

**Report to Congress on
International Economic and Exchange Rate Policies
May 2005**

This report reviews developments in international economic policy, including exchange rate policy, focusing on the second half of 2004. The report is required under the Omnibus Trade and Competitiveness Act of 1988, which states, among other things, that: “The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade.”

This report reviews the effects that significant international economic developments have had on the United States and foreign economies and evaluates the factors that underlie those developments. For the specific purpose of assessing whether an economy is manipulating the rate of exchange between its currency and the U.S. dollar according to the terms of the Act, Treasury has traditionally undertaken a careful review of the trading partner’s exchange rates, external balances, foreign exchange reserve accumulation, macroeconomic trends, monetary and financial developments, institutional development, and financial and exchange restrictions among other things. Attention is given to both the changes and the interactions of significant variables. Isolated developments in any one area do not typically provide sufficient grounds to conclude that exchange rates are being manipulated under the terms of the Act. A combination of factors, on the other hand, can and has in the past led Treasury to find that certain countries had satisfied the terms of the Act¹.

After reviewing developments in the United States, the report examines exchange rate policies in major economies across five regions of the world: (1) the Western Hemisphere, (2) Europe and Eurasia, (3) Sub-Saharan Africa, (4) the Middle East and North Africa and (5) South and East Asia.

To summarize, the report finds that:

- Economies around the world continue to follow a variety of exchange rate policies, ranging from a flexible exchange rate with little or no intervention to currency unions and full dollarization. For example, Canada follows a flexible exchange rate regime with no intervention, twelve countries are members of the European Monetary Union, and El Salvador, Ecuador and Panama use the U.S. dollar as their “domestic” currency.
- The report finds that no major trading partner of the United States met the technical requirements for designation under the Omnibus Trade and Competitiveness Act of 1988 during the second half of 2004. A number of economies continue to use pegged

¹ These issues are discussed more completely in Treasury’s March 11, 2005, [Report To The Committees On Appropriations on Clarification Of Statutory Provisions Addressing Currency Manipulation](#).

exchange rates and/or intervene in foreign exchange markets. A peg or intervention, though, does not in and of itself satisfy the statutory test. Treasury has consulted with the IMF management and staff, as required by the statute, and they concur with these conclusions.

- Nevertheless, Treasury has engaged, and will continue to engage, with several economies, including some in Asia, to promote the adoption of market-based exchange policies and regimes. Most notable among these is China. Current Chinese policies are highly distortionary and pose a risk to China's economy, its trading partners, and global economic growth. Concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies. If current trends continue without substantial alteration, China's policies will likely meet the statute's technical requirements for designation.
- While China's ten-year-long pegged currency regime may have at times contributed to stability, it no longer does so. The peg blocks the transmission of critical price signals, impedes needed adjustment of international imbalances, attracts speculative capital flows and is a large and increasing risk to the Chinese economy. Indeed, Chinese officials have publicly acknowledged the need to move to a more flexible system, have repeatedly vowed to do so and have undertaken the necessary and appropriate preparations. It is widely accepted that China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions. Treasury will continue to engage with China and closely monitor changes in its foreign exchange policy over the coming weeks and months.
- Treasury is continuing to engage actively with economies to encourage, in both bilateral and multilateral discussions, flexible market-based exchange rate regimes combined with a clear price stability goal and a transparent system for adjusting policy instruments. In this light, the communiqués of the G-7 Finance Ministers and Central Bank Governors in October of 2004 and February and April of 2005 stated: "...that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."

The United States International Accounts²

The current account deficit is conceptually equal to the gap between domestic investment and domestic saving, as a matter of international accounting. When investment in the United States is higher than domestic saving, foreigners make up the difference, and the United States has a

² The IMF annually reviews U.S. economic performance and policies through the so-called IMF Article IV surveillance process. The last Article IV surveillance review took place in July 2004. The IMF staff paper and the results of the IMF Executive Board's discussion of the U.S. Article IV review can be found at <http://www.imf.org/external/pubs/ft/scr/2004/cr04230.pdf>. In addition, the IMF discusses U.S. economic policies and performance in the context of its twice yearly World Economic Outlook reports. These can be found at <http://www.imf.org/external/pubs/ft/weo/weorepts.htm>

current account deficit. In contrast, if saving exceeds investment in a country, then that country has a current account surplus as its people invest abroad.

The growth of the U.S. current account deficit over more than a decade has been linked to high levels of domestic U.S. capital formation compared to domestic U.S. saving. Perceived high rates of return on U.S. assets, based on sustained strong productivity growth relative to the rest of the world, sound U.S. economic performance and the attractiveness of the U.S. investment climate, attract foreign investment. Sustained external demand for United States assets has both supported the dollar in the foreign exchange markets over the years and allowed the United States to achieve levels of capital formation that would have otherwise not been possible. Robust growth in investment is critical to the non-inflationary growth of production and employment.

In the second half of 2004, for example, the U.S. current account deficit was \$679 billion (at a seasonally adjusted annual rate and on a national income and product accounting, or NIPA, basis) or 5.7 percent of GDP. This \$679 billion deficit equaled the gap between \$2,369 billion in investment and \$1,690 billion in saving³. That is, U.S. domestic investment was \$679 billion more than domestic saving with net foreign investment making up the difference.

The U.S. economy performed well over the second half of 2004. Real GDP increased at an average annual rate of 3.9 percent in the final two quarters, led by rapid gains in both business fixed investment and personal consumption. Improved labor markets (with almost one million new payroll jobs added during July-December and a decline in the unemployment rate to an average of 5.4 percent), as well as a rise in household net worth, contributed to increased consumer spending and favorable balance sheets despite low saving. Public saving is expected to improve, as solid economic growth and tight controls imposed by fiscal policies are expected to cut the Federal budget deficit by more than half, from 3.6 percent of GDP in FY 2004 to 1.5 percent by FY 2009.

