June 2006, central bank reserves stood at $25.5 billion, down from $28.0 billion at end-2005. Argentina's access to international capital markets has been reduced as a result of its 2005 debt restructuring, and reserves are currently being accumulated to give the country a cushion against external shocks.

Argentina's reserve accumulation has fueled monetary growth and inflationary pressures. Annual inflation reached 11.0 percent at end-June 2006 compared to 12.3 percent at year end 2005 and 9.0 percent at end-June 2005. Nominal interest rates on repo transactions rose in the first half of 2006 to eight percent from six percent at the end of 2005. The increase was not, however, outpaced by inflation, producing some rise in real interest rates. Argentina's benchmark sovereign debt traded 385 basis points over U.S. Treasuries at end-June 2006 versus 504 basis points at end-2005.

On an accumulated basis, foreign direct investment into Argentina rose 10.7 percent to $4.7 billion from the end of 2004 to the end of 2005. Argentina had a $3.2 billion seasonally adjusted current account surplus in the first half of 2006, equivalent to 3.1 percent of GDP compared to 1.8 percent in the first half of 2005. During the first half of 2006, the United States had a trade surplus with Argentina of $224 million compared to a deficit of $100 million in the first half of 2005. This reflected, in part, export supply restrictions of the Argentine government designed to control inflation. Export taxes currently in place to boost fiscal performance are also placing downward pressures on Argentina's export performance.

Real GDP increased at a seasonally adjusted annual rate of 7.2 percent during the first half of 2006 versus 9.7 percent in the second half of 2005.

Capital controls remain in effect on currency inflows. Residents are limited in the amount of foreign currency they can bring into the country. Non-residents are required to keep dollars in the country for a minimum of one year, with 30 percent held on deposit in an interest-free account at the central bank.

Brazil

Brazil has a flexible exchange rate regime and relies on inflation targeting to guide monetary policy. The real continued to strengthen during the first half of 2006, appreciating 7.3 percent in nominal terms, from 2.33 to 2.16 reals to the dollar (although the real effective exchange rate depreciated by 0.95 percent). The real has appreciated by 82 percent relative to the dollar since reaching a low in October 2002, likely reflecting both overshooting during the 2002 crisis and a structural improvement in export competitiveness. Although the external accounts continue to be in surplus, they have narrowed in 2006 on the back of the real's continued recovery. On a seasonally adjusted basis, Brazil's current account surplus was $4.3 billion (0.9 percent of GDP) in the first half of 2006, down from $7.3 billion (1.7 percent of GDP) in the second half of 2005, while the trade surplus fell from $23.4 billion (5.3 percent of GDP) to $21.3 billion (4.7 percent of GDP) over the same period. The U.S. trade deficit in goods with Brazil narrowed from $4.6 billion in the first half of 2005 to $3.8 billion in the first half of 2006.

Slowing net exports contributed to a deceleration of the Brazilian economy during the second quarter of 2006. Beginning in the fourth quarter of 2005, the economy began to pick up steam, growing by 4.7 percent at a seasonally adjusted annualized rate. By the first quarter of 2006, the economy grew by 5.2 percent at an annual rate. However, a slowdown in export volumes and continued strong growth of imports resulted in a deceleration in real GDP growth in the second quarter of 2006 to 1.8 percent.

The strong real has aided the disinflation process in Brazil. The inflation outlook improved over the past year, with year-on-year inflation at 4.0 percent in June, within the targeted "tolerance range" of 2.5 percent to 6.5 percent. The same range has been targeted for 2007. The central bank increased net international reserves to $62.7 billion by June 2006 compared to $53.8 billion in December 2005. The central bank has a broad objective of increasing reserves in the medium run to make the economy less vulnerable to shocks, but it does not commit to a specific numerical target. In December 2005, Brazil repaid its $15.5 billion in IMF obligations.

Brazil has taken several steps this year to liberalize its foreign exchange market. In July 2006, Brazil loosened its repatriation requirements for exporters, enabling them to keep up to 30 percent of their export revenue abroad as long as they wish and the remaining 70 percent for up to a year. Previously, exporters were required to repatriate all of their foreign currency earnings within seven months of their receipt. Repatriation requirements for foreign exchange generated by financial market operations and Treasury purchases were also lengthened to a year. Brazil also will now allow the registration of foreign capital not previously eligible for registration, enabling foreign companies to remit profits and dividends related to this capital abroad.

Mexico

Mexico has a flexible exchange rate regime. During the first half of 2006 the Mexican peso depreciated nominally by 5.8 percent, from 10.6 to 11.3 pesos to the dollar. The J.P. Morgan trade-weighted effective exchange rate index for the peso depreciated by 5.8 percent during the same period. The depreciation during the first half of the year reversed much of the peso's gains since 2004 and reflected uncertainty associated with the presidential elections on July 2 as well as narrowing interest-rate spreads with the United States.

Rising oil prices continued to contribute to a rapid accumulation of Mexico's international reserves. Reserves grew by $10 billion during the first half of the year, reaching $79 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. The Bank of Mexico follows a transparent rule for selling these reserves. Every 13 weeks, the Bank of Mexico retains half of the reserves accumulated during that period and sells the other half evenly over the ensuing three months. The stated goal of this transparent procedure is to prevent uncertainty in the financial markets and minimize discretionary actions by the financial authorities.

Mexico's seasonally adjusted current account deficit was 0.4 percent of GDP in the second quarter of 2006 compared to a deficit of 0.9 percent of GDP in the second quarter of 2005. The current account deficit was easily financed by foreign direct investment. Mexico's trade surplus with the United States for the first half of 2006 was $31.3 billion, up from $24.3 billion in the first half of 2005. Mexico is the second largest supplier of oil to the United States, and the rise in the U.S. trade deficit reflects rising oil prices.

A resurgence of automobile and agriculture exports caused the economy to grow briskly in the first six months of 2006. Real GDP increased at annual rates of 6.6 percent and 5.6 percent during the first and second quarters, respectively. At the same time inflation approached the Bank of Mexico's three percent target in the first half of 2006, although it has edged up in subsequent months. Year-on-year headline inflation was 3.2 percent in June, compared with 3.3 percent in December 2005. The December reading was Mexico's lowest year-end inflation since the 1960s.

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. The nominal exchange rate was held at 2,147 bolivars to the dollar at end-June 2006, unchanged from end-December 2005 and end-June 2005. The J.P. Morgan trade-weighted real effective exchange rate index for the bolivar appreciated by 6.4 percent during the first half of 2006.

Oil accounts for about one third of Venezuelan GDP, roughly 90 percent of the country's exports and close to half of government revenues. High oil prices have not only supported highly expansionary fiscal policies, but have accounted for the rising current account surplus and foreign reserve accumulation. The stock of central bank reserves increased to $31.2 billion by end-June 2006 compared to $29.6 billion at end-2005 and $28.1 billion at end-June 2005. Reserve accumulation is contributing to monetary expansion and inflationary pressures. High inflation with a fixed exchange rate has contributed to real exchange rate appreciation, eroding competitiveness, evidenced by continued strong growth of imports.

