DEPARTMENT OF THE TREASURY

INTERIM REPORT TO THE CONGRESS

ON

INTERNATIONAL ECONOMIC AND

EXCHANGE RATE POLICY

AUGUST 1996

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I. Summary and Conclusions

This interim report reviews developments in U.S. international economic policy, including exchange rate policy, during the period from October 1, 1995 through March 31, 1996. This report, which is an update of the annual report submitted in December 1995, is required under Section 3005 of the Omnibus Trade and Competitiveness Act ("the Act") of 1988.

The dollar appreciated against the currencies of many of our major trading partners, continuing the trend that began in May 1995. By early 1996, it had essentially returned to its levels of late 1994 on a broad trade-weighted basis.

The world economic expansion continued at a moderate pace during the period covered by the report, and the outlook for 1996 is positive for most regions. Signs of recovery are showing in Japan; the United States, Canada and United Kingdom should sustain recent trends; growth in Latin America has picked up, led by renewed expansion in Mexico and Argentina; and the emerging market economies of Asia should continue their strong expansion. Continental Europe has experienced a slowdown, but may now anticipate a moderate recovery beginning in the second half of 1996. Inflation remains subdued throughout the G-7. The consensus forecast of private economists sees a further reduction of the current account imbalances of the United States and Japan. Current accounts in other key industrial countries are expected to remain moderate.

The Report presents an updated assessment of whether countries have manipulated exchange rates between their currencies and the dollar to prevent balance of payments adjustment or gain an unfair competitive advantage in international trade. This assessment concludes that none of our major trading partners is manipulating its exchange rate to maintain an unfair competitive advantage or prevent balance of payments adjustment as defined in the Omnibus Trade and Competitiveness Act.

The U.S. Treasury continues to monitor exchange rate policies and capital account regimes of major U.S. emerging market trading partners, and will continue to encourage countries to avoid recourse to exchange rate manipulation or capital controls to prevent balance of payments adjustment or gain unfair competitive advantage in international trade.

II. Developments in the World Economy

The expansion continued in 1995, but most industrial country trading partners saw slowdowns at some point during the year. Expansion is continuing in 1996. Inflation continues to be muted in most countries.

Among industrial countries, aggregate real GDP growth in 1995 moderated, particularly in western Europe. (The industrialized countries of western Europe, Japan and Canada remain our major trading partners, accounting for approximately 23 percent, 11 percent and 22 percent, respectively, of our exports in 1995.) For the G-7 countries as a whole, real GDP growth was 1.9 percent in 1995, after reaching 2.8 percent in 1994[1].

Underlying conditions remain solid. Aggregate GDP growth in the G-7 is expected to remain at approximately 2 percent in 1996, with stronger growth in Japan and an improved showing in Europe during the second half of the year. Inflationary pressures remain subdued, and a number of countries have embarked on fiscal consolidation programs which should strengthen the basis for sustained growth in the future.

- In Japan there were some encouraging signs of a revival of growth toward the end of 1995 and in early 1996, which markets expect to be sustained during the remainder of the year and in 1997. (Unless otherwise noted, market forecasts refer to a survey of private economists by Consensus Economics.)

- European growth slowed noticeably in the second half of 1995, first in Germany and France and later elsewhere. However, most analysts expect growth to pick up in the second half of this year as the effect of interest rate cuts takes hold. In Germany, a strong exchange rate, high wage settlements and other factors reduced investment and export growth. A decline in consumer confidence further weakened demand. Softer export performance and low levels of business and consumer confidence, aggravated by unemployment levels of nearly 12 percent, contributed to slower growth in France. Growth in the UK slowed to a rate of 2.5 percent in 1995, but the economy remains one of the strongest in Europe. Strong export performance contributed to growth in Italy in 1995, but inflation levels remain high.

- Real GDP growth slowed in Canada in 1995 due to a weakening of the export sector and sluggish domestic demand. Financial markets responded well to the referendum decision against Quebec separation. Private economists expect growth to pick up in 1996.

- Inflation in the G-7 in 1995 averaged only 2.3 percent and was below 3 percent for all

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[1] Figures for this section were obtained from the April 1996 edition of the International Monetary Fund's World Economic Outlook and from Treasury estimates.

countries but Italy and the UK[2]. Japan experienced a decline in consumer prices.

Growth and inflation results in emerging market economies were mixed.

Growth in emerging markets has averaged several percentage points higher than that in the industrial countries in recent years. This continued in 1995, despite a sharp decline in Mexico and a related slowdown elsewhere in Latin America. Among the emerging markets, Mexico accounts for 8 percent of U.S. exports, the rest of Latin America 9 percent, four newly industrialized economies of Asia (Korea, Taiwan, Hong Kong and Singapore) 13 percent, and China 2 percent.

- Growth in all but three (Hong Kong, Singapore, and Taiwan) of the nine East Asia dynamic economies accelerated last year. Four recorded growth rates above or near 9.0 percent (South Korea, Singapore, Malaysia and Thailand), and China recorded growth in excess of 10 percent. In 1996, growth in the region is expected to slow slightly due to the tightening of monetary policy in many countries.

- The growth rate in Latin America declined sharply to 0.9 percent in 1995 from 4.7 percent in 1994. However, this conceals a wide range of outcomes, with declines in real GDP of nearly 7 percent in Mexico and 4.4 percent in Argentina, very low growth in Venezuela, but solid growth in Brazil, Chile, and Peru. Prospects for 1996 are brighter in a number of respects. In Mexico and Argentina, the economy has begun to recover; the Mexican government is forecasting 3 percent GDP growth in 1996. In Latin America outside Mexico, GDP growth is expected to recover to an annual rate of approximately 3 percent in 1996.

- Inflation in the regions of Latin America and Asia in 1995 remained higher on average than in the G-7. However, many Latin American countries made substantial progress toward lower inflation. While some Asian economies experienced increased inflationary pressures, tightened monetary policy in many countries is expected to reduce inflation in the region in 1996.

III. <u>Developments in World Currency Markets</u>

The period from October 1, 1995 to March 31, 1996 was highlighted by a significant further appreciation of the dollar and by a reduction in the level of exchange market volatility.

The dollar experienced a broad-based appreciation during the period covered by the report. On a real trade-weighted measure the U.S. currency rose approximately 2.4 percent due to real gains

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[2]UK inflation as measured by the Retail Price Index (RPI). The RPIX measure of inflation, which excludes mortgage interest and is used by the IMF, showed a 2.8% rise in 1995.

against the yen, Canadian dollar and low-inflation European countries.[3] On a bilateral basis, the dollar appreciated 7.5 percent versus the yen and 3.4 percent against the DM. Implied volatilities from options prices fell by nearly half from a peak of 18.25 percent in the $/Yen rate and 18.05 percent in the $/DM rate in April 1995 to 9.65 percent ($/Yen) and 9.35 percent ($/DM) at the end of March.

Market participants cited several fundamental factors as contributing to the dollar's strong performance relative to that of the European currencies and yen during the reporting period.

- Increased confidence in U.S. economic performance and recognition of strong fundamentals including low inflation, continued growth, and fiscal consolidation.

- A substantial decline in Japan's current account surplus and expectations of further reductions in 1996 and 1997. Also, the more modest decline in the U.S. current account deficit after the second quarter of 1995, and expectations of further improvements in 1996 and 1997.

- Accommodative monetary policy in Japan, which contributed to the yen's decline. At times, the yen was also weakened by concerns about the health of the Japanese financial system.

- Expectations of higher growth rates in the United States relative to those in Europe, which tended to support the dollar. Weakening economic conditions in Europe, and particularly in Germany, which led to expectations of interest rate cuts.

    - The German Bundesbank and other European central banks cut rates substantially in December and January.

