Report to Congress on International Economic and Exchange Rate Policies

For the period July 1, 2002, through December 31, 2002

THIS REPORT IS REQUIRED UNDER SECTION 3005 OF THE OMNIBUS TRADE AND COMPETITIVENESS ACT OF 1988 (THE "ACT"). THIS REPORT REVIEWS DEVELOPMENTS IN U.S. INTERNATIONAL EXONOMIC POLICY, INCLUDING EXCHANGE RATE POLICY.

Major Findings:

- **Countries around the world continue to use a variety of exchange rate policies, ranging from flexible rates with no intervention to currency unions and to full dollarization.**

- **There was no reversal of the trend toward greater flexibility observed since the mid 1990s.** Treasury continues to monitor the exchange rate practices of major U.S. trading partners and to encourage policies that promote economic growth and economic stability.

- **No major trading partners of the United States manipulated exchange rates under the terms of Section 3004 of the Act during the period July 1, 2002, through December 31, 2002**.

The United States:

Current Account

The U.S. current account deficit rose to a seasonally adjusted (sa) $137 billion or 5.2% of GDP in the fourth quarter of 2002. The current account deficit for the entire year rose to $503 billion or 4.8% of GDP in 2002 from a cyclically depressed level of $393 billion, or 3.9% of GDP, in 2001. The value of imports, particularly of consumer goods and petroleum and petroleum products, increased strongly in the period[1] from the first half of 2002. Export growth was sluggish as the recovery in foreign economies lagged the United States recovery.

U.S. Balance of Payments and Trade

($ billions, SA, unless otherwise indicated)

	2001	2002	2002			
			Q1	Q2	Q3	Q4
Balance on Currenct Account						
Billions of $	-393.4	-503.4	-112.5	-127.7	-126.3	-136.9
Per Cent GDP	-3.9	-4.8	-4.4	-4.9	-4.8	-5.2
Select Financial Flows						
(+=capital inflow)						
Net Bank Flows	-48.3	110.4	-9.3	-11.9	68.0	63.6
Net Direct Investment Flows	3.0	-93.4	-13.2	-37.1	-23.5	-19.6
Net Securities Sales	342.7	417.6	73.3	112.3	131.0	101.0
Net Liabilities to Unaffiliated Foreigners by Non Banking Concerns	68.0	21.2	32.4	4.4	-8.0	-7.5
Memo: Statistical discrepancy	10.7	28.5	24.9	54.4	-43.4	-7.4
Trade in Goods						
Balance	-427.2	-484.4	-106.6	-122.6	-122.9	-132.3
Total Exports	718.8	682.6	164.4	172.2	175.4	170.7
of which:						
Agricultural Products	54.9	54.4	13.8	13.5	13.3	13.8
Capital Goods Ex Autos	321.7	290.6	70.9	73.3	75.3	71.1
Automotive Products	75.4	78.4	18.4	20.1	20.6	19.3
Consumer Goods	88.3	84.4	20.5	21.0	21.5	21.4
Industrial Supplies *	160.2	157.0	36.8	39.7	39.9	40.5
Total Imports	1145.9	1166.9	271.0	294.8	298.2	302.9
of which						
Petroleum and Products	103.6	103.6	19.2	27.1	27.7	29.6
Capital Goods ex Autos	298.0	283.9	69.3	72.1	71.3	71.2
Automotive Products	189.8	203.9	47.6	51.8	52.5	52.0
Consumer Goods	284.5	307.9	71.4	76.9	78.8	80.7
Advanced Technology (NSA)						
Balance	4.4	-17.5	-2.0	-2.1	-5.5	-8.0
Exports	199.6	178.6	43.6	45.6	44.9	44.6
Imports	195.2	196.1	45.6	47.6	50.3	52.5

Source: BEA

* Including Petroleum & Products

Financial Flows

Net financial flows into the United States remained strong. Although net foreign purchases of U.S. corporate bonds and equities declined during the period from first half 2002 levels, increased net sales of Treasury and agency securities were large enough to offset these declines. The inflows easily financed the U.S. current account deficit and reflected international investors' continued strong interest in investment opportunities in U.S. markets.