The U.S. current account was \$708 billion in deficit (at a seasonally adjusted annual rate and on a balance of payments basis⁴) in the second half of 2004. A major item financing the current account deficit has been net private foreign purchases of U.S. securities, which reached an annualized \$552 billion in the second half of 2004. (Included in these were net private foreign purchases of U.S. Treasury securities amounting to \$26 billion.) In addition, foreign official institutions increased their U.S. assets by \$308 billion.

Viewed over a longer period, the U.S. current account balance declined, as a percent of GDP, from a one percent surplus in the first quarter of 1991 to a four percent deficit in the fourth quarter of 2000, to a six percent deficit in the second half of 2004.

Due to the current account deficit the net investment position of the United States (with direct investment valued at the current stock market value of owners' equity) fell to a negative \$2.7

³ Including the (relatively small) statistical discrepancy.

⁴ Although the current account measures are conceptually the same, balance of payments statistics are compiled on a slightly different basis from national income statistics. Saving includes the statistical discrepancy between the income and product accounts.

trillion as of December 31, 2003, the latest date for which data are available, from a negative \$2.6 trillion at the end of 2002. A \$398 billion valuation adjustment due to exchange rate changes offset much of 2003's financial outflow. Despite a large negative position, U.S. residents earned \$30 billion more on their foreign investments in 2004 than foreigners earned on their U.S. investments. These positive net income receipts are the result of large net inflows of income from direct investment offsetting net outflows of income on portfolio investment.

The U.S. current account deficit is the counterpart of the aggregate surplus of other economies in the world. The policies of all countries affect the global pattern of current account balances. It is important that policies that the United States follows keep the United States and the world economy strong. The adjustment of global imbalances is a shared responsibility. First, in the United States, policies aimed at increasing saving of the public sector and the private sector should contribute to global adjustment and reinforce the continuing stability of the international financial system. Second, in Europe and Japan, policies for further structural reforms are needed to boost sustainable growth. Third, greater flexibility of exchange rates is needed, particularly in emerging Asia economies that lack such flexibility.

The U.S. Dollar

The Federal Reserve Board's "broad" nominal dollar index decreased 6.7 percent during the second half of 2004. The dollar depreciated 8.9 percent against the "major" foreign currencies (seven other industrialized economy currencies) and 3.8 percent against the currencies of "other important trading partners" of the United States (largely currencies of emerging market economies). The broad index declined 16.9 percent from February 27, 2002, when it reached its recent peak, through December 31, 2004. Over this latter period the dollar depreciated 29.5 percent against the major currencies while appreciating 1.8 percent against the currencies of other important trading partners.

The consumer price index (CPI) rose 2.0 percent annualized rate from July through December and in the final month of the year was 3.3 percent higher than a year earlier. Excluding food and energy, the core CPI rose 2.2 percent during the 12 months ending in December 2004. With the economy expanding and underlying inflation modest, the Federal Reserve continued to remove monetary accommodation, increasing its federal funds target rate four times, by a total of 100 basis points, in the second half of the year to reach to 2.25 percent on December 14. The yield on 10-year Treasury notes fluctuated during the latter half of the year, but finished the year at about 4.2 percent in December, essentially unchanged from the end of 2003 and 50 basis points lower than in June despite the rise in short term interest rates.

As discussed below, the currencies of different economies showed varying degrees of flexibility relative to the dollar, as some monetary authorities sought to dampen or prevent movements of their exchange rates against the dollar while others did not intervene at all. The United States did not intervene in foreign exchange markets during the second half of 2004.

Western Hemisphere

Nominal exchange rates in the region on average appreciated against the U.S. dollar in the second half of the year, as Latin America posted nearly 6 percent real GDP growth in 2004, the highest regional growth rate in a quarter-century. Interest rate spreads between the Latin American Emerging Market Bond Index (EMBI+) and U.S. Treasury securities decreased from 569 basis points in end-June to 434 basis points by end-December 2004.

Argentina

Argentina has had a flexible exchange rate since the end of 2001 when it abandoned its convertibility law, which pegged the peso one-to-one to the U.S. dollar. Argentina's currency remained relatively steady in the second half of 2004, depreciating 0.5 percent from 2.96 pesos per dollar to 2.97 pesos per dollar. Argentina's trade surplus was \$6.2 billion in the second half of 2004, with exports rising 20 percent and imports rising 53 percent compared to the same period the previous year. The seasonally adjusted current account fell from 2.2 percent of GDP in the first half of 2004 to 1.9 percent of GDP in the second. The U.S. trade deficit with Argentina was \$334 million in the second half of 2004.

Argentina's gross foreign exchange reserves grew by \$2.2 billion during the second half of the year to \$19.6 billion at the end of December 2004 as Argentina's central bank accumulated international reserves during periods of peso strengthening. The economic recovery continued after the severe contraction in the first half of 2002, with real GDP growing 14.0 percent at a seasonally adjusted annualized rate in the third quarter of 2004 and 11.4 percent in the fourth quarter. Consumer prices accelerated, with a net increase of 5.2 percent in seasonally adjusted terms from June 2004 to December 2004.

