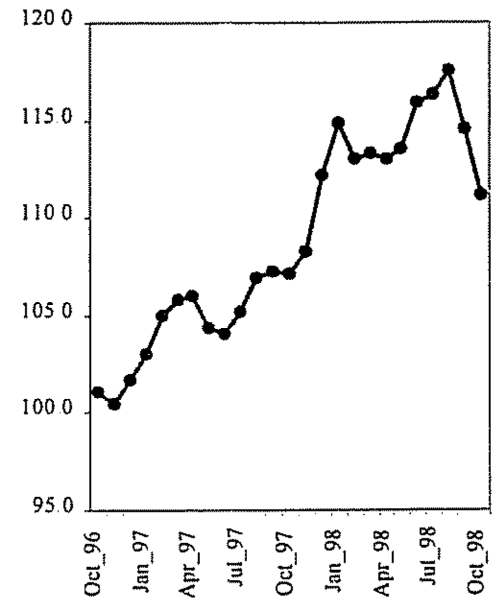
Department of the Treasury

Annual Report to Congress on International Economic and Exchange Rate Policy
Period Covered: November 1, 1996 to October 31, 1998

Real Value of the Dollar
JP Morgan Broad Real Dollar Index (1990=100)



This report reviews developments in U.S. international economic policy, including exchange rate policy, during the period from November 1, 1996 through October 31, 1998. This report is required under Section 3005 of the Omnibus Trade and Competitiveness Act of 1988 ("the Act").

EMBARGOED FOR RELEASE UNTIL:

4:30 p.m., January 22, 1999

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Summary and Recommendations

Major Findings

- **The U.S. economy performed strongly over the period November 1, 1996 to October 31, 1998, despite the financial crisis in emerging markets and the weakness of some of the industrial countries.** The U.S. economy over this period experienced a combination of strong growth, low inflation, and strong employment growth not seen in nearly three decades.

- **However, as the financial crisis resulted in economic contractions or declining growth rates across emerging markets and Japanese weakness continued, U.S. exports declined sharply and the U.S. current account deficit rose significantly.**

- **For most of the period covered by this report, the relative strength of the U.S. economy and a growing aversion to risk fueled strong capital inflows into the United States, causing an appreciation of the dollar.** Global investors showed a preference for U.S. assets in general, and U.S. Treasury securities in particular, reflecting their confidence in the U.S. economy. In September, however, the dollar retreated against most major currencies as financial markets reacted with growing concern to losses stemming from the global financial turmoil.

- **Treasury determined that none of our major trading partners has manipulated exchange rates under the terms of Section 3004 of the Act during the period under consideration.**

Policy Priorities

- **Encourage policies that promote strong growth and low inflation in the G-7 nations, with a particular focus on fiscal stimulus and banking reform in Japan and structural reform in Europe.**

- **Remain prepared to support financial assistance, led by the IMF and the IFIs, in support of strong programs to promote recovery in emerging market economies and limit the spread of financial contagion.**

- **Continue efforts to open foreign markets to U.S. exports.**

- **Continue to monitor the policies and practices of our trading partners for evidence of currency manipulators.**

- **Develop and implement proposals to strengthen the international financial architecture and reduce the risk of future financial crises.**

Currency Market Developments

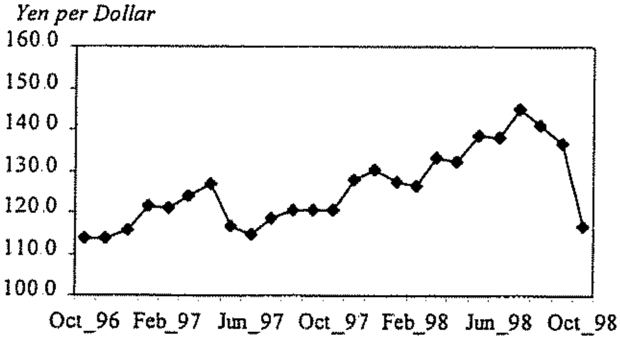
Recent Developments

While the dollar appreciated during most of the period from November 1, 1996 through October 31, 1998, in recent weeks the dollar fell steeply against some major currencies. An increase in risk aversion worldwide produced substantially wider credit spreads, equity market declines, and record-low benchmark bond yields on flight-to-quality flows. In this environment, the dollar depreciated as many market participants rapidly liquidated long dollar positions to offset losses in other markets and closed out short positions in other currencies in a widespread effort to de-leverage.

Japan

Between October 1996 and August 1998, the dollar appreciated strongly against the Japanese yen, rising 19%, primarily reflecting economic stagnation in Japan and market concerns about the state of the banking system. The dollar depreciated sharply against the yen, however, in October 1998 as market participants covered short yen positions in response to financial market turmoil. Japan's economy recorded its fourth consecutive quarter of negative real GDP growth in the third quarter of 1998 while the Japanese government continued to delay implementation of initiatives required to restore growth and stability to the economy. Of pressing importance are decisive actions to restore confidence to Japan's ailing banking system. Delays in implementing fiscal stimulus packages also slowed recovery in Japan. The approval by the Japanese parliament of a significant amount of public funds to strengthen Japan's banks is an encouraging development. To ensure recovery, it is crucial that Japan's banks take action now to use these funds quickly and effectively, with appropriate conditions, including stronger disclosure and steps to clean up the banks' balance sheets and permanently dispose of bad assets.

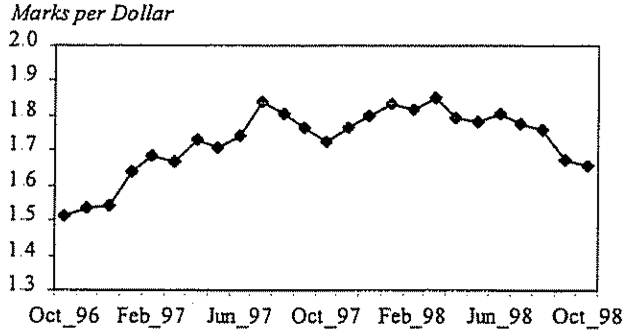
Currency Movements: Japan
Yen per Dollar



Germany

Between October 1996 and August 1997, the dollar appreciated by 14% against the German mark. This appreciation appeared to reflect stronger growth in the U.S. compared to Germany plus uncertainty concerning the implementation of the European Monetary Union (EMU). Market participants, concerned about prospects for EMU, chose the safety of both dollars and pounds. As the outcome of the EMU became more certain late in 1997, and German growth prospects improved, the dollar stabilized against the mark. In recent months, however, the dollar has depreciated sharply against the mark. This followed Federal Reserve actions to loosen U.S. monetary policy, the September unwinding of long dollar positions, and somewhat weaker U.S. growth and earnings prospects. Movements of the French franc and Italian lira against the dollar matched movements in the mark against the dollar.