International Investment Position and Earnings

The latest available data indicate that the negative net investment position of the United States (with direct investment valued on a market-value basis) widened to $2.3 trillion at the end of 2001 from $1.6 trillion at the end of 2000. Despite this large negative position, net income payments on investment assets amounted to only $5 billion dollars in 2002. This represents a decline from a positive $21 billion in net earnings on investment assets in 2001, reflecting a fall in net income on direct investment from $103 billion in 2001 to $78 billion in 2002.

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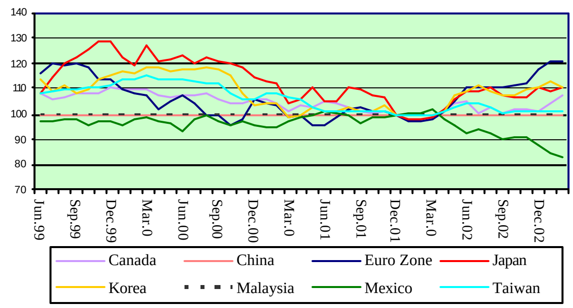
[1] "The period" means July 1, 2002, through December 31, 2002 unless otherwise indicated

The Dollar in Foreign Exchange Markets

The Federal Reserve Board's broad nominal dollar index did not change significantly over the period. There was, however, a dichotomy in the dollar's performance against the two component currency groupings in the broad index: the Federal Reserve Board's trade-weighted index of the dollar's exchange value against seven major foreign currencies declined 1.6% during the period while the index of the currencies of the other important U.S. trading partners (OITP) rose 2.5%[2].

Exchange Rates in Dollars
(December 2001 = 100)



The appreciation of the dollar against the OITP currencies over the second half of 2002 was largely due to currency depreciation in Latin America, particularly in Brazil and Mexico. The Brazilian real, which carries a 4% weight in the OITP index, depreciated 20.1% and the Mexican peso, which carries a 22.9% weight in the index, depreciated 4.3% over the period.

G-7 Finance Ministers and Central Bank Governors referred to exchange rates among the major currencies in their September 27, 2002 communiqué, reaffirming: "We will continue to monitor exchange markets closely and cooperate as appropriate."

The United States did not intervene in foreign exchange markets during the period.

Major Industrial Economies

Euro Zone Countries

The Euro Zone current account surplus increased to 1.1% of GDP (sa) during the period from 0.7% of GDP in the first half of 2002. Euro Zone exports, valued in dollars, rose 12.5% in the period from the first half of 2001, while Euro Zone imports increased 9.2%. For 2002 as a whole, the current account swung to a $60 billion surplus from an $11 billion deficit in 2001.

The nominal euro appreciated 6.4% against the dollar, while the Eurostat index of the real effective exchange rate appreciated 3.7% over the period. The euro appreciated 17.8% against the dollar in the year through December 31, 2002.

Japan

The yen was virtually flat against the dollar during the period, appreciating 0.9%, to ¥118.8 at the end of December 2002 from ¥119.9 at the end of June 2002. JP Morgan's real trade-weighted index of the yen, however, fell 2.2% under the pressure of Japanese deflation. The Ministry of Finance indicated that Japan did not intervene in the foreign exchange market during the period.

Japan's current account surplus shrank to $54 billion (2.6% GDP) in the second half of 2002, down from $58 billion (3.0% GDP) in the first half of the year, reflecting a smaller merchandise trade and services surplus and an increasing current account transfers deficit. While the merchandise trade surplus grew 6% to $48.1 billion in the period, Japan's services deficit expanded 17% to $22.5 billion, more than offsetting the growth in the merchandise trade surplus. The growing services deficit, along with a larger transfers deficit, accounted for much of the overall decline in the current account surplus.

Long-term financial account outflows were very large during the period. Net outflows associated with direct investment and with portfolio investment in equities, bonds and notes reached $92 billion during the period, compared with $47 billion in the first half of 2002 and $79 billion in the second half of 2001. This long-term outflow for 2002 as a whole was the largest of the past decade.

