Report to Congress on International Economic and Exchange Rate Policies

U.S. Department of the Treasury
Office of International Affairs

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This Report reviews developments in international economic and exchange rate policies, focusing on the second half of 2009, and is required under the Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C. § 5305 (the "Act").[1]

[1] The Treasury Department has consulted with the Board of Governors of the Federal Reserve System and IMF management and staff in preparing this Report.

Table of Contents

Key Findings

The Omnibus Trade and Competitiveness Act of 1988 (the "Act") requires the Secretary of the Treasury to provide semiannual reports on the international economic and exchange rate policies of the major trading partners of the United States. Under Section 3004 of the Act, the Report must 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." The period covered in this Report is July 1, 2009, to December 31, 2009, but information from the first half of 2010 also is included when available and where relevant. Treasury has concluded that no major trading partner of the United States met the standards identified in Section 3004 of the Act during the period covered in this Report.

The United States is now in its fifth quarter of economic growth. Growth has averaged 3.5 percent per quarter on an annualized basis during the recovery, which is well above the 2.4 percent weighted-average growth rate of other G-7 economies. Unemployment, however, at 9.5 percent in June 2010, remains unacceptably high and will require continued strong emphasis on sustained economic growth. The U.S. is saving more and borrowing less from abroad. The U.S. current account deficit in 2009 ($378.4 billion) was the smallest since 1999 in dollar terms, and the smallest since 1998 relative to GDP (2.7 percent). The current account deficit in the first quarter of 2010 was 3.0 percent of GDP. Over the next several years, U.S. national saving will increase further. The return of economic growth, the wind-down of emergency recovery measures, and other policies enacted and proposed by the Administration will reduce the U.S. federal budget deficit from 10.6 percent of GDP in FY2010 to around 4 percent of GDP by FY2013. The President's National Commission on Fiscal Responsibility and Reform is tasked with finding additional improvements to eliminate the primary deficit by 2015.

The world economy was pulled back from the brink and has resumed growth, but a durable recovery is still not fully secure. Global economic growth is now projected by the IMF to be 4.6 percent in 2010, which is nearly 2.5 times the pace of growth projected for 2010 in the spring of 2009. Although unemployment rates remain elevated and unacceptably high, job growth has returned. International trade has increased sharply and has nearly returned to its pre-crisis level following a collapse in value of more than 35 percent between the second quarter of 2008 and the first quarter of 2009. The IMF expects global trade will expand faster than global output in 2010, returning to its pre-crisis pattern. Financial markets have improved significantly and private credit is again available more broadly, although volatility has increased since spring 2010.

Emerging market economies have recovered more quickly than most advanced economies. Economies in Asia, but also some in Latin America (Brazil for example) have performed especially well. Some emerging market economies have begun to scale back their macroeconomic stimulus. China was a significant source of economic support in 2009, generating a 13 percent increase in domestic demand that contributed 1.6 percentage points to global growth at a time when total world demand declined 0.6 percent. China's stimulus contributed to the expansion of U.S. exports to China by 15 percent in the second half of 2009, while U.S. exports to the rest of the world decreased by 13 percent.

Some economies, notably in Europe, are recovering more slowly. The IMF is forecasting economic growth of 1.0 percent in the euro area in 2010 and 2.4 percent in Japan. Much of this projected growth is expected to be export driven, as private sector demand continues to be weak, particularly in Japan and Germany, two economies with large external surpluses. Both economies need to focus on reforms that strengthen private sector demand growth, to contribute to a better balanced and more sustainable global economy.

In April 2010, and continuing through May, financial market concerns mounted over the sustainability of budget deficits and sovereign debt levels in several European economies, particularly Greece. The result was a sharp increase in financial market volatility, higher yields and spreads on some sovereign bonds, and a re-pricing of equities and exchange rates as international investors scaled back on their risk exposures. On May 9, the member states of the euro area agreed to create a €440 billion ($530 billion) European Financial Stability Facility (EFSF). The EFSF will be able to make loans to other euro area countries in financing difficulties, backed by guarantees from each euro area country. European authorities have announced their intention to publish the results of an expanded bank stress test which will include banks representing at least half of banking sector assets in each of the 27 European Union countries in the second half of July.

Strengthening the economic recovery was the main focus at the just completed G-20 Leaders' Summit in Toronto. Leaders used the Summit to assess progress under the first phase of the Framework for Strong, Sustainable, and Balanced Growth, agreed in September 2009 at the Pittsburgh Summit. Leaders affirmed that their highest priority is to safeguard and strengthen the recovery, including through further efforts to rebalance global demand, implementation of structural reforms that enhance growth potential and boost domestic sources of growth in countries with external surpluses, and greater exchange rate flexibility in some emerging markets. Recognizing the essential role of sound public finances, Leaders agreed to fiscal consolidation over the medium-term, differentiated according to national circumstances, with the paths of adjustment carefully calibrated to sustain the recovery in private demand while also leading to stable or declining debt-to-GDP ratios by 2016. They also agreed that there is scope for significant economic improvement and decided that the next phase under the Framework would be to develop country-specific policies that could form a G-20 Action Plan at the November 2010 Leaders' Summit in Seoul, Korea.

As noted, no major trading partner of the United States met the standards identified in Section 3004 of the Act during the reporting period. Global current account imbalances, at 3.8 percent of global GDP in 2009, are well below the peak ratio of 5.9 percent in 2006. U.S. bilateral trade imbalances moderated in 2009 against all but one of the economies (Brazil) covered in this Report. The U.S. current account deficit is at its lowest level in over a decade. Of the 17 currencies covered in the Report, three were fixed against the dollar during the reporting period (the Saudi Arabia riyal, the Venezuelan bolivar, and the Chinese renminbi); and the other fourteen fluctuated against the dollar. On a nominal effective basis, the dollar depreciated in the second half of 2009 by 3.2 percent, and appreciated by 2.8 percent through the first five months of 2010.

On June 19, 2010, China announced that it was ending its peg to the dollar and returning to an exchange rate regime that would be more flexible and more market based. China's policy shift is a significant development, but what matters is how far and how fast the renminbi appreciates.

Between July 2005 and July 2008, the last period where the Chinese authorities allowed the exchange rate to move in response to market forces, the Chinese currency appreciated 21.2 percent against the dollar. As was the case then, it will take time before we can assess whether China's recent exchange rate change will produce a sufficiently market-determined exchange rate to correct the undervaluation. China's continued foreign reserve accumulation, the limited appreciation of China's real effective exchange rate relative to rapid productivity growth in the traded goods sector, and the persistence of current account surpluses even during a period when China's trading partners were in deep recession together suggest that the renminbi remains undervalued.

Treasury will monitor closely the pace of appreciation, and will report on progress in the fall Report to Congress.

IMF Article IV Reports on China, when they have been published, have provided valuable information about assessments of macroeconomic and exchange rate policy. We encourage China to resume publication of its Article IV Reports.

Introduction

This Report focuses on international economic and foreign exchange developments in the second half of 2009. Where pertinent and when available, data and developments through mid-June 2010 are included.

Exports and imports of goods to and from the areas whose economies and currencies are discussed in this Report accounted for more than 80 percent of U.S. merchandise trade in the second half of 2009.

U.S. Macroeconomic Trends

The economy began to grow again in the second half of 2009 following four straight quarters of contraction, with the recovery continuing into the first part of 2010. Activity picked up in a number of sectors, including housing, although the expected expiration of the homebuyer tax credit induced volatility in housing sales and activity measures in late 2009 and the first half of 2010. Conditions in financial and credit markets continued to improve, with some risk measures returning to pre-crisis norms. Job losses slowed notably during the second half of the year and employment expanded in the first part of 2010, but the labor market remains weak. The fiscal stimulus provided by the American Recovery and Reinvestment Act (ARRA), which was enacted early in 2009, played a key role in stabilizing the economy and setting the stage for a return to growth. The stimulus measures coupled with the impact of the recession caused the federal budget deficit to widen sharply in the fiscal year that ended on September 30 (FY2009). The deficit is projected to fall to 5.1 percent of GDP in FY2012 as the economy recovers and the stimulus unwinds. Most private forecasters expect moderate economic growth through 2011.

The U.S. Economic Recovery Began in the Second Half of 2009 and Continued into 2010

Real GDP increased by 2.2 percent at an annual rate in the third quarter of 2009 after contracting in five of the six previous quarters. The rebound was fueled in large part by a jump in consumer spending led by a surge in motor vehicle purchases spurred by the Cash for Clunkers program. Federal government expenditures also made a substantial 0.6 percentage point contribution to real GDP growth in the third quarter. Even excluding the surge in auto consumption and jump in Federal outlays, underlying demand strengthened. Residential investment rose for the first time in four years, and business investment in equipment and software edged up after six quarters of decline.

The economy continued to improve in the fourth quarter, with real GDP growth accelerating to a 5.6 percent annual rate. The pickup in growth was due mainly to a sharp slowdown in the pace of inventory liquidation, but even excluding inventories, final sales were up 1.7 percent in the fourth quarter, the fastest growth in more than a year. Nearly every major component of GDP showed increased strength. Consumer spending continued to rise, and business purchases of equipment and software increased at the fastest pace in about a decade. Residential investment rose for a second straight quarter, but business spending on structures fell further, extending a downward trend that began in the third quarter of 2008. Export growth remained strong, outpacing the rise in imports. The decline in the trade deficit made a small positive contribution to fourth-quarter real GDP growth.

Real GDP continued to expand in early 2010, with the economy growing at a 2.7 percent annual rate in the first quarter. Consumer spending strengthened, rising at its fastest pace in three years. Business investment in equipment and software grew at a double-digit pace for the second straight quarter, and businesses added to their inventories for the first time in two years. The downward trend in business spending on structures extended into the first quarter, and residential investment declined after two quarters of growth. Exports continued to rise, but imports rose faster as U.S. demand strengthened. The trade deficit widened as a result, thus subtracting from first-quarter real GDP growth. A consensus of private forecasters expects that growth accelerated in the second quarter to between 3½ and 3¾ percent.

The Housing Sector Stabilized

Residential investment – a drag on growth since the start of 2006 – turned up mildly in the second half of 2009 as housing activity generally stabilized. Single-family housing starts hit bottom early in the year and by the middle of 2009 they had risen by about one-third to a still low level. Since June 2009, however, starts have remained roughly constant, with the exception of a notable pickup in March and April 2010, ahead of the April 30, 2010 expiration of the home buyer tax credit. Building permits issued for the construction of single-family homes followed a similar path, although they continued to trend somewhat higher in the second half of 2009 and first quarter of 2010. Single-family permits fell in April and May, dipping below starts in both months. The drop in permit authorizations suggests the pace of new construction could slow in the months ahead.

Home sales jumped in the second half of 2009, apparently reflecting the effects of the first-time home buyer tax credit, which was enacted in February 2009 and scheduled to expire in November (before it was extended through April 2010). Sales of new single-family homes accelerated to 401,000 units at an annual rate in the third quarter from an average annual rate of 361,000 in the first half of the year but then slowed in the final months of 2009. In May 2010, new single-family home sales dipped to a 300,000 unit annual rate – the slowest pace since the data began to be collected in 1963, at least partly reflecting effects of the end of the homebuyer tax credit. Sales of existing single-family homes – the bulk of all home sales – rose through much of 2009, shooting up nearly 13 percent in the fourth quarter to a 5.2 million annual rate – the strongest quarterly pace since early 2007. Existing home sales slowed heading into 2010, but accelerated in the spring along with new home sales as the April 30 expiration of the home buyer tax credit neared. The inventory of new and existing homes on the market continued to shrink in the second half of 2009 and into 2010. As of May, the number of unsold new homes on the market was at its lowest level since 1970; relative to sales there was an 8.5-month supply. The stock of existing homes for sale stood at an 8.3-month supply. Major house price measures stabilized in late 2009.

The Labor Market Conditions Have Improved

Labor market conditions improved somewhat in the second half of 2009 compared to the first half of the year. The monthly pace of job loss slowed sharply from a peak of 753,000 on average in the first quarter to 90,000 per month in the fourth quarter, and nonfarm payrolls rose by 64,000 in November. Still, 4.7 million jobs were lost during the course of the year, bringing the cumulative decline in payroll employment from December 2007 through December 2009 to 8.4 million. Job growth resumed in January 2010 and continued through May, with nearly

500,000 jobs added to private-sector payrolls in the first five months of 2010. The unemployment rate continued to climb through October 2009, reaching a 26-year high of 10.1 percent. The jobless rate averaged 10.0 percent in the fourth quarter, up from 8.2 percent in the first quarter and double its level at the start of the recession in December 2007. The unemployment rate eased to 9.5 percent in June.