The monetary base expanded by 53 percent from the end of the first quarter of 2005 through the end of the first quarter of 2006. Annual inflation was 11.8 percent at end-June 2006 compared to 14.3 percent at end-2005. Venezuela's benchmark sovereign debt spread was 228 basis points over U.S. Treasuries at end-June 2006 versus 318 basis points at end-2005.

For the first half of 2006, net FDI inflows were -$3.2 billion versus $0.8 billion for the first half of 2005, and net portfolio flows were -$8.1 billion versus $1.6 billion in the first half of 2005. Venezuela had a $15.2 billion current account surplus in the first half of 2006 versus a $14.9 billion surplus in the second half of 2005 and a $10.6 billion surplus in the first half of that same year. For 2005, the current account balance was $25.5 billion, or 18.2 percent of GDP. Venezuela's rising current account surplus can be attributed to higher world oil prices. During the first half of 2006 the U.S trade deficit with Venezuela was $14.5 billion, up from $13 billion in the first half of 2005. The higher U.S.-Venezuela trade deficits primarily reflect increasing oil prices; about 11 percent of U.S. oil imports come from Venezuela. Real GDP increased at a seasonally adjusted annual rate of 6.5 percent during the first quarter of 2006 versus 15.6 percent during the fourth quarter of 2005. Real GDP rose by 9.3 percent in 2005.

Venezuela maintains extensive controls on capital inflows and outflows. These controls require exporters to surrender their foreign exchange earnings to the government at the official exchange rate.

The Eurozone

Eurozone quarterly growth increased to an average annualized rate of 3.0 percent during the first three quarters of 2006 from 1.9 percent during the same period in 2005. Domestic demand strengthened in the second quarter with a very strong increase in domestic investment. During the first half of 2006, imports followed suit, increasing 18 percent from the first half of 2005 compared to export growth of 13 percent. The combined effect caused the Eurozone's current account deficit to widen slightly from 0.26 per cent of GDP in the first half of 2005 to 0.3 percent in the first half of 2006. The Eurozone's trade surplus with the United States increased $2.2 billion during the first half of 2006 compared with the same period in 2005 to $45 billion.

Over the first half of 2006, the euro appreciated 7.8 percent against the dollar to $1.278. The Eurozone's moderate inflation relative to that of its major trading partners, however, helped contain real effective exchange rate appreciation to only 3.1 percent. The ECB has not intervened in foreign exchange markets since November 2000 and the value of Eurozone foreign exchange reserves increased by only $1.7 billion between December 2005 and June 2006 reaching $169.1 billion.

Although CPI-measured inflation has fallen below the ECB's two percent ceiling to 1.6 percent in October, the ECB remains hawkish citing inflationary concerns. The ECB has raised its key policy rate (the minimum bid rate on main refinancing operations) five times from a December 2005 level of 2.25 percent to 3.25 percent in December, 2006.

Germany

Germany's GDP increased at an annualized rate of 3.4 percent over the first three quarters of 2006 compared with 1.9 percent growth during the same period in 2005. During this period, investment increased at an average 7.4 percent annualized rate compared to 2.6 percent during the same period in 2005. Strong growth induced a healthy, 19 percent, increase in imports outpacing a 12 percent increase in exports during the first six months of 2006 compared with the same period in 2005, with the current account surplus narrowing somewhat from five percent of GDP during the first half of 2005 to 4.2 percent in first half of 2006. Germany's trade surplus vis-à-vis the U.S. increased by $15 million during the first six months of 2006 to $24.4 billion.

The Netherlands

The Netherlands posted a $25.6 billion current account surplus in the first half of 2006, which represented an increase to 10.5 percent of GDP from 6.4 percent of GDP in the second half of 2005. For the first half of 2006, the current account surplus is largely explained by the trade surplus (96 percent), balance on services (14 percent), and balance on income (eight percent), which offset a deficit on current (outward) transfers (-18 percent). For the full 2005 year, the current account surplus was 7.7 percent of GDP. Merchandise exports in the first half of 2006 grew by 15.3 percent over the same period in 2005 while merchandise imports grew 16.7 percent. The U.S. trade surplus with the Netherlands grew to $6.8 billion in the first half of 2006, up $258 million from the same period in 2005.

GDP growth was estimated to be 2.7 percent (annualized) over the first half of 2006, driven by the growth in investment, government consumption, and net exports. Headline inflation was 1.8 percent in June (y/y) while core inflation was 0.8 percent.

Spain

Spain's GDP increased 3.8 percent, at an annual rate, in the first half of 2006 from 3.6 percent in the second half of 2005. Consumption and investment increased 2.7 percent and 7.3 percent, respectively, over this period. Spain faces a risk of overheating given strong domestic demand and record low unemployment. Unemployment fell sharply to 5.5 percent in the second quarter of 2006 from 12.7 percent in the second quarter of 2005. Spain's CPI increased 4.0 percent y/y in June 2006, which was up from 3.2 percent y/y in June 2005. The IMF estimates the output gap to be close to zero.

Rapid growth of investment over the past decade has sustained growth in domestic demand and been the principal factor in a widening current account deficit. Gross fixed capital formation rose 7.0 percent in the first half of 2006 from the second half of 2005. Investment represented over 30 percent of GDP and the current account deficit reached $54.7 billion, or 9.3 percent of GDP in the first half of 2006. In the first half of 2006, goods imports increased 14.9 percent over the same period in 2005 while goods exports increased 12.9 percent. Spain's bilateral surplus on trade in goods with the United States was $11.3 billion in the first half of 2006, $346 million higher than during the same period last year.

Switzerland

Switzerland posted a $31.8 billion current account surplus (15.8 percent of GDP) in the first half of 2006, up from $26.3 billion (15.1 percent of GDP) in the same period in 2005. The trade surplus declined $1 billion (from $2 billion to $1 billion) in the first half of 2006 compared to the corresponding period in 2005, while the surplus in the services account increased $2 billion to $13 billion during the same period. The surplus on trade in goods accounted for only 3.5 percent of the current account surplus in the first half of 2006. On the other hand, the surplus on trade in services, including financial services, accounted for 43.1 percent, while the surplus on net income receipts, including net receipts from foreign investment, accounted for 61.1 percent of that period's current account surplus. The net transfers balance was in deficit over the period, reducing the current account surplus by 7.7 percent. Goods exports increased by 17 percent in the first half of 2006 over the corresponding period in 2005, while imports grew 18.7 percent over the same period, but the trade balance contributed only 2.6 percent to the overall current account surplus. The U.S. trade surplus vis-à-vis Switzerland was $73.3 million in first half of 2006, up from a deficit of $1.2 billion from the corresponding period in 2005.