Canada

The Canadian current account surplus declined to 1.3% of GDP (sa) during the period from 1.7% of GDP during the previous 6 months. The current account surplus has been below 2% of GDP for six consecutive quarters.

The Canadian dollar fell 3.9% against the U.S. dollar during the period, while the JP Morgan Broad Real Trade Weighted Index of the Canadian dollar fell 5.0%. For 2002 as a whole, the Canadian dollar appreciated 0.8% against the dollar. The Canadian dollar floats freely. A 1998 study by the Bank of

[2] The seven major currencies account for 54.6% of the weight in the broad index while the nineteen OITP countries account for 45.4%.

Canada of its foreign exchange intervention concluded that its prior policy of regular intervention had very limited impact. Canada has not intervened in foreign exchange markets since 1998, except to make a small contribution to the brief G7 intervention in support of the euro in September 2000.

Latin America

Economic and political uncertainty in a number of countries undermined growth and capital flows for Latin America in 2002. Although the region saw real economic contraction of about 0.5% in 2002, prospects were improving by year-end with 2-3% growth for the region expected in 2003. In the second half of 2002, a sharp rise in Brazilian borrowing spreads contributed to the Latin America Emerging Market Bond Index (EMBI+) reaching a spread of 1,399 basis points over U.S. Treasuries in September 2002 before falling to roughly 1,000 basis points in December. In general, adverse conditions led to weaker nominal exchange rates throughout the region in 2002.

Argentina

The end of Argentina's one-to-one peg of the peso to the U.S. dollar in early 2002 led to a sharp decline in the peso. The currency then stabilized and strengthened from 3.81 Argentine pesos (ARP) per dollar at end-June to ARP 3.36 at end-December for a 13.4% appreciation over the period. The peso has strengthened further in 2003. The government has eased deposit and exchange controls throughout the year, although some restrictions remain in place.

After the severe economic and financial crisis at the end of 2001 and in the first half of 2002, economic indicators began to show an upward trend in the second half of 2002, with seasonally adjusted at an annual rate (saar) real GDP growth of 2.4% in the third quarter and 3.4% in the fourth. Consumer prices spiked in April 2002, but grew less rapidly thereafter with a net increase of 41% for the year through December 2002 .

Outflows from the banking sector in the first half of the year were reversed in the period with total deposits increasing by ARP 5.6 billion. Interest rates on one-month central bank debt fell from about 70% in August to less than 10% by end-December 2002. The monetary base increased sharply in the second half of 2002 but its growth rate fell in the first months of 2003. In 2002, Argentina enjoyed a current account surplus of 8% of GDP due to a trade surplus of $16.4 billion – 60% higher than in 2001 – with imports down 58% in 2002 and exports down 5%. Argentine gross foreign exchange reserves grew by $847 million in the second half of 2002 for an end-December reserve figure of $10.5 billion.

Brazil

The real depreciated 20% over the period, with the decline concentrated in the run-up to presidential elections in late-October. Market concerns forced the government to retire a significant portion of maturing debt as domestic and external demand for public securities was inadequate to match rollover requirements.

The central bank took some steps to tighten monetary policy, such as increasing reserve requirements, overnight repurchase operations, and raising the targeted Selic overnight interest rate from 18% to 25%, over the September-December 2002 period. However, its inability to sterilize fully payments for retiring debt contributed to increasing the money supply at 50% and 127% annualized rates in the third and fourth quarters respectively. A weakening currency and rising monetary aggregates heightened inflationary pressures, with the year-on-year consumer price index increasing by 12.5% in December.

Real (price adjusted) currency depreciation contributed to higher exports and helped reduce the current account deficit from 4.6% of GDP in 2001 to 1.7% in 2002. The central bank intervened in the foreign exchange market in support of the real, with a resulting fall in net international reserves from $26.5 billion at end-June to $14.2 billion by end-December.