Brazil

Brazil has a flexible exchange rate regime and relies on inflation targeting to guide monetary policy. The *real* appreciated 16.9 percent against the dollar during the second half of 2004 from BRL3.11/US\$ to BRL2.66/US\$. Brazil's sovereign risk spread stood at 383 basis points over U.S. Treasuries at end-2004 versus 646 basis points at the end of June. Year-on-year inflation stood at 7.6 percent in December, above the central bank's 5.5 percent target for 2004 but within the target band. Brazil had a \$6.3 billion, or 2.0 percent of GDP, current account surplus in the second half of 2004 compared to \$5.4 billion, or 1.9 percent of GDP, in the first half. The United States had a trade deficit with Brazil of \$4.9 billion in the second half of 2004 compared to a \$3.4 billion deficit in the second half of 2003. Foreign direct investment increased to \$14.1 billion in the second half of 2004 compared with \$4.0 billion in the first half. The central bank increased net international reserves to \$27.5 billion by end-December 2004 compared to \$24.9 billion at end-June, as the central bank purchased international reserves at the end of the year. Real GDP (saar) increased 4.4 percent and 1.7 percent in the third and fourth quarters respectively. For the full-year 2004, GDP posted a 5.2 percent increase—the highest growth rate in ten years.

Canada

Canada has a flexible exchange rate regime. It has not intervened in the foreign exchange market since 1998, except to make a small contribution to the brief G-7 intervention in support of the euro in September 2000. Its central bank targets an inflation rate of 2 percent with a +/- 1 percent band. During the second half of 2004, the Canadian dollar appreciated against the U.S. dollar by 11.4 percent, from 1.34 C\$/US\$ to 1.20 C\$/US\$. The J.P. Morgan broad real trade-weighted index for the Canadian dollar appreciated by 8.3 percent while the J.P. Morgan narrow nominal trade-weighted index for the Canadian dollar appreciated by 9.5 percent. Canada's current account surpluses during the third and fourth quarters of 2004 were \$6.4 billion, or 2.6 percent of GDP, and \$5.2 billion, or 1.9 percent of GDP, respectively. The merchandise trade surplus with the U.S. during the period was \$33.6 billion. Canada's international reserves declined in second half of 2004 to \$34.5 billion from \$35.4 billion in the first half. Year-on-year headline inflation in December 2004 was 2.1 percent. The economy expanded in the second half of 2004, with annualized real GDP growth of 3.4 percent and 3.0 percent in the third and fourth quarters, respectively.

Mexico

Mexico has a flexible exchange rate regime. Its central bank targets an inflation rate of 3 percent with a +/- 1 percent band. The Bank of Mexico also follows a transparent rule for selling foreign reserves accumulated by state enterprises. During the second half of 2004 the Mexican peso appreciated by 3.5 percent against the dollar, from 11.54 pesos/dollar to 11.15 pesos/dollar. The J.P. Morgan narrow nominal trade-weighted index for the peso depreciated by 0.4 percent, while the J.P. Morgan broad real trade-weighted index for the peso appreciated by 0.4 percent. Mexico's current account deficits during the third and fourth quarters of 2004 were \$2.3 billion, or 1.4 percent of GDP, and \$2.9 billion, or 1.7 percent of GDP, respectively. Mexico's merchandise trade surplus with the U.S. during the period was \$22.8 billion. Foreign direct investment in the second half of 2004 was \$5.4 billion, versus \$11.2 billion in the first half of the year. International reserves grew by \$2.4 billion during the second half of the year, reaching \$61.5 billion by the end of December. Year-on-year headline inflation was 5.1 percent in December. The economy grew robustly in the second six months of 2004, with real seasonally adjusted GDP increasing at annual rates of 3.8 percent and 5.6 percent during the third and fourth quarters, respectively.

Europe and Eurasia

The Euro-zone

During the second half of 2004, the euro remained relatively stable through mid-October, but appreciated sharply thereafter, gaining 9 percent from mid-October, or 11.2 percent from end-June, to year-end. The index of the real effective exchange rate of the European Central Bank (ECB) appreciated 4.9 percent over the second half of the year. The ECB did not intervene in foreign exchange markets during 2004.

The countries in the Euro-zone taken together had a current account surplus during the second half of 2004 equal to \$11.3 billion (sa), or 0.2 percent of GDP, down from \$38.4 billion, or 0.8 percent of GDP, in the first half of the year. Goods exports increased 8.4 percent while goods imports increased 12.9 percent in the second half of 2004 over the same period in 2003. The trade surplus of the Euro-zone vis-à-vis the U.S. was \$44.2 billion in the second half of 2004 compared to \$39.7 billion in the second half of 2003.

Euro-zone growth was an estimated 0.8 percent (annualized) in the second half of 2004. Germany and Italy have held back Euro-zone growth while France had annualized growth of 1.5 percent in the second half led by strong domestic demand. For the region, final consumption expenditure rose 1.0 percent in the second half of 2004 while investment increased 2.5 percent. Core inflation was 1.9 percent yr/yr in December 2004 compared to 2.0 percent yr/yr in June 2004. Headline inflation – which includes energy and other volatile prices excluded in the core index – was 2.4 percent yr/yr at the end of the second half of 2004, the same rate as at the end of the first half.

Central Europe & Ukraine

The currencies of the major central European economies appreciated sharply against the dollar during the second half of 2004. This partly reflected the dollar's depreciation against the euro during the period, but each of the currencies also strengthened against the euro, their main reference currency, supported by attractive domestic interest rates.

In Hungary, short term yields of 10.0 percent helped the forint appreciate 2.1 percent against the euro (14.0 percent against the dollar), despite continued concern about large fiscal and current account deficits. The National Bank of Hungary's index of the real value of the forint rose by slightly less, 1.8 percent, as inflation slowed.