    - Data released in late winter showing a contraction in fourth quarter German GDP indicated that economy was weaker than previously believed, and central bank officials openly supported a strengthening of the dollar against the mark. While the Bundesbank did not cut rates further during this period, rates in other European countries continued to decline.

    - Interest rate differentials widened in the dollar's favor, as stronger than anticipated growth in employment and a rebound in cyclical indicators caused Treasury yields to rise.

- Bouts of uncertainty during the period concerning the prospects for European Economic

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[3] In this report, we use JP Morgan's April real trade-weighted indices based on trade among 45 major currencies for analysis of real broad trade-weighted exchange rate movements. The indices are deflated by wholesale price indices for finished manufactured goods.

and Monetary Union (EMU), which tended to strengthen the DM against most other European currencies and the dollar.

Performance of currencies of emerging market trading partners

The performance of Latin American currencies during the period was mixed.

- The Mexican peso depreciated by less than 1 percent on a real trade-weighted basis during the period; however, it experienced significant intra-period volatility. During the fourth quarter of 1995, the peso fell by roughly 10 percent on a real basis. Mexico's tight monetary policy and its over-performance on 1995 fiscal targets, combined with its access to private capital and further disbursements under its IMF stand-by agreement, allowed the peso to rebound during the first quarter of 1996. In real terms, the peso appreciated by over 10.5 percent between January and March 1996, putting its real rate 24 percent below its November 1994 level. Against the dollar, the peso depreciated in real terms by 3.6 percent during the period covered by the report.

- On a real, trade-weighted basis, the currencies of Argentina and Chile remained virtually unchanged. Against the dollar, Argentina's currency, which is pegged to the dollar, experienced a slight real depreciation, while Chile's currency depreciated over 4 percent in nominal terms and approximately 3 percent in real terms.

- Brazil's currency depreciated by less than 1 percent on a real trade-weighted basis. Versus the dollar it depreciated roughly 3.5 percent in nominal terms and appreciated slightly in real terms.

- Colombia's managed float resulted in an appreciation of its real trade-weighted peso by approximately 2.2 percent. Against the dollar, the Colombian currency depreciated over 8 percent in nominal terms, but experienced a very small appreciation in real terms.

- Venezuela's currency depreciated by approximately 11.5 percent on a real trade-weighted basis. The official rate, which is pegged to the U.S. dollar, was devalued by 41 percent on December 11, 1995. Over the period, the currency experienced a roughly 70 percent depreciation in nominal terms against the dollar; in real terms the depreciation was just under 20 percent. (In April, the government freed the exchange rate and eliminated capital and price controls. Following the announcement, the key official rate depreciated 40% but subsequently appreciated slightly and stabilized. On July 8, the government instituted a band around a central parity that will be adjusted for anticipated inflation.)

In Asia, most currencies appreciated on a real trade-weighted basis.

- Thailand's currency appreciated by around 4.5 percent on a real trade-weighted basis during the period covered by the report. Against the dollar, it depreciated by less than 1

percent in nominal terms but appreciated very slightly in real terms.

- Singapore's currency appreciated by over 4 percent in real trade-weighted terms. Against the dollar, it appreciated on both a nominal and real basis by approximately 2 percent and 1 percent, respectively.

- The Chinese yuan experienced a negligible nominal depreciation and a slight real appreciation against the dollar. On a real trade-weighted basis, the Hong Kong dollar appreciated approximately 4 percent.

- The Korean won remained little changed over the period, appreciating less than 1 percent on a real trade-weighted basis, and depreciating slightly against the dollar in both real and nominal terms.

- The New Taiwan dollar experienced a 2.8 percent appreciation in real trade-weighted terms; against the dollar, it depreciated very modestly in both real and nominal terms.

IV. Exchange Rate Policy and Operations

The U.S. monetary authorities did not operate in the foreign exchange markets during the period from October 1, 1995 through March 29, 1996.

Throughout the period, U.S. Treasury Secretary Rubin reiterated that "a strong dollar is in the interest of the United States." A strong dollar improves confidence in U.S. assets and thus contributes to lower interest rates and reduced capital costs to U.S. business, expanding investment in the U.S. economy. A strong dollar also contributes to sustaining the economic expansion by holding down inflation and to raising real wages and living standards of Americans.

The communique issued by the G-7 finance ministers and central bank governors after their October meeting stated that the G-7 "welcomed the orderly reversal in the movements of the major currencies that began following our April meeting. We would welcome a continuation of these trends consistent with underlying economic fundamentals. We reaffirmed our commitment to reduce imbalances and cooperate closely in exchange markets."

Following the January meeting of G-7 finance ministers and central bank governors, Deputy Secretary Summers stated that the ministers and governors "welcomed developments since their last meeting. And there was a general feeling that the situation had improved significantly since last Spring and a general sense of satisfaction that G-7 cooperation had been effective. They reaffirmed their previous commitment to reduce imbalances and to cooperate closely in the exchange markets."

After the April G-7 meeting of finance ministers and central bank governors, Secretary Rubin stated that: "The ministers and governors welcomed developments in the exchange markets since

our last meeting and, more broadly, since a year ago. We also reaffirmed our standing commitment to reduce imbalances and cooperate closely in exchange markets. We also took satisfaction from the ongoing adjustment in external imbalances, and underlying conditions should favor further adjustment."

V. U.S. Trade and Current Account: Developments and Outlook

There are a number of reasons for optimism that our underlying external position has improved significantly.

The U.S. current account deficit peaked in the second quarter of 1995 and then began to decline. For 1995 as a whole, the deficit was $148.2 billion, little changed from $148.4 billion for 1994 but smaller as a share of GDP. A number of developments suggest a solid improvement in the underlying current account deficit.

- The U.S. trade deficit is now well below 1994 and first half 1995 levels. There has been volatility -- the deficit fell sharply in the fourth quarter and then rebounded a bit in early 1996 -- but for the September - March period as a whole the trade deficit was down 21 percent from the previous six months. The November and December goods and services deficits were $6.84 billion and $6.96 billion, respectively, the first monthly deficits below $7 billion since March of 1994.

- A weak recovery in Japan and slow growth in the second half of the year in Continental Europe held back exports, while adjustment in Mexico also delayed a turnaround in the current account deficit in 1995. These factors should weigh less heavily on our external position this year, allowing a strengthening underlying trend to emerge.

- On the other hand, a delay in disbursements on some international grants that usually are paid out at the start of the fiscal year reduced the fourth-quarter and full-year current account deficits. There could be a corresponding transitory upward tick in the 1996 deficit.

There are strong underlying forces supporting further declines in the current account deficit:

- The United States remains highly competitive in world markets, as export growth has remained strong despite weakness in some major export markets, notably Mexico. Growth of export earnings exceeded 14 percent in 1995, buoyed by continued strong U.S. price and cost competitiveness. Import payments rose 12 percent, but peaked in the second quarter.

- Prospects are good for continued recovery in Japan, improvement in Mexico, and sustained strength in East Asia and Canada; the only question mark is in Europe.

- The outlook of private market economists is for sustained progress in reducing the U.S. budget deficit, a fundamental determinant of U.S. national saving performance and consequently of the current account deficit.

VI. Issues in Key Trading Partners' Exchange Regimes and External Balances

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

For this purpose, Treasury has undertaken a broad review of five factors which are helpful in forming an analytical framework for the determination of manipulation. These factors are developments in exchange rates, external balances, foreign exchange reserve accumulation, macroeconomic trends, and exchange restrictions.

Based on its review, Treasury has determined that none of our major trading partners has manipulated its exchange rate under the terms of Section 3004 during the period examined. However, as in previous reports, we note that some emerging markets still maintain significant capital controls. The U.S. Treasury will continue to encourage such countries to liberalize these controls. In addition, a number of high growth emerging market economies continue to face the challenge of controlling inflation. Many of these countries are concerned about the macroeconomic effects of large capital inflows. Where appropriate, these countries should be encouraged to provide for greater flexibility in the exchange rate regime as part of the adjustment process.