Inflation Was Subdued Despite a Jump in Energy Prices

Consumer price inflation accelerated in the second half of 2009 as energy prices rose. The consumer price index rose 2.7 percent year-over-year in December 2009, a reversal from the 1.4 percent decline recorded in June 2009. Energy prices surged more than 18 percent after falling by more than 25 percent during the year ending in June. Food prices moved in the opposite direction, easing by 0.5 percent during the twelve months ending in December 2009 after rising more than 2 percent over the twelve months ending in June. Excluding both volatile categories, core consumer inflation was 1.8 percent during 2009, little changed from the year ending in June 2009. Both headline and core consumer inflation moderated in early 2010. Headline consumer prices were up 2.0 percent over the twelve months ending in May, and core prices rose 0.9 percent. Growth of compensation costs slowed considerably during 2009 and remained subdued at the start of 2010, exerting little upward pressure on price inflation.

Conditions in Financial and Credit Markets Continued to Improve

Equity markets posted gains in 2009 and early 2010, partly rebounding from the steep losses recorded in 2008, and some measures of financial and credit market risk returned to pre-crisis norms. The S&P 500 climbed steadily through the second half of 2009, ending the year 23.5 percent higher than on December 31, 2008. Financial market volatility decreased notably throughout the year, and conditions in credit markets continued to improve. The 3-month U.S. dollar LIBOR-OIS spread — a measure of stress in term interbank funding markets — narrowed further in the second half of 2009 and early 2010. By early April 2010, this spread had returned to its historical average of 9 basis points, down from a peak of 365 basis points on October 10, 2008. Spreads for corporate debt over Treasuries also narrowed a great deal but remained elevated compared to their pre-August 2008 levels. The 10-year Baa corporate yield spread over Treasuries averaged 241 basis points in April 2010, down 136 basis points since June 2009 and well below the December 2008 peak of 616 basis points. Mortgage rates remained near historically low levels throughout 2009 and well into 2010. The January 2010 *Senior Loan Officer Opinion Survey on Bank Lending Practices* from the Federal Reserve indicates that commercial banks generally stopped tightening standards on most loan types in the fourth quarter of 2009, and that fewer banks increased their lending spreads on loans compared with October. However, the survey also showed that loan demand from businesses and households was still soft. Loan demand remained weak in early 2010, according to the April survey.

Financial market volatility increased sharply in early May 2010, reflecting concerns about the health of the euro area and the implications for the global economy. The Chicago Board Options Exchange Volatility Index (VIX) — a measure of stock market volatility — rose to nearly 46 percent—its highest level since March 2009—but has since partly retreated. Equity markets have slipped since late April, erasing gains posted earlier in the year. Interest rate spreads widened, reflecting an uptick in risk aversion. Despite these developments, financial and credit market conditions in mid 2010 remained far better than during the height of the financial crisis in late 2008. As of mid June 2010, the S&P 500 was up more than 60 percent from its March 2009 low. The VIX was roughly stable in the mid 20 percent range. Interest rate spreads remained well below late 2008 levels.

The Fiscal Situation Is Expected to Improve as the Economy Recovers

Measures to support the economy, coupled with the severe effects of the recession raised the federal budget deficit. In FY2009 (October 2008 to September 2009), the budget deficit was $1.413 trillion (9.9 percent of GDP), up from $459 billion (3.2 percent of GDP) in FY2008. The Office of Management and Budget (OMB) projects the deficit will widen further in FY2010 to $1.6 trillion (10.6 percent of GDP) but then decline sharply to $828 billion (5.1 percent of GDP) in FY2012 as the economy recovers. Receipts as a share of GDP are expected to recover from 14.8 percent in FY2010 to 18.1 percent in FY2012. The President's National Commission on Fiscal Responsibility and Reform is tasked with finding additional improvements to eliminate the primary deficit by 2015.

National Saving

Growth of the federal budget deficit in recent years contributed to a sharp drop in the national saving rate, which turned negative in 2008 for the first time since the mid 1930s. Between 2006 and 2009, net national saving as a share of net national product fell from 4.3 percent to -2.9 percent. Private saving (again as a share of net national product) rose about 1½ percentage points on net over this period. Public saving, however, plunged as the federal budget deficit widened sharply. Federal saving (as measured by the budget balance) has been negative for much of the past four decades. Steep increases in the budget deficit in 2008 and 2009 pulled the federal deficit as a share of net national product higher, from just under 2 percent in 2006 and 2007 to a postwar high of 9.6 percent in the first three quarters of 2009. Smaller projected budget deficits going forward – reflecting the improving economy and the phase-out of the temporary spending programs – should help to partly reverse the decline in the national saving rate.

The Global Economy

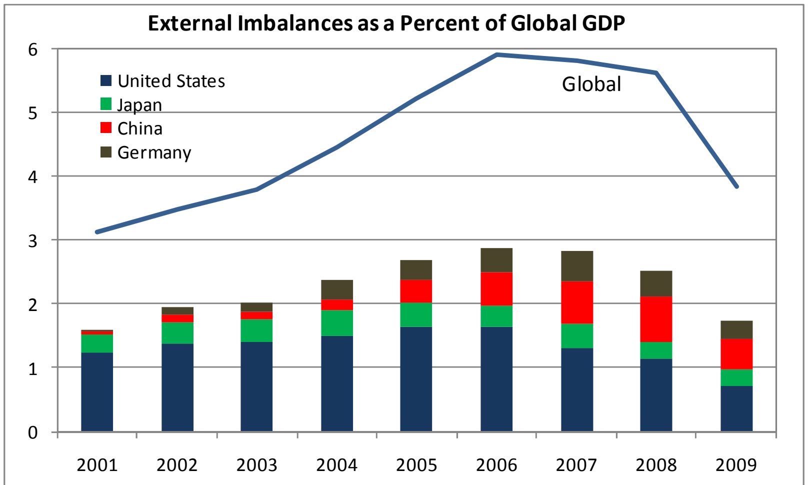
Global economic conditions improved in the second half of 2009, with clear signs of economic recovery in most countries. By the fourth quarter, signs of recovery were evident in all the economies discussed in this Report, except Venezuela. The recovery has been strongest in the emerging economies, notably in Asia. Global trade expanded and financial market conditions improved substantially in the second half of 2009. Nevertheless, in many countries the economic recovery was dependent on fiscal and monetary policy stimulus, and in particular, labor markets remained weak.

The global economy continued to strengthen in early 2010. Real GDP increased in all the countries discussed in this Report in the first quarter, with the exception of Mexico and Venezuela. The IMF projects the global economy to grow by 4.6 percent this year, well above the 1.9 percent growth it forecast in April 2009. Nevertheless, downside risks have increased somewhat as a result of the sovereign debt problems in Europe and their effect on financial markets.

Global trade plummeted between the second quarter of 2008 and the first quarter of 2009, falling by $1.7 trillion. Trade has risen substantially since then, reaching 80 percent of its previous peak by the end of the first quarter of 2010. Commodity prices, which fell by 35 percent during the height of the crisis, have been on the upswing since February 2009. Although this increase has dampened the recovery in some countries, it has boosted growth in commodity exporting economies.

In late 2009, many central banks began removing the extraordinary policy measures they put in place to support financial institutions and maintain liquidity. A few central banks began raising interest rates and taking other steps to tighten monetary conditions, notably Brazil, China, and India. The Bank of Canada raised its policy rate by 25 basis points in June 2010, the first G-7 central bank to start raising interest rates. Central banks in some advanced economies indicated that accommodative policies would remain in place for some time, as inflationary pressures remained subdued and output gaps remained large.

Fiscal policy remained highly stimulative in the second half of 2009, playing a key role in boosting real GDP. In many countries, fiscal policy is expected to remain supportive through 2010. Even as policy remained accommodative in the near-term, many countries began to put in place medium-term plans to return fiscal balances to sustainable levels. These plans have been accelerated recently in some countries in the wake of the increasing focus on sovereign debt problems.



Source: IMF April 2010 WEO database.

Global imbalances (the sum of the absolute values of external imbalances of individual countries) peaked in 2006 at 5.9 percent of global GDP. The decline in imbalances since then was initially driven by a reduction in U.S. external imbalances. The pace of the contraction in imbalances accelerated as the global crisis hit and global trade and financial flows were severely impacted. In 2009, global imbalances were 3.8 percent of global GDP, the lowest level since 2003. As the recovery takes hold, there are signs that imbalances are on the rise again. Policies to produce a more balanced pattern of global demand are crucial to a strong, sustained recovery.

In order to help ensure a durable economic recovery, at the G-20 Pittsburgh Summit in September 2009, Leaders established a Framework for Strong, Sustainable, and Balanced Growth. In November, the G-20 Finance Ministers and Central Bank Governors launched the Framework, establishing a structure whereby G-20 members would: develop shared policy objectives; set out individual medium-term national policy frameworks; collectively assess the implications of the national frameworks for the pattern and sustainability of global growth; and, agree on a cooperative process of mutual assessments of the policy frameworks.

At the G-20 Toronto Summit in June 2010, Leaders of the G-20 agreed that the highest priority was to safeguard and strengthen the recovery and lay the foundation for strong, sustainable, and balanced growth, and strengthen financial systems against risk. Although they welcomed plans already put in place to support these goals, the Leaders emphasized that a more ambitious path of reforms could result, over the medium term, in higher output and employment while reducing global poverty and imbalances. In this regard, Leaders of the advanced economies agreed to implement growth friendly fiscal consolidation that would reduce deficits by half by 2013 and stabilize or reduce debt-to-GDP ratios by 2016. Leaders also agreed on the need for: structural reforms to boost growth; greater exchange rate flexibility in some emerging markets; and, greater progress in rebalancing global demand. The next step of the mutual assessment process will focus on identifying additional measures that individual G-20 member countries can take toward achieving strong, sustainable, and balanced growth.

U.S. International Accounts

The U.S. current account deficit for 2009 was the smallest since 1999 in dollar terms and the smallest deficit as a share of GDP since 1998. The deficit fell to 2.4 percent of GDP ($84.4 billion) in the second quarter of 2009. As the recovery began to take hold the deficit rose moderately, reaching 3.0 percent of GDP ($109.0 billion) in the first quarter of 2010.

U.S. Balance of Payments and Trade

($ billions, seasonally adjusted unless otherwise indicated)

	2008	2009	2009	2009	2009	2009	2010
			Q1	Q2	Q3	Q4	Q1
Current Account:							
Balance on Goods	-834.7	-506.9	-121.2	-113.5	-132.1	-140.1	-151.3
Balance on Services	135.9	132.0	30.8	33.1	32.8	35.4	36.0
Balance on Income 1/	152.0	121.4	24.6	26.3	35.5	35.1	41.7
Net Unilateral Current Transfers	-122.0	-124.9	-29.7	-30.3	-33.6	-31.3	-35.5
Balance on Current Account	-668.9	-378.4	-95.6	-84.4	-97.5	-100.9	-109.0
Balance on Current Account as % of GDP	-4.6	-2.7	-2.7	-2.4	-2.7	-2.8	-3.0
Major Capital Flow Components (financial inflow +)							
Net Bank Flows	10.7	-590.1	-263.0	-215.4	-104.4	-7.3	-192.8
Net Direct Investment Flows	-22.8	-134.0	-39.3	-30.5	-22.5	-41.6	-57.7
Net Securities Sales	917.3	290.2	111.2	14.7	72.8	91.5	152.0
Net Liabilities to Unaffiliated Foreigners by Non-banking Concerns	384.6	123.0	-8.9	48.7	91.9	-8.7	44.3
Memoranda:							
Statistical Discrepancy	85.0	162.5	87.6	69.8	19.9	-14.8	77.7
Change in Foreign Official Assets in the United States	550.8	450.0	107.9	128.7	96.6	116.8	75.0
Trade in Goods							
Balance	-816.2	-503.6	-120.3	-113.5	-130.7	-139.0	-148.4
Total Exports	1287.4	1056.0	252.3	250.6	266.2	286.9	303.1
of Which:							
Agricultural Products	108.4	93.9	22.0	23.4	22.8	25.8	25.9
Capital Goods Ex Autos	457.7	390.5	98.5	94.1	95.8	102.1	105.9
Automotive Products	121.4	81.7	17.5	17.3	21.9	25.0	27.1
Consumer Goods Ex Autos and Food	161.3	150.0	36.5	36.3	37.5	39.7	40.7
Industrial Supplies and Materials 2/	388.0	296.7	67.1	69.3	77.5	82.7	90.5
Total Imports	2103.6	1559.6	372.6	364.2	396.8	426.0	451.5
of Which							
Petroleum and Products	779.5	462.5	52.4	57.0	68.8	75.4	85.4
Capital Goods ex Autos	453.7	369.3	91.5	87.6	91.9	98.4	101.8
Automotive Products	231.2	157.6	32.0	32.5	44.1	49.1	50.4
Consumer Goods Ex Autos and Food	481.6	428.4	106.0	105.0	106.3	111.2	113.7

1/ Including compensation of employees

2/ Including petroleum and petroleum products

Source: BEA, Bureau of Census

Merchandise exports increased $50.8 billion (20.1 percent) between the first quarters of 2009 and 2010 and service exports rose $9.6 billion (7.8 percent) over the same period. However, imports rose more in dollar terms — as merchandise imports increased $78.8 billion (21.2 percent) led by a 63.0 percent increase in petroleum imports and a 57.7 percent increase in automotive vehicles and parts. Service imports rose a more modest 4.6 percent.