In Poland, the zloty rose 10.5 percent against the euro during the second half of 2004 (an appreciation of 23.4 percent against the dollar). Zloty appreciation reflected the differential between domestic interest rates and Euro-zone yields, as well as increased political stability and improved macroeconomic performance. The National Bank of Poland's index of the zloty in real terms rose 8.1 percent.

In Ukraine, the hryvnia rose 0.3 percent against the dollar during the second half as the central bank continued to manage the bilateral exchange rate against the dollar heavily.

Russia

The large net inflows resulting from high oil prices continued during the second half of 2004. Russia's current account surplus in the second half of 2004 was \$33.8 billion (nsa), or 10.5 percent of GDP, compared to \$15.8 billion, or 6.6 percent of GDP, in the second half of 2003. The ruble appreciated 4.9 percent against the U.S. dollar in the second half of 2004 compared to 0.6 percent in the first half. However, because of the relative strength of the euro, J.P. Morgan's Broad Real Effective Exchange Rate Index appreciated just 0.6 percent in the second half of 2004 compared to 5.1 percent in the first half. Russian monetary authorities continued to

intervene to moderate the appreciation of the ruble against the dollar, and official reserve assets increased \$36.3 billion to a record high of \$124.5 billion. Consumer prices rose 11.9 percent in the year through December 2004 compared to 10.2 percent in the year through June 2004.

Sub-Saharan Africa

Overall, Sub-Saharan African's current account deficit narrowed to an estimated 1.6 percent of GDP in 2004 from 2.4 percent in 2003. An improvement in the current account balances of the region's main oil exporters drove the overall change. The growth in the U.S. trade deficit to \$27 billion, from \$19 billion in 2003 with sub-Saharan Africa reflects higher U.S. oil imports, which accounted for 73 percent of all U.S. imports from the region.

Roughly half of sub-Saharan African countries officially peg their currencies to other currencies, primary the Euro. Most sub-Saharan African currencies appreciated in nominal terms against the U.S. dollar in the second half of 2004. The South African Rand, which floats relatively freely appreciated about 10 percent against the U.S. dollar during the second half of 2004, benefiting from higher prices of South Africa's commodity exports. However, the value of the currencies of six countries with managed or independently floating exchange rate regimes changed little against the U.S. dollar over the six month period, most notably the Nigerian Naira, despite significant increases in oil receipts. Of the countries for which reliable data is available, the Democratic Republic of the Congo's currency depreciated the most in nominal terms (11 percent).

Middle East and North Africa

Strong economic growth continued across the Middle East and North Africa, supported by high oil prices. GDP growth in the oil-exporting countries of the Gulf Cooperation Council countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE) remained robust. Mainly due to higher oil prices, current accounts across the Gulf remained largely in balance or surplus, having increased significantly, along with holdings of official reserves. Oil-exporting GCC countries tie their currencies directly to the U.S. dollar.

Many other countries in the region, such as Jordan and countries in North Africa, also maintain pegged exchange rate regimes. Changes in current account balances largely reflected changes in terms of trade, with balances rising in large oil exporters like Algeria and falling in importers like Morocco. In Egypt, exchange rate flexibility increased considerably following the launch of an interbank foreign exchange market in December 2004. The current account surplus rose due to higher oil prices and increased receipts from tourism and the Suez Canal (reflecting robust global trade). This, along with a small but growing net increase in capital inflows due to tighter monetary policy, growing investor confidence in the reform-oriented economic team, and an expected surge in privatizations, led to upward pressures on the pound and virtually eliminated the spread between official and parallel markets. In the six months ending December 2004, the pound appreciated 1.9 percent in nominal terms against the dollar, and the current account registered a \$2.9 billion surplus, a \$900 million increase over the same period in 2003. Net international reserves increased from \$14.8 billion end-June 2004 to \$15.4 billion end-December 2004.

Turkey maintained its floating exchange rate regime. Overall, the Turkish lira appreciated by 10.4 percent in nominal terms against the U.S. dollar in the second half of 2004, as capital inflows increased in anticipation of a European Union decision to begin accession negotiations and high real interest rates. However, during this period, the central bank's index of the real trade-weighted lira rose 4.1 percent, reflecting 1.7 percent nominal depreciation against the euro. Inflation fell from 12.7 percent in 2003 to 9.4 percent in 2004, its lowest level in decades. The current account deficit widened in 2004 to 5.1 percent of GNP (\$15.4 billion), from 3.4 percent in 2003, on the back of strong domestic demand, as GNP grew 9.9 percent over the first three quarters of 2004, compared to the same period in 2003. Imports and exports increased 39.1 percent and 30.8 percent, respectively, compared with 2003, driving the trade deficit to \$23.8 billion, up 70 percent from \$14.0 billion in 2003. Reserves stood at \$37.6 billion at end-2004, up from \$35.2 billion at end-2003, still only 75 percent of short-term external debt.

In Israel, which also maintains a floating exchange rate, the shekel appreciated 4.4 percent in nominal terms against the dollar during the second half of 2004, while remaining constant in real trade-weighted terms due to significant trade weights of the euro and sterling. Capital inflows surged in 2004 as the decline in foreign direct investment in 2004 was more than offset by strong portfolio investment throughout the year (reversing the general trend of positive FDI and negative portfolio investment). While posting a small deficit in the second half of 2004 as private consumption rose, the current account registered a slight surplus for the year (0.4 percent of GDP) due to strong growth in goods and services exports. GDP growth increased in 2004 to 4.3 percent for the year, up from 1.3 percent in 2003, with an acceleration in the second half of 2004. Foreign exchange reserves rose 3.6 percent in the second half of 2004, reaching \$26.6 billion at end-December, after remaining unchanged in the first half of 2004.