As a small open economy, Swiss economic conditions are heavily influenced by conditions in the Eurozone, Switzerland's major trading partner. Monetary policy was tightened during first half of 2006, following the ECB's policies, and the Swiss Franc appreciated 0.8 percent against the euro and 6.2 percent against the dollar; however, its nominal effective exchange rate remained unchanged and the IMF's index for the real effective exchange rate of the Swiss Franc appreciated 1.1 percent. Foreign exchange reserves remained relatively stable at $36.2 billion during the period. The Central Bank did not intervene in the foreign exchange market during the first half of 2006, but does intervene occasionally to "counteract market disturbances."

GDP growth was estimated to be 2.9 percent (annualized) during first half of 2006. Consumption and (fixed) investment grew 1.6 percent and 5.6 percent, respectively on an annualized basis during the same period, while net exports grew 8.1 percent in first half of 2006 compared to first half of 2005. During the first half of 2006 headline inflation was 1.56 percent y/y while core inflation was 0.8 percent y/y.

Norway

Norway is a major oil and gas exporter. Its current account surplus during first half of 2006 was $29.4 billion (17.5 percent of GDP), up $2.2 billion from $27.2 billion (14.2 percent of GDP) in the second half of 2005. Merchandise exports were up 25.2 percent over the same period last year while imports increased 15.1 percent. The U.S. trade deficit with Norway in first half of 2006 was $2.4 billion, down from $2.5 billion in first half of 2005. The Norwegian kroner appreciated 7.8 percent against the dollar during the period while the IMF's nominal and real effective exchange rate indices for the kroner appreciated 1.4 percent and 2.4 percent, respectively. Foreign exchange reserves grew $2.6 billion to $49.0 billion during first half of 2006, slightly faster than during the corresponding period in 2005. Norway's Central Bank does not intervene in foreign exchange markets to influence the kroner, but management of the Government Pension Fund (GPF) portfolio has some of the characteristics of intervention. In the process, it may influence the kroner.

Most of Norway's oil and gas revenue is invested overseas through the GPF and, at end-June 2006, the GPF's market value was $241 billion (86 percent of 2005 GDP) and growing rapidly. The return on the GPF's investment can be used for current government consumption while the principal remains as a retirement fund for future generations.

GDP increased 1.7 percent (at an annual rate) during the first half of 2006 compared to the second half of 2005. Consumption grew by 4.6 percent (annualized) during the same period while fixed investment (annualized) declined 1.9 percent Headline inflation was 2.1 percent (annualized) during the period while core inflation was 0.9 percent.

Russia

Strong growth in exports, boosted by high oil prices, helped increase Russia's current account surplus to $56.5 billion (not seasonally adjusted, or "nsa") in the first half of 2006 from $42.8 billion in the first half of 2005. As a share of GDP, the surplus rose to 11.3 percent in the 12 months through June from 11 percent during the comparable period in 2005. The bilateral trade balance with the U.S. amounted to a surplus of $7.5 billion in the first half of 2006; this compared with $5.9 billion in the first half of 2005. In addition, the shift to net private sector inflows that began in the second half of 2005 accelerated in the first half of 2005, as direct investment rose sharply and portfolio investment outflows slowed. As a result, the balance of payments' financial accounts, exclusive of changes in reserves, shifted to a surplus of $9.4 billion during the first half 2006 from a deficit of $2.9 billion in the first half 2005.

The increase in capital inflows, together with central bank intervention to moderate the pace of exchange rate appreciation, boosted total international reserves to $250.6 billion at the end of June from $182.2 billion at the end of 2005. Net of valuation changes, reserves rose $62.4 billion during the first half of 2006, compared with an increase of $61.5 billion for all of 2005. In addition, the balance of Russia's oil stabilization fund rose to $76 billion at the end of June from $43 billion at the end of 2005. Limited sterilization of the central bank's foreign exchange market intervention has resulted in continued rapid growth in the money supply, as M2 (using the monetary survey definition) rose 38.0 percent in the 12 months through June compared with 36.3 percent in 2005.

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 appreciated six percent against the dollar during the first half of 2006. The IMF's nominal trade-weighted index of the ruble appreciated 3.1 percent in the first half of 2006 while its real trade-weighted index[17] appreciated by 4.2 percent. This compared with nominal appreciation of 2.5 percent and real appreciation of 9.3 percent for the full-year 2005. The ruble has remained little changed against the dollar since the end of June, rising by only 0.2 percent.

The ruble's appreciation (together with smaller increases in administered prices) helped slow the increase in the CPI from 10.9 percent y/y in December 2005 to 9.0 percent y/y in June. CPI rose again to 9.6 percent y/y by August, however, compared with the end-2006 inflation target of 8.5 percent. Real GDP increased 6.5 percent y/y during the first half of 2006, little changed from 6.4 percent in 2005. Output growth has been supported by strong household spending and fiscal easing as the government is spending a larger share of oil revenues ahead of the 2007-2008 election cycle.

South Africa

South Africa's flexible exchange rate responded quickly to changing economic conditions over the first half of 2006. The rand, typically classified as one of the "commodity" currencies, was relatively strong against the dollar from January to May. However, from mid-May to mid-June it depreciated 22 percent on the heels of a drop in precious metals prices and cooling investor interest in emerging markets. Bond and equity prices also fell. The Central Bank believed that rand weakness and rising fuel prices pushed inflation expectations above the upper end of the inflation target range (3-6 percent), and increased its policy interest rate 50 basis points in both June and August. Actual inflation was 4.8 percent in June, within the target range.

[17] The IMF's CPI-based index.

Robust domestic demand, supported by a 25 percent y/y increase in the extension of credit to the private sector in the second quarter following a similar increase in the first quarter, contributed to above trend real GDP growth of 4.2 percent in the first quarter (q/q, sa), and 4.9 percent in the second quarter.

Strong domestic demand also contributed to a current account deficit that averaged an estimated 6.1 percent of GDP in the first two quarters of 2006. South Africa's imports from the United States increased 27 percent (about $750 million) in the first half of this year relative to the same period in 2005, while South Africa's exports to the United States were little changed. Portfolio inflows financed most of the current account deficit. Foreign exchange reserves rose more than $3 billion in the first half of 2006 to almost $24 billion (4.3 months of imports) at the end of June.

Egypt

Since January 2005, the Central Bank of Egypt (CBE) has used partially sterilized interventions in the foreign exchange market to maintain a de facto peg of the Egyptian pound against the dollar. In the six months ending in June 2006, the pound-dollar exchange rate stayed within a narrow one percent range, while the CBE's net international reserves increased by five percent, to $22.9 billion. Net reserves grew by 20 percent for the year ending in June, contributing to 15 percent growth in reserve money and 13 percent growth in broad money (M2).