Importantly, U.S. exports increased across all categories in the fourth quarter of 2009 and the first quarter of 2010, and rose in all categories except agriculture for the last three quarters, suggesting that the trade recovery is broad based. U.S. exports of industrial supplies and materials, and automotive vehicles and parts led the increase, growing by $23.3 billion (34.7 percent) and $9.7 billion (55.3 percent), respectively, on a year-over-year basis in the first quarter of 2010. Capital goods exports rose by $7.4 billion (7.6 percent) over this period.

Net investment income and net unilateral current transfers are also showing signs of recovery. U.S. net investment income rose $17.1 billion (69.5 percent) to $41.7 billion in the first quarter of 2010 on a year-over-year basis, as income from U.S. direct investment overseas rose due to the global recovery in growth and payments to foreigners remained largely stable due to low U.S. interest rates. Over the same period, the deficit in net unilateral transfers rose $5.7 billion (19.2 percent) to $35.5 billion, as U.S. government grants increased and private remittance outflows stabilized.

Net International Investment Position

U.S. net international indebtedness, as measured by the Net International Investment Position (NIIP), narrowed to $2.74 trillion at the end of 2009 from $3.49 trillion at end-2008 when direct investment is valued using the current cost of tangible assets. The value of U.S. assets held abroad fell to $18.4 trillion in 2009, while the value of foreign-held assets in the U.S. decreased to $21.1 trillion. As a share of GDP, net international indebtedness narrowed to a 19.2 percent in 2009 from 24.2 percent in 2008. With direct investment valued using the market value of owner's equity, the net international indebtedness narrowed to $2.93 trillion (20.6 percent of GDP) in 2009 from $4.16 trillion (28.8 percent of GDP) in 2008.

U.S. NIIP

($tr)	2008	2009
US-owned assets abroad	19.24	18.38
Financial Derivatives	6.13	3.51
Official assets	0.92	0.49
Private assets	12.20	14.38
Direct investment	3.74	4.05
Foreign securities	3.99	5.47
Foreign-owned assets in the US	22.74	21.12
Financial Derivatives	5.97	3.38
Official assets	3.94	4.37
US government securities	3.26	3.59
US Treasury securities	2.40	2.87
Other assets	12.83	13.36
US Treasury securities	0.85	0.83
Net int'l investment position	-3.49	-2.74
% of GDP	-24.2	-19.2

While net financial flows increased overall U.S. net indebtedness in 2009, price and exchange rate movements more than offset these financial flows and worked to reduce net indebtedness in 2009. Net financial flows increased net indebtedness by $0.2 trillion, as net foreign acquisitions of U.S. financial assets exceeded net U.S. acquisitions of overseas assets. The rise in value of foreign assets held by U.S. residents outpaced value gains of foreign holdings of U.S. assets by $0.5 trillion. In addition, the depreciation of the dollar raised the dollar value of U.S. assets held by foreigners by $0.3 trillion.[2]

U.S. Bilateral Trade Balances

U.S. bilateral trade deficits with key trading partners generally declined in 2009, as shown in the table below. In the first four months of 2010, U.S. trade deficits expanded with most key trading partners, relative to the deficits in the first four months of 2009.

During 2009, the U.S. trade deficits with Canada and China declined the most in dollar terms. Both U.S. imports from and exports to Canada declined in 2009, but imports fell by twice as much as exports, partly as a result of lower average commodity prices. Similarly, U.S. imports from China fell at a much faster pace than U.S. exports.

Reflecting improved economic conditions, U.S. trade with Canada rose by more than 25 percent in the first four months of 2010, relative to the same period in 2009, but import growth was somewhat stronger resulting in a rise in the trade deficit. Although the U.S. trade deficit with China rose in the first four months of 2010 on a year-over-year basis, U.S. exports grew by more than three times the rate of growth in U.S. imports.

U.S. Bilateral Merchandise Trade Balances

	Trade Balance $ billions		Change in Balance[1]			
			2008-2009		Jan to Apr 2009-2010	
	2009	Jan-Apr 2010	Percent	$ billons	Percent	$ billions
U.S. trade deficit						
Canada	-21.6	-11.8	-72.4	-56.8	78.4	5.2
China	-226.9	-71.0	-15.4	-41.2	5.7	3.8
Euro Area	-50.6	-18.8	-34.9	-27.1	30.2	4.4
India	-4.7	-3.5	-41.1	-3.3	45.6	1.1
Japan	-44.7	-17.8	-39.7	-29.5	44.4	5.5
Korea	-10.6	-1.2	-20.9	-2.8	-76.0	-3.8
Malaysia	-12.9	-4.1	-27.6	-4.9	6.2	0.2
Mexico	-47.8	-20.8	-26.2	-17.0	49.9	6.9
Norway	-2.9	-1.6	-28.0	-1.1	112.4	0.9
Russia	-12.9	-5.3	-26.3	-4.6	42.4	1.6
Saudi Arabia	-11.3	-5.9	-73.4	-31.0	136.9	3.4
Taiwan	-9.9	-2.1	-13.4	-1.5	-51.1	-2.2
United Kingdom	-1.8	--	-64.4	-3.2	--	--
Venezuela	-18.7	-7.7	-51.7	-20.1	90.0	3.6
U.S. trade surplus						
Brazil	6.0	3.1	226.5	4.2	90.7	1.5
Singapore	6.5	4.3	-45.5	-5.4	102.0	2.1
Switzerland	1.5	0.3	-65.8	-2.8	-64.8	-0.6
United Kingdom	--	0.7	--	--	-14.3	-0.1

1. A negative sign in these columns indicates a decline in the U.S. bilateral trade deficit or surplus.
Source: U.S. Census Bureau

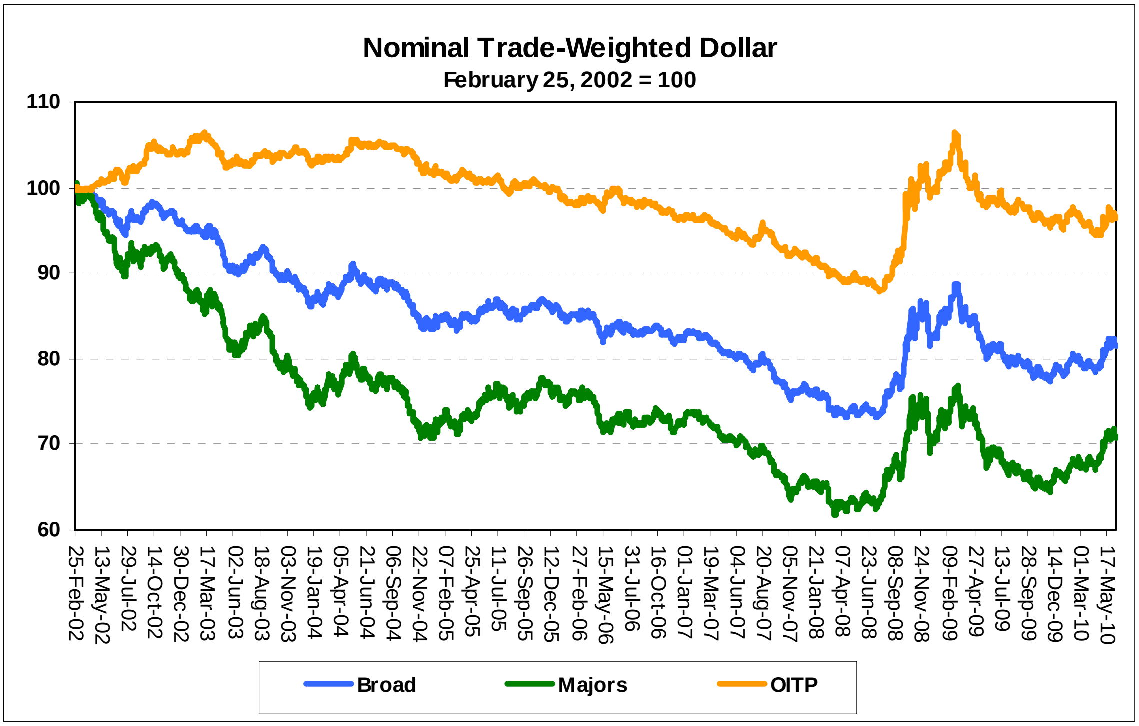
Among the countries discussed in this Report with which the U.S. has a merchandise trade surplus, the surplus with Brazil more than tripled in 2009, and is on track to expand further in 2010. The U.S. surplus with Singapore declined in 2009, but is up sharply in the first four months of 2010. U.S. exports to Singapore grew by 40 percent on a year-over-year basis in January through April 2010, the fastest rate in over 20 years.

The Dollar in Foreign Exchange Markets

On a nominal trade-weighted basis, the dollar depreciated by 5.0 percent from early July 2009 through November 2009. In December 2009, however, the dollar began to appreciate, and by mid-June 2010, it had moved 3.7 percent higher. This reflected an appreciation of 7.8 percent

[2] The NIIP is a measure of the stock of U.S. holdings of foreign assets minus the stock of U.S. liabilities owned by foreigners. For this reason, changes in the valuation of these asset and liability stocks can cause large year-to-year fluctuations, particularly when assets and liabilities are valued based on market prices.

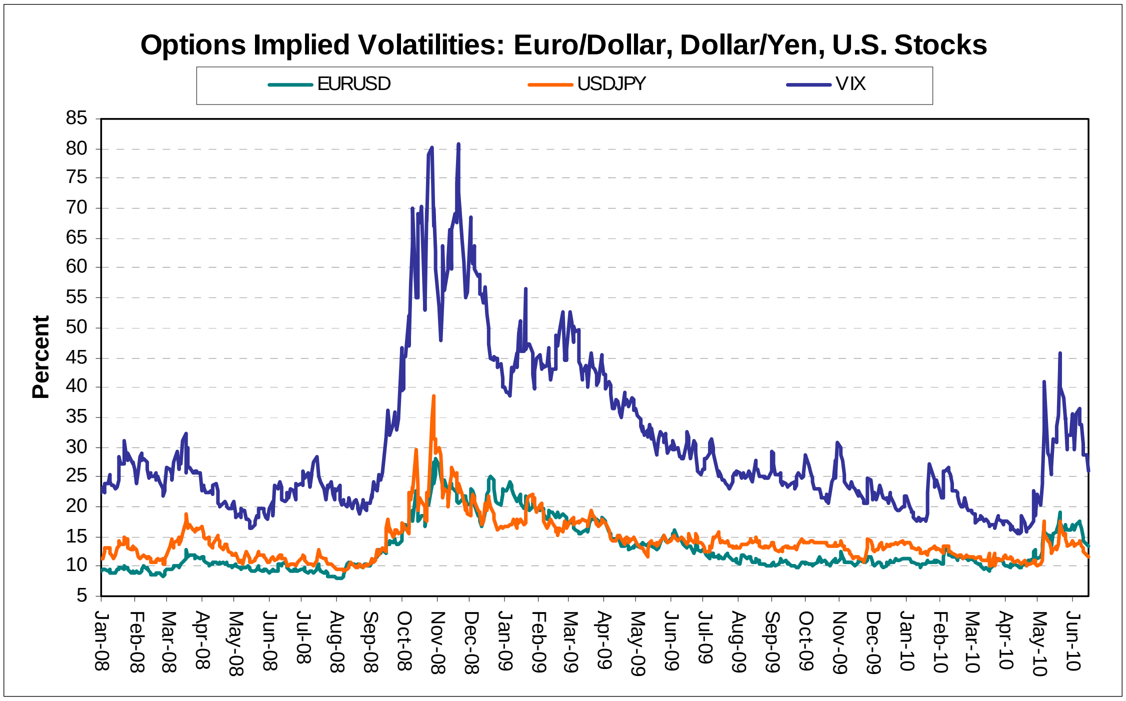
against major currencies and a depreciation of 0.2 percent against the currencies of other important trading partners (OITP) since the end of November.