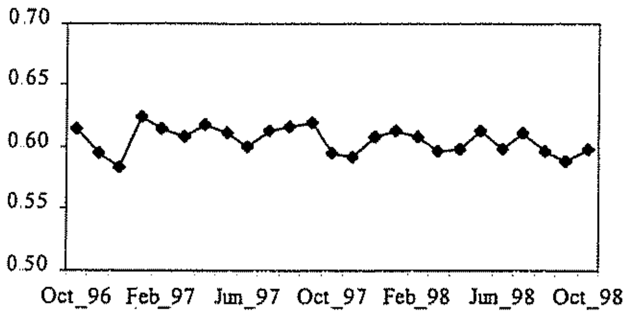
Currency Movements: Germany
Marks per Dollar



United Kingdom

The dollar remained relatively stable against the pound during the period covered by this report. Both currencies benefited from safe-haven flows in response to uncertainty concerning the implementation of the EMU. Furthermore, both the United States and the United Kingdom recorded strong economic growth over this period. The pound was also supported by interest rate hikes by the Bank of England in response to inflation concerns in the United Kingdom. In response to evidence of a slowing domestic economy, however, the Bank of England cut interest rates by 25 bps. on October 8, 1998.

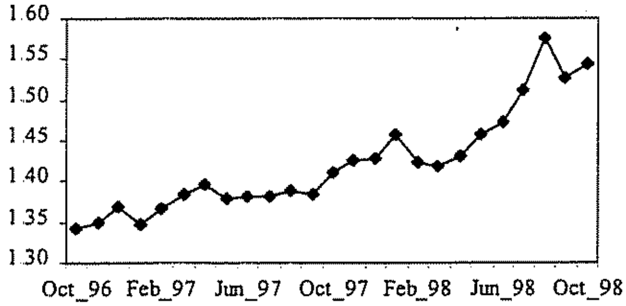
Currency Movements: United Kingdom
Pounds per Dollar



Canada

During the period covered by this report, the dollar appreciated by 13% against the Canadian dollar. The fall in the Canadian dollar stemmed from weak external demand combined with a fall in commodity prices; both factors reduce the demand for Canadian dollars. The Bank of Canada attempted to halt the slide of the Canadian dollar through a series of interest rate hikes, including a 100 basis point rise on August 27, 1998, as well as interventions in the foreign exchange market. Although the Bank of Canada matched the recent Federal Reserve interest rate reductions, the impact of previous interest rate hikes has been slowing economic growth in Canada.

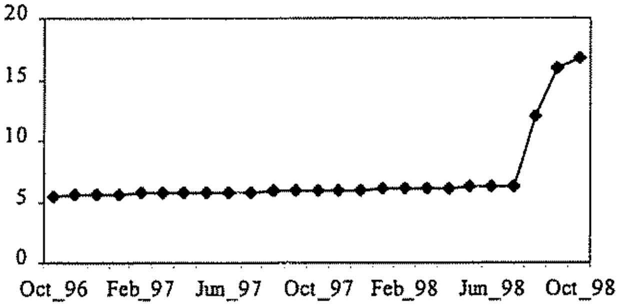
Currency Movements: Canada
Canadian Dollars per Dollar



Russia

Throughout much of the period of this report, until August 1998, the Russian currency remained stable. Western nations, along with the IMF, provided a substantial package of financial support to the Russian government on the condition that the Russian government stabilize its fiscal position through a combination of increased tax collection and spending cuts. These reforms, however, did not fully materialize and the combination of Russia's growing fiscal deficit, reduced confidence in Russia, and the general dollar withdrawal from emerging markets led to a sharp decline in Russian foreign currency reserves as Russia intervened to support the fixed exchange rate. In the face of these falling reserves, on August 17th, 1998, the Russian authorities allowed the ruble to float, resulting in a sharp fall in the value of the ruble, and intense pressure on Russian banks. The devaluation was shortly followed by a government announcement that debt payments would be suspended and negotiations would be undertaken with creditors on domestic debt restructuring. Subsequently, the IMF suspended its July 1998 support package.

Currency Movements: Russia
Rubles per Dollar



Economic and Monetary Union in Europe

On January 1, 1999, eleven European Union (EU) members, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain, will initiate the final stage of the European Economic and Monetary Union (EMU). To qualify for admission into the monetary union, each nation must meet a set of economic criteria. Three other EU member states, Denmark, Sweden, and the UK, chose not to join the monetary union at this time. Greece intends to join as soon as it has fulfilled the entry requirements. The conversion rates of the existing currencies to the euro (and each other) will be irrevocably fixed based on the central parities of the current European Monetary System. A new common currency, the euro, will replace the separate national currencies, which will continue to circulate until 2002, when they will lose their status as legal tender. Euro notes and coins will then become the new legal tender.

The current national central banks (NCBs) will be united within the European System of Central Banks (ESCB) with the newly created European Central Bank (ECB), located in Frankfurt. The ESCB will determine a joint monetary policy while actual policy implementation will be conducted on a decentralized basis in coordination with the NCBs. The Maastricht Treaty, which established the EMU, stipulates that the central objective of monetary policy is price stability. The external value of the euro will be determined by market forces and might receive some attention as an indicator variable.

While the establishment of the EMU will be a significant event for Europe, the direct economic impact on the United States is likely to be limited. The EMU should be expected to create net benefits for the United States if Europe pursues strong economic growth policies and the EMU contributes to stability on world financial markets. A successful EMU will depend on structural reforms to improve the competitiveness and flexibility of European labor, product, and capital markets. There has been some speculation that the euro will eventually play a role in international financial markets equal to that of the dollar. Any such a development would almost certainly occur gradually and it is not clear that it would have tangible negative implications for the United States. For the foreseeable future, the dollar will continue to play a critical role in the international financial system as long as the United States continues to pursue sound macroeconomic policies.