South and East Asia

South and East Asia contributed to the global economy's strong growth in 2004. Developing East Asia grew at 7.3 percent in 2004. Japan grew at 2.7 percent, its highest rate since 1996. Strong external demand, particularly in the United States, and the revival of the global IT industry supported growth in the region. But a revival of domestic investment in economies of the region also underpinned economic growth. The growth of domestic demand in China, in particular, is contributing significantly to the global growth. Although imports into the region grew rapidly with improving economic performance, export growth was also strong and current account surpluses increased in most major economies of the region.

Within the year, growth was strongest in the first quarter. By the third and fourth quarter growth rates had dropped significantly in a number of East Asian countries – Japan in particular. This was in part due to excessive inventory buildups in the IT sector, but also reflected a moderate slowing of U.S. growth and rising oil prices. Solid growth within the region and rising oil prices also marked the end of concerns about deflation in a number of countries outside Japan, and the beginning of a shift in monetary policy to avoid inflation. In some cases, notably Korea, exchange rate appreciation was viewed as a way of containing imported inflation.

Capital flows into the region went through two broad cycles. After slowing significantly in the second quarter of 2004, capital inflows picked up sharply in the last half of the year, and were especially strong in the fourth quarter. As a result, private capital flows into the region rose for the fourth straight year in 2004 and may be nearing pre-Asian Crisis levels. Net inward foreign direct investment increased by more than 30 percent to an estimated \$72 billion. Net portfolio and other capital inflows increased as well. Monetary authorities faced growing foreign demand for domestic currency assets and upward pressures on their currencies over the year as a whole, particularly in the second half.

Trade flows among East Asian economies have increased sharply in recent years, reflecting increased integration of economies in the region. But increased intra-regional trade also reflects the increasing diffusion of component production among economies in the region, often for products that are exported outside East Asia. As a result, monetary authorities of economies with more flexible exchange rates appear to be increasingly concerned about the effect of currency appreciation on their competitiveness relative to other economies in East Asia. While noting these concerns, the Administration has encouraged increased exchange rate flexibility for East Asian economies generally, both in bilateral discussions and in regional fora such as APEC. APEC Finance Ministers made a significant move in this direction in their statement of September 3, welcoming steps taken by member economies to facilitate the move to greater exchange rate flexibility.

India

Faced with strong financial inflows and rising inflation, the central bank allowed greater flexibility in the managed floating exchange rate regime and liberalized controls on capital outflows. The Indian rupee appreciated against the U.S. dollar by 6.3 percent during the second half of 2004. Foreign institutional investors poured \$5 billion into Indian equity markets in the second half of 2004 compared with \$3.5 billion in the first half, as investor concerns that the newly elected government would slow market oriented reforms receded. Income from remittances also remained strong. The U.S. bilateral merchandise trade deficit with India was steady at \$4.7 billion in the second half of 2004, compared to \$4.8 billion for the first half. Despite increases in exports of services, a sharp rise in commodity imports due to higher prices pushed the current account into a deficit of 0.1 percent of GDP in 2004, from a surplus of 1.3 percent of GDP in 2003. Foreign exchange reserves increased to \$125 billion at year end from \$114 billion at the end of June.

Japan

Japan's economic recovery, which began in the second quarter of 2002, stalled in the second half of 2004. Japan's economy contracted slightly in the second and third quarters of the year and grew marginally in the fourth quarter. Japan also appeared to lose some ground in its long fight to eliminate deflation, as core consumer prices (the Japanese CPI less fresh foods) fell by 0.2 percent year-on-year during the second half of 2004, after falling 0.1 percent on a year-on-year basis in the first half of the year. However, other price measures, such as the deflators for private consumption and GDP, showed continued progress toward price stability.

Japan has had a persistent current account surplus and capital outflows to the rest of the world, a consequence of a surplus of Japanese savings over domestic investment. Rates of return on domestic investment have been generally low, although the Prime Minister's program of structural reform and deregulation and the recent acceleration of corporate restructuring and mergers and acquisition activity hold out the prospect of higher returns. Japan's global current account surplus remained steady at about 3.5 percent of GDP (or \$83.1 billion) in the second half of 2004. Japan's bilateral merchandise trade surplus with the United States totaled \$39 billion in the second half of 2004, up from \$36.2 billion in the first half. Capital continued to flow out of Japan in the second half of 2004 reportedly in response to changing expectations of U.S. growth relative to Japanese growth and higher U.S. interest rates.

During the June 30 to December 31, 2004 reporting period, the yen appreciated 5.6 percent against the dollar, reaching a level of 103.8 at year-end. At the same time that the Japanese economy appeared to weaken, economic releases from the United States showed continued strength. This differential was reflected in currency values during the first three months of this year. The yen hit a peak value of 101.9 to the dollar on January 17, 2005, but by March 31 was trading at 107.0 to the dollar, a depreciation of 3.1 percent from its end-year level. Over a more extended period, since early February 2002 through the end of March 2005, the dollar has depreciated by 20 percent against the yen, less than its 29.5 percent depreciation against the major currency component of the Federal Reserve Board's Broad Nominal Index of the dollar over the same period.

Japanese authorities have not intervened in the foreign exchange market since March 16, 2004.⁵ Japanese foreign exchange reserves rose by \$25.7 billion in the second half of 2004 to \$824.3 billion, due to interest earnings and a depreciation of the dollar against other currencies held as Japanese reserves. This contrasts with an increase in Japanese foreign exchange reserves of \$145.8 billion in the first half of 2004, a period in which the authorities did intervene.