The dollar's depreciation in the summer and fall of 2009 reflected market perceptions of growth prospects in economies overseas relative to the U.S. economy. With improved prospects abroad came an improvement in global investors' interest in taking greater exposure in a number of risk asset classes, including non-dollar currencies, commodities, and emerging markets. Of particular interest to investors were the assets and currencies of countries benefitting from the recovery in global trade and commodities prices -- among which were Brazil, China, India, and South Korea, as well as Australia, New Zealand, and Canada. Further, moderating volatility in the foreign exchange market and asset markets provided an environment conducive to taking greater risk exposure.

In December 2009, the dollar began a steady appreciation that continued through the first half of 2010, as market participants reassessed earlier expectations that total returns on risk asset classes would remain attractive relative to dollar assets. In addition, the U.S. economic growth outlook improved relative to forecasts for other major economies – supporting market expectations that U.S. interest rates would rise more than interest rates in the euro area, Japan, and the U.K. The reduction in risk exposure was not contained only to Europe or the advanced economies; market participants' positioning in emerging markets became increasingly selective and cautious in early 2010.

In the spring of 2010, spreading market concerns about sovereign debt in Greece and other euro area periphery countries led to a reduction of risk across all asset classes — not only periphery countries' sovereign debt but also global equities, commodities, and emerging market assets and currencies. Subsequently, the periphery countries' sovereign yield spreads to benchmark German government bonds and their respective sovereign credit default swap spreads widened sharply, demand for dollar liquidity pushed up spreads in unsecured funding markets, and volatility spiked higher in asset and currency markets. These pressures moderated considerably, but were not reversed completely, after the announcement in May of a €750 billion financial stability mechanism by the European Union together with IMF financial involvement to support Greece and other scenarios to defend against contagion within the euro area; a European Central Bank (ECB) securities markets program to purchase euro area sovereign bonds; and the reactivation of the dollar liquidity swap lines among the Federal Reserve, the Bank of Canada, Bank of England, the ECB, the Swiss National Bank, and the Bank of Japan. Markets were generally confident that these measures have materially reduced the risk of a large-scale systemic crisis, but there were still questions regarding the implementation of fiscal reforms.



Analyses of Individual Economies

Asia

<u>China</u>

China, like other emerging markets, was hit by the global financial crisis and recession. Its aggressive fiscal and monetary stimulus has resulted in a strong domestic demand-led economic recovery and a significant decline in its current account surplus. While some of the current account adjustment resulted from temporary cyclical factors and a substantial easing of monetary and fiscal policies, China has made progress in rebalancing its growth – depending less on exports for growth and more on domestic demand, and most importantly, consumption. Nevertheless, the decline in the current account surplus is likely to be reversed unless the government perseveres with policy efforts to rebalance the economy and to advance and implement a more flexible, market-determined exchange rate.

China's real GDP rose by 9.1 percent on a year-over-year basis in 2009, as fixed investment and consumption contributed approximately 8.2 percentage points and 4.6 percentage points to growth, respectively. Net exports subtracted 4.2 percentage points from growth in 2009, the first time net exports contracted since 1999.[3]

In the first quarter of 2010, China's economy continued to grow rapidly, with GDP rising by 11.9 percent year-on-year, as fixed investment and consumption contributed 6.9 percentage points and 6.2 percentage points of growth, respectively, substantially higher than in recent years. Net exports subtracted 1.2 percentage points from growth. In June 2010, the IMF projected that China would grow by 10.5 percent this year.

Exports fell sharply in the fourth quarter of 2008 as global demand dried up, and by May 2009, China's exports were down 26.1 percent from their May 2008 level. The rebound was also rapid, and by the end of 2009, exports had almost fully recovered to their pre-crisis level. By May 2010, China's exports were 49 percent above their May 2009 level and were 9.3 percent above their May 2008 level. Mainly reflecting China's massive stimulus package, the current account surplus fell from 9.4 percent of GDP in 2008 to 5.8 percent of GDP in 2009. In the first quarter of 2010 the current account surplus fell to 4.5 percent of GDP but the data are not seasonally adjusted, making comparisons with the annual data difficult.

U.S. exports to China have rebounded much more rapidly than overall U.S. exports, and are now 20 percent above their pre-crisis levels. In the second half of 2009, U.S. exports to China increased by 15 percent on a year-over-year basis, while U.S. exports to the rest of the world fell by 13 percent. In the first quarter of 2010, U.S. goods exports to China rose by more than 40 percent compared to the same period the year before, while U.S. exports to the rest of the world rose by less than 20 percent.

Part of the decline in China's trade surplus can be attributed to policies that China has implemented to boost consumption. As part of its stimulus package, China increased pension payments by 10 percent, and provided consumer subsidies for purchases of durable goods such as appliances and autos. To support long-term growth in consumption and reduce precautionary saving by households, the government increased social spending by 18 percent in 2009 (equivalent to 1.5 percent of GDP) and announced further measures to expand the safety net, including a three-year healthcare reform package (equivalent to 2.4 percent of 2009 GDP over 2009-11) and a new rural pension system. China's central government also has recently supported decisions by many provincial and municipal governments in the last year to substantially increase minimum wages. Higher wages will support the government's goal of spurring growth of household income and consumption. China's massive infrastructure investment program also should encourage domestic demand-led growth. Infrastructure investment is focused on the under-developed western and central regions, helping to drive a process of industrialization and urbanization that should lift incomes by absorbing excess rural labor, and spur housing investment (and associated consumer spending) in fast-growing interior cities.

[3] The expenditure components' contributions to GDP reflect China's preliminary 2009 GDP figure of 8.7 percent year-over-year, and have not yet been updated to reflect the revised GDP growth figure of 9.1 percent year-over-year.

Much of the recent decline in China's trade surplus, however, is likely a result of cyclical or temporary factors. Most importantly, there has been a significantly larger than normal growth differential between China and the rest of the world during the crisis period. Due in part to its timely and large-scale stimulus, China's economic slowdown was shallower than that of most of the rest of the world, and its economy began to recover much earlier. This resulted in much higher domestic demand growth in China relative to its major trading partners. According to the People's Bank of China, China's economic output has been above the economy's potential since the end of 2009. By March 2010, real industrial production was running 3 percent above potential. In comparison, according to the IMF, advanced economies, which are the end destination for the majority of China's exports, were running an output gap of 4.5 percent in 2009 and projected to run an output gap of 3.1 percent in 2010, as a result of growth that was far below long-term trends.

Looking forward, China's trade surplus is likely to rise again as the rest of the world recovers. The differential output gap between China and its major trading partners likely reached its cyclically widest point in the first half of 2010. As China withdraws stimulus, its output likely will return to potential. As advanced countries recover, their output gaps will narrow, as they already have for the last two quarters, and the differential between China's and advanced economies' output gaps will narrow.

To solidify the recent progress in reducing China's current account surplus, the government must implement exchange rate reform to complement the other structural reforms listed above. China reformed its exchange rate regime in 2005, moving off of its peg to the U.S. dollar and gradually to a more market-determined exchange rate. In July 2008, as the global financial crisis was growing, China temporarily returned to a policy of pegging the renminbi to the dollar, which it said was in response to growing volatility in global financial markets.

According to the Bank for International Settlements (BIS), China's real effective exchange rate (REER) has appreciated 22.7 percent since its exchange rate reform in July 2005, with 40 percent of that appreciation occurring since China re-pegged the RMB to the dollar in July 2008. Taking a longer view, China's REER is only 6.8 percent stronger than its average monthly level in the five-year period between 1998 and 2002.

In order to limit renminbi movement against the dollar, the PBOC purchases and sells foreign exchange reserves on a daily basis. Cumulatively, China has been a net purchaser of foreign exchange over the last ten years, as China has acted much more often to limit renminbi appreciation, rather than depreciation. These foreign exchange purchases reflect the PBOC's efforts to resist renminbi appreciation against the dollar. Although the pace of reserve accumulation has declined slightly over the past year, China continues to purchase large amounts of foreign exchange, adding to its reserves. In 2009, China's net purchases of foreign exchange reserves totaled $398 billion (8.1 percent of GDP), down from $480 billion (10.8 percent of GDP) in 2008, primarily reflecting China's narrowing current account surplus. In the first quarter of 2010, China purchased $96 billion (8.2 percent of GDP) in foreign exchange reserves, on pace with its 2009 accumulation.

Under its heavily managed exchange rate regime, China's reserve accumulation is in large part a reflection of resisting full appreciation that reflects market demand for the renminbi. China's central bank held $2.4 trillion worth of foreign reserves at the end of the first quarter of 2010, equivalent to 54 percent of China's 2009 GDP, or over 27 months of imports. China's state sector as a whole including the central bank, public banks, and China Investment Corporation holds roughly $3 trillion in foreign currency assets. China's foreign exchange reserves are roughly three times as high as the reserves held by Japan, the country with the second largest holdings.

On June 19, 2010, China announced that it was returning to an exchange rate regime that would be more flexible and more market based, with the renminbi allowed to trade within a band of plus/minus 0.5 percent against the dollar on a daily basis. On June 21, the first trading day following China's announcement, the renminbi appreciated 0.43 percent, the largest single day appreciation against the dollar since China's initial 2.1 percent revaluation on July 21, 2005. Between the June 19 announcement and July 2, the renminbi appreciated a total of 0.81 percent versus the dollar, while average intraday volatility has been much higher than that seen during the 2007-08 period of steady renminbi appreciation against the dollar.

China's policy shift is a significant development and a welcome step forward in fostering stronger, more sustainable, and more balanced global growth. What matters is how far and how fast the renminbi appreciates. This strengthening would complement other policy reforms to rebalance Chinese economic growth toward consumption and sustain the reduction in China's external imbalances.

China's continued rapid pace of foreign reserve accumulation; the limited appreciation of China's real effective exchange rate relative to rapid productivity growth in the traded goods sector; and the persistence of current account surpluses even during a period when China's trading partners are in deep recession – together suggest that the renminbi remains undervalued.

As during the 2005-08 period, it will take time before we can accurately assess whether China's recent exchange rate change will produce a sufficiently market-determined exchange rate to correct the undervaluation. A central bank that pursues a heavily managed exchange rate cannot announce in advance what future exchange rates will be, given the large amount of international capital that would move to take advantage of those announcements and complicate its conduct of monetary policy. Although between July 2005 and July 2008 the Chinese currency appreciated 21.2 percent against the dollar, the rate of appreciation varied significantly over the course of this period.

Exchange rate appreciation should play an important role in rebalancing China's economy towards domestic demand-led growth. It could also expand China's ability to set an independent monetary policy appropriate for Chinese economic conditions. As China's recovery strengthens, moving further to a more flexible, market-determined exchange rate would give monetary authorities greater scope to maintain price stability. This is particularly important in the short-run as China's economy grows above trend, and inflation is rising. In May 2010, consumer prices increased 3.1 percent year-on-year, above the government's 3 percent target for the year. Producer prices are rising even faster at 7.1 percent. Greater flexibility of China's exchange rate should also reduce incentives for foreign exchange intervention by other countries trying to maintain trade competitiveness vis-à-vis China, contributing to sustained and more balanced global growth.