1. External positions

Three Asian developing economies, China, Taiwan and Singapore, have both a global current account surplus and a bilateral trade surplus with the United States.

Persistent overall current account surpluses might, but do not necessarily, indicate an attempt to prevent effective external adjustment through exchange rate policy, as well as saving in excess of domestic investment. However, only a few of our trading partners have both a material current account surplus and significant bilateral trade surplus with the United States.

- Taiwan's global current account surplus fell to $5 billion (1.9 percent of GDP) last year from $6.2 billion in 1994 and $6.7 billion in 1993. Taiwan's bilateral trade surplus with the

United States remained unchanged in 1995, at $9.7 billion.

- Singapore's current account surplus reached $14.7 billion (18.3 percent of GDP) in 1995. Its bilateral surplus in trade with the United States was only a small fraction of this, at $3.2 billion in 1995.

- China's current account surplus in 1995 increased to $15.4 billion, 2.3 percent of GDP. Its bilateral trade surplus with the United States increased to $33.8 billion from approximately $30 billion the year before, according to official U.S. data.

It is important to note that U.S. exports to many emerging Asian economies are growing rapidly. U.S. exports to developing Asia grew 26 percent in 1995, while U.S. imports from the region grew only 15.7 percent.

- U.S. nominal exports to China jumped 27 percent, far surpassing the 17 percent pace of growth of U.S. imports from China. Exports to Taiwan rose 13 percent, outpacing the 8 percent growth of U.S. imports from Taiwan.

2. Exchange restrictions and capital controls

The trend in Asia toward liberalization of exchange restrictions has continued.

Restrictive exchange regimes and capital controls can be a concern in situations where they are designed to maintain an undervalued exchange rate or otherwise delay reduction in an external surplus. In general, foreign exchange restrictions continue to be eased across the region, with the exception of a modest shift in one country.

- Taiwan took some steps toward easing capital controls. The government decided in late December to remove restrictions on the repatriation of investment principal and profits, including capital gains and dividends, and on portfolio investment. In addition, the ceiling on investments by foreign institutional investors was doubled to $400 million. In March, the ceiling on total foreign equity in a company listed on the Taiwan Stock Exchange was raised from 15 percent to 20 percent. Furthermore, the ceiling on total yearly remittances by corporations, without the approval of the central bank, was raised from $10 million to $20 million, for both inward and outward remittances.

- Korea has been easing capital controls over the past several years. It is liberalizing restrictions on capital outflows first, followed by long-term capital inflows and finally short-term capital inflows. By the end of 1996, Korea will abolish its daily trading band for the won, following periodic steps to widen the band over the past few years.

- China marginally eased foreign exchange restrictions. China is now conducting an experiment in four major provinces wherein foreign funded enterprises (FFEs) can obtain

foreign exchange directly from designated Chinese banks for all approved foreign exchange transactions. Previously, FFEs were not permitted to obtain foreign exchange directly from Chinese banks, but were instead relegated to foreign-only "swap centers."

- Thailand is the only emerging economy in the Asia/Pacific region that tightened its capital controls over the past six months, as modest controls were imposed in part for prudential reasons related to banks' foreign liabilities but also to slow a strong surge of short term capital inflows and therefore temporarily relieve upward pressure on the baht. However, Thailand displayed a willingness to adopt some flexibility in its exchange rate policy, allowing the currency to deviate significantly from its real rate peg for the first time in nearly ten years.

3. Movements in exchange rates

Most Asian emerging market currencies experienced a real trade-weighted appreciation during the reporting period.

Large depreciation in exchange rates, if induced artificially rather than by market forces responding to fundamentals, could suggest evidence of an attempt to gain competitive advantage in trade. Manipulation could also be reflected in the absence of a significant appreciation when such a move is justified by underlying fundamentals. However, equilibrium real exchange rates may change over time, especially for a rapidly developing economy, and are therefore difficult to define.

On balance, the movements in the exchange rates of our developing country trading partners do not provide evidence of exchange rate manipulation to gain unfair competitive advantage in trade. Among the emerging economies of East Asia, most experienced appreciation of their currencies in real trade-weighted terms during the period covered by this report.

- Singapore's currency climbed approximately 4.3 percent on a real trade-weighted basis, while those of Hong Kong and Indonesia appreciated by around 4 percent. Korea's currency climbed nearly 1 percent, while the value of the Philippines' currency remained virtually unchanged.

- The real trade weighted value of the Thai baht climbed around 4.5 percent in the six month period ended March 31, raising the real trade-weighted value of the baht to its highest level since February 1986.

- The Indian rupee recorded a small trade-weighted real appreciation of less than 1 percent, rebounding strongly in March after a depreciation of nearly 5 percent from September to October of 1995. This depreciation resulted from a drop in net capital inflows as changes in the domestic political climate caused investors to reconsider their pace of investment.

The authorities intervened in the market, spending billions in reserves, to slow and smooth the depreciation.

4. Movements in Reserves

Changes in the reserve position of emerging Asian economies varied.

Significant and persistent accumulation of foreign exchange reserves could be a source of concern if it reflects efforts to maintain an excessively competitive exchange rate designed to promote trade and current account surpluses.

India, Malaysia, Taiwan and the Philippines experienced declining levels of international reserves during the reporting period. Five of the other key emerging Asian economies continued to record significant reserve accumulation. However, this accumulation was often accompanied by real appreciation of the currency, or did not cause the level of reserves to become excessive.

- For Indonesia and South Korea, international reserves remained below five months of imports.
- For Thailand, reserve accumulation was accompanied by a substantial current account deficit (estimated at $13.5 billion or 8.1 percent of GDP last year) and significant real appreciation of the currency.
- Both Singapore and China accumulated significant amounts of reserves in the period covered by the report.
    - Despite its extremely large global current account surplus, however, Singapore's bilateral trade surplus with the United States remains relatively modest. In addition, the authorities took some steps to slow reserve accumulation by allowing the currency to appreciate. The Singapore dollar rose 1.5 percent against the U.S. dollar over the same period even as the dollar climbed nearly 8 percent against the yen.
    - China allowed its currency to continue to appreciate in real trade weighted terms during this period. An in-depth examination of the Chinese situation follows.

China: Detailed Assessment

We continue to monitor closely China's situation with particular attention to its bilateral trade balance with the United States. We do not find that China is manipulating its exchange rate as described in the Act. Furthermore, we are encouraged by several positive signs with regard to future trends. China's trade position appears to be adjusting. And several factors, including a real

appreciation of the yuan and an increase in domestic demand, should contribute to external adjustment this year.

China's export growth appears to be slowing while import growth remains strong.

The surge in Chinese global exports during 1994 continued for part of 1995. China's aggregate trade surplus totaled $17.3 billion in 1995, up from $7.3 billion in 1994, while the bilateral surplus increased to $33.8 billion from approximately $30 billion the year before[4].

However, while China's export growth was high at the beginning of the year, the growth rate slowed each month.

- In comparison with the same quarter in 1994, exports grew 62 percent in the first quarter of 1995, 32.6 percent in the second quarter, 20 percent in the third quarter, and just 0.3 percent in the fourth quarter.
- Exports to the United States followed this declining trend, with the growth rate falling (on a cumulative basis) from 25.9 percent in the first quarter, to 22.9 percent in the second, 19.4 percent in the third, and 17.5 percent in the fourth quarter, or 17 percent for the year as a whole.
- In the first quarter of 1996, China actually recorded an overall trade deficit of $1.15 billion (although a surplus is expected for the year as a whole).
- Moreover, U.S. exports to China grew by 26.5 percent in 1995.