Latin America

Latin America experienced strong growth in 1997, but appears to be entering a period of slowdown in 1998. As global investors have become more risk averse, capital flows into Latin America have dried up, so that affected nations, in order to finance their current account deficits, have had to adjust with some combination of reserve loss, depreciation, and slower growth. Furthermore, weak commodity prices have hurt Latin American exporters, further exacerbating external and internal imbalances. Regional developments include the following:

- **Mexico.** The Mexican peso depreciated strongly against the dollar since October 1997, driven by both falling oil prices (Mexico is a large oil exporter) and reduced capital inflows to Mexico attributable to general investor aversion to emerging markets following the Asian crisis and Russian devaluation. The fall in the value of the peso added to Mexican inflation pressures, prompting the Bank of Mexico to tighten monetary policy, which in turn slowed economic growth: Real GDP growth in Mexico fell to 4.3% in the 2nd quarter of 1998 from 6.6% in the 1st quarter of 1998.

- **Venezuela.** The dollar appreciated against the bolivar over the period of this report, also driven by lower oil prices and capital outflows. Since government revenue is dependent upon oil exports, falling oil prices also increase the fiscal deficit. High interest rates imposed to maintain the value of the bolivar are likely to lower economic growth.

- **Argentina.** Argentina's currency board arrangement did not come under significant pressure and Argentina posted strong growth in the first half of the year despite the financial turmoil affecting the emerging markets. Fiscal discipline and forward-looking external debt management helped to maintain investor confidence throughout the first half of 1998, but recent declines in capital flows to emerging markets in general led to modestly higher interest rates in the aftermath of the Russian devaluation.

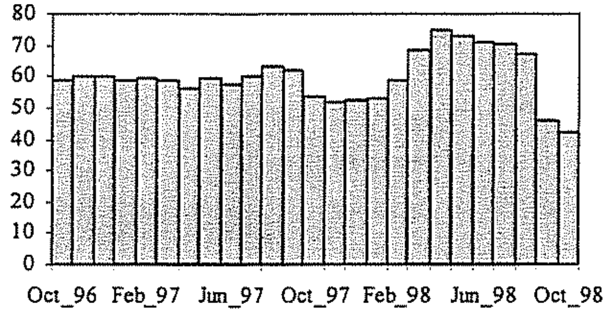
- **Brazil.** Global financial market turbulence contributed to a large loss of foreign exchange reserves in September, reflecting capital outflows by both domestic and foreign residents. The government reacted with steep hikes in interest rates, the announcement of deep fiscal cuts, and the initiation of discussions with the IMF on a program of international support. Reserve outflows slowed sharply in October. Under the Brazilian government's 1999 budget program, supported by the IMF, 1999 GDP growth was forecast to be -1%.

Real GDP Growth
% change over a year ago

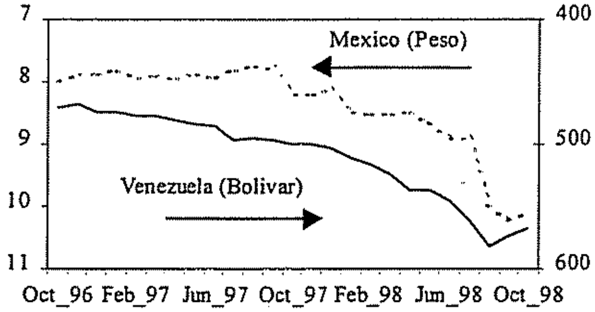
	Mexico	Brazil	Venezuela	Argentina
Q4_96	7.1	5.0	1.7	9.0
Q1_97	4.9	4.6	0.5	8.0
Q2_97	8.6	4.8	7.6	8.3
Q3_97	7.9	2.7	7.3	9.9
Q4_97	6.7	1.9	4.9	8.2
Q1_98	6.6	0.9	7.7	7.2
Q2_98	4.3	1.5	-0.6	6.9

Source: Haver Database

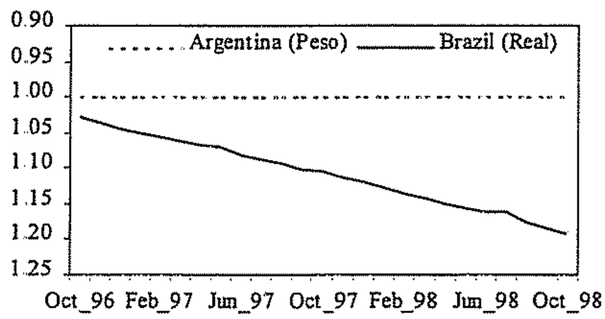
Brazil's Foreign Currency Reserves
$ Billion



Currency Movements
Domestic Currency Units per Dollar



Currency Movements
Domestic Currency Units per Dollar



Asian Financial Crisis

During the period of this report, a financial crisis developed in Asia that directly impacted Korea, Indonesia, Philippines, Malaysia, and Thailand and indirectly affected the other economies in the region. This financial crisis was precipitated by a variety of factors, some common to all the nations affected.

- **The depth and severity of the crisis was partially attributable to weak financial systems in the crisis countries, weaknesses that were exacerbated by close links between governments, banks, and corporations that led to fundamentally unsound investments.**

In the years preceding the crisis, the emerging economies in Asia experienced a period of rapid growth. This growth was fueled by a variety of factors, including high domestic savings as well as even higher levels of investment supported by large foreign capital inflows. In general, governments implemented either de facto or explicit fixed exchange rate regimes.

It is now clear, however, that throughout much of the region the essential underpinnings of a modern financial system were either weak or did not exist. Financial regulation and supervision were inadequate, and financial systems lacked transparency and did not have appropriate mechanisms to analyze and manage risk. Furthermore, among the problems evident in some of the Asian economies were an unsustainable combination of large current account deficits, fixed exchange rates, and inconsistent monetary policies. Significant amounts of capital flowed into unproductive areas.

- **Large amounts of capital flowed into these flawed financial systems – from 1990 to 1997, foreign capital flows quadrupled in the region – from foreign investors who failed to adequately assess the risks involved.**

The Thai baht came under pressure in early 1997, due in part to falling export growth and the failures of financial institutions. Thailand's government responded by aggressively intervening in foreign exchange markets and imposing capital controls, but with the depletion of nearly all of its reserves was nonetheless forced to abandon the currency peg in July 1997.

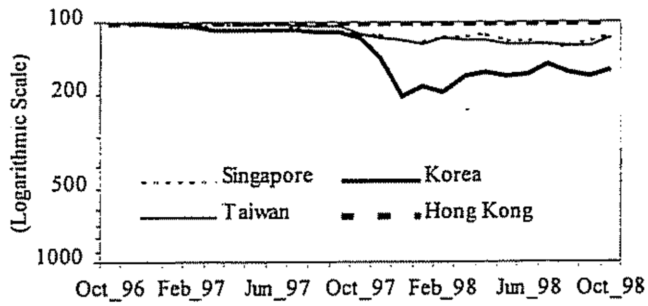
The devaluation of the baht put pressure on other currencies in the region as the depth of the region's problems were gradually revealed and there was market contagion, with hedging and deleveraging exacerbating initial exchange rate pressures. As the crisis began to unfold, banks and foreign investors withdrew capital; local companies sought to hedge hard currency exposures; exporters ceased converting their earnings into domestic currency; and citizens shifted their savings to hard currencies.