The CBE has made gradual progress towards the goal of a floating exchange rate regime, abandoning the formal peg against the dollar in early 2003, and launching an inter-bank foreign exchange market in December 2004. The CBE has announced that it will adopt a formal inflation targeting regime to guide monetary policy.

During the fiscal year ending in June 2006, Egypt's current account narrowed to a projected 1.7 percent of GDP, down from 3.3 percent of GDP in the year ending June 2005. Driven by higher prices, exports of oil and natural gas increased by 93 percent in the year ending June 2006, to constitute 55 percent of total exports. By contrast, non-energy exports declined by four percent, and Egypt's projected trade deficit remained above 11 percent of GDP. The stress of nominal appreciation on non-energy sectors would be eased if ongoing structural reforms increased productivity growth in these sectors. Egypt had a deficit of $713 million on trade in goods with the United States from January through August 2006, down from a deficit of $830 million during the same period last year

Reforms, increased privatizations, and the robust regional economy helped Egypt attract large capital inflows for the second straight year. The overall financial account surplus (excluding reserve accumulation) was a projected 3.3 percent of GDP in the year ending June 2006, compared to 3.8 percent of GDP in the year ending June 2005. Net foreign direct investment reached a record $6.1 billion in the year ending June 2006.

The Egyptian economy, which grew five percent in 2005, has continued to perform strongly in 2006. Increased economic activity and ample growth in liquidity contributed to consumer price inflation of 6.4 percent y/y in June, compared to 4.7 percent y/y inflation during the same period in 2005.

Saudi Arabia

The riyal has been unofficially pegged to the dollar since 1986 (officially since 2003), so interest rates largely followed recent increases in the United States. The Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the U.A.E.) has set a goal of establishing a formal monetary union by 2010, although the relationship of the new currency to other currencies has not been announced.

With Saudi Arabia's large current account surplus and fixed exchange rate, the net foreign assets of the Saudi Arabian Monetary Agency rose to $176 billion from $152 billion during the first six months of 2006, providing approximately 30 months of import cover. Gross liquid reserves rose by a much smaller amount over the same period, increasing to $30 billion from $26 billion.

Saudi Arabia is one of the most oil-dependent economies in the world, with oil accounting for around 50 percent of GDP and almost 90 percent of export and government revenue. With high oil prices over the past few years, real GDP growth has averaged close to six percent, with average nominal GDP growth just under 20 percent.[18] Despite this strong growth, 2005 CPI inflation remained below one percent in 2005 and is projected to be about 1.5 percent in 2006, reflecting small changes in the prices of imported goods and the large share of administered prices in the CPI basket.

Oil export revenues continued to increase on the back of high oil prices, rising from $110 billion in 2004 to a projected $197 billion in 2006. The surge in oil export revenue led to an increase in the current account surplus from 20.7 percent of GDP in 2004 to an estimated 31 percent in 2006. Finally, the bilateral trade surplus with the United States has grown substantially, reaching $20.4 billion in 2005, compared with $15.7 billion in 2004, and surplus of $14.4 billion recorded in the first eight months of this year.

The government's financial position improved as revenue from oil rose by $46 billion to $134 billion in 2005 and is projected to reach $150 billion in 2006. The budget surplus was approximately $57 billion in 2005 (18 percent of GDP) and is projected to exceed $60 billion in 2006. The government is using much of that surplus to reduce government debt, which is expected to be reduced to 17 percent of GDP in 2006. Based on historical experience, these surpluses are likely to diminish over time as the government increases spending; the government projects domestic spending to rise by 20 percent in 2006.

Singapore

The Monetary Authority of Singapore (MAS) uses the exchange rate as its operational monetary policy tool to control inflation. MAS manages the Singapore dollar (SGD) against an undisclosed basket of currencies and since April 2004 has operated on a policy of "modest and gradual"

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[18] Using actual 2004 and 2005 rates and projected 2006 rates.

appreciation against this basket.[19] In the first half of 2006, the SGD appreciated 4.7 percent against the U.S. dollar, compared with 1.1 percent appreciation in the second half of 2005. JP Morgan's nominal and real trade-weighted indexes of the SGD appreciated 1.8 percent and 5.2 percent, respectively, in the first half of this year.[20] The faster pace of appreciation of the real trade-weighted index in the first half of 2006 reflected a slight pick-up in inflation in the first few months of the year.

CPI inflation was a relatively modest 1.3 percent (y/y) in the first half of 2006, although higher oil prices are beginning to have a stronger impact on overall consumer prices. The economy expanded by 3.0 percent (saar) in the second quarter of this year, compared with 7.6 percent in the first quarter. The second quarter deceleration was largely due to weaker manufacturing sector growth, although manufacturing has more recently shown signs of a rebound.

High savings rates and declining investment have driven large and growing current account surpluses in Singapore. In the first half of 2006, the current account surplus reached 31 percent of GDP, compared with an overall 2005 surplus of 28.5 percent of GDP. Singapore's gross national savings rate of around 45 percent of GDP is among the world's highest and reflects an extremely high corporate savings rate (estimated by the IMF at 25-30 percent of GDP[21]). The government also records large fiscal surpluses.[22] Household savings are on par with international levels. Meanwhile, domestic investment, at around 20 percent of GDP, remains well below savings. Corporate profits and government savings – including profits from government-linked companies – are often invested overseas. Gross capital formation declined markedly in the early part of the decade – from 33 percent of GDP in 2000 to 16 percent in 2003 – as a result of several factors, including a property market slowdown, the bursting of the IT bubble in 2000-01, and the SARS outbreak of 2003.

Reserves increased by $12 billion in the first half of this year, reaching $129 billion, or about seven months of import cover. Singapore has a large bilateral merchandise trade deficit with the U.S., which reached $2.7 billion over the first half of the year. This was slightly lower than the bilateral trade deficit of $3.0 billion in the first half of 2005.

India

India's economy grew 9.7 percent annualized in the first half of 2006 after 8.5 percent growth in 2005 due to strong activity in the manufacturing and services sectors. Strong domestic demand and increases in fuel prices put upward pressure on wholesale price inflation which was 5.1 percent y/y in June, up from 4.5 percent y/y in December. In response, the Reserve Bank of India (RBI) twice increased its reverse repo policy rate by 25 basis points, in January and June. The RBI characterizes its monetary policy as seeking price stability while ensuring adequate

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[19] MAS manages the exchange rate within an undisclosed band. Its policy options are to (1) change the midpoint of the band to allow for a one-off adjustment, (2) change the band's slope to signal a possible turning point in the monetary policy cycle, or (3) widen the band.

[20] The trade weights in the JP Morgan NEER and REER indexes are based on Singapore's 2000 bilateral trade in manufactured goods.

[21] IMF No. 06/150. Singapore: 2005 Article IV Consultation, May 2006 http://www.imf.org/external/pubs/ft/scr/2006/cr06150.pdf.