China's trade balance prospects:

Several factors should contribute to a reduction in China's overall trade surplus this year. These factors include:

- Effective appreciation of the yuan. China's high inflation rate relative to major trading partners has resulted in significant appreciation of the yuan in real effective terms. China's real effective exchange rate appreciated by 13 percent in January-September 1995 -- decreasing China's export competitiveness.
- Resurgent domestic demand. China has apparently succeeded in achieving a temporary soft landing -- cooling the economy and lowering inflation without damaging growth prospects. Domestic demand growth is expected to pick up again this year, and imports are likely to rise as a result.

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[4]Historically, China's trade data differ considerably from those of its major trading partners, and these numbers should be seen as indicators of broad movements only. Consequently, in this Report, we use Chinese data for aggregate trade only where no other statistics are available. U.S. data are used for bilateral trade statistics.

- Reduction of export incentives (the VAT rebate for exports). The initial reduction of the VAT rebate from 17 percent to 14 percent effective July 1, 1995, contributed to an export surge in the first half of the year as exporters rushed to finish transactions before the rebate was lowered. Further reductions in the rebate level are not expected to have this effect.

- China is moving to lower tariffs on some 4,000 items as part of its effort to liberalize its economy and to enter the WTO. This should reduce import prices and could contribute to higher import consumption.

The United States' bilateral trade balance with China for 1996 is more difficult to predict insofar as it depends partly on large scale purchases such as aircraft deliveries. However, in line with the overall decline expected in China's external balances in 1996, the U.S. deficit with China should grow more slowly than in 1995.

APPENDIX

OMNIBUS TRADE AND COMPETITIVENESS ACT OF 1988 (H.R. 3)

SEC. 3004. INTERNATIONAL NEGOTIATIONS ON EXCHANGE RATE AND ECONOMIC POLICIES.

(a) Multilateral Negotiations.--The President shall seek to confer and negotiate with other countries--

(1) to achieve--

(A) better coordination of macroeconomic policies of the major industrialized nations; and

(B) more appropriate and sustainable levels of trade and current account balances, and exchange rates of the dollar and other currencies consistent with such balances; and

(2) to develop a program for improving existing mechanisms for coordination and improving the functioning of the exchange rate system to provide for long-term exchange rate stability consistent with more appropriate and sustainable current account balances.

(b) Bilateral Negotiations.--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. If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses; and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payments adjustments and to eliminate the unfair advantage. The Secretary shall not be required to initiate negotiations in cases where such negotiations would have a serious detrimental impact on vital national economic and security interests; in such cases, the Secretary shall inform the chairman and the ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and of the Committee on Banking, Finance and Urban Affairs of Representatives of his determination.

SEC. 3005. REPORTING REQUIREMENTS.

(a). Reports Required.—In furtherance of the purpose of this title, the Secretary, after consultation with the Chairman of the Board, shall submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, on or before October 15 of each year, a written report on international economic policy, including exchange rate policy. The Secretary shall provide a written update of developments six months after the initial report. In addition, the Secretary shall appear, if requested, before both committees to provide testimony on these reports.

(b) Contents of Report.— Each report submitted under subsection (a) shall contain—

(1) an analysis of currency market developments and the relationship between the United States dollar and the currencies of our major trade competitors;

(2) an evaluation of the factors in the United States and other economies that underlie conditions in the currency markets, including developments in bilateral trade and capital flows;

(3) a description of currency intervention or other actions undertaken to adjust the actual exchange rate of the dollar;

(4) an assessment of the impact of the exchange rate of the United States dollar on—

(A) the ability of the United States to maintain a more appropriate and sustainable balance in its current account and merchandise trade account;
(B) production, employment, and noninflationary growth in the United States;
(C) the international competitive performance of United States industries and the external indebtedness of the United States;

(5) recommendations for any changes necessary in United States economic policy to attain a more appropriate and sustainable balance in the current account;

(6) the results of negotiations conducted pursuant to section 3004;

(7) key issues in United States policies arising from the most recent consultation requested by the International Monetary Fund under article IV of the Fund's Articles of Agreement; and

(8) a report on the size and composition of international capital flows, and the factors contributing to such flows, including, where possible, an assessment of the impact of such flows on exchange rates and trade flows.

(c) Report by Board of Governors.–Section 2A(1) of the Federal Reserve Act (12 U.S.C. 225a(1)) is amended by inserting after "the Nation" the following: ", including an analysis of the impact of the exchange rate of the dollar on those trends".

SEC. 3006. DEFINITIONS.

As used in this subtitle:

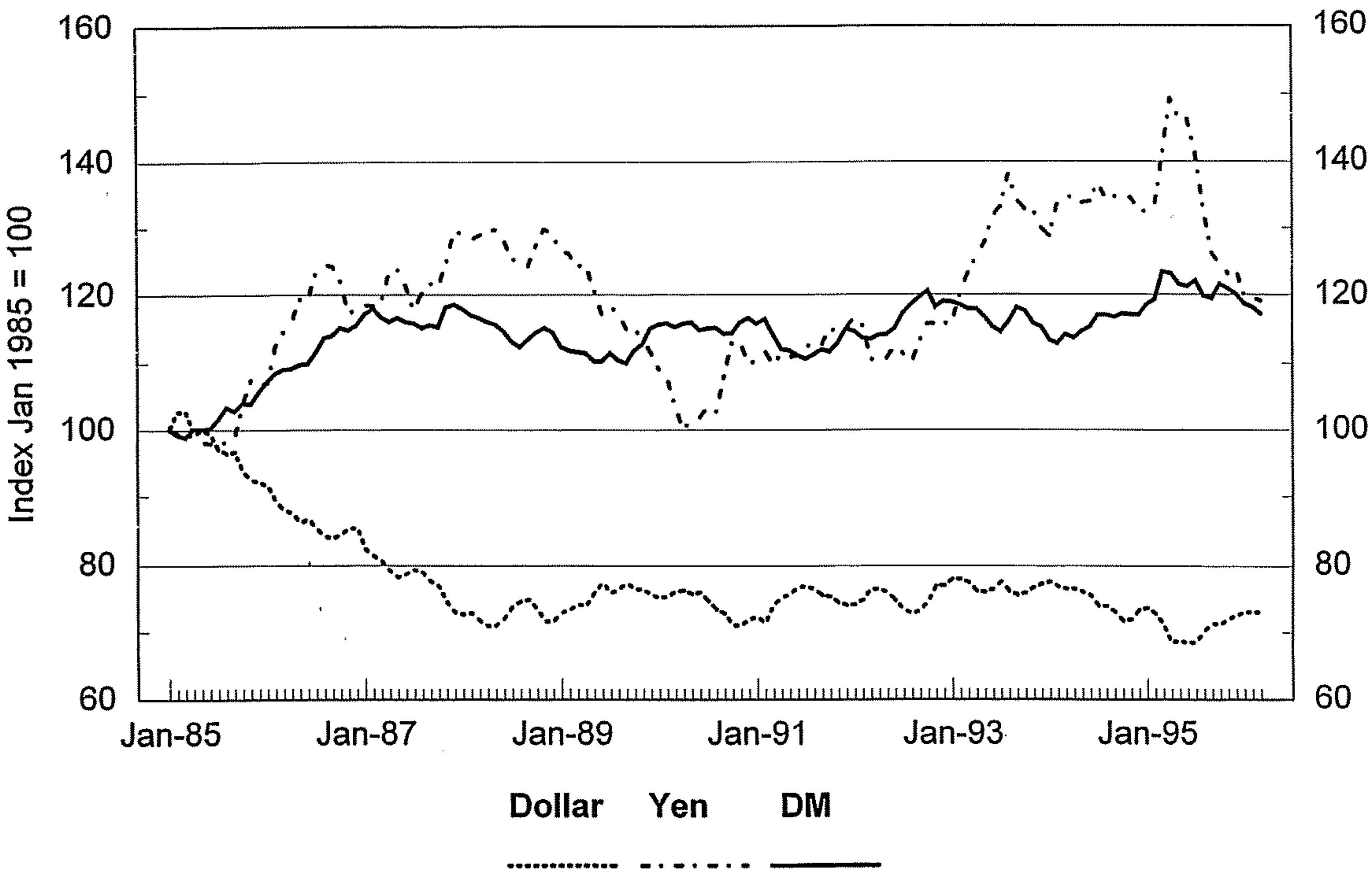
(1) Secretary.–The term "Secretary" means the Secretary of the Treasury.