Thailand, Indonesia, Korea, Malaysia, Hong Kong and the Philippines came under the most intense pressure. With the exception of Hong Kong, all these countries experienced sharp declines in currency values. Stock and land prices also fell steeply in all these countries, Asian banks and companies faced severe financial constraints, and affected economies have suffered from recessions and sharp reversals of current account positions.

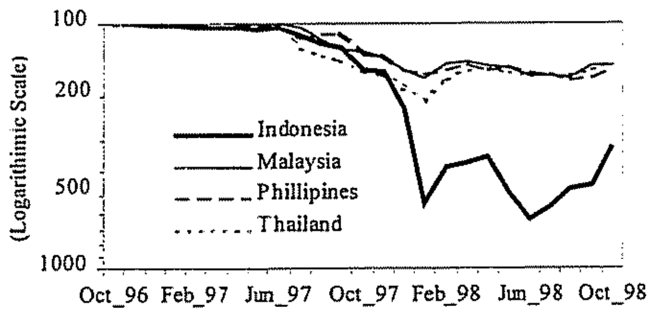
Authorities from both Hong Kong and China have repeatedly stated their intentions to not devalue their currencies. Hong Kong authorities took steps to strengthen their linked exchange rate system, and although China has experienced weaker export growth as a result of the crisis, their external position remains strong, with a large balance of payments surplus and a high level of foreign reserves.

The approach of the international community to the Asian financial crisis emphasized programs designed in conjunction with the IMF that require nations to take concrete steps to reform their economies. New programs were initiated for Korea, Thailand, and Indonesia while an existing program for the Philippines was strengthened. The goal of these reforms was to restore financial stability, promote stronger and more stable exchange rates, attract new capital, and restore economic growth. Programs, designed to address issues specific to each nation, were based around strengthening financial systems, opening markets to both capital and trade, and following appropriate monetary and fiscal policies. These programs have

Currency Movements: NIEs
Domestic curreny units per dollar, Oct 1996 = 100



Currency Movements: ASEAN-4 Nations
Domestic currency units per dollar, Oct 1996 = 100



been supported by temporary financial assistance from international organizations, led by the IMF, providing nations with room to establish the conditions necessary to restore economic confidence as well as prevent a deeper, more prolonged crisis.

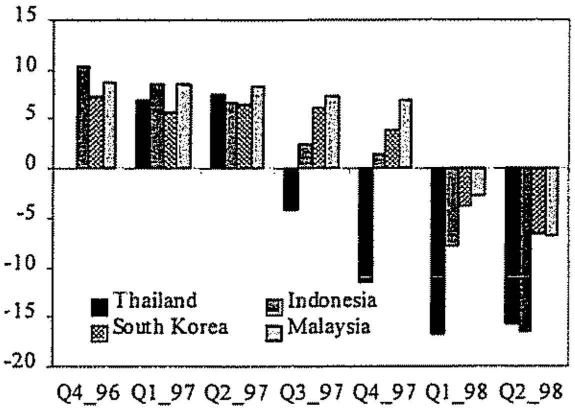
The impact of the crisis varied widely among the affected economies. Growth has slowed in Taiwan, a mild recession is occurring in the Philippines and Singapore, while Indonesia, Malaysia, Korea, Thailand, and Hong Kong are experiencing severe recessions.

- **The recession in Japan, which reduces the demand for Southeast Asian exports, slowed recovery in the region.** Jan.-Oct. 1998 Japanese imports from the NIEs and ASEAN-4 were down 13.4% from the same period in 1997, implying that Japanese imports from the region may fall by $10.2 billion in 1998 (120 yen/$).

Signs of improvement, however, are evident in both interest rates and currency values. Interest rates throughout the region fell significantly from their recent highs, and currency values throughout the region stabilized and generally appreciated significantly relative to their lowest levels. As the crisis evolved, international financial institution (IFI) programs for Korea, Thailand, Indonesia, and the Philippines focused on stimulative fiscal policies, including the expansion of social safety nets. Furthermore, trade balances within the region have improved, mostly as the result of falling imports. Current policy prescriptions emphasize the continued adherence to the IFI programs and implementation of necessary structural reforms, especially in the banking sector, efforts to accelerate the pace of corporate and financial restructuring, and the expansion of social safety nets to protect the poor and unemployed.

Real GDP Growth

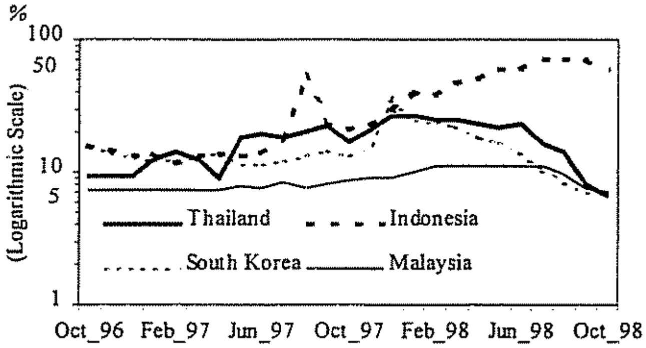
% change over a year ago



Source: IMF (Q4_96 data not available for Thailand)