China's exchange rate reform must be reinforced by macroeconomic policies that support domestic demand and other structural reforms to create a strong foundation for consumption-led growth. At the second meeting of the U.S.-China Strategic and Economic Dialogue (S&ED) on May 24-25, 2010, the two countries reiterated their commitment to "pursue policies of adjusting domestic demand and relative prices to lead to more sustainable and balanced trade and growth." China committed to continue its efforts to enhance the contribution of domestic consumption to its GDP growth, including through policies to: gradually increase the share of household income in national income; accelerate development of the service sector; speed up the reform of monopolies; increase access to finance for small- and medium-sized enterprises; and continue to strengthen the social safety net. If successfully implemented, and accompanied by market-based exchange rate reform, these initiatives should increase the role of domestic demand, particularly consumption, in China's GDP growth, reduce China's reliance on exports for growth, and maintain China's overall strong economic rate of growth.

IMF Article IV Reports on China, when they have been published, have provided valuable information about assessments of macroeconomic and exchange rate policy. We encourage China to resume publication of its Article IV Reports.

India

The global economic and financial crisis had a relatively muted effect on India, due to the country's limited dependence on external demand, and strong fiscal and monetary stimulus measures. Nevertheless, economic growth slowed to 6.8 percent in 2009, compared to an average rate of 9.4 percent in 2005 to 2007. Real GDP expanded by 16.8 percent on a seasonally adjusted annualized basis in the third quarter of 2009, before contracting in the fourth quarter by 2.8 percent as the worst monsoon in nearly 25 years resulted in a steep decline in agricultural output. The fourth quarter was only a pause in the recovery. The economy grew by 13.5 percent on an annualized basis in the first quarter of 2010. The IMF expects the Indian economy to grow by 9.4 percent in 2010.

The 2009 monsoon also boosted inflation. Rising food prices helped push average monthly CPI inflation to 13.3 percent year-over-year in the second half of 2009, compared to an average of 9.6 percent in the first half of the year. In April 2010, CPI inflation was 14.4 percent. As a result of India's robust recovery in the second half of 2009, and rising inflationary pressures, the Reserve Bank of India (RBI) and the Indian government are normalizing monetary and fiscal policy conditions. In January 2010, the RBI raised its cash reserve ratio by 75 basis points (to 5.75 percent) to reduce excess liquidity in the banking system. In March, it raised both the repo (lending) and reverse-repo (liquidity absorption) rates (by 25 basis points), and in April, it raised all three policy rates by an additional 25 basis points.

In February 2010, the Indian government released its FY2010-11 (April to March) budget which prescribed a modest fiscal consolidation, aiming to reduce the central government fiscal deficit to 5.5 percent of GDP from 6.9 percent of GDP in FY2009-10. The planned deficit reduction would be achieved through increased revenue mobilization, rather than cutbacks in government spending. India is expected to continue to pursue fiscal consolidation, due to its large general government deficit (about 11 percent of GDP in FY2008-09) and high public debt to GDP ratio (about 80 percent, substantially higher than most emerging market economies).

Following a narrowing of the current account deficit to 0.5 percent of GDP in the first quarter of 2009, the deficit began to rise, reaching 4.2 percent in the fourth quarter. The widening of the deficit was primarily a consequence of a stronger rebound in imports than exports and a decline in the surplus of trade in services. Capital inflows strengthened in the second half of 2009, due to a resurgence of investor risk appetite.

India’s official exchange rate arrangement is a managed float, and the rupee moved significantly in both directions during 2009. The rupee was unchanged against the dollar in the third quarter of 2009, but appreciated by 2.8 percent in the fourth quarter in line with improvements in risk appetite and capital inflows. The rupee appreciated an additional 4.6 percent in 2010 through April, but has since fallen 4.0 percent through mid-June. On a real effective basis, the rupee appreciated by 3.9 percent in second half of 2009 and by 9.6 percent during the first five months of 2010, according to the BIS index. Foreign currency reserves rose by $4.5 billion in the second half of 2009 to $259 billion, and as of end-March 2010 declined to $255 billion. The changes were due primarily to valuation effects.

The stated aim of foreign exchange intervention is to smooth volatility. While the RBI seeks to achieve its monetary objectives of price stability and well-anchored inflation expectations by adjusting market liquidity through its policy rates and the cash reserve ratio, at times, it has used the exchange rate to help meet monetary objectives.

Japan

Japan is continuing to emerge from the most severe recession in its postwar history. After falling 8.6 percent between the first quarter of 2008 and the first quarter for 2009, real GDP has risen over the past four quarters, with 5 percent real GDP growth in the first quarter of 2010 on a seasonally-adjusted annualized basis. The recovery has been driven primarily by export growth.

Japan’s exports began to recover in March 2009 after a sharp decline in external demand from the global recession. Japan’s trade balance returned to surplus in the second quarter of 2009, following three consecutive quarters in deficit, and remained in surplus through the first quarter of 2010. Throughout this time, the current account remained in surplus driven by Japan’s substantial positive net income on foreign investment. Japan’s current account surplus was 2.8 percent of GDP in 2009 and rose to 3.8 percent of GDP in the first quarter of 2010.

Japan’s policy environment remains accommodative. The government announced a fifth stimulus package in December 2009 following four separate stimulus packages in 2008 and 2009. The government expects the December package to add approximately 0.7 percentage points to GDP in 2010, on top of the cumulative 2.0 percentage point contribution from the previous four packages. The consolidated fiscal deficit is estimated to have widened from 2.9 percent of GDP in FY2007 (April 2007 to March 2008) to about 11 percent of GDP in FY2009 as a result of the stimulus measures and a fall in revenue.

The Bank of Japan (BOJ) has maintained an accommodative policy stance, keeping its policy rate (the uncollateralized overnight call rate) at 0.1 percent since December 2008. Japan slipped back into deflation in early 2009. As of April 2010, headline consumer prices fell 1.2 percent year-over-year. Core prices (excluding perishable foods and energy) were down 1.2 percent in December. BOJ Policy Board members expect deflation to persist into early 2012.

In October 2009, the BOJ began to unwind some of it crisis response measures, halting outright purchases of commercial paper and corporate bonds. However, the central bank did extend several other market stabilization measures, including special lending facilities for three-month funds against corporate debt collateral and for sectors viewed as having above-average growth potential, as well as the payment of interest on excess reserve balances. In May 2010, market stress related to conditions in Europe led the BOJ to inject over $20 billion into the financial system and to re-establish its dollar-swap arrangement with the U.S. Federal Reserve.

The Japanese yen appreciated by 3.4 percent against the dollar in the second half of 2009, but depreciated by 0.4 percent against the dollar in the first quarter of 2010, before rising 2.1 percent through mid-June. On a real effective basis the yen appreciated by 2.5 percent in the second half of 2009 but depreciated by 1.3 percent in the first five months of 2010. Yen movement over this period has largely reflected investor reactions to changing political dynamics in Japan, including the political transition last September and change in administration this May, as well as shifts in investors' risk appetites.

Japan maintains a floating exchange rate regime and Japanese authorities have not intervened in the foreign exchange market since March 2004. Japan's foreign exchange reserves rose by 0.8 percent in the second half of 2009 to $996 billion as a result of valuation changes on existing reserve holdings and interest earnings. In 2010, they have declined by 0.9 percent and stood at $987.6 billion at the end of May.

Malaysia

Following two quarters of sharp declines, real GDP began expanding in the second quarter of 2009 and rose by 9.8 percent and 13.1 percent on a seasonally adjusted annualized basis in the third and fourth quarters of 2009, respectively. The robust recovery continued in the first quarter of 2010, with real GDP rising by 7.2 percent. The government stimulus played a key role in the third quarter of 2009, whereas export growth was the key factor supporting growth in the fourth quarter of 2009 and first quarter of 2010.

The Bank Negara Malaysia (BNM) began raising its policy rate in March 2010, as output strengthened and consumer prices began rising after falling through much of the second half of 2009. In May, the BNM raised its policy rate again, bringing it to 2.5 percent. The government intends to adopt a less stimulative fiscal policy in 2010, with a projected deficit of 5.3 percent (compared to 7.0 percent in 2009).

Malaysia's current account surplus has exceeded 12 percent of GDP since 2002, reflecting its persistent saving-investment imbalance. Saving in Malaysia remains high at approximately 38 percent of GDP, while investment stood at 20 percent of GDP in 2009, reflecting the constraints on domestic investment opportunities from issues such as ownership set-asides for ethnic Malays and the government's large shareholding in publicly held corporations. Malaysia's current account surplus increased to 21 percent of GDP during the height of the economic downturn, reflecting a steep decline in imports. The current account surplus has since returned to 17 percent of GDP as imports (which are heavily concentrated in intermediate goods) have increased in line with a rise in industrial production.

The government of Malaysia is taking initial steps to address constraints on domestic investment opportunities as part of a broad reform initiative to raise Malaysian growth and income levels. In March 2010, Malaysia's prime minister outlined the goals of the New Economic Model (NEM), which builds on earlier commitments to bolster the services sector, to increase foreign direct investment, and to reduce government ownership in the private sector. The release of the 10th Malaysia Plan in June provided more specific policy reforms that will help the government achieve the NEM's goals. Implementation of these reforms will take time, however, as the NEM calls for significant changes in economic policy and challenges many of the political assumptions of past policy by shifting from ethnic-based to income-based government assistance.

The central bank continues to maintain a managed floating exchange rate regime. Officially, the central bank has no explicit exchange rate target and in fact has intervened in both directions to limit changes in the exchange rate. Since the first quarter of 2009, the ringgit's nominal exchange rate has steadily appreciated against the dollar, rising 7.6 percent in the last three quarters of 2009 (compared to its low in March 2009) and an additional 5 percent in 2010 through mid-June. The real effective exchange rate was steady through most of the second half of 2009, falling 0.3 percent between the end of June and end of December, but has appreciated by 6.6 percent in the first five months of 2010. By the end of the first quarter of 2010, Malaysia's foreign exchange reserves expanded to $86.1 billion, up from its low of $82 billion in mid-2009, but BNM intervened heavily in the early part of the crisis to limit ringgit depreciation, and reserves remain sharply lower than their June 2008 peak. With the onset of the debt crisis in Greece, however, the ringgit came under moderate pressure. Foreign exchange reserves fell by $1.1 billion, and the ringgit depreciated slightly in May.

Singapore

Singapore is a highly open economy and, as such, trade has a larger impact on Singapore than on other countries in Southeast Asia. Following several years of steady growth (real GDP growth averaged 7.8 percent from 2005-2007), collapsing exports in 2008/09 led to the most severe contraction in the country's history. Economic recovery began in the second quarter of 2009, with real GDP growing by 18.5 percent at a seasonally adjusted annualized rate and rising 11 percent in the third quarter reflecting broad-based export growth in the manufacturing and services sectors, as well as improving domestic demand. After a 1 percentage point contraction in the fourth quarter, the economy rebounded in the first quarter of 2010, growing by 38.6 percent on a seasonally-adjusted annualized basis, driven by strong investment and export growth. Private consumption was stagnant. Overall, real GDP fell by 2 percent in 2009, but the government forecasts significant export-led growth this year, recently revising upward its growth projection to between 7 and 9 percent.

Although an upturn in external demand has driven the country's recovery, the fiscal stimulus package, which emphasized new spending and corporate subsidies designed to retain employment, helped limit the recession's impact. In February 2010, the government announced a budget for 2010, which is expected to result in a deficit of 1.1 percent of GDP (versus a deficit of 3.5 percent of GDP in 2009). The government is phasing out corporate employee retention subsidies, but working to boost long-term growth with a new strategy focused largely on increased productivity.

Singapore's current account surplus peaked at 30.6 percent of GDP in the first quarter of 2007, but fell to 15.0 percent by the first quarter of 2009. Rebounding exports in the second half of 2009 combined with weak import demand increased the current account surplus to 20.6 percent of GDP in the last quarter of 2009. The current account balance dropped again to 15.3 percent during first quarter of 2010 as imports picked up pace.