(2) Board.–The term "Board" means the Board of Governors of the Federal Reserve System.

Exhibit 1

Real Broad Trade Weighted Exchange Rate Indices

January 1985 through March 1996

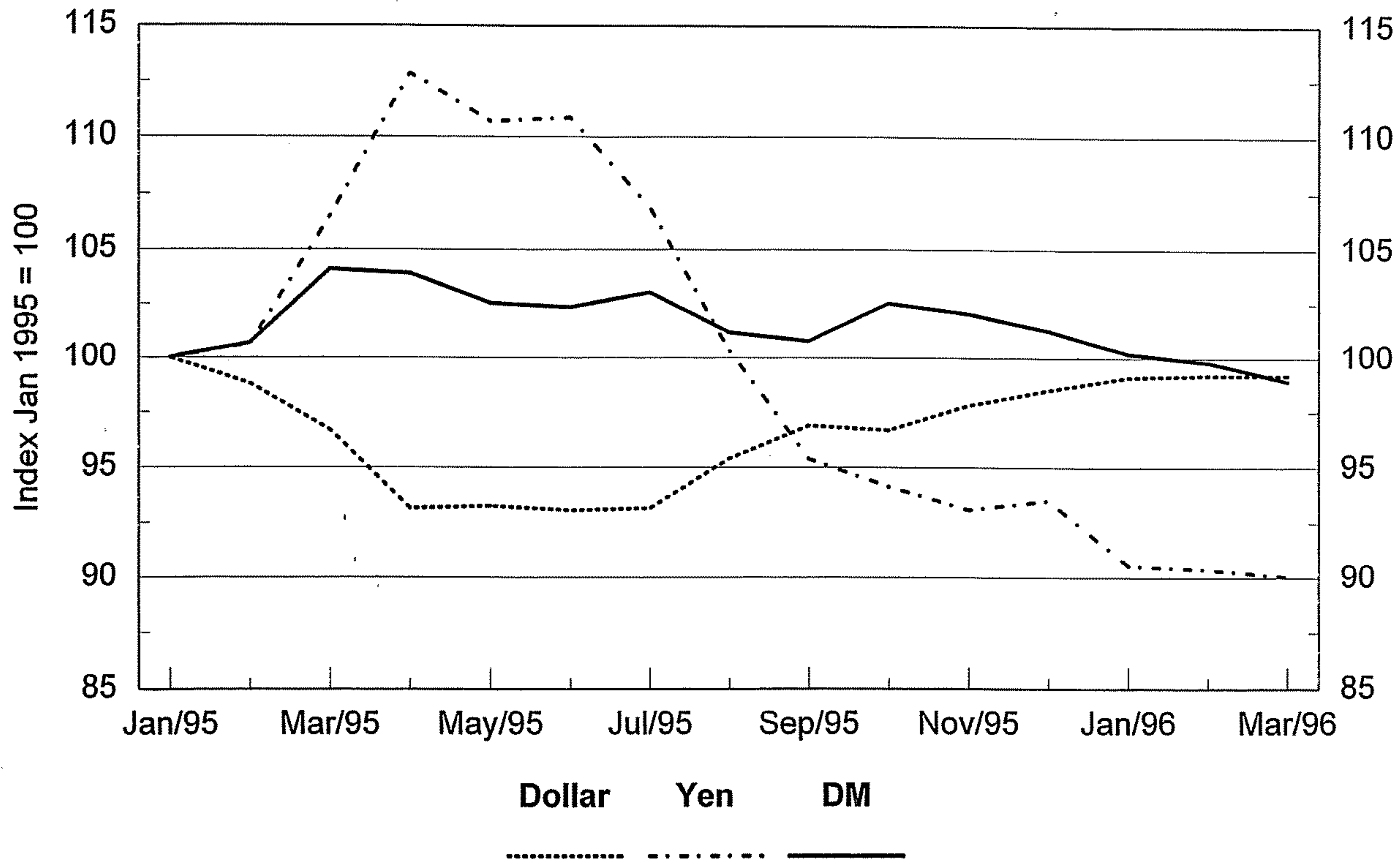


Source: JP Morgan; 1990 trade weights of 22 OECD and 23 Developing Countries.
Monthly Average.

Exhibit 2

Real Broad Trade Weighted Exchange Rate Indices

Monthly Average January 1995 through March 1996



Source: JP Morgan; 1990 trade weights of 22 OECD and 23 Developing Countries.
Monthly averages.