Short Term Interest Rates

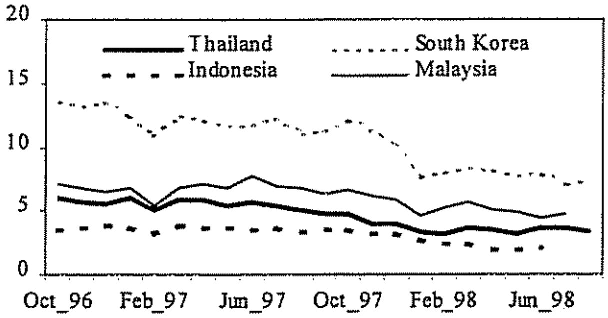
%



Source: JP Morgan

Merchandise Imports

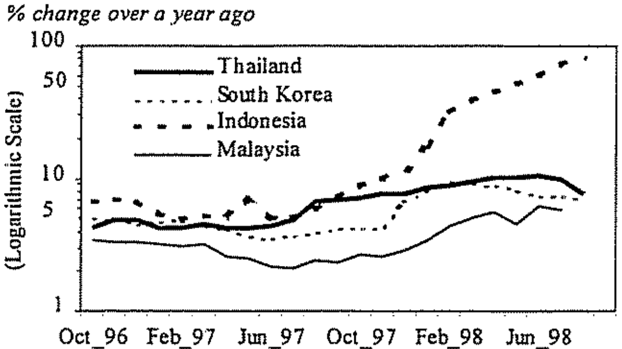
$ Billion



Source: JP Morgan

Consumer Prices

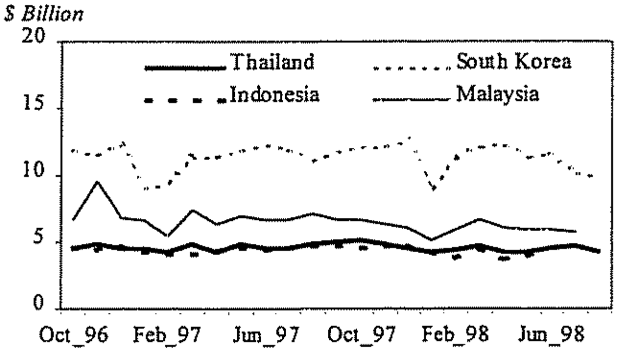
% change over a year ago



Source: JP Morgan

Merchandise Exports

$ Billion



Source: JP Morgan

U.S. Economy

Overview of the U.S. Economy

The continuing U.S. economic expansion was characterized by a combination of strong growth and low inflation during the period covered by this report (November 1, 1996 to October 31, 1998). Between the 4th quarter of 1996 and the 3rd quarter of 1998, U.S. real GDP grew at an average rate of 3.9%, while the inflation rate (CPI) fell from an annual rate of 3.2% in November 1996 to 1.5% in October 1998. The U.S. unemployment rate fell significantly over this period from 5.4% in November 1996 to 4.3% in April 1998 – a 28 year low – before rising to 4.6% in October 1998.

GDP growth in the 2nd and 3rd quarters of 1998 was 1.9% and 3.9%, respectively, compared to 5.5% in the 1st quarter. Falling exports, however, illustrated the impact of slowing economies abroad and reduced GDP growth by 0.9% and 0.2% in the 2nd and 3rd quarters of 1998, respectively. In comparison, rising exports contributed 1.1 percentage points to GDP growth in 1997. While strong domestic demand compensated for weak demand abroad, it is clear that economic weakness among some of our major trading partners had a negative impact on U.S. GDP growth.

- **On the other hand, foreign economic weakness reduced the demand for key commodities, including oil, which helped to lower import prices and maintain low inflation.**

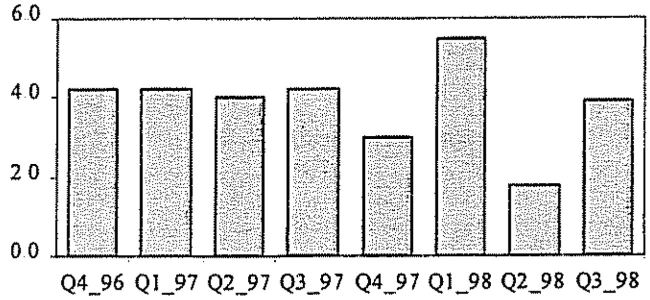
IMF Article IV Consultation

The underlying strengths of the U.S. economy were recognized by the IMF Executive Directors in the conclusion of the IMF Executive Board's 1998 consultation with the United States on August 3, 1998 (in accordance with Article IV of the IMF's Articles of Agreement). The IMF Executive Directors attributed the balance of strong growth and low inflation to the combination of sound macroeconomic policies as well as flexible labor markets.

The Executive Directors cautioned that the potential for inflation remained a concern given low unemployment rates and high levels of capacity utilization. Furthermore, conditions that helped maintain low inflation, such as low commodity prices, are temporary in nature. An easing of monetary policy may be appropriate, however, should a significant slowdown in the rest of the world sufficiently slow the U.S. economy.

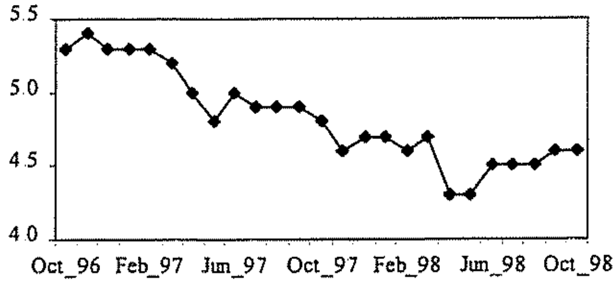
The Executive Directors noted that the appreciation of the dollar in 1997 and the first half of 1998, accompanied by a rise in the U.S. current account deficit, eased demand pressures within the U.S. economy and aided the short-term external adjustment of nations affected by the Asian financial crisis.

U.S. Real Gross Domestic Product
% change over previous quarter



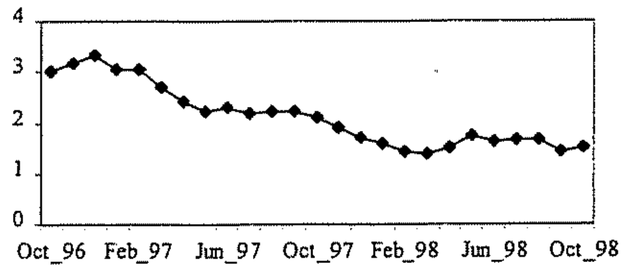
Source: Bureau of Economic Analysis

U.S. Civilan Unemployment Rate
%



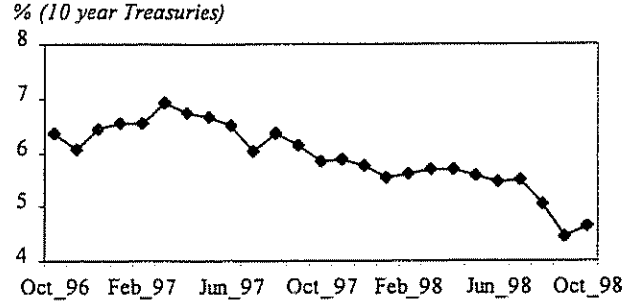
Source: Bureau of Labor Statistics

U.S. Consumer Price Inflation
% change over a year ago



Source: Bureau of Labor Statistics

U.S. Interest Rates
% (10 year Treasuries)