In 2009, the central bank continued to intervene to limit exchange rate volatility, consistent with the stated goal of using the exchange rate to address price stability. The Monetary Authority of Singapore (MAS) manages the currency within a tight nominal effective exchange rate (NEER) band, and maintained a zero appreciation policy through the first quarter of 2010. Accordingly, the Singapore dollar (SGD) appreciated minimally in nominal effective terms in 2009: 1.5 percent. On a real effective basis, the SGD depreciated by nearly 7.3 percent in 2009 (7.3 percent in the first half and 0 percent in the second half of 2009), as consumer prices declined (on a year-over-year basis) through the second half of 2009. Noting a stronger than expected recovery, in April 2010 MAS re-centered the exchange rate band at the prevailing NEER, and reverted to a "gradual and modest appreciation" trend for the band. The SGD appreciated 2.1 percent on a NEER basis and 2.4 percent on a real effective basis from January through May 2010.

Against the U.S. dollar, the SGD appreciated by 3.0 percent in the second half of 2009. During this period, renewed capital inflows allowed the MAS to accumulate foreign exchange reserves that had been lost during the depth of the crisis. Foreign exchange reserves totaled $187.4 billion by end-December, and by May 2010 had reached $198 billion -- equivalent to about eight months of imports and about 100 percent of GDP – above pre-crisis reserve levels. From January through April 2010, the SGD appreciated an additional 2.5 percent against the U.S. dollar, but depreciated by 2.1 percent in May during a period of heavy capital outflows triggered by concerns on European credit risk.

South Korea

Despite being one of the hardest-hit countries in the region by the global financial crisis, South Korea is showing signs of a durable recovery. The Korean economy managed to avoid a contraction in 2009 with 0.2 percent growth, driven by significant domestic economic stimulus and positive net exports. Real GDP grew at 8.8 percent in the first quarter of 2010 on a seasonally-adjusted annualized basis, attributed by the Bank of Korea (BOK) to double digit gains on exports and investment, particularly in machinery and equipment. The IMF expects real GDP to grow by 5.7 percent in 2010.

The government has announced that it will gradually and cautiously remove stimulus measures in the second half of 2010. Korea's 2009 fiscal stimulus package totaled 3.8 percent of GDP ($30 billion), one of the largest among G-20 countries, and contributed to a record fiscal deficit of 4.1 percent of GDP. The government plans to scale back spending in the second half of 2010 and in 2011 to achieve a fiscal balance by 2014.

On the monetary side, the benchmark interest rate has remained at 2 percent since February 2009, the lowest level in over a decade. However, the BOK has absorbed much of the liquidity extended to the financial system during the crisis, including all of the foreign currency liquidity provided to exporters and banks. On June 24, the BOK reduced the ceiling on special loans for small- and medium-sized enterprises, unwinding some of its liquidity support to the sector.

South Korea posted a record $40 billion trade surplus in 2009 with the recovery of Korean merchandise exports, which expanded by 16.8 percent in the second half of 2009 and benefited from improved terms of trade, global inventory restocking, and stimulus programs overseas that boosted demand for Korean automobiles and electronics. Korea's exports to China, which make up a quarter of its total exports, rebounded particularly strongly in 2009, while exports to the United States, which account for ten percent of total exports, recovered to pre-crisis levels in the first quarter of 2010. Korean imports from the United States are also recovering, expanding 13 percent in the first quarter of 2010.

Korea's current account reached a record annual surplus of 5.2 percent of GDP in 2009. In the first quarter of 2010 the surplus declined to at 1.3 percent of GDP as the merchandise trade surplus fell. Investors returned to Korean markets in 2009. The main pressure on the capital account during the financial crisis – the inability of banks to roll over short-term debt – has eased, as global liquidity levels have begun to normalize, and Korea's short-term external debt declined from a record peak of $189 billion in the third quarter of 2008 to $154 billion in the first quarter of 2010. Recently, the government proposed regulations on the currency forward transactions of domestic and foreign banks operating in Korea that may affect both capital inflows and outflows.

The BOK maintains a floating exchange rate but intervenes to smooth won volatility. The won appreciated 8.5 percent against the dollar in the second half of 2009 and 3 percent in the first quarter of 2010, as global liquidity conditions began to improve, the Korean economy continued to grow, and capital inflows returned. On a real effective basis the won appreciated 5.9 percent in the second half of 2009 and 3.8 percent in the first quarter of 2010. Between the end of March and mid-June the won depreciated 6.6 percent against the dollar as market turbulence resulting from concerns about European sovereign debt led to an increase in risk aversion. Foreign exchange reserves increased by $34.5 billion in the second half of 2009 and reached a record high of $274 billion in April 2010 (180 percent of short-term external debt and 9.2 months of imports).

Taiwan

Taiwan's economic recovery gained momentum in the second half of 2009 as global demand for exports rebounded. Taiwan's economy has historically been vulnerable to swings in global demand, as exports amount to over 70 percent of its GDP. Real GDP rose 11.2 and 16.7 percent at an annualized rate in the third and fourth quarters, respectively, although for all of 2009 output declined by 1.9 percent. The economy continued to expand rapidly in the first quarter of 2010; real GDP grew 11.3 percent supported by rapid export growth and rising investment. The authorities expect real GDP to grow by 6.1 percent in 2010.

The authorities continued stimulus policies in the second half of 2009 and into 2010. In May 2010, the legislature approved an additional economic stimulus and public construction budget of $5.9 billion, equal to 0.2 percent of GDP. Apart from the stimulus, the government plans to spend $3.6 billion over four years for relief and reconstruction following Typhoon Morakat in August 2009.

With the economy recovering and consumer prices starting to rise again, the central bank raised its policy rate by 12.5 basis points in June 2010. In September 2009, Taiwan's finance ministry announced a comprehensive budget-reform program aimed at keeping central government public debt below the 40 percent legal limit. The 2010 budget approved in January targeted a fiscal deficit of 3 percent of GDP, and in May 2010, the legislature proposed tightening the debt limit further, while the authorities counter-proposed relaxing debt limits for borrowing by municipalities, counties, and townships. Currently, central government public debt stands at 32 percent of GDP. The authorities have set a goal of a balanced budget by 2016.

Taiwan's trade surplus rose sharply in 2009 as imports fell faster than exports in the first quarter and recovered more slowly the remainder of the year. In the first five months of 2010, strong export growth continued, particularly to China and developing Asia, and nominal exports are back to pre-crisis levels. Taiwan's exports to the United States contracted 17.5 percent in the second half of 2009, and Taiwan's imports from the United States fell 2.1 percent. For the first four months of 2010, U.S. exports to Taiwan increased 75 percent and U.S. imports from Taiwan increased 13.7 percent compared with the same period last year.

The current account surplus in the second half of 2009 was 9.5 percent of GDP, down from 12.8 percent in the first half of the year. In addition to the large trade surplus, the income surplus in 2009 was the highest on record, on increased income from residents' direct investment abroad and lower payments to foreign equity investors. Foreign portfolio inflows were strong, in part due to expectations of improved economic and financial linkages with China. However, domestic residents and corporates recorded an even larger net outflow in investments as they reversed the trend of repatriating offshore portfolio investments during the crisis. In the first quarter of 2010, the current account surplus was 8.8 percent of GDP, barely down from 8.9 percent of GDP in the fourth quarter of 2009, and net inflows from portfolio investment and other investment slowed.

Appreciation pressure on the currency increased in the second half of 2009 on optimism about the benefits of increased economic ties with China. The New Taiwan Dollar (NTD) appreciated by 2.7 percent against the U.S. dollar and by 1.9 percent on a real effective basis, using the central bank's exchange rate index, in the second half of 2009. In the first quarter of 2010, the NTD appreciated by 0.81 percent against the U.S. dollar but depreciated by 1.4 percent between the end of March and mid-June, as a result of increased risk aversion linked to sovereign debt problems in Europe. On a real effective basis, the NTD appreciated 3.4 percent in the first five months of 2010.

In November 2009, the authorities banned overseas equity investors from putting money in time deposits to counter speculative inflows. According to Taiwan's central bank, Taiwan's exchange rate is market-determined except in instances when "the market is disrupted by seasonal or irregular factors" and the central bank intervenes.

Taiwan's foreign currency reserves increased by $31 billion in the second half of 2009 to $348 billion. Reserves grew by an additional $12 billion in the first five months of 2010, which the central bank attributed to returns from foreign exchange management. Taiwan's foreign exchange reserves represent the equivalent of 95 percent of GDP, 20 months of imports, and about five times the economy's short-term external debt.

Europe

Euro Area

Real GDP in the 16 economies of the euro area rose in the second half of 2009 following five quarters of decline. Output expanded at an annualized rate of 1.6 percent and 0.5 percent in the third and fourth quarters of 2009, respectively. The euro area economy expanded at a 0.8 percent annualized rate in the first quarter of 2010. There are however large divergences in growth rates across the euro area. Recessionary conditions continued in Finland, Greece, Ireland, and Slovenia. In contrast, the first quarter marked the fourth consecutive quarterly rise in real GDP in France, Germany, and Slovakia. The IMF projects real GDP in the currency area will grow by 1.0 percent in 2010.

The euro area's current account deficit fell to 0.4 percent of GDP in the second half of 2009 and to 0.2 of GDP in the first quarter of 2010. Despite the near balance in euro area current account, substantial imbalances remain among euro area countries. Germany's current account surplus declined during the peak of the crisis, but began rising in the second quarter of 2009 as global trade started recovering. Germany's current account surplus was 6 percent of GDP in the second half of 2009, although it moderated to 4.8 percent of GDP in the first quarter of 2010. The current accounts of the other major euro area economies remained in deficit. France's current account deficit was a seasonally-adjusted 2.0 percent of GDP in the second half of 2009, Italy's deficit was 2.8 percent of GDP, and Spain's was 5.2 percent of GDP.

Fiscal measures to support the economy will continue through 2010, but the debt crisis in Greece has prompted a more rapid shift in focus to deficit reduction in some countries with high fiscal deficits and rising debt levels. The ECB has resumed long-term liquidity auctions and revised plans to raise its collateral requirements. Notably, in May the ECB also announced plans to purchase European public and private securities to reduce the funding stresses in some euro area markets. The ECB has purchased almost $60 billion in securities as of June 11, although it is sterilizing these purchases by offering one week fixed-rate deposits. The ECB's policy rate, the minimum refinancing rate, has been set at 1 percent since May 2009.

Euro area leaders agreed in early May to an €80 billion ($96 billion) support package for Greece (supplemented by an additional €30 billion in IMF funding) with each euro area country's contribution determined by its capital share in the ECB. After market fears spread to other euro area countries, national leaders agreed to apply a similar formula to create a €440 billion ($530 billion) special purpose vehicle called the European Financial Stability Facility (EFSF). The EFSF will be able to make loans to other euro area countries in financing difficulties, backed by guarantees from each euro area country, again with each country's share determined by its capital share in the ECB. The EU itself has the ability to make up to an additional €60 billion ($72 billion) in loans, so the total potential support for the rest of the euro area (Greece is supported separately) is €500 billion ($600 billion)   While the EU itself will play a relatively minor role in financing, it must approve each country's adjustment program prior to loan disbursement, and European leaders are currently in negotiations to give the EU enhanced budget surveillance and enforcement capabilities to prevent a repeat of the crisis.

Euro area bank credit to households and non-financial corporations began declining on a year-over-year basis in September 2009 and though the fall in credit shows signs of bottoming out, credit continued to fall through April 2010. Ongoing challenges in repairing financial institutions' balance sheets could continue to constrain bank lending, increasing the risks to recovery in the euro area. The EU will coordinate a new set of stress tests of the 25 largest European banks in July, an exercise intended to gauge whether the banks are strong enough to cope with a sharp deterioration in the economy. The results of these tests are expected to be published, which should help reduce market uncertainty, and national regulators may extend the stress tests to other banks.

The value of the euro in foreign exchange markets is market-determined. The ECB has not intervened in the foreign exchange market since November 2000, when it defended the euro against depreciation. The euro rose by 2.0 percent against the dollar in the second half of 2009, but market concerns over European growth prospects, high levels of debt in some countries, and uneven policy response have pushed the euro down 15.7 percent in 2010, through mid-June. On a real effective basis, the euro rose 0.5 percent in the second half of 2009, but has fallen by 10.0 percent in the first five months of 2010.