Exhibit 3

Yen per Dollar Exchange Rate

September 29, 1995 through March 29, 1996

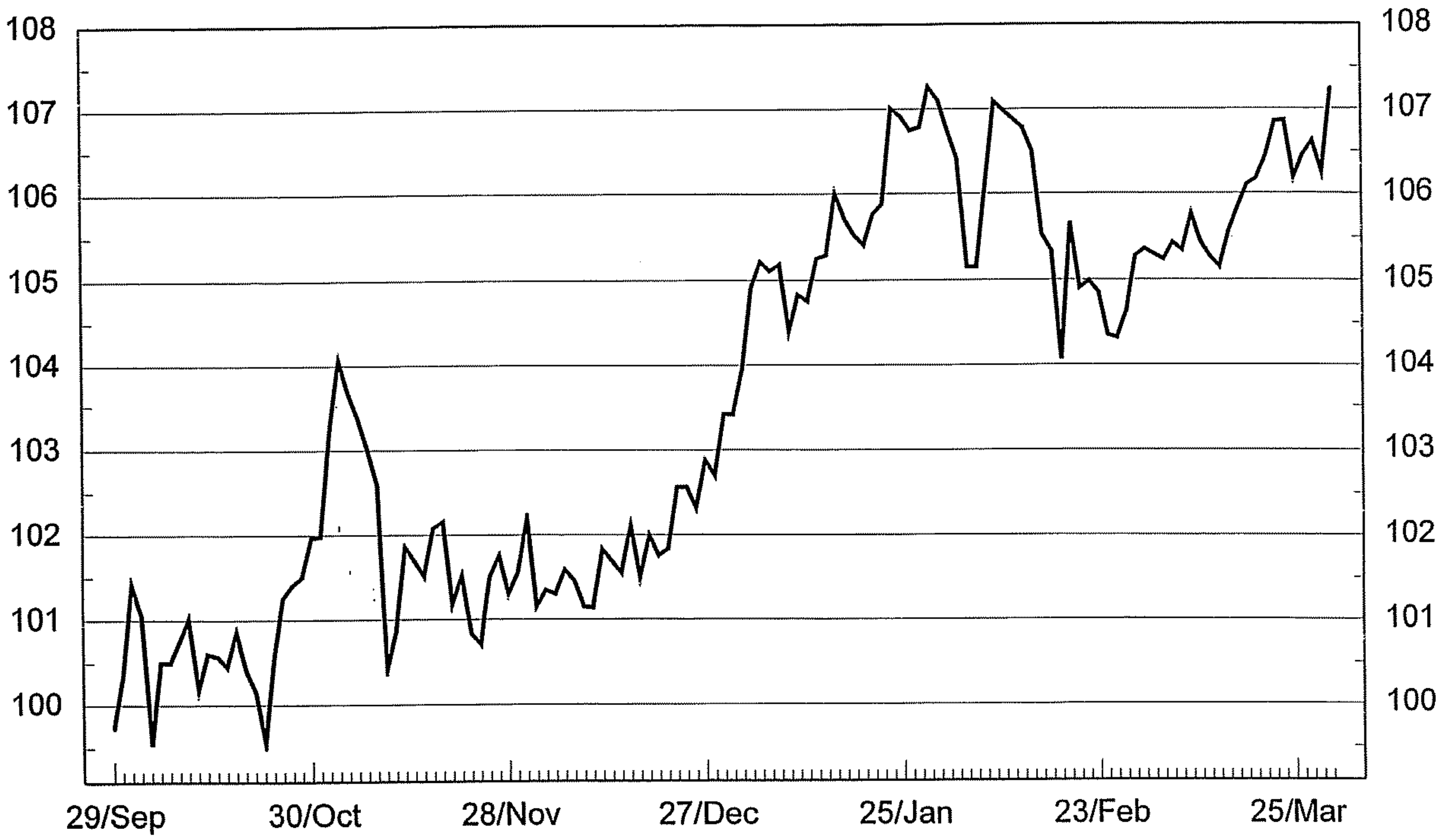


Exhibit 4

DM per Dollar Exchange Rate

September 29, 1995 through March 29, 1996

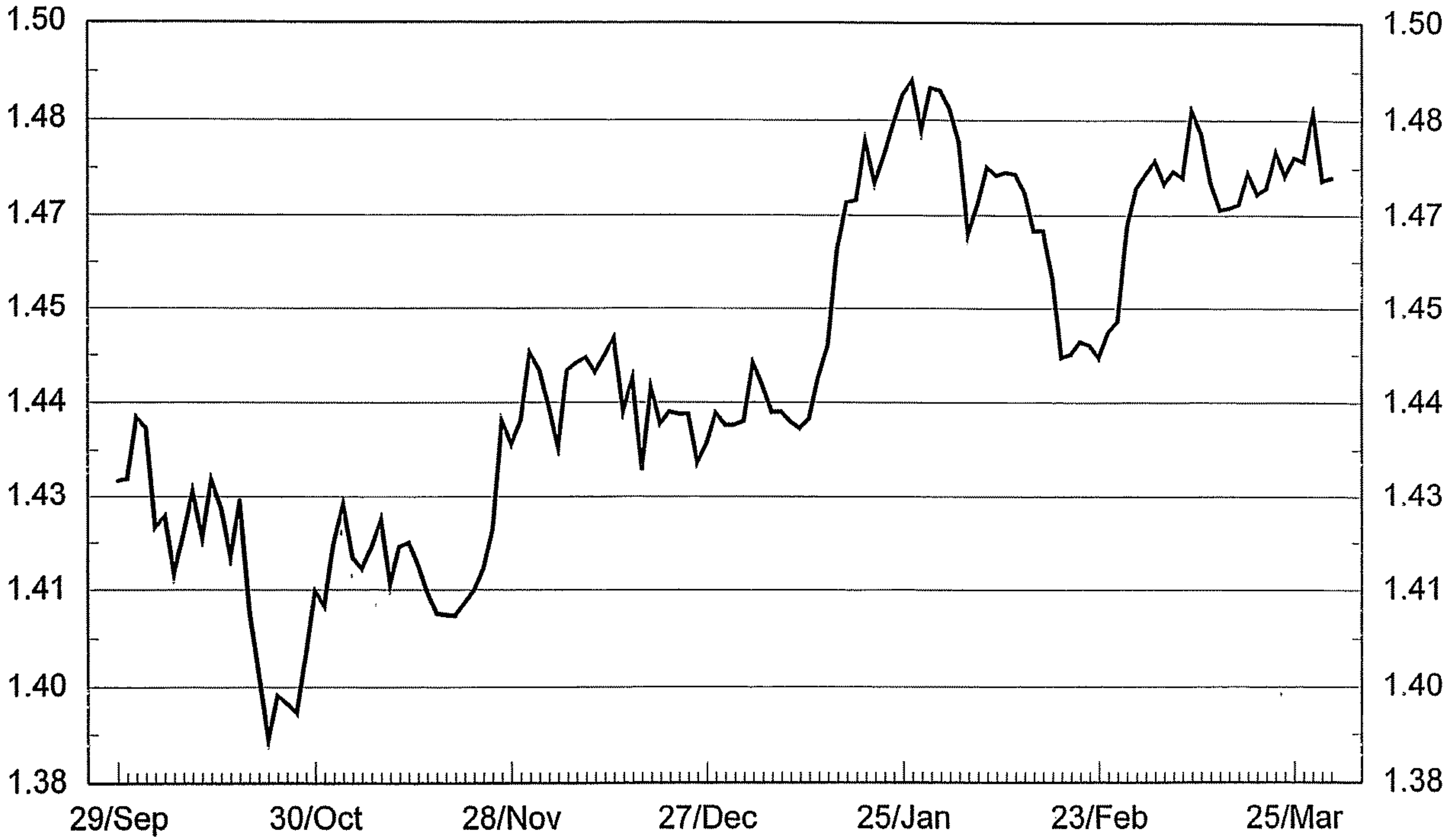
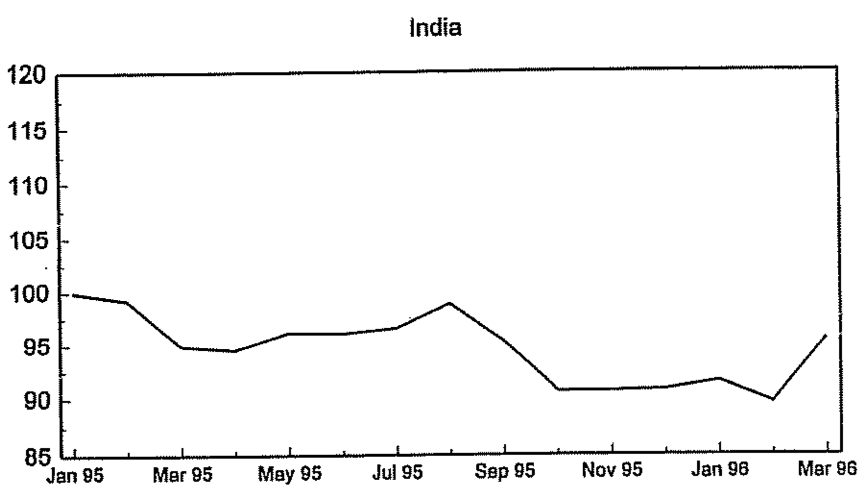