Source: U.S. Treasury

Trade Flows

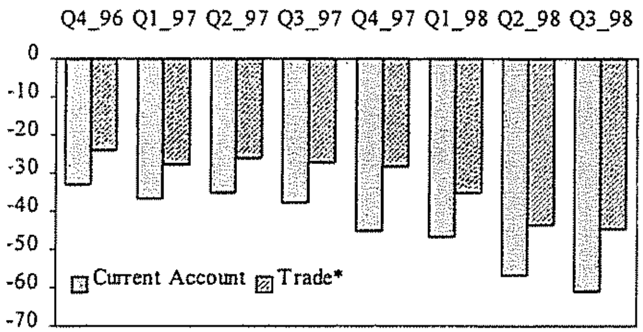
The strength of the U.S. economy, combined with weakness abroad, generated a rise in both the trade and current account deficits during the period covered by this report. The current account deficit rose from $33 billion in the 4th quarter of 1996 to $56.5 billion in the 2nd quarter of 1998. Between the 4th quarter of 1996 and the 3rd quarter of 1998, the goods and services trade deficit increased from $24.2 billion to $44.5 billion.

- **The primary factor underlying the rising current account deficit was the recent fall in U.S. exports.**

Consistent economic growth in the United States, as well as an appreciating dollar, sustained growth in nominal imports. In contrast, economic weakness abroad, particularly in Asia, severely decreased the demand for U.S. exports. Export *growth* began to slow in the 4th quarter of 1997, while exports fell throughout the first three quarters of 1998. From the 4th quarter of 1996 to the 2nd quarter of 1997, nominal imports rose an average of 2.4% each quarter, while nominal exports rose an average of 3.8% each quarter. From the 3rd quarter of 1997 to the 2nd quarter of 1998, the period immediately following the Asian financial crisis, nominal imports rose an average of 1.3% each quarter, while nominal exports *fell* an average of 0.4% each quarter.

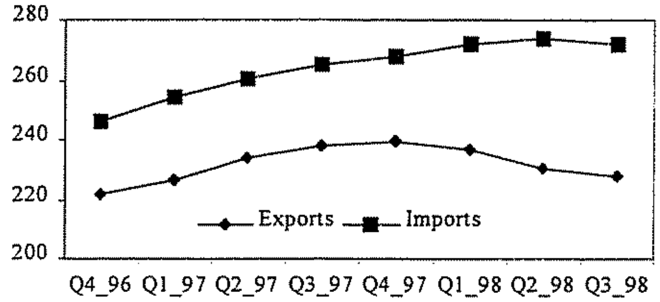
Developments in key bilateral merchandise trade balances

U.S. External Balances
$ Billion (Balance of Payments Basis)



* *Balance on goods and services.*
Source: Bureau of Economic Analysis, Bureau of the Census

U.S. Trade in Goods and Services
$ Billion (Balance of Payments Basis)



Source: Bureau of Economic Analysis. Bureau of the Census

U.S. Bilateral Merchandise Trade Balances
$ Billion

	Mexico	Canada	Japan	China	EU
Q4_96	-4.0	-5.4	-13.4	-10.5	-4.6
Q1_97	-4.0	-4.6	-13.4	-9.7	-0.8
Q2_97	-4.3	-3.8	-12.6	-11.2	-3.8
Q3_97	-3.4	-3.9	-14.8	-15.3	-6.5
Q4_97	-2.9	-4.2	-15.3	-13.2	-5.6
Q1_98	-2.7	-3.8	-15.5	-11.5	-1.7
Q2_98	-4.4	-3.4	-15.6	-13.6	-6.9
Q3_98	-4.3	-5.8	-15.4	-17.2	-8.5

Source: Bureau of Economic Analysis, Bureau of the Census

included the following:

- **The trade deficit with Mexico decreased steadily until the 2nd quarter of 1998, when the deficit rose to $4.4 billion.** The appreciation of the dollar against the peso contributed to a drop in U.S. exports to Mexico.

- **The trade deficit with Canada decreased 4.6% in the first three quarters of 1998 from the same period last year.** The fall in the deficit with Canada was likely the result of the low prices of Canada's commodity exports.

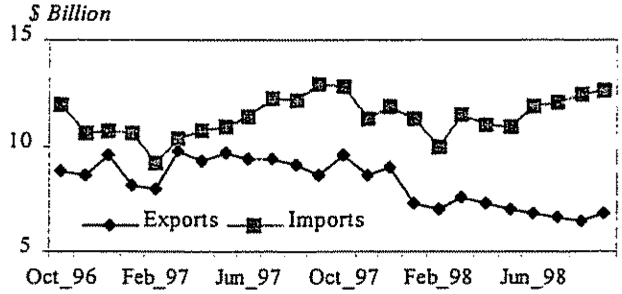
- **The trade deficit with Japan expanded significantly.** The deepening recession in Japan as well as the appreciation of the dollar against the yen contributed to a sharp fall in U.S. exports to Japan. This resulted in a rising trade deficit with Japan beginning in the 4th quarter of 1997 and continuing into 1998.

- **The trade deficit with China has recently shown signs of significant expansion.** The third quarter 1998 bilateral trade deficit with China was the United States' largest bilateral trade deficit that quarter.

- **The trade deficit with the EU increased 54% in the first 3 quarters of 1998 compared to the same period last year.** This increase is likely the result of the dollar appreciation and comparatively stronger U.S. growth.

- **The trade deficit with emerging Asia widened considerably as the result of falling U.S. exports to the region.** During the period of this report, nominal imports from emerging Asia grew only moderately.

U.S. Merchandise Exports to Emerging Asia
$ Billion



Source: Bureau of Economic Analysis

Capital Flows

During the period covered by this report, the weakness of many foreign economies contrasted sharply with the solid economic performance of the U.S. economy. Furthermore, uncertainty in global financial markets heightened investors' sensitivity to risk. **Investors responded to these changes in the global economy by purchasing U.S. assets in general, and U.S. Treasury securities in particular.** This trend in asset allocation illustrates investors' confidence in the U.S. economy and the fact that U.S. Treasury securities are an essentially risk-free asset.

Rising capital inflows have two immediate effects on the U.S. economy. First, the demand for dollars generated by the capital inflows results in an appreciation of the dollar. The appreciation of the dollar lowers the price of U.S. imports and raises the price of U.S. exports. This, in turn, causes a deterioration in the current account balance, but helps maintain low inflation.