Norway

Norway's economy returned to modest growth in the second half of 2009, with real GDP expanding 2.2 percent in the third quarter and 0.5 percent in the fourth quarter on a seasonally adjusted annualized basis. Real GDP declined by 0.5 percent in the first quarter of 2010 as a result of a contraction in the petroleum sector. Excluding this sector, mainland real GDP has grown for the past four quarters, boosted by household consumption. Interest rate cuts by the Norges Bank helped fuel disposable income growth due to the predominance of floating rate mortgages. Fiscal stimulus also helped to mitigate the downturn.

The Norges Bank began removing its policy accommodation in October 2009, raising interest rates by a cumulative 50 basis points in the fourth quarter, and a further 25 basis points in the first quarter of 2010. The central bank also discontinued swap operations designed to boost liquidity in the financial sector. A sharp increase in lending by mortgage companies has more than offset deleveraging by private banks, prompting continued concerns about the risks of a real estate bubble. In the May 2010 budget revision, the government announced that some stimulus spending planned (but not implemented) for 2009 would be shifted to 2010, while gradually tightening fiscal policy to reduce the non-oil structural deficit.

Norway has a floating exchange rate and has not intervened in exchange markets since January 1999. Foreign exchange reserves fell by 2.7 percent in the second half of 2009 but have risen 7.5 percent in 2010 through April. Though the central bank undertakes foreign exchange transactions for operational purposes, including the management of the Government Pension Fund-Global (GPF-G), its purchases were very limited throughout 2009, due to increased government spending of oil revenues. The krone appreciated 10.2 percent against the dollar in the third quarter of 2009, but stabilized in the fourth quarter (depreciating 0.3 percent). The krone has depreciated a further 9.9 percent against the dollar in 2010 through mid-June, mostly since early April. On a real effective basis, the currency rose 6.5 percent in the second half of 2009 and appreciated a further 4.7 percent through May 2010. Norway's current account surplus declined in 2009 averaging 13 percent of GDP in the second half of the year. The surplus rose to 19 percent of GDP in the first quarter of 2010 as imports fell.

Russia

Russia's economy rebounded sharply in the third quarter of 2009, with real GDP rising by 11.3 percent on an annualized basis. However, investment – largely in the form of inventory restocking – accounted for most of the increase, while consumption continued to decline at a moderate pace. Economic growth slowed in the fourth quarter (to 3.6 percent annualized) and the first quarter of 2010 (to 0.4 percent annualized). The IMF projects 4.3 percent growth for 2010, though some private forecasters predict considerably higher growth. Inflation continued to slow during the second half of 2009, reaching 8.8 percent on a year-over-year basis in December and 6.0 percent in May 2010. Russian authorities reported a fiscal deficit for 2009 of 5.9 percent of GDP, which was less than earlier government projections due to higher than expected average oil prices.

A partial recovery in commodity prices and a resumption of capital inflows since the first quarter of 2009 has put renewed upward pressure on the ruble. To discourage short-term inflows and support the economic recovery the Central Bank of Russia (CBR) continued to reduce its policy interest rates, cutting its refinancing rate by a cumulative 275 basis points during the second half of 2009. While moving toward greater flexibility in the ruble exchange rate (the trading band was widened by 10 percent in January 2009), the CBR continues to watch the currency's value against a dollar/euro basket and to intervene to prevent sharp movements. The CBR purchased a net $11.6 billion in foreign exchange during the second half of 2009, while the ruble appreciated 1.9 percent in nominal terms against the dollar/euro basket. In the first four months of 2010, foreign currency reserves rose by $19.3 billion. In May, however, foreign currency reserves fell by $6.3 billion as the euro declined and concerns about European growth weighed on the ruble. The ruble's real exchange rate appreciated 0.2 percent in the second half of 2009, after falling 4.2 percent in the first half. In the first five months of 2010, the ruble's real exchange rate has risen 10.8 percent.

Exports and imports both began growing in early 2009, but exports have expanded more rapidly, resulting in a rise in the current account surplus to 5.9 percent of GDP in the fourth quarter of 2009. The current account surplus rose by a further 7.6 percent during the first quarter of 2010.

The balance of the Oil Reserve Fund declined to $61 billion in December 2009, from $95 billion in June 2009. The Russian government had initially forecasted that the Fund would be depleted by the end of 2010, but higher than expected oil prices may allow authorities to preserve a portion of the Fund for 2011. As of end-May 2010, the balance stood at just under $40 billion. Russian officials have increased issuance of domestic debt and recently issued a $5.5 billion Eurobond. The Government intends to limit recourse to the National Welfare Fund, which stood at $85.8 billion as of May 2010, and which is set aside to meet long-term pension obligations.

Switzerland

The Swiss economy returned to growth in the third quarter of 2009, after four consecutive quarterly contractions. Real GDP grew by 2.2 percent and 3.5 percent on an annualized basis in the third and fourth quarters of 2009, respectively. The economy continued to expand in the first quarter of 2010, albeit at a more moderate pace of 1.6 percent. Switzerland's flexible economy and largely debt-free public sector helped it weather the crisis relatively well. Although real GDP fell by 1.5 percent in 2009, this was less than many other advanced economies, and the

IMF forecasts that Switzerland will grow by 1.5 percent this year. However, Switzerland's low levels of public debt and relatively robust recovery amid growing uncertainty in the euro area have pushed the Swiss franc to historically high levels, which could weaken the competitiveness of Switzerland's open and closely Europe-integrated economy.

The Swiss government's strong fiscal position (net debt was only 10 percent of GDP at the end of 2009) allowed it to implement countercyclical measures worth about 0.8 percent of GDP last year, helping maintain demand during the economic downturn. The government also extended massive support to the financial sector, amounting to up to 9 percent of GDP. In August 2009, however, the government was able to sell its $5.2 billion stake in UBS to institutional investors. The Swiss National Bank (SNB) has begun to withdraw some of its support measures, while maintaining its target for the Swiss three-month LIBOR at "approximately" 0.25 percent since March 2009. In December 2009, the SNB announced an end to its policy of "credit easing," i.e., the purchase of Swiss franc bonds issued by private sector borrowers.

In March 2009, the SNB initiated a policy to intervene in the foreign exchange market to "prevent any appreciation of the Swiss franc against the euro." These interventions were unsterilized, and as the threat of deflation diminished and upward pressure on the Swiss franc continued, the SNB subsequently amended its policy. In March 2010, the SNB shifted its stance to prevent "excessive" appreciation, and in June 2010, appeared to end its foreign exchange intervention policy altogether, noting it would resume intervention if further currency appreciation threatened deflation. Switzerland's foreign exchange intervention resulted in a massive increase in Swiss foreign exchange reserves. Reserves doubled in dollar terms between February and December 2009, and continued to rise in early 2010, reaching $118 billion by the end of March 2010. While the SNB's actions were targeted at preventing excessive currency appreciation that could undermine Switzerland's economic recovery, during 2009 it has also had the effect of reducing financial stresses in Central Europe, where Swiss franc-denominated loans are common and where the Swiss franc's recent appreciation was adding to difficulties faced by borrowers in those countries.

The U.S. dollar fell by 4.7 percent against the Swiss franc in the second half of 2009, but has appreciated in 2010, rising 7.1 percent by mid-June. On a real effective basis, the Swiss franc rose 1.1 percent in the second half of 2009 but has depreciated by 0.6 percent in the first five months of 2010. Switzerland's current account surplus was 9.1 percent of GDP in the second half of 2009, in line with Switzerland's historical trend (the Swiss current account was near balance in the second half of 2008, but only because the financial crisis caused a huge deficit on net income).

United Kingdom

The United Kingdom (UK) economy returned to modest growth in the fourth quarter of 2009, with real GDP expanding 1.8 percent on a seasonally-adjusted annualized basis, following six consecutive quarters of decline. Domestic consumption expenditure provided a modest boost to the economy while investment continued to decline. A rise in exports during the fourth quarter was more than offset by rising imports. For 2009 as a whole, real GDP contracted 4.9 percent. In the first quarter of 2010 the economy grew by 1.2 percent on an annualized basis led by a rebound in investment and government consumption. Household consumption and exports were stagnant. The expiration of the temporary cut in the VAT at the end of December 2009, likely reduced consumption in the first quarter relative to the fourth quarter. The IMF expects growth of 1.2 percent in 2010.

The economic downturn, in conjunction with stimulus measures, caused a sharp increase in the UK's fiscal deficit. The overall fiscal deficit increased from 4.8 percent of GDP in 2008 to 11.5 percent of GDP in 2009. Consequently, public debt increased from 52 percent of GDP in 2008 to 68 percent of GDP in 2009. The new coalition Government that formed after the May 2010 elections has committed to an accelerated reduction in the fiscal deficit, led by expenditure reductions. On June 22, the Government announced discretionary fiscal consolidation measures in its emergency budget amounting to more than 6 percent of GDP through the 2014-2015 budget cycle. Roughly 80 percent of the consolidation will come in spending reductions.
The Bank of England (BOE) maintained its repo rate at 0.50 percent through the second half of 2009 and continued its policy of aggressive "unconventional" monetary easing measures focused on purchases of long-term government debt. In March 2010, the BOE suspended its quantitative easing program but kept the policy rate unchanged. Inflation, as measured by the consumer price index, was 3.3 percent on a year-over-year basis in May 2010, well above the BOE's 2 percent target. Much of the rise, however, is attributed to an increase in the value-added tax that took place in January.

The pound depreciated against the dollar in the second half of 2009, falling 1.8 percent, after rising by 11.3 percent in the first half. The downward trend in the pound against the dollar continued into 2010, with the pound depreciating an additional 9.0 percent through mid-June 2010. On a real effective basis, the pound depreciated by 3.1 percent in the second half of 2009 but appreciated by 0.1 percent through May 2010. The U.K. has a freely floating market-determined exchange rate, and the BOE has not intervened in the foreign exchange market since September 2000, when it did so in coordination with other G-7 central banks to support the euro.

The current account deficit declined in the second half of 2009, falling to 1.7 percent of GDP in the third quarter of 2009 and 0.5 percent of GDP in the fourth quarter of 2009, well below its peak of 2.8 percent in the fourth quarter of 2009.

Middle East

Saudi Arabia

Saudi Arabia weathered the global economic crisis relatively well, with robust countercyclical spending supporting domestic demand. Real GDP grew by 0.1 percent in 2009 and the IMF expects growth to rise to 3.7 percent in 2010 on the back of continued fiscal stimulus and rising oil prices. The recovery is supported by a large fiscal stimulus package of 3.3 percent of GDP in 2009 and 3.5 percent in 2010. Saudi Arabia's fiscal stimulus package is part of a 5-year, $400 billion investment plan that is aimed to help diversify the economy over the long-term.

Despite the stimulus package and an accommodative monetary policy stance, private sector credit growth has slowed significantly, with credit growth flat in 2009 and the first quarter of 2010, after averaging 23 percent growth in 2007 and 2008. Bank deposits at the Saudi Arabian Monetary Authority (SAMA) continue to be in significant excess of statutory requirements.

Higher average oil prices and a slight increase in oil production are projected to boost fiscal and current account surpluses in 2010. The IMF projects Saudi Arabia's current account surplus to widen from 5.5 percent of GDP in 2009 to 9.1 percent of GDP in 2010. The trade surplus narrowed by 70 percent in 2009 to 12.2 percent of GDP, as imports fell 19 percent and exports fell by 40 percent. Foreign assets held by SAMA fell from $400 billion in December 2008 to $372 billion in September 2009 but have risen since then, reaching $416 billion in April 2010. The Saudi riyal is pegged to the U.S. dollar. On a real effective basis, the riyal depreciated by 1.2 percent in the second half of 2009, but rose by 5.2 percent in the first five months of 2010.

Western Hemisphere

Brazil

Brazil's economy recovered from the crisis relatively quickly and has led the region in returning to growth. Several years of adherence to a strong macroeconomic framework provided space for modest fiscal expansion and significant monetary policy expansion to cushion the economy from the financial crisis.

As a result, Brazil suffered a sharp but short recession, and has shown strong recovery since the second quarter of 2009. Real GDP expanded at seasonally adjusted annualized rates of 9.0 and 9.3 percent in the third and fourth quarters, respectively, of 2009, and 11.4 percent in the first quarter of 2010. The IMF forecasts growth of 7.1 percent in 2010.