China

China kept its fixed exchange rate of 8.28 to the U.S. dollar throughout the reporting period, a rate it has maintained since 1995, through periods of both upward and downward pressures on the exchange rate. While the benefits of China's ten-year-long pegged currency regime may have at times served well the Chinese economy, this is no longer the case for the large, increasingly market-based economy that China has become. China's fixed exchange rate is now an impediment to the transmission of price signals and international adjustment, and imposes a risk to its economy, China's trading partners, and global economic growth. China has clearly stated that it intends to move to a market-based flexible exchange rate, and has undertaken the necessary and appropriate preparations. It is now widely accepted that China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions.

⁵ The Japanese Ministry of Finance announces its total foreign exchange intervention at the end of each month, and publishes the dates and amounts of intervention at the end of each quarter. See <http://www.mof.go.jp/english/e1c021.htm>

To maintain the fixed exchange rate the Chinese authorities supplied renminbi for net inflows of foreign exchange, accumulating foreign exchange reserves in the process. This accumulation of foreign reserves accelerated in second half of 2004. China's official foreign exchange reserves grew by a net \$139 billion to \$610 billion during the second half of 2004, with over two-thirds of the increase taking place in fourth quarter.

China's fixed exchange rate regime and the large amount of renminbi the monetary authorities supply in maintaining the fixed exchange rate made effective macroeconomic policy management more difficult during the second half of 2004 and into 2005. To soak up ("sterilize") the additional renminbi created by purchasing foreign exchange, China's central bank sells bonds to domestic banks. Net issuance of central bank sterilization bonds has risen sharply since September 2004. Chinese policymakers also took a series of administrative measures over the last year to curb lending, and raised domestic interest rates slightly in October 2004 in order to constrain investment and contain consumer prices.

These macroeconomic policy measures had some effect in cooling off the economy during the second half of 2004. However, economic growth remained quite strong in the fourth quarter of last year, and 2005 data suggest that China's growth rate and inflation risks are rebounding. In the first quarter of 2005, real GDP, driven by trade and investment, grew by 9.5 percent. Industrial output and investment growth also remained brisk. China's exports grew rapidly on sharp increases in textile and apparel exports following the end of quotas and increased electronics shipments. After a 3.9 percent year-over-year increase in consumer prices in March, inflation moderated in April, but still remains higher than at the end of 2004. Real interest rates fell as a result, countering the authorities' efforts to contain the increase in bank lending.

China's experience over the reporting period illustrates some of the difficulties of maintaining the fixed exchange rate. Rapid growth in exports, increased liquidity, and low real interest rates continue to support China's economic growth, and concerns remain about overinvestment and inflationary pressures. In this regard, China needs to rely more on domestic demand growth, particularly consumption growth. The central bank has had to work hard to counteract the growth in domestic liquidity from foreign exchange intervention. It is also very limited in its ability to raise interest rates since this would spur greater capital inflows. The rapid growth of credit and very high rate of investment in turn risk undermining the progress China has made in reforming its banking system by creating new flows of non-performing loans.

China's global trade surplus increased in the second half of 2004 to a (seasonally unadjusted) total of \$40 billion (4.2 percent of GDP), up from a \$21 billion surplus (2.6 percent of GDP) in the same period in 2003. The trade surplus in the second half of 2004 offset a deficit during the first half, bringing China's reported trade surplus to \$32 billion for all of 2004.⁶ The increase in

⁶ These trade figures are on an FOB-CIF basis. Several studies have noted that China's global trade surplus (one component of its current account surplus) as reported in aggregate by China's trading partners differs markedly from what is reported by Chinese official statistics. One difficulty that arises is that much trade to and from China travels via Hong Kong. Importing countries usually accurately determine the source of their imports through certificates of origin. But exporters (both Chinese and partner country exporters) often record the destination of their exports as Hong Kong, even though the goods go on to other markets. This explains a significant part of the discrepancy between Chinese and partner country trade estimates of China's trade surplus, since a significant part of the trade between China and partner countries is recorded as trade with Hong Kong.

China's global trade surplus is partly due to recovery in the global IT market and the increase in Chinese shipments of components. But there are also reports that trade transactions are also being used to move capital into China for domestic investment or in anticipation of a revaluation of the renminbi. This could occur either through accelerating the collection of payments due for Chinese exports while delaying payment for imports, or by over-invoicing exports and under-invoicing imports. Both responses are common in countries with capital controls. China's bilateral surplus on trade in goods with the United States also expanded in the second half of 2004 to \$93.5 billion compared to \$70.2 billion for the last half of 2003. U.S. trade in both directions continued to expand at a faster rate than total U.S. trade. While total U.S. exports to all destinations grew by 13 percent in 2004, U.S. exports to China grew 22 percent during the same period.

China's balance of payments surplus amounted to \$206 billion in 2004, up 76 percent from 2003 (China's balance of payments data are available only on an annual basis). China's current account surplus increased sharply in 2004 to \$68.7 billion, or 4.2 percent of GDP. This surplus has increased in recent years from \$17.4 billion in 2001 (1.5 percent of GDP), to \$45.9 billion (3.1 percent of GDP) in 2003⁷. China's capital and financial account saw a net inflow of \$111 billion in 2004 (compared to \$53 billion in 2003). Reserve accumulation figures suggest that private financial inflows surged in the second half of 2004, as speculation on an appreciation of the renminbi increased and as property markets in major urban areas heated up. Despite recent liberalization, China maintains greater controls on capital outflows than inflows, which contributes to upward pressure on reserves and the balance of payments.

In the context of an economy with large and dependable capital inflows, large prospects for productivity gains, and unsustainably high rates of investment, China's current account surplus is large.