[22] The IMF projects, however, that its overall surplus of six percent of GDP in 2005 will fall to four percent in 2006.

credit to productive sectors of the economy to support growth. It targets short-term interest rates and monitors trade-weighted exchange rates over the medium term.

The RBI manages the exchange rate without a pre-announced target or a band. The rupee depreciated by 2.1 percent against the dollar in the first half of 2006, while in real trade-weighted terms the effective exchange rate, as calculated by JP Morgan, depreciated by 3.7 percent. In the first half of 2006, foreign exchange purchases by the Reserve Bank of India totaled $15.6 billion as compared with $10.9 billion in the first half of 2005. India's foreign exchange reserves, on the other hand, increased more strongly, by $25 billion in the first half of 2006, exceeding the $7.2 billion increase in the first half of 2005. Foreign exchange reserves increases reflected interest earnings and exchange rate changes as well as net transactions in foreign exchange.

The current account deficit was $7.6 billion sa (2.0 percent of GDP) in the first half of 2006, wider than the $2.4 billion figure (0.7 percent of GDP) in the first half of 2005. The deficit was driven by strong growth of oil, steel, and machinery imports associated with robust domestic growth. The U.S. bilateral trade deficit with India was $5.7 billion in the first half of 2006, which is $764 million larger than in the first half of 2005. Capital inflows continue to finance the current account deficit. Net foreign direct investment and portfolio inflows were $7.6 billion in the first half of 2006 compared to $7.0 billion in the first half of 2005. Foreign institutional investment inflows in the first half of 2006 continued to support net portfolio inflows of $3.8 billion, while foreign direct investment was also $3.8 billion.

Japan

The current economic recovery, which has become the longest in Japan's post-war history, may finally have allowed Japan to escape from a decade of persistent deflation. Economic growth has accelerated modestly from less than 0.3 percent in the first year of the recovery (2002) to an average of 2.2 percent in the first three quarters of 2006. Growth this year has largely been reliant on net exports and business investment, with private consumption contracting in the most recent quarter and below year-ago levels. Consumer prices (the CPI less fresh food) were rising at a rate of 0.1 percent y/y in October 2006, while other price indices, such as the GDP deflator, continued to fall.

High oil prices have helped contain Japan's trade and current account surpluses. Over the first half of 2006, Japan's trade surplus fell to $33.8 billion compared to $41.4 billion in the same period in 2005 as the value of imports grew by 23 percent, well outpacing export growth (16.1 percent y/y). The U.S. bilateral deficit with Japan, however, widened by $1.4 billion to $43.1 billion in the first half of the year compared with the same period of 2005, despite U.S. shipments to Japan expanding at a faster rate than imports (8.0 percent y/y versus 5.2 percent). As a share of GDP, Japan's current account surplus through the first three quarters of 2006 is running at about the same 3.7 percent level that it did in 2005.

On July 14, the BOJ raised interest rates to 0.25 percent from effectively zero. This marked the start of the first monetary policy tightening cycle in more than 16 years. The lead-up to the BOJ's increase in official interest rates, which began with an exit from quantitative easing in

March, initially contributed to some increased volatility in foreign exchange markets. However, volatility has moderated since mid-year.

Over the January to June 2006 reporting period, the yen strengthened 2.9 percent versus the dollar, closing at ¥114.51 on June 30. Persistent Japanese deflation since 1998, which has only recently dissipated, has led to a substantial depreciation of the yen in real terms. BOJ data indicate that the yen is now at its weakest level in real trade-weighted terms in more than 20 years. The Japanese authorities, however, have not intervened in the foreign exchange market since March 2004 when the yen was around ¥109 per dollar.[23] Gold and foreign exchange reserves totaled $885.6 billion at the end of October 2006, up from $864.9 billion at the end of June and $846.9 billion at end-December 2005.

South Korea

South Korea's economy continues to perform well with real GDP growing at a 4.9 per cent seasonally-adjusted annual rate in the first half of 2006, after posting 4.0 percent growth in 2005. Private forecasters project real GDP growth in the 4½-5 percent range both this year and next. In addition, core consumer price inflation stands below the center of the central bank's target range of about 2.5 -3.5 percent. South Korea's flexible exchange rate regime, under which the won has appreciated steadily since 2003, has contributed significantly to containing inflation. Despite substantial real appreciation of the South Korean won over this period, growth of South Korean exports has remained strong, expanding in excess of 15 percent over the year through the second quarter of 2006.

For the future, the Korean government has set an ambitious reform agenda to enhance productivity and income growth to offset expected declines in the labor force as Korea's population ages. That agenda includes liberalizing the financial sector and increasing its integration into the global financial system and opening the services sector to domestic and foreign competition.

The Bank of Korea tightened monetary policy over the reporting period to limit the risk of overheating and to contain the inflationary impact of high oil prices. The Bank of Korea raised the call money rate target from 3.25 percent to 3.75 percent from October to December 2005, and to 4.5 percent by August 2006. The won appreciated 6.6 percent in nominal terms against the dollar over the first half of 2006 and almost 25 percent from the end of 2003 to the end of June 2006. The magnitude of average daily fluctuations in the won/$ exchange rate is comparable to that of the euro against the dollar. The won has also appreciated in real effective terms, strengthening five percent in the first half of 2006 and 24 percent from its end-2003 level.

Core consumer price inflation remains subdued, rising 2.2 percent y/y in October 2006, below the bottom end of the Bank of Korea's 2.5-3.5 percent target range. Starting in January 2007, the Bank will target headline inflation using the same target band.

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[23] The Japanese Ministry of Finance announces its total foreign exchange intervention at the end of each month, and publishes the dates and amounts of intervention at the end of each quarter. See http://www.mof.go.jp/english/e1c021.htm.

Despite South Korea's strong export performance, the current account surplus declined during the reporting period due to high oil prices and rapid real import growth. The current account surplus fell from $7.4 billion (1.9 percent of GDP) in the second half of 2005, to $0.3 billion (0.1 percent of GDP) in the first half of 2006. Foreign exchange reserves increased $10 billion in the first half of 2006, reaching $224 billion, about equal to South Korea's total foreign debt.

China[24]

In the first half of 2006, China's economic growth accelerated slightly, despite administrative measures taken to slow investment. And, despite the Chinese authorities' stated goal of rebalancing growth towards domestic consumption, output growth continued to rely heavily on investment and net exports. In fact, despite the goal of reducing the country's external surplus, China's global merchandise trade surplus rose to $80 billion, or roughly seven percent of GDP, in the first six months of this year. The Chinese currency, the renminbi (RMB), appreciated by 0.94 percent against the dollar in the first half of 2006. Chinese authorities took several steps to develop the foreign exchange market, and average daily fluctuations of the RMB were twice as large in the first half of 2006 as in the last half of 2005, although the degree of flexibility is still low by comparison to other major currencies. Overall, Chinese authorities continue a cautious, measured approach toward economic reform with a goal of minimizing the risks of instability. Lack of monetary policy autonomy due to limited exchange rate flexibility presents a major obstacle to rebalancing growth and improving the efficiency of financial intermediation.