Mexico

The Mexican peso, which freely floats, depreciated 4.3% in the period following an 8.6% depreciation in the first half of 2002. JP Morgan's index of the real trade-weighted value of the peso depreciated 1.8% in the period following a 2.8% depreciation in the first half of 2002. The recent depreciation in the real trade-weighted peso is a small reversal of appreciation over several years

Mexico's macroeconomic fundamentals remain robust, although growth remained slow with real GDP in the period increasing at a 1.3% rate (saar) from the first half of 2002 and 1.9% from the comparable period of 2001. The Bank of Mexico tightened monetary policy in September and December. In spite of the economic slowdown, fiscal discipline has been maintained, with the deficit at 1.6% of GDP during the period.

The current account deficit fell to 1.3% of GDP in the period, helped by higher prices for oil (10% of exports) and by weak domestic demand curbing import growth. At $7.4 billion, inward direct investment covered over 90% of the current account deficit in the period. During this period, international reserves grew by $6 billion, reaching $51.6 billion by end-December.

Central and Eastern Europe

In Russia, sustained high oil prices helped slow the ruble's rate of nominal depreciation against the U.S. dollar to 1% (31.45R/$ to 31.78R/$) during the period compared to 4% in the first half of 2002. Foreign exchange market intervention, in response to inflows from significant external borrowing by Russian (mainly oil) companies as well as increased export receipts, helped boost reserves $5.5 billion to a record level $48 billion at end-December 2002. In Ukraine the hryvnia continued stable during the period at around 5.33 hryvnia/$.

After appreciating steadily for several years in real terms, the currencies of the major Central European economies were relatively stable during the period. This reflected both nominal depreciation versus the euro, the key currency for trade, and a slowdown in inflation in the major area economies, including deflation in the Czech Republic. For example, the Polish zloty weakened slightly (-0.8%) versus the euro in nominal terms during the second half of 2002, while strengthening by 5.0% versus the dollar (a reflection of the dollar's decline against the euro). The drop in inflation due to tight monetary policy and favorable food prices supported the zloty's weakening by 2.2% for the period (8.6% for the year) in trade-weighted real terms. The Hungarian forint saw sizable nominal gains against the euro in the period, but slowing inflation allowed the forint to remain steady in real terms. In the Czech Republic, the nominal weakening of the crown against the euro (6.8% during the period) and deflation (0.4% y-o-y in December) contributed to a drop in the real effective exchange rate.

Asia

Economic recovery of emerging markets in Asia moderated in the second half of 2002, as export growth slowed everywhere except for Indonesia and Korea. Virtually all economies had trade and balance of payment surpluses, with China increasingly providing final processing and assembly of products from the rest of Asia ultimately exported to the U.S. Hence, while a number of Asian countries had large global trade and current account surpluses, China did not, because of its deficits with its Asian trading partners.

Export growth softened in part because of softer OECD high-tech demand, while higher oil prices also affected the many oil importers in the region. Reserves generally increased significantly during the period, with the exception of the Philippines. A number of economies continued to experience net investment and debt service outflows. In other cases, especially China, foreign direct investment (FDI) inflows growth supported reserve increases.

Inflation continued to decline throughout the region, with China and Hong Kong experiencing deflation. But exchange rate movements were mixed, with both Korea's and Indonesia's currencies appreciating on a real effective (REER) basis. Both Chinese and Hong Kong currencies weakened significantly in REER terms because of the weight of their trade with Korea and Indonesia. The currencies of other economies weakened only moderately in REER terms, with Taiwan and the Philippines weakening more than others.

China

China's exports accelerated to a 30% y/y growth rate in the period, up from a 14% y/y growth rate in the previous half-year. Imports also accelerated to a 31% y/y growth rate from a 10% y/y rate in the previous period, so that China's surplus of trade in goods rose modestly to $17 billion (2.5% of GDP) from $15 billion (2.4% of GDP) a year earlier.

The current account surplus for 2002 will probably rise modestly from the 1.5% of GDP level reached in 2001. China's current account surplus, as a per cent of GDP, has declined significantly since 1997 when it reached 4.1% and the deterioration of China's trade surplus in early 2003 suggests this trend will continue.