China has committed to push ahead firmly and steadily to a market-based flexible exchange rate, and is taking concrete steps to bring about exchange rate flexibility. Chinese Premier Wen said on March 14, 2005 that China would "create a market-based, managed and floating exchange rate." Chinese Central Bank Governor Zhou has said recently that "rigid exchange rates present huge risks."

Since September 2003, when the Treasury began its intensive engagement with China to hasten its move to a more flexible exchange rate, the Chinese Government has taken important steps to establish the necessary financial environment and infrastructure to support exchange rate flexibility.

First, China has undertaken measures to increase the volume of foreign exchange trading, an important step in aiding market development and reducing the volatility of exchange rates. China has reduced restrictions on capital flows and allowed its firms and citizens greater scope to engage in market transactions. In February, China eliminated the foreign exchange surrender requirements for many commercial firms, which can now exchange their export earnings with

⁷ In addition to the trade balance, a widening surplus on transfers and a narrowing deficit on investment income are significant factors increasing the current account surplus. At this time, trade statistics are the only current account items available for 2004.

authorized banks rather than the central bank. Domestic Chinese insurance companies and China's national social security fund are authorized to invest in overseas capital markets, thereby increasing the volume of renminbi foreign exchange transactions. Recently, China increased the amount of foreign currency that business travelers can take out of the country, permitted Chinese emigrants to transfer assets overseas, and allowed Chinese students to take more money abroad to pay for living expenses. As a result, the volume of foreign exchange market transactions in renminbi has expanded rapidly in the past few years. China needs to continue to liberalize its exchange regime by increasing the scope for foreign investment in China and allowing its residents greater access to foreign exchange.

Second, China has also taken steps to develop foreign exchange market instruments and to increase its financial institutions' experience in dealing with fluctuating currencies. China has introduced, or will introduce soon, financial instruments and systems for trading currencies and managing currency risk through hedging. Foreign exchange forward contracts can now be offered in China, and foreign exchange futures trading systems and instruments are being developed. Domestic and foreign banks can trade non-renminbi currency pairs (such as US dollar-yen), and certain Chinese banks will act as market-makers for this foreign currency trading. The Treasury and U.S. financial regulators provided substantial technical assistance to China in these efforts, through the Technical Cooperation Program (TCP) established with the People's Bank of China.

Finally, China has taken steps to strengthen its financial sector and its financial regulation, making the financial sector more resilient to foreign exchange rate fluctuations. In addition to raising one-year deposit and lending rates late last year, China's central bank eliminated a ceiling on interest rates on bank loans, giving banks greater scope to price risk. Further market oriented reforms in this area are needed. China's banking regulator tightened loan accounting standards by introducing a risk-based loan classification system to track non-performing loans (NPLs) more effectively. It also tightened loan supervision by increasing the number and scope of bank audits and on-site bank examinations, and by setting more aggressive targets for reducing NPLs and increasing capital. The larger banks have upgraded their credit risk management systems, centralized and standardized credit extension procedures, and improved corporate governance practices following regulatory measures to allow foreign interests to take strategic stakes, to define clearly responsibilities for Boards, management and shareholders, and to raise disclosure requirements. China needs to continue this progress and to take further steps to allow foreign investment in the major commercial banks, show that its tightened NPL classification system is yielding results, and strengthen the functioning of its securities markets. To assist the Chinese authorities, Treasury provided technical guidance last year on banking supervision, credit analysis, international accounting standards, and resolution of non-performing loans.

In summary, the fixed exchange rate that China now maintains is a substantial distortion to world markets, blocking the price mechanism and impeding adjustment of international imbalances. It is also a source of large and increasing risk to the Chinese economy. China has completed significant preparations over the last two years for adoption of a more flexible, market-oriented exchange rate. China is now ready to move to a more flexible exchange rate and should move now. Treasury will monitor progress on China's foreign exchange market developments very closely over the next six months in advance of preparation of the fall report.

Korea

In contrast to strong growth in other parts of emerging East Asia, Korean growth in 2004 was held back by the continuing effects of a credit card boom and bust. With household spending depressed, Korean economic growth during the year was largely driven by increased exports. The growth rate decelerated in the second half of 2004 to 3.2 percent (annualized), from 4.7 percent growth in the first half, largely due to a continued decline in private consumption.

Export growth slowed in the second half of 2004, but exports were still up 25 percent year-on-year, after growing at 37 percent year-on-year in the first half. Export growth to China was particularly strong, up 42 percent for 2004. Total import growth did not keep pace, but still rose by 26 percent for the year. The difference in import and export growth rates was reflected in Korean external balances. The U.S. bilateral trade deficit with Korea totaled \$19.8 billion for the full year 2004. For the second half of 2004 the trade deficit totaled \$10.8 billion, up 44 percent from the same period a year earlier, as U.S. imports from Korea grew by 23 percent and exports to Korea by 10 percent. Korea's current account surplus was 4.0 percent of GDP for the second half of 2004, compared to 4.1 percent for the first half of the year.

Total capital and financial flows, exclusive of reserve accumulation, registered a net surplus (inflow) of \$7.5 billion (n.s.a.) for the second half of 2004, an increase over the small (\$0.8 billion) inflow for the first half. The financial inflows resulted from Korean residents' increasing their foreign borrowings. The Korean authorities continued to intervene in the second half, as official foreign reserves increased by \$32 billion to \$199 billion, equivalent to 112 percent of the total external debt of Korea.

Despite this intervention, the won appreciated 14.8 percent versus the dollar over the course of 2004; during the fourth quarter alone the won appreciated 10 percent. Citing a slowdown in the pace of economic recovery, particularly in domestic demand, the Korean central bank reduced its benchmark call rate a quarter-point again in November following on a similar cut in August. The effect of the won appreciation in the fourth quarter was to reduce inflation pressures, particularly those due to oil price increases. This, in turn, allowed the Central Bank of Korea to pursue its more accommodative monetary stance despite inflation coming in at the upper end of the 2.5-3.5 percent target range.