Exhibit 5
Real Trade-Weighted Exchange Rates

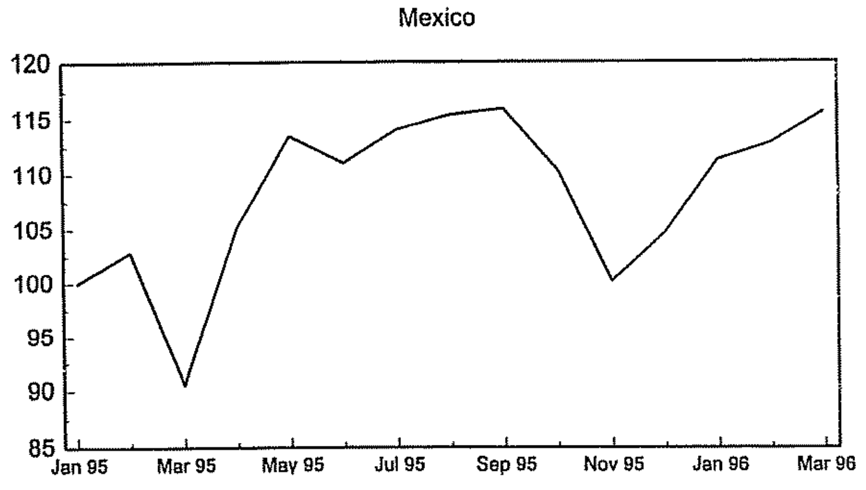
Selected Emerging Markets

Jan 1995 = 100

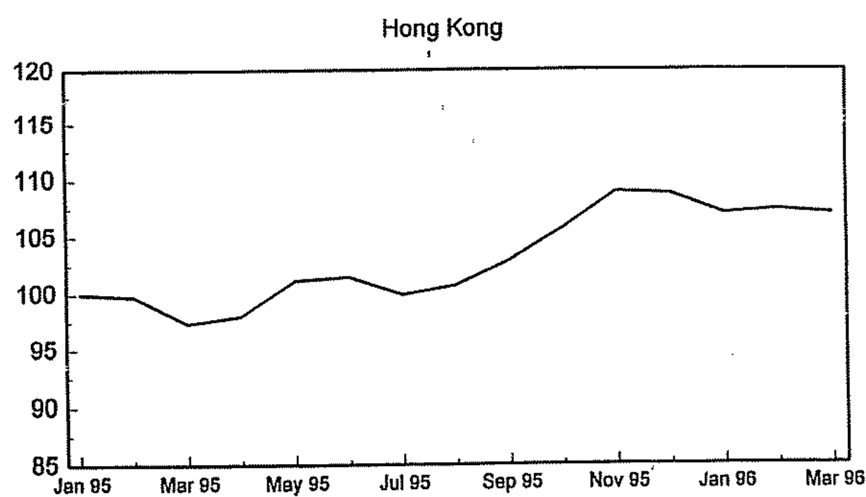
India



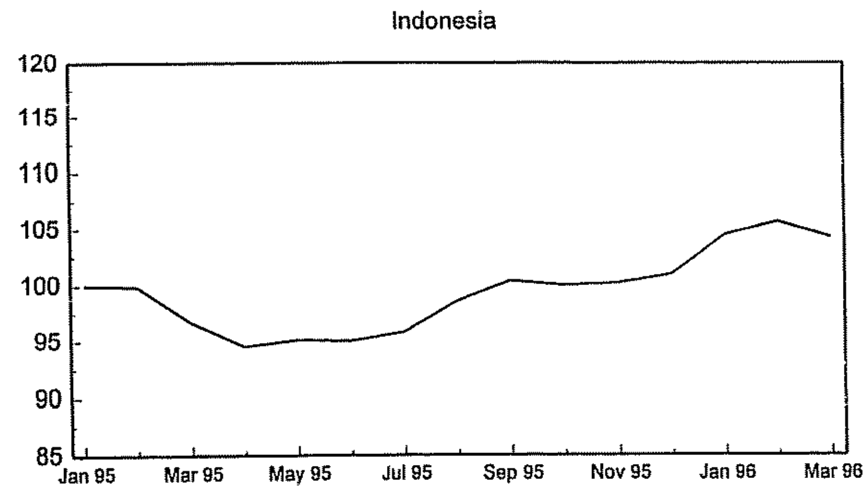
Mexico



Hong Kong



Indonesia



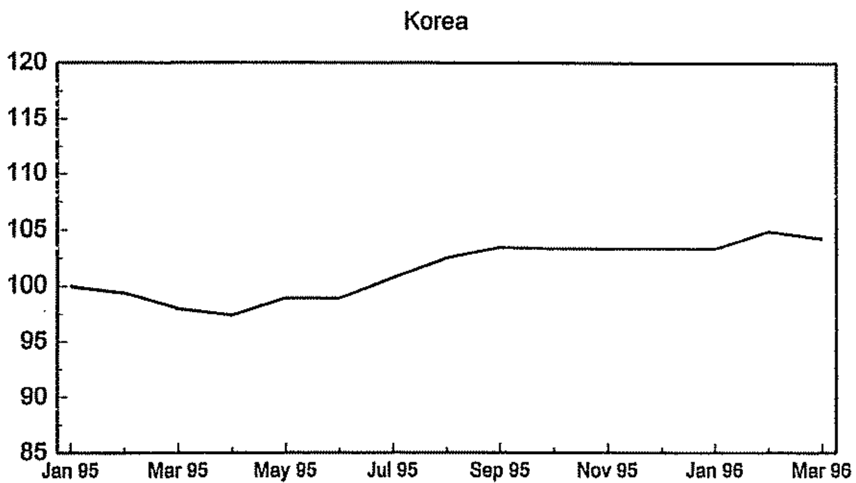
Source: JP Morgan; 1990 trade weights of 22 OECD and 23 Developing Countries. Monthly average.