Unexpectedly high growth numbers in the first half of 2006, despite measures taken to slow investment, prompted authorities to impose additional tightening measures to rein in economic activity. Real GDP growth accelerated from 9.9 percent in 2005 to a seasonally-adjusted annual rate of 10.3 percent in the first quarter of 2006, and 11.3 percent in the second quarter. The acceleration in growth was in part spurred by a goods trade surplus in the first half of this year that was nearly 50 percent larger than in the corresponding period in 2005, despite the revaluation of the RMB in July 2005 and continued modest appreciation through the first half of 2006. Continued strong growth in investment also contributed to the acceleration in growth, with fixed asset investment up 30 percent.

A burgeoning trade account has given rise to an increasingly large current account surplus. In fact, the current account surplus has risen from 1.5 percent of GDP in 2001 to four percent of GDP in 2004 and up to seven percent of GDP in 2005. In the first half of 2006, the current account balance rose further to around eight percent of GDP.

In response to the acceleration of growth in the first half of 2006, the People's Bank of China (PBOC) implemented a series of tightening measures. Required bank reserve ratios were increased twice (by a total of one percentage point) and renminbi-denominated commercial lending rates were raised twice (by 0.54 percent overall). The authorities also imposed

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[24] The latest IMF Article 4 report on China discusses these issues, especially exchange rate issues, in great detail. See http://www.imf.org/external/pubs/ft/scr/2006/cr06394.pdf

administrative measures aimed at dampening investment including re-evaluation of planned projects, restrictions in property markets, and guidance to banks to lend less.[25]

The authorities have begun to liberalize the exchange rate regime and the operation of exchange rate markets. On July 21, 2005, the government ended the RMB's eight-year peg against the dollar, and introduced a new exchange rate regime described as "a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies." The RMB was allowed to fluctuate up to 0.3 percent on either side of a central rate set daily and was initially revalued by 2.1 percent against the dollar.

During the first half of 2006, the authorities took further steps to reform the currency market. In January 2006, authorized banks – including some foreign banks – were allowed to act as market makers for spot trading of foreign exchange. Previously, all trades had been with the State Administration for Foreign Exchange (SAFE), with relatively high fees.[26]

RMB flexibility with respect to the dollar increased significantly in the first half of 2006 relative to the last six months of 2005, although it remains small in comparison with other currencies with flexible exchange rate regimes. Measures of flexibility include average daily movement, maximum one-day movements, and net value changes over a period of time. In terms of average daily movement in the second half of 2005, the RMB fluctuated 0.02 percent around the central parity rate in daily trading. This average daily fluctuation increased to 0.03 percent in the first half of 2006, and further to 0.05 percent since June 2006. In the second half of 2005, the RMB's largest single intra-day fluctuation from the central parity rate was 0.07 percent, while on May16, 2006, the fluctuation reached 0.15 percent. Since June, the most the RMB has diverged from the central parity rate in one day is 0.17 percent on August 14. This is the closest that intra-day fluctuation has come to the bounds of the 0.3 percent fluctuation band. Finally, the RMB gained 0.5 percent against the dollar in the second half of 2005 and gained 1.0 percent against the dollar in the first half of this year. In total, starting with the initial revaluation on July 21, 2005, the RMB has appreciated by 5.88 percent as of December 14, 2006.

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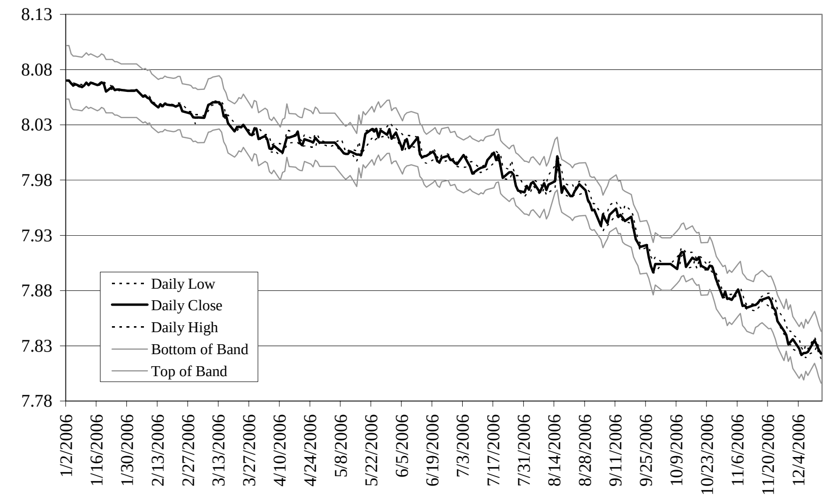
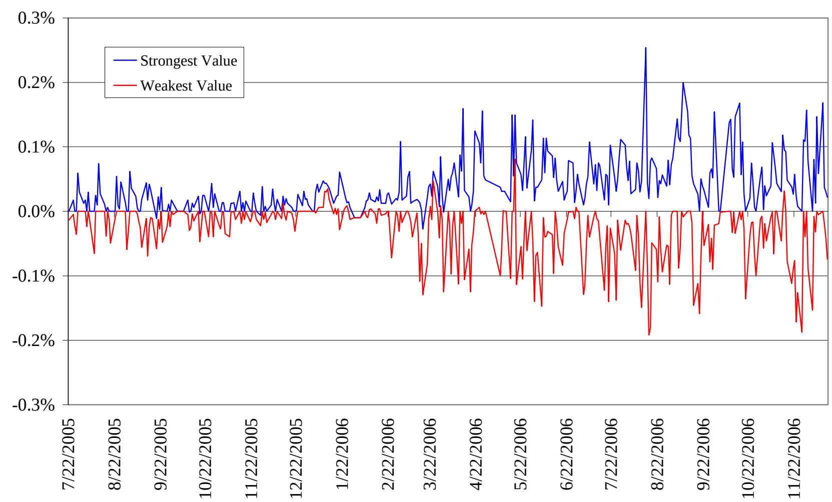
[25] Some banks with overly rapid loan growth were required to purchase $31 billion in below-market rate bonds issued by the PBOC.

[26] An additional innovation in January was that the "central parity rate" would be set each morning before market opening based on a weighted average of the prices that market makers were offering. This allows further scope for daily movement, as the central parity rate can theoretically change by any amount each morning. The 0.3 percent band still applies to movements within a day's trading.