Taiwan

Taiwan's GDP growth moderated to 3.8 percent saar in the second half of 2004 relative to the first half of the year. GDP growth in the second half of 2003 reached 9.4 percent due to a sharp recovery of domestic demand (in particular business investment) and strong export growth (particularly to China). The 2004 slowdown was the result of both a decline in investment and a modest slowdown in government consumption.

Accommodative monetary policy, accompanied by higher oil and commodity prices, halted three years of deflation in 2004 with headline consumer price index growing at a rate of 2.9 percent in the third quarter and 1.9 percent in the fourth. In the third quarter of 2004, the central bank

raised interest rates for the first time in four years on concerns of inflation, particularly related to rising oil prices. It has continued to raise rates in the fourth quarter and first quarter of this year.

Taiwan's exports increased by 16.5 percent year-on-year in the second half of 2004, while imports expanded by 28.8 percent, resulting in a trade surplus of \$2.5 billion in the third quarter and a trade deficit in the fourth quarter of \$0.2 billion. Taiwan's bilateral trade surplus with the United States increased slightly from \$6.8 billion in the second half of 2003 to \$7.1 billion in the second half of 2004.

The current account surplus in the second half of 2004 was 4.8 percent of GDP (\$7.5 billion), down from a surplus of nearly 7.7 percent of GDP in the first half. The 2004 current account surplus of \$19.0 billion, 6.2 percent of GDP, was the smallest annual figure in three years. Taiwan continued to experience portfolio capital inflows in the second half of 2004, primarily due to increased investment in equities. This was more than offset by portfolio outflows during that same period; resulting in a net outflow in the capital and financial account.

Taiwan's foreign exchange reserve accumulation slowed significantly in the second half of 2004, with foreign exchange reserves increasing by \$12 billion, compared to a \$23 billion in the first half of 2004. By year end, total foreign exchange reserves had reached just over \$242 billion, or 79.2 percent of GDP and about four times short-term external debt.

The New Taiwan (NT) dollar has been on an appreciating trend since the third quarter of 2004, increasing 6.0 percent against the dollar in the second half of 2004. Since then the NT dollar continued its appreciating trend reaching a peak of NTD30.79/USD in early March. While Taiwan's central bank maintains that "the NT dollar exchange rate is determined by market forces," the Central Bank Governor has also recently stated that it may "enter the foreign-exchange market to make adjustments" to maintain stability as the currency strengthens.

Malaysia

Although Malaysia's economic growth slowed a bit in the second half of 2004, to a 4.4 percent annual rate, due in part to moderation in global growth, growth for 2004 as a whole – 7.1 percent – was the highest in four years. Private consumption and exports were the primary drivers of growth. Fiscal consolidation continued, as public spending on infrastructure was cut and total public sector spending grew moderately. Investment grew modestly, but still remained well below its levels in the early 1990s.

The current account surplus was \$7.8 billion, or 12.7 percent of GDP, in the second half of 2004, up from 11.5 percent in the second half of 2003. Large current account surpluses are a striking feature of the Malaysian economy in the last few years. After running substantial external deficits prior to the Asian Financial Crisis in 1997, Malaysia has had significant and growing trade and current account surpluses. The trade surplus in 2004 was \$25.2 billion (21.4 percent of GDP), up from \$21.8 billion (21.0 percent of GDP) in 2003. The current account surplus in 2004 was \$14.9 billion. Malaysia's current account surplus is in large part the counterpart to a sharp fall in domestic investment that took place in the aftermath of the Asian Financial Crisis. After rising to over 40 percent of GDP in 1995-97, total investment dropped sharply in 1998, and

has not recovered. Over the last few years, investment as a percent of GDP has declined gradually, reaching 20.5 percent in 2004. The decline in private investment has been even more striking, falling from over 30 percent of GDP in 1997 to below 8 percent in 2003.

The trade balance is the predominant component of Malaysia's current account surplus, and was \$11.4 billion for the second half of 2004, up from \$10.6 billion in the latter half of 2003. Malaysia's bilateral trade surplus with the United States totaled \$9.8 billion in the second half of 2004, compared with \$7.9 billion in the second half of 2003.

Malaysia has maintained a fixed peg to the dollar (3.80 ringgit to a dollar) since September 1998, when it also expanded capital controls. Most of the controls on capital flows have since been relaxed. Further liberalization took effect April 1, 2005, to allow: increased investment abroad; maintenance of currency export proceeds with licensed banks onshore; and hedging in any committed or anticipatory current account transaction or on any committed capital account payments. Offshore trading of the ringgit remains, however, prohibited, and foreign portfolio investment by residents continues to be limited.

Malaysia experienced net financial account inflows of \$1.73 billion in the last half of 2004, versus a net outflow of \$0.55 billion in the second half of 2003, reportedly due in part to speculation on an upward revaluation of the currency. At the end of 2004, total foreign exchange reserves stood at \$61.7 billion, almost six times short-term external debt and up from \$49.0 billion at end-June 2004.

Malaysian authorities remain publicly committed to the fixed exchange rate system, and have declared that that the peg is supported by strong fundamentals. But the low level of private domestic investment and the growing current account suggest opportunities for domestic-led growth that Malaysia is not taking advantage of. Although a small open economy such as Malaysia can benefit from a pegged exchange rate, increasing imbalances in the economy may warrant closer scrutiny and monitoring of the exchange rate regime going forward.