Although China had a relatively balanced global position, U.S. data show China had a bilateral merchandise trade surplus with the U.S. of $60 billion during the period, compared to $49 billion in the same period a year earlier. In general, inputs from other emerging Asian countries are increasingly routed through China for assembly and export, principally to the U.S. China has a significant deficit with nearly all its Asian trading partners. It has been estimated that China's trade deficit with major emerging market economies in East Asia was about $45 billion in 2001. China maintains a de facto currency peg to the dollar, which it has kept within a tight band since 1995.

Capital inflows increased sharply in the period, although the growth of FDI decelerated to 8% y/y from 19% during the previous half. As a result of the higher current account surplus and higher capital inflows, gross foreign reserves grew 18% in the period to $243 billion. The JP Morgan index of the real trade-weighted renminbi stayed fairly stable, depreciating only 0.7%, during this period. China continues to maintain wide-ranging controls on both capital outflows and inflows.

Korea

Korea's overall economy did well in the period, with GDP growing 3.9% and 8.3% (q/q, saar) in the third and fourth quarters of 2002, respectively. Stronger net exports boosted the current account surplus in the period to 1.2% of GDP, versus 0.8% a year earlier. The capital and financial account excluding reserve accumulation recorded a small surplus of 0.3% of GDP, as domestic banks and firms increased foreign-currency borrowing.

Korea maintains a floating exchange rate, intervening only to curb what it views as excessive volatility. The won appreciated 1.3% against the U.S. dollar on a nominal basis, while the JP Morgan real trade-weighted index appreciated 0.1%. Official intervention was modest. Gross reserves increased by $9 billion (8%) during the period to $121.4 billion, in part as a result of interest earnings and valuation adjustments as the euro appreciated against the dollar during the period. As of December 2002, reserves were approximately 188% of short-term external liabilities (residual maturity basis), a decrease from 235% at the end of June. Korea maintains relatively few restrictions on capital flows.

Taiwan

Taiwan's economy grew by 4.1% and 4.7% (q/q, saar) in the third and fourth quarters, respectively. Its current account surplus grew to 8.9% of GDP in the period, up from 7.9% in the second half of 2001. Growing trade with Mainland China (a $13.9 billion bilateral trade surplus during the period) and higher foreign investment earnings are major factors in the large current account surplus.

Taiwan's financial account excluding reserve accumulation recorded a moderate, 1% of GDP, deficit during the period, as direct investment abroad surged, portfolio investment abroad exceeded inflows, and foreign currency deposits increased in expectation of a Taiwan dollar (TWD) depreciation. The TWD depreciated 3.2% on a nominal basis against the U.S. dollar during the period, while the JP Morgan real trade-weighted index depreciated 2.6%. Official reserves grew by US$13 billion (9%) in the period to $162 billion (nearly 400% of total external debt).

Malaysia

Malaysia's economy continued to expand in the period, with GDP growth accelerating to 6.2% (q/q, saar) in the third quarter before slowing to 3.0% in the fourth. Growth was underpinned by private consumption and development expenditure by the government, offsetting softening external demand. The current account surplus declined to 7.4% of GDP in the third quarter of 2002 (latest data available) from 9.9% a year earlier as a result of accelerating imports. Although the United States remained the largest destination of Malaysian exports, exports to ASEAN countries grew by 14.6% y/y, while exports to the United States grew by just 5.1%.

Malaysia has maintained a fixed peg to the dollar since September 1998, when it also imposed capital controls. Controls have since been relaxed, but offshore trading of the ringgit remains prohibited and foreign portfolio investment by residents continues to be restricted. The Malaysian authorities have steadfastly maintained the peg despite alternating periods of downward and upward pressure on the ringgit. The JP Morgan index of the ringgit's real trade-weighted value depreciated 1.9% during the period. Since the introduction of the peg, however, the ringgit has appreciated 7.4% in real traded-weighted terms. At the end of the period, reserves stood at $34.6 billion, little changed from levels in the first half of 2002.

<u>Summary</u>:

This report reveals a wide variety of exchange rate policies used by the major trading partners of the United States. Based on a broad review Treasury concluded that no major trading partners of the United States manipulated exchange rates under the terms of Section 3004 of the Act during the period[3].

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