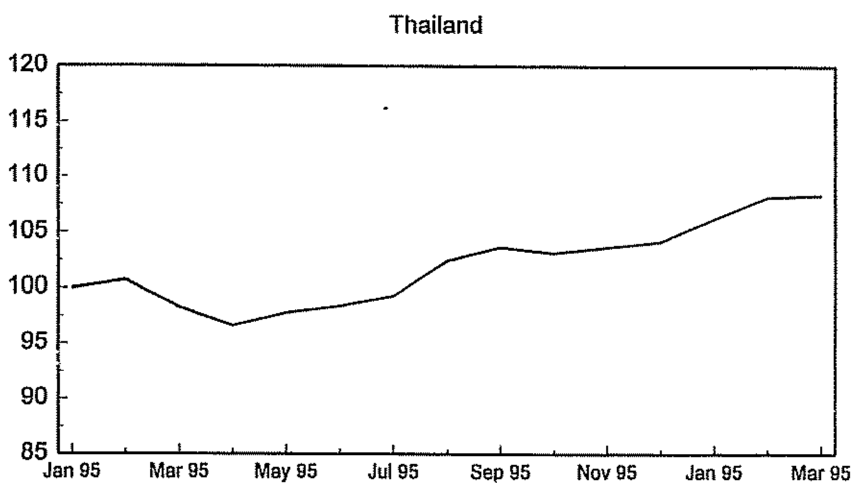
Exhibit 5

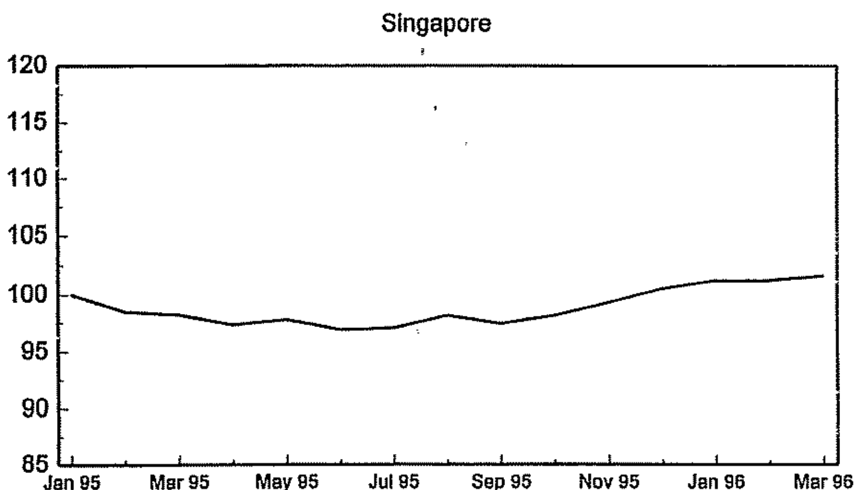
Real Trade-Weighted Exchange Rates

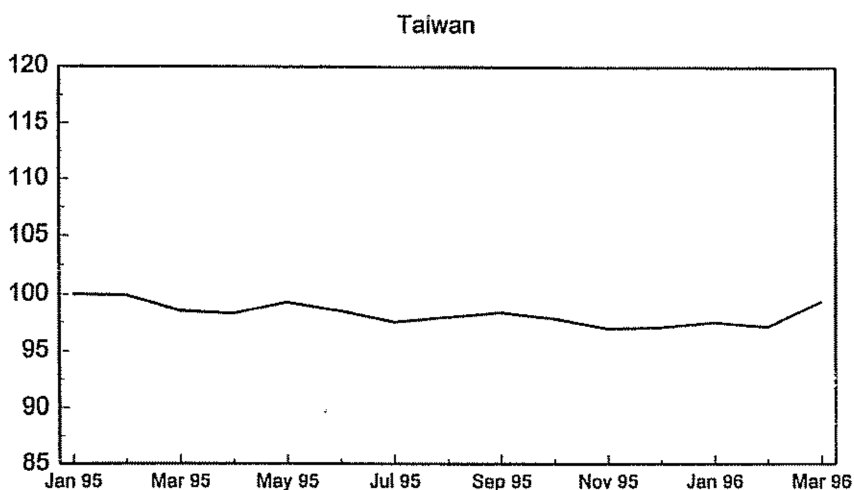
Selected Emerging Markets

Jan 1995 = 100







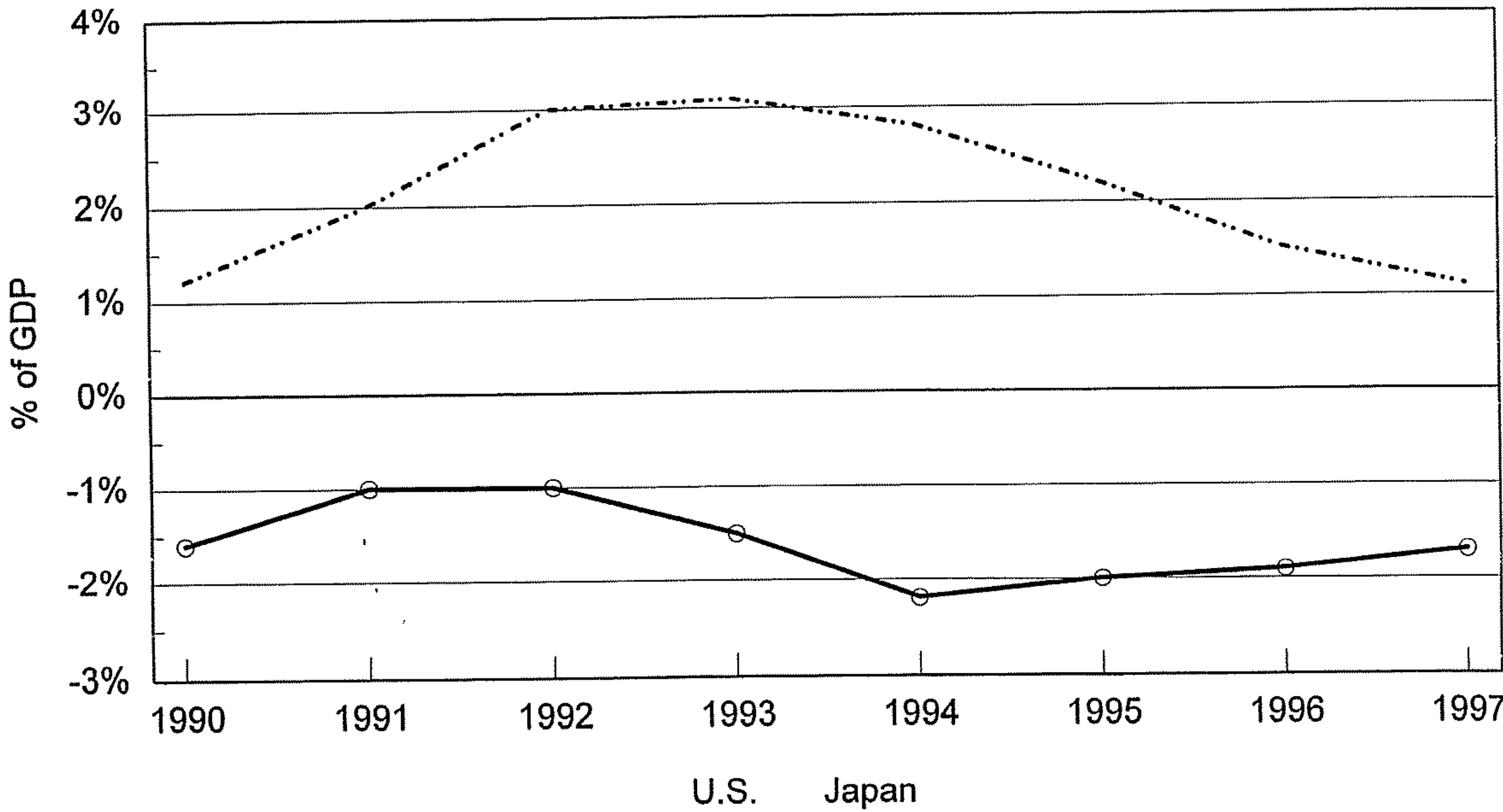


Source: JP Morgan; 1990 trade weights of 22 OECD and 23 developing countries. Monthly average.

Exhibit 6

U.S. and Japanese Current Accounts

1990 through 1997



Source: IMF data, Consensus forecasts, Treasury estimates

Exhibit 7
G-7 Real GDP Growth
(% change year/year)

	1995	Consensus Forecasts 1996F	1997F
United States	2.0	2.2	2.2
Japan	0.8	2.5	2.2
Germany	1.9	0.9	2.2
France	2.2	1.4	2.5
Italy	3.0	1.6	2.2
United Kingdom	2.5	2.3	3.2
Canada	2.3	1.9	2.9
Total G-7	1.9	2.0	2.3

F=Forecast
Source: Consensus Economics, Consensus Forecasts, June 1996

Exhibit 8
G-7 Consumer Price Inflation
(% change year/year)

	1995	Consensus Forecasts 1996F	1997F
United States	2.8	2.9	2.9
Japan	-0.1	0.1	1.3
Germany	1.8	1.6W	1.9W
France	1.8	2.0	1.9
Italy	5.4	4.1	3.6
United Kingdom	3.4	2.4	3.1
Canada	2.1	1.6	1.8
Total G-7	2.3	2.2	2.4

F=Forecast; W= Westerm Germany only
Source: Consensus Economics, Consensus Forecasts, June 1996

Exhibit 9

G-7 Current Account Balances

($ billion)

	1995	Consensus Forecasts 1996F	1997F
United States	-148	-144	-136
Japan	110	69	54
Germany	-17	-13	-11
France	17	15	14
Italy	27	31	32
United Kingdom	-11	-11	-13
Canada	-8	-4	-3
Total G-7	-30	-57	-63

F=Forecast

Source: Consensus Economics, Consensus Forecasts, June 1996

Exhibit 10

U.S. Current Account: Selected Dates

($ billion; b/p basis)

	1987	1992	1995
Exports	**250**	**440**	**576**
Ag	30	44	57
Non-Ag	220	396	519
Imports	**-410**	**-536**	**-749**
Oil	-43	-52	-55
Non-Oil	-367	-485	-694
Mdse Trade Bal	**-160**	**-96**	**-173**
Services, net	7	58	68
Investment Income, net	9	11	-8
Transfers	-24	-36	-35
Current Account	**-167**	**-63**	**-148**
(As % of GDP)	(3.6)	(1.0)	(2.0)

Geographic Breakdown of Trade Balance

($ billion; b/p basis)

	1987	1992	1995
W. Europe	**-28**	**3**	**-15**
Asia	**-105**	**-99**	**-129**
Japan	-57	-51	-60
Korea	-9	-3	0
Taiwan	-18	-10	-10
Singapore	-2	-2	-4
Hong Kong	-6	-1	4
China	-3	-18	-34
Canada	**-12**	**-10**	**-21**
Latin America	**-12**	**6**	**-9**
Mexico	-6	5	-16
Rest of World	**-4**	**-3**	**-1**

Source: Department of Commerce (BEA) and Survey of Current Business