- **The U.S. capital account is the mirror image of the U.S. current account.** A current account deficit implies a capital account surplus.

Second, capital inflows lead to lower interest rates in the United States. Both of these effects were evident in the period covered by this report.

In the long-run, a rising capital account surplus implies that the stock of U.S. assets owned by foreigners is increasing. This means that a larger amount of the return generated by U.S. assets will be payable to foreigners in the future. Furthermore, increased capital flows, along with increasing trade deficits, create greater vulnerabilities to changes in global financial markets views towards investment in the United States as well as greater sectoral dislocations in the U.S. economy. **It is important to recognize that the United States is currently experiencing record levels of business investment, part of which is supported by foreign investors. It is vital that this investment is employed productively to support both future repayments to foreigner investors and increased standards of living in the United States.**

Policy Priorities

The most important policies in responding to the present challenges include the following objectives:

- **Maintain sound domestic policies to offset the impact of the rising current account deficit.** An adjustment of the U.S. external imbalance would be eased by policies designed to raise the level of national savings. Maintaining a balanced budget is essential to this goal.

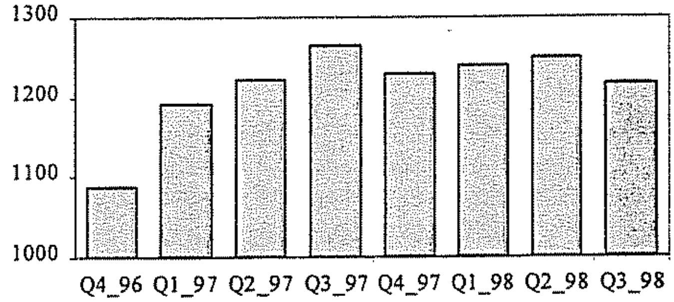
- **Pursue policies that promote strong growth and low inflation in the G-7 countries.** It is important to encourage the Japanese authorities to follow through on their recent efforts to restore economic growth in Japan.

- **Maintain financial assistance for strong programs, anchored with IMF support, designed to promote recovery in emerging market economies and limit the spread of financial contagion.**

- **Continue efforts to open foreign markets to U.S. exports.**

- **Continue to lead efforts to create an international financial architecture as modern as the markets.** The reform of the international financial system should be based on increasing financial transparency, strengthening domestic economic institutions, and creating mechanisms so that creditors and investors more fully bear the consequences of their actions.

Foreign Holdings of U.S. Treasury Securities
$ Billion



Source: U.S. Treasury

Capital Flows into the United States
$ Billion. sa

	Q4_96	Q1_97	Q2_97	Q3_97	Q4_97	Q1_98	Q2_98	Q3_98
Net Portfolio Flows	78	85	69	84	46	106	66	6
U.S. acquisition of foreign assets*	-72	-53	-33	-66	-56	-14	-42	3
Foreign acquisition of U.S. assets	150	138	102	150	102	120	108	3
Foreign Official	38	27	-5	21	-27	11	-10	-46
Private**	112	111	107	129	129	109	118	49
Net Banking Flows	-16	-46	1	-17	62	-47	13	54
Assets	-61	-64	-27	-30	-28	3	-25	-28
Liabilities	45	18	28	13	90	-50	38	83

Source: Bureau of Economic Analysis
* Net private claims on foreigners by nonbanks plus net private U.S. purchases of foreign securities
** Net purchases of U.S. Treasury securities, net nonbank liabilities to foreigners, net purchases of govt. non-Treasury securities, and net U.S. currency flows.

U.S. Exchange Rate Policies

G-7 Statements on Exchange Rate Policies

During the reporting period, November 1, 1996 to October 31, 1998, G-7 Finance Ministers and Central Bank Governors reaffirmed their standing commitment to reduce imbalances and cooperate closely in the exchange rate markets.

- **April 15, 1998**. "We discussed developments in our exchange and financial markets. We reaffirmed our view that exchange rates should reflect economic fundamentals and that excess volatility and significant deviations from fundamentals are undesirable. We emphasize that it is important to avoid excessive depreciation where this could exacerbate large external imbalances. In light of this, we support appropriate steps by Japan aimed at stimulating domestic demand led growth and reducing external imbalances, thus also correcting the excessive depreciation of the yen. We will continue to monitor developments in exchange markets and to cooperate as appropriate."

- **October 3, 1998.** "We discussed developments in our exchange and financial markets reaffirming the views we expressed in our April statement. We will continue to monitor developments in exchange markets and to cooperate as appropriate."

Currency Intervention

On June 17, 1998, the U.S. monetary authorities intervened in the foreign exchange markets, purchasing a total of $833 million worth of Japanese yen. This operation was the first currency intervention by U.S. authorities since August 1995 and the only intervention during the period covered by this report.

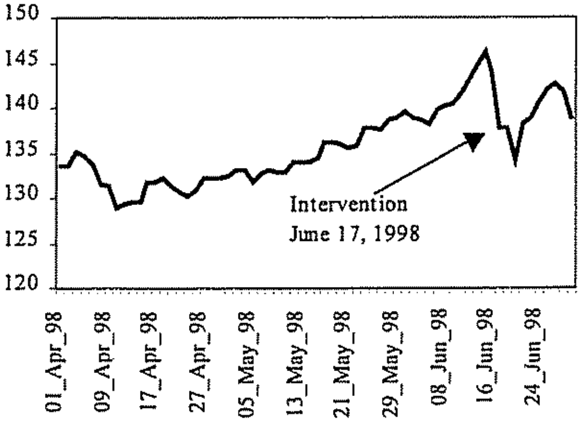
Throughout the 2nd quarter of 1998, the yen was pressured by anticipation of renewed capital flows out of Japan following the March 31 conclusion of the Japanese fiscal year, the beginning of Japan's liberalization of its foreign exchange laws, and continued weakness in the Japanese economy and financial system. In late May Japan's April unemployment rate was reported at 4.1 percent, its highest level since World War II and the yen subsequently declined to a seven-year low of ¥139.25 and the Japanese benchmark bond yield established record lows. The yen continue its decline and on June 15 fell to a multi-year low of ¥146.13 (New York close).

During the June 17 New York morning session, the New York Federal Reserve's foreign exchange desk intervened on behalf of the U.S. monetary authorities, selling dollars and buying yen. As the operation began, Japanese Prime Minister Hashimoto issued a statement in which he pledged to "make every effort to restore [the Japanese] banking system to health [and] to achieve domestic demand-led growth...."

