

**Report to Congress on
International Economic and Exchange Rate Policies
May 2006**

Summary

This report reviews developments in international economic and exchange rate policies, focusing on the second half of 2005,¹ and is required under the Omnibus Trade and Competitiveness Act of 1988 (the “Act”).² This report also updates the special Appendix to the November 2005 Report on International Economic and Exchange Rate Policies and includes a second Appendix highlighting the key issues in countries’ choice of exchange rate regimes.

The global economy is strong, but global imbalances have grown, the result of disparate economic growth rates, saving rates, and investment climates of larger economies. Rising petroleum prices have rapidly increased the current account surpluses of major oil exporters, enlarging global imbalances. Addressing global imbalances is a shared responsibility and should occur in an orderly manner that maximizes sustained global growth. Members of the international community need to implement sound economic policies and remove distortions impeding an orderly adjustment of imbalances. They must resist protectionism and maintain open trade and investment regimes. The United States cannot be expected to resolve these imbalances by itself.

This report expresses particular concern about the international economic and exchange rate policies of China and reaches the central conclusion that far too little progress has been made in introducing exchange rate flexibility for the renminbi. In the final analysis, however, the Treasury Department is unable to determine, from the evidence at hand, that China’s foreign exchange system was operated during the last half of 2005 for the purpose (i.e., with the intent) of preventing adjustments in China’s balance of payments or gaining China an unfair competitive advantage in international trade. Thus, the technical requirements for China to be designated under the terms of the Act have not been met. In reaching this conclusion, the Treasury Department took into account a number of factors:

- On July 21, 2005, China abandoned its eight-year peg to the dollar and moved to a managed floating exchange rate regime. Since that time, the renminbi has further appreciated, though slightly, against the dollar. The examination period for this Report, the second half of 2005, is the first that includes the Chinese exchange rate policy change.
- The renminbi has risen to a significant degree on average against China’s trading partners. While strengthening by 2.6 percent against the dollar in the last half of 2005, against the

¹ The Treasury Department has consulted with the IMF in preparing this report. This report focuses on the period July 1, 2005, through December 31, 2005.

² The Act 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.”

currencies of all of China's trading partners (JP Morgan index) the renminbi appreciated by 4.9 percent in the second half and more than nine percent during 2005 as a whole.

- China continues to take steps to create market infrastructure and financial instruments for a floating currency. China introduced interbank foreign currency trading and allowed banks to act as market-makers in foreign currency in early January. China reached agreement with the Chicago Mercantile Exchange to develop and trade currency futures to allow renminbi hedging. And China has further reduced restrictions on capital flows to create a deeper, more liquid foreign exchange market.
- China's commitment to move to a flexible exchange rate is clear, and has been repeated at the highest levels of the Chinese leadership. President Hu Jintao, when he came to the United States in April, said that China will continue to develop the foreign exchange market and increase the flexibility of the exchange rate. Premier Wen Jiabao, in his policy speech to the National People's Congress on March 14, 2006, stated that China will expand the foreign exchange market and allow more flexibility and fluctuation of the Chinese currency.
- China's leaders have also begun a fundamental realignment of the Chinese economy to reduce its balance of payments surplus, boost domestic consumption, and reduce domestic inequality. China's most recent five-year plan places strong emphasis on consumption and rural development to spur domestic demand.
- The Governor of China's central bank, Zhou Xiaochuan, announced a five-point plan on March 20, 2006, to reduce China's current account surplus and raise domestic consumption. This plan involves actions to boost domestic demand, reduce Chinese saving, accelerate removal of trade barriers, grant greater market access for foreign firms, and achieve greater exchange rate flexibility.
- China's leadership has made a clear commitment to rebalance the sources of growth in the Chinese economy. President Hu Jintao, in his meeting with President Bush on April 20, 2006, stated that China does not want a large current account surplus and would take steps to reduce it, relying on domestic demand to boost growth.
- China is acting to implement this strategy. A flexible exchange rate is an essential component of this rebalancing program, and China's leaders recognize that flexibility is essential.
- China's ongoing efforts to modernize