Increased investor confidence in future growth and recovering commodity prices led to a return of capital inflows. The Brazilian real was the strongest performing emerging market currency against the dollar in the second half of 2009, appreciating 11 percent. Appreciation eased in the first quarter of 2010, and since the end of March 2010 through mid-June the real has depreciated by 0.6 percent on growing import demand and softening capital inflows in the context of increasing global market volatility. According to JP Morgan data, on a real effective basis, the real increased by 6.6 percent in second half of 2009, following a 17.8 percent appreciation in the first half. In the first five months of 2010 the real appreciated a further 4.4 percent on a real effective basis.

Rising payments on foreign investment in Brazil have resulted in a current account deficit over the past few years, despite a positive trade balance. The current account deficit increased to 2.3 percent of GDP in the fourth quarter of 2009, the largest deficit since 2002. In the first quarter of 2010 the current account deficit was 2.2 percent of GDP. The pace of foreign investment in Brazil accelerated in the second half of 2009 as global carry trade flows resumed and as investors viewed Brazil's growth prospects and response to the crisis as increasingly positive.

With the economy recovering, Brazil has begun to exit from both fiscal and monetary policy stimulus. While some policies such as expansion of the public payroll and the minimum wage increase were permanent in nature, several temporary fiscal measures have been removed or are in the process of being phased out. Brazil's primary fiscal surplus declined to 2.1 percent of GDP in 2009, but the government has recommitted to achieving a target of 3.3 percent in 2010. In the second half of 2009, due largely to the decline in revenues associated with slower growth, Brazil's net public sector debt ratio was 42.9 percent of GDP, up from 38.4 percent at the end of 2008.

In February 2010, the central bank announced that minimum reserve requirements, which had been lowered in response to the crisis, would return to pre-crisis levels. The central bank has gradually wound down actions to increase dollar liquidity and trade finance through repurchase and swap market transactions and a dollar facility that was aimed at supporting credit to Brazilian importers and exporters whose market access to trade finance had been interrupted.

The Brazilian real's exchange rate is largely market-driven, with central bank interventions aiming at moderating rates of change and preventing excessive fluctuation. From September 2008, in the face of the worsening crisis, the central bank intervened in the foreign exchange market to support the Brazilian real and promote orderly conditions. Beginning in the second half of 2009, intervention has aimed at smoothing appreciation of the real in response to capital inflows. Foreign currency reserves increased by $32 billion in the second half of 2009, and $4.2 billion through April 2010, to $238 billion total, which exceeds its total external debt ($203 billion). In a further attempt to slow appreciation of the real, in October 2009, the government implemented a 2 percent tax on all portfolio inflows. In November, the government extended this tax to cover purchases of Brazilian equities from abroad.

Canada

In the second half of 2009, the Canadian economy began to show clear signs of a recovery. After contracting in the first and second quarters of 2009, the Canadian economy expanded at a 0.9 percent annual rate in the third quarter of 2009. Domestic demand and inventory restocking drove growth in the third quarter, more than compensating for a negative contribution from net exports. The economy continued to expand in the fourth quarter of 2009 and first quarter of 2010, expanding at a 4.9 percent and 6.1 percent annual rate, respectively. The recovery has been driven particularly by consumption and investment.

The Canadian economy was supported by the strong policy stimulus put in place in 2009. Fiscal stimulus has focused on infrastructure investment, and government investment spending increased at a 21 percent annual rate in the third quarter and 22 percent annual rate in the fourth quarter. Stimulative monetary policy also helped to spur a recovery in private consumption and investment. Private consumption and investment continued to pick up in the first quarter of 2010, while government investment spending moderated.

Fiscal stimulus is slated to continue through FY2010 (April 2010 – March 2011). However, the government is focused on fiscal consolidation over the medium-term, targeting a balanced budget by the end of FY2014. The central bank maintained its policy rate at the record low 0.25 percent between mid-2008 and mid-2009 to support growth. Citing robust growth and inflation pressures, it became the first G-7 central bank to hike rates since 2008, raising the policy rate by 25 basis points in early June.

Canada's international trade began recovering in the second half of 2009, but remains well below its pre-crisis peaks. For the year 2009, Canada's exports fell 24.6 percent, led by a decline in energy exports, while imports declined 15.7 percent. As a result of the sharper drop in exports, Canada's current account deficit increased to 3.6 percent of GDP in the third quarter (from 3.3 percent of GDP in the second quarter) before falling to 2.6 percent of GDP in the fourth quarter of 2009. Both exports and imports have rebounded strongly in the first four months of 2010, rising 5.2 percent year-on-year and 3.8 percent year-over-year, respectively. Stronger export growth helped reduce the current account deficit to 2.0 percent of GDP in the first quarter of 2010.

Canada has a freely floating, market-determined exchange rate and relies on inflation targeting to guide monetary policy. Canada's monetary authorities have not intervened in the foreign exchange market for over a decade. In the second half of 2009, the Canadian dollar appreciated 9.6 percent against the U.S. dollar, and appreciated a further 2.9 percent in 2010 through mid-June. On a real effective basis, the Canadian dollar strengthened 4.6 percent in the second half of 2009, and a further 3.2 percent in 2010 through mid-June.

Mexico

The Mexican economic recovery, which began in spring 2009, strengthened in the second half of the year. On a seasonally adjusted annual basis, the economy grew by 10.1 percent in the third quarter and 7.9 percent in the fourth quarter – surpassing its peak in early 2008 – but contracted 1.4 percent in the first quarter of 2010. Consumption, which grew weakly in the fourth quarter of 2009, fell in the first quarter of 2010 and investment also declined. The first quarter was likely only a pause in the recovery, as output is projected by the IMF to rise 4.5 percent in 2010.

External demand for manufactured goods is leading the recovery. Seasonally adjusted exports of manufactured goods rose by 20 percent between June and December 2009, and an additional 14 percent in the first five months of 2010. Oil exports have also rebounded, posting four consecutive quarterly increases on rising oil prices.

Although fiscal policy was stimulative in the first half of 2009, below-budget oil and tax revenues forced the government to enact spending cuts in the second half of year. Despite modest fiscal stimulus, domestic demand remained subdued and signs of recovery in domestic demand emerged only late in the year. Moreover, concerns about fiscal stability forced the government to pass a more austere 2010 budget comprising a combination of tax increases and expenditure restraint. In line with this goal, tax revenue was up 7.2 percent year-on-year in the first four months of 2010, while expenditures were up 4.8 percent. Even so, the government is targeting a deficit of 0.75 percent of GDP in 2010 – an exception to the balanced budget rule – to smooth the withdrawal of fiscal support.

Monetary stimulus has also supported recovery: the central bank reduced its policy rate by a cumulative 375 basis points in the first half of 2009, and has maintained the rate at 4.5 percent since then. Inflation continued its downward path in the second half of 2009, falling to 3.6 percent in December from 5.7 percent in June. Prices jumped by nearly 5 percent year-over-year in March – just under the upper bound of the first quarter inflation range – due to one-off tax increases and higher administered prices, before moderating to 3.9 percent in May.

The seasonally adjusted current account deteriorated in the third quarter to a deficit of 1.3 percent of GDP, before returning to near balance in the fourth quarter and a slight surplus in the first quarter of 2010. Although exports (seasonally adjusted) rebounded by 14.0 percent in the second half of 2009 compared with the first half, imports also grew by 11.9 percent over this period. The growth in exports reflects renewed external demand. The recovery in imports was largely due to rising demand for intermediate goods in the export sector rather than a revival of domestic demand. In the first quarter of 2010, exports and imports continued to rise, up 10.7

percent and 11.7 percent, respectively, on a seasonally adjusted quarter-over-quarter basis. Remittances from overseas continue to decline, falling by 19.5 percent year-over-year in the second half of 2009, and another 12.0 percent year-over-year in the first quarter of 2010.

Mexico has a flexible exchange rate and employs an inflation-targeting monetary policy regime. On a real effective basis, the peso appreciated 4.0 percent in the second half of 2009 and, through May 2010, the peso had appreciated by an additional 3.7 percent. The peso rose by 0.7 percent against the dollar in the second half of 2009, and a further 5.5 percent through the first quarter of 2010. The peso depreciated by 1.5 percent in the second quarter of 2010 (through mid-June).

Pemex, the state-controlled Mexican oil company, is obligated by Mexican law – along with the rest of the non-financial public sector – to sell its foreign currency earnings to the Bank of Mexico to service the country's foreign debt. Reserves have historically accumulated, therefore, when the foreign currency obtained by the Bank of Mexico is greater than foreign debt payments. To complement dollars obtained from Pemex and boost the stock of reserves, the foreign exchange commission began in February 2010 to auction options to sell $600 million to the central bank each month. This mechanism is a non-discretionary cushion against market volatility and does not target a specific exchange rate. Meanwhile, the central bank continued intervening in the foreign exchange market, selling $31 billion in reserves between October 2008 and October 2009; it discontinued the daily dollar auctions last fall as external conditions eased. At the end of December, foreign currency reserves stood at $94 billion, up from $80 billion at the end of June, and boosted primarily by proceeds from the oil hedge contracted in late 2008. Reserves had risen further to $98 billion by the end of April 2010.

Venezuela

Venezuela's real GDP has been contracting for five consecutive quarters. Real GDP fell by 3.1 percent in 2009, driven in part by a drop in oil prices, and declined by a further 6.6 percent in the first quarter of 2010 on a seasonally adjusted annualized basis. Structural factors have played a role in reducing output. Increased public intervention in the economy and the poor business environment have led to a deterioration in productivity and investment.

Markedly lower oil revenues have led the government to draw down international reserves and increase its reliance on local debt to finance its expansionary fiscal policy. The government has increased domestic debt issuance to finance its growing fiscal gap. Domestic public and private banks take on the bulk of the domestic debt (issued at market rates), increasing the probability of crowding out lending to the private sector. Bank lending to the private sector has declined in the past two years. Petróleos de Venezuela S.A. (PDVSA), the state-owned oil company, has also tapped local debt markets to compensate for lower oil export receipts.

Consistent with the policy objective to increase the public sector role in the economy, public sector consumption as a share of GDP expanded by 3 percent in 2009, in spite of a decline in government revenue. In January 2010, the central bank announced plans to transfer $7 billion (or 20 percent) of its foreign currency reserves to the National Development Fund, an off-budget fund used by the government to finance domestic and international development projects. As of June 1, 2010, foreign currency reserves had declined by $8.5 billion, or 24 percent from total foreign reserves of $35 billion.

Venezuela pegged its currency to the U.S. dollar in 2003, following a period of rapid exchange rate depreciation, capital outflows, and falling international reserves. The government maintains its peg through tight controls on capital movements and the supply of available foreign exchange. Purchases of foreign exchange in Venezuela are subject to approval by the Venezuelan Commission for Currency Administration (CADIVI).

The official nominal exchange rate of 2.15 strong bolivars per U.S. dollar was fixed from April 2005 until January 2010, when the government implemented a new three-tiered exchange rate system to increase the domestic value of oil export revenues. The official rate for all transactions was devalued 50 percent to 4.30, with access to a subsidized preferential rate of 2.60 for suppliers of critical products including basic foodstuffs and medicine. The unofficial parallel rate continued to depreciate until May 18, when the government halted parallel market trading near a rate of 8.20.

The government instituted a replacement for the parallel market on June 9, 2010, through trading of international sovereign and PDVSA bonds cleared through the central bank. Under this system, the central bank declares a daily rate band (currently approximately 4.30 – 5.40) and matches price offers to clear individual transactions. Restrictions including individual limits on the size and volume of individual and overall transactions have been announced, and all transactions are subject to government approval based on demonstrable need.

Inflation remains high; reflecting continued expansionary monetary and fiscal policy. The rate of inflation decelerated in 2009, with consumer prices rising 25 percent for the year, ending in December, compared to 31 percent in the previous year. Inflation, however, is accelerating in 2010, partly as a result of the January 2010 exchange rate devaluation. Consumer prices were up 31 percent in May 2010 from a year ago. Domestic real interest rates continue to be significantly negative. The fixed nominal exchange rate, combined with high inflation, resulted in a 9 percent appreciation of the real effective exchange rate in 2009. The January exchange rate devaluation combined with persistent inflation has resulted in a 45 percent depreciation of the real effective exchange rate through May 2010.

The current account surplus declined from $37.4 billion in 2008 to $8.6 billion in 2009 largely the result of lower oil prices. Foreign direct investment in Venezuela declined by $3.1 billion in 2009, reflecting the continued poor business environment.