Later, Secretary Rubin issued the following statement:

> "This morning, the Prime Minister of Japan outlined his Government's plans to restore the health of the Japanese financial system and to strengthen domestic demand... In the context of Japan's plans to strengthen its economy, the U.S. monetary authorities operated in the exchange market this morning in cooperation with the monetary authorities of Japan. We are prepared to continue to cooperate in exchange markets, as appropriate."

Daily Currency Movements: April - June 1998
Japanese Yen per Dollar



Foreign Exchange Rate Policies

Elements of Manipulation

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 manipulated the rate of exchange between their currency and the dollar for purposes of preventing effective balance of payments adjustments or gaining unfair comparative advantage in international trade. The Secretary of Treasury is required to undertake negotiations with those manipulating countries that have material global account surpluses and significant bilateral surpluses with the United States, unless there would be a serious detrimental impact on vital national economic and security interests.

- **Treasury undertook a broad review of the performance of major trading partners of the United Stated and concluded that none of them has manipulated their exchange rate under the terms of Section 3004 during the period examined.**

In evaluating evidence of currency manipulation, Treasury looks at the following five factors:

- **External Balances.** Persistent global current account surpluses are fundamentally a reflection of an excess of national savings over national investment, but in some cases may also indicate an attempt to use exchange rate policy to prevent external adjustment.

- **Exchange Restrictions and Capital Controls.** Restrictive exchange regimes and capital controls can be a concern, particularly where the restrictions are designed to maintain an consistently undervalued exchange rate or prevent the adjustment of an external surplus.

- **Exchange Rate Movements.** Large depreciations of exchange rates, if induced artificially rather than by market forces responding to fundamentals, could suggest an attempt to gain a comparative advantage in trade. Manipulation could also be reflected in the absence of a significant appreciation of the exchange rate when justified by fundamentals. Equilibrium real exchange rates, however, are determined by a number of factors and are therefore difficult to define.

- **Movements in Reserves.** Significant and persistent accumulation of foreign exchange reserves could be a source of concern if it reflects efforts to maintain an excessively competitive exchange rate.

- **Macroeconomic Trends.** When analyzing these economies, Treasury looks at the macroeconomic policy stance and other conditions that are important determinants of exchange rates.

Country Assessments

Economies were closely examined as potential exchange rate manipulators if they had significant global current account surpluses and bilateral surpluses with the United States as well as a fixed or actively managed exchange rate system during some point of this report.

- **Singapore.** Singapore's stated policy in combating the regional financial crisis has been to reduce business costs rather than devaluing its currency. Singapore's currency has depreciated 12% in nominal terms versus the dollar since 1996, but the Singapore dollar remained stable in trade-weighted terms since the start of the crisis. Singapore's current account surplus is expected to fall from 14.7% of GDP in 1997 to 13.5% of GDP in 1998. Following growth of over 7% in each of the past two years, no economic growth is expected for this year and a small decline in GDP is forecast by the market for next year.

- **China.** During the period covered by the report, the exchange rate of the *renminbi* was kept fixed to the dollar. In 1997 China experienced a record current account surplus (about 3.2% of GDP) and a record inflow of direct foreign investment (over $44 billion), which together resulted in a large balance of payments surplus. These surpluses led to a $35.9 billion increase in China's foreign reserves in 1997. The large current account and balance of payments surpluses continued in 1998, although reserve growth slowed significantly. China's growth, meanwhile, continued to slow. China experienced sharp declines in exports to Japan and other Asian countries, but export growth remained relatively strong to the United States and Europe. China's leaders consistently reiterated their commitment to maintain the stability of the *renminbi*.

- **Taiwan.** Taiwan's exchange rate policy since the start of the Asian financial crisis has generally been directed towards maintaining the value of the New Taiwan Dollar (NTD) in the face of significant regional financial turmoil. From July 1997 to mid-October 1997, the Central Bank of China (CBC) used over $7 billion in reserves in an effort to support the value of the NTD. As the crisis in Asia intensified and pressures on reserves continued, the CBC relaxed its support of the currency on October 17, 1997. Since then, the NTD has depreciated some 16%, with roughly a 7% real depreciation from October 1997 through September 1998. Taiwan's current account surplus as a percent of

GDP fell from 4.0% GDP in 1996 to an estimated 2.7% GDP in 1997 and, according to private sector forecasts, will fall further to 0.6% GDP in 1998. While recently imposed restrictions on financial markets (e.g., banning the use of New Taiwan dollar forward contracts for domestic companies, closing Taiwan's bond market to foreign issues, and jaw-boning of foreign banks not to "speculate") represent a reversal in progress made towards financial liberalization, these actions have been taken in order to defend a stronger NTD and not to promote the competitiveness of Taiwan exports.

- **Malaysia.** The Malaysian government imposed broad capital and exchange controls on September 1, 1998. The government's stated reasons for imposing capital controls appeared to be to induce the return of *ringgit* capital that had been accumulating offshore and to preserve the value of the *ringgit* while providing more freedom for monetary policy to address domestic conditions. The government fixed the *ringgit* exchange rate at RM3.8/$1 on September 2nd, a rate that was 10% higher than the rate prevailing in the market at the time and 23% higher than the lowest rate reached this year. On a trade-weighted basis, the *ringgit* has appreciated 6% since the end of 1997. Although Malaysia's current account balance improved dramatically (the current account balance is expected to swing to a surplus of 8.3% of GDP this year from a deficit of 4.9% of GDP in 1996), and Malaysia has both a current account surplus and a bilateral trade surplus with the United States, this is primarily a result of the collapse in import demand driven by the economic slowdown. Exports were actually down 18% year over year in dollar terms during August. While it is the opinion of the Treasury Department that Malaysia is not using currency controls to gain a competitive advantage in trade, Treasury believes that the Malaysian government's goal of defending the *ringgit* could be achieved more efficiently through appropriate macroeconomic policies

Policy Priorities

- **Treasury intends to continue monitoring the markets for evidence of currency manipulation.**

Appendix

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

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

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

(1) to achieve-

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

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

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

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

SEC.3005. REPORTING REQUIREMENTS.

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

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

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

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

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

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

(A) the ability of the United States to maintain a more appropriate and sustainable balance in its current account and merchandise trade account;

(B) production, employment, and noninflationary growth in the United States;

(C) the international competitive performance of United States industries and the external indebtedness of the United States;

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

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

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

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

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

SEC. 3006. DEFINITIONS.

As used in this subtitle:

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

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