2006: Daily RMB-to-US Dollar



Intra-Day RMB fluctuations from the Daily Reference Rate



Continued strong investment demand for renminbi means that an inflexible RMB faces continued market pressure. In order to maintain the managed float, the central bank intervenes in the foreign exchange market, exchanging RMB for foreign currency and accumulating foreign exchange reserves. In 2005, the average monthly accumulation was $17.4 billion. Reserve accumulation accelerated in the first half of 2006, averaging $20.4 billion monthly. From July to September of 2006, reserve accumulation slowed to an average of $15.6 billion per month. On October 13, 2006, the PBOC announced that its foreign exchange reserves totaled $987.9 billion at the end of September. On November 6, China's state television reported on an evening news program that reserves reached $1 trillion in October. In order to reduce the expansionary impact of reserve accumulation on the money supply, the PBOC "sterilizes" foreign currency purchases by issuing PBOC bonds, through swaps and repurchase agreements, and by periodic increases in the required reserve ratio of banks. In the first half of 2006, PBOC sterilization operations averaged $10.8 billion monthly, about 60 percent of foreign exchange purchases for the period.

China's cautious approach to exchange rate reform continues to exacerbate distortions in the domestic economy and impede adjustment of international imbalances. With capital flows increasingly mobile into and out of the Chinese economy, limited exchange rate flexibility cedes a great deal of control of monetary policy to foreign monetary authorities and international investment sentiment. Use of higher interest rates to slow credit growth and enforce bank lending discipline is also constrained by the effect that higher interest rates have in spurring greater capital inflows. Clamping down on exchange rate fluctuations in the belief that this is prudent has in fact increased pressures in other parts of the economy.

Limited exchange rate flexibility has also become an obstacle to the broader goal of reducing economic imbalances enunciated by China's leaders. Premier Wen's speech before the National People's Congress in March underscored that among the main goals of the 11th Five-Year Plan were rebalancing growth towards domestic consumption and improving investment efficiency. Soon after, PBOC Governor Zhou outlined a five-point plan to address the growing current account surplus, and President Hu reiterated these points during his visit to Washington in April 2006. The plan aims to increase domestic demand, reform social security (to reduce required saving), increase exchange rate flexibility, widen market access for foreign firms, and boost China's imports (through further trade liberalization). Limited exchange rate flexibility impedes the rebalancing of Chinese growth away from exports towards consumption and away from coastal areas towards the interior. Failure to let the exchange rate adjust also impedes the reduction of China's current account surplus and foreign reserve accumulation.

Chinese officials have repeatedly stated that the exchange rate will gradually become more flexible and that there will not be any surprise adjustments. They contend that greater flexibility cannot be achieved overnight and that progress is ongoing. Indeed, Chinese officials continue to enact measures that are preconditions for greater exchange rate flexibility, including steps to liberalize the capital account, reform the financial sector, enhance the foreign exchange market, and develop new financial products.

In the first half of 2006, China continued with modest capital account liberalization, including in the pilot programs that allow Chinese investors to make portfolio investments overseas and foreign investors to make portfolio investments in China. From April to November 2006, the China Banking Regulatory Commission (CBRC) granted one asset management company and 15 banks – including foreign banks – a total of $13.1 billion in quotas to provide overseas investment services for Chinese residents, as part of the Qualified Domestic Institutional Investors (QDII) program to allow pooling of RMB funds to be invested overseas. However, only a small proportion of the allotted QDII quota has been used to date. In August 2006, the China Securities Regulatory Commission (CSRC) expanded the number of institutions qualified to invest in local shares as Qualified Foreign Institutional Investors (QFII) by reducing the minimum size for institutions and shortening the required holding period for investments. Also in April 2006, foreign exchange regulations were liberalized to allow Chinese firms and residents to buy more foreign assets. Individuals can now convert up to $20,000 worth of RMB to take out of China.

China has taken steps to improve its financial sector to be able to adapt to currency and interest rate fluctuations. Since the beginning of 2004, China has promoted foreign investment in its banking system by selling more than $20 billion worth of strategic stakes to foreign bankers, securities firms, and institutional investors. Further, institutional investors have bought $30 billion worth of stakes in four of China's five largest banks through public listings in Hong Kong. The higher disclosure requirements of listing in Hong Kong and the presence of foreign investors will likely increase market pressure for the banks to improve their risk management capabilities and corporate governance systems.

China has expanded the availability of financial instruments for managing and hedging foreign exchange and other financial risk. The foreign currency market maker system introduced in January allows for deeper spot market trading and increased transactions between banks. In March, the Chicago Mercantile Exchange (CME) announced its plan to allow Chinese financial institutions to electronically trade CME foreign exchange and interest rate products through the China Foreign Exchange Trading System platform[27], pending regulatory approval by the CFTC. In August, the CME also began selling RMB futures contracts on its U.S. platform. In April 2006, 54 foreign and domestic banks operating in China were authorized to trade foreign exchange swaps. In September, the China Financial Futures Exchange was established in Shanghai, which will start by launching mainland stock futures. However, foreign currency hedging opportunities were restricted when the authorities banned onshore banks from trading in offshore non-deliverable forwards.

The Department of the Treasury engages intensively with Chinese economic policy makers on economic issues of both bilateral and global importance. China' exchange rate policy, its effect on Chinese domestic and external imbalances, and China's financial sector are particular focal points of that engagement. Recognizing that resolving imbalances in China requires reform across many economic sectors, Treasury convenes the Joint Economic Commission with the Chinese government as well as a Financial Sector Working Group to promote mutual understanding and guidance.

Additionally, Secretary Paulson was appointed by President Bush to be the U.S. co-chair of the newly formed Strategic Economic Dialogue (SED) with China's top economic leaders, a forum for addressing critical economic issues and planning for long-term cooperation. The first SED was held in Beijing on December 14 and 15. It was agreed that discussions will be conducted on development of efficient innovative service sectors and on ways to improve health care. A bilateral investment dialogue will be launched with exploratory discussions to consider the possibility of a bilateral investment agreement, enhancing cooperation on transparency issues, and launching a joint economic study on energy and environment. The two countries are committed to invigorating ongoing work within the U.S.-China Joint Commission on Commerce and Trade on high-tech trade, intellectual property rights, and market economy status/structural issues. Utilizing other existing mechanisms, both sides agreed to increase bilateral cooperation on more efficient and environmentally sustainable energy use, facilitation of personal and business travel, development assistance, and multilateral development bank lending. Finally, both sides agreed that NYSE and NASDAQ should open offices in China, that China will participate in the government steering committee of the FutureGen project, and that the United States will support China's membership in the Inter-American Development Bank. Both sides

[27]This interbank foreign exchange trading platform is a government owned, but technically independent arm of SAFE, which is controlled by the PBOC.

concluded an agreement on facilitating financing to support U.S. exports to China and agreed to re-launch bilateral air services negotiations.

China's currency policy is a core issue in the China-United States economic relationship. More flexibility in China's exchange rate will help it achieve more balanced economic growth, enhance the effectiveness of monetary policy, safeguard the health of the financial sector and promote over time an orderly reduction of external imbalances.

Taiwan

Taiwan has experienced sluggish domestic demand growth and low or negative inflation rates since a sharp decline in fixed investment spending led to recession in 2001. Strong export growth has allowed Taiwan to achieve annual real GDP growth rates between 3-6 percent since the recession ended, but at the cost of increased dependence on external demand.

That pattern persisted in the first half of this year, as slowing exports and continued weak domestic demand brought a sharp deceleration in economic growth, from 7.8 percent (saar) in the second half of 2005 to just 1.5 percent in the first half of 2006. Net exports, which accounted for more than half of all growth since the 2001 recession ended, contributed just 0.3 percentage points in the first half of this year. Inflation remained very low, and negative by some measures, during the January-June reporting period. Consumer prices excluding food and energy rose 0.3 percent year-on-year in June and 0.2 percent through September (according to the most recent available data), while the GDP deflator declined 1.2 percent year-on-year in the second quarter.

Taiwan's current account surplus narrowed slightly to $10.3 billion (5.8 percent of GDP) in the first half of 2006, down from $10.7 billion (6.2 percent of GDP) in the second half of 2005, as a declining trade surplus outweighed growth in the income surplus and a declining services deficit. Net financial outflows from Taiwan totaled $11.9 billion during the first half of 2006, up from a $9.4 billion net financial outflow during the second half of 2005. The main component of net financial outflows during the first half of 2006 was $14.0 billion in net portfolio outflows, as Taiwanese residents increased their purchases of foreign assets and foreign portfolio inflows slowed.

Recent net financial outflows have roughly offset Taiwan's current account surplus, reducing pressure on Taiwan's managed floating exchange rate regime. As a result, net accumulation of foreign exchange reserves, which averaged nearly $29 billion a year from 2001 to 2005 and totaled $19 billion the first half of 2005, slowed to $1.1 billion in the second half of 2005 and $2.7 billion in the first half of 2006. Taiwan's reserves totaled $260.4 billion in June 2006, rising to $261.6 billion in September.

The Taiwan dollar (NT$) remained within the 31-35/US$ trading range in which it has fluctuated for the past five years. After ending 2005 at 33.29/US$, the NT$ appreciated 2.6 percent to 32.44/US$ at end-June, but has since depreciated by 2.3 percent to 33.22/US$ as of October 30, 2006.

Malaysia

Malaysia has begun to edge toward a more flexible exchange rate regime, allowing a modest appreciation of the ringgit against the dollar this year and permitting increased volatility in day-to-day currency movements, after abandoning its fixed U.S. dollar peg in July 2005. However, Malaysia's large and growing current account surplus still suggests that macroeconomic imbalances in the economy need to be addressed.

Malaysia, a net oil exporter, has had current account surpluses in excess of eight percent of GDP since the late 1990s, even before the run-up in oil prices began. Higher oil prices helped push the surplus up to $20.0 billion, or 15.2 percent of GDP, in 2005, and to an annualized $21.0 billion, or 14.4 percent of GDP in the first half of 2006. Malaysia's non-oil current account surplus has been growing, at least through last year. The current account surplus excluding mineral fuel exports came to 1.8 percent of GDP for the first three quarters of 2005 (according to the most recent available data), up from 0.4 percent of GDP in 2004.

The swing in Malaysia's current account surplus from large deficits in the mid-1990s to large surpluses since 1998 reflects a dramatic decline in private investment since the 1997-98 Asia crisis. Private sector fixed investment fell from more than 31 percent of GDP in 1996-97, to 7.6 percent of GDP by 2003 and has only recently begun to recover, to 8.8 percent of GDP in 2005. The reasons for the sustained weakness in Malaysian private investment, which fell more sharply and rebounded more weakly than in other crisis-hit Asian countries, are not well understood. As explanations for the sluggish recovery of private investment, some analysts cite weak Malaysian corporate sector profitability, due in part to excess investment during the pre-crisis period, and financial market imperfections that limit external financing for smaller firms. Those factors may be fading in importance, as Malaysian investment spending has shown signs of recovery over the past 2½ years.

Malaysia has recorded solid economic growth and low-to-moderate inflation over the past several years despite weak investment spending. Real GDP grew 5.2 percent in 2005, led by consumption and external demand. Growth accelerated to 6.8 percent (saar) in the first half of 2006, on stronger public and private fixed investment. (Malaysia's quarterly national accounts data do not break out public and private investment.) Higher fuel, transport and food prices pushed overall consumer price inflation steadily higher over the course of 2005 and into 2006. CPI inflation peaked in March 2006 at 4.8 percent y/y, its highest level since 1998, before subsiding to 3.3 percent y/y in August.

After abandoning its fixed exchange rate of 3.8/$ in July 2005 and revaluing to 3.75/$, the ringgit gradually weakened over the remainder of 2005 and ended the year at 3.779/$, a net appreciation of only 0.6 percent. The ringgit moved over a wider range in the first half of 2006, appreciating 5.7 percent to 3.575/$ by May 17. The general sell-off of emerging market assets in May and June led the ringgit to weaken to 3.639/$ at the end of June, for a gain of 2.7 percent in the first half. The ringgit had been relatively stable since the end of June until recent increases in the growth outlook pushed the ringgit up almost three percent in the first week of December. Average daily ringgit fluctuations against the dollar have also risen this year, to 0.17 percent through September compared to 0.05 percent for the second half of last year. Nevertheless, daily volatility of the ringgit remains below that of the South Korean won and well below that of such major international currencies as the euro.

Malaysian authorities' exchange rate policy has been to "lean against the wind" – intervening to strengthen the currency when it was depreciating, as in the last half of 2005, and accumulating foreign reserves when the currency was appreciating. Malaysia's authorities intervened heavily in the first half of the year in response to upward pressure on the currency. However, this policy was relaxed in early December, and the ringgit was allowed to appreciate at a faster pace at a time when there was broad appreciation of Asian currencies against the dollar. Foreign exchange reserves, which had declined by nearly $10 billion in the fourth quarter as the central bank intervened to offset large capital outflows and to limit ringgit depreciation, rose by more than $8 billion in the first half of 2006, to $78.7 billion (60 percent of 2005 GDP) at the end of June. Attempts to contain upward pressure on the currency may have constrained the central bank's monetary policy. The central bank did raise overnight interest rates modestly from 2.7 percent to 3.5 percent in three steps starting in December.

Malaysia has gradually relaxed most of the controls on capital flows imposed when the ringgit was pegged in 1998. Remaining controls include: offshore trading of the ringgit remains prohibited; limits on foreign portfolio investment by residents are still in place; and restrictions on local or foreign currency-denominated credit extended from residents to non-residents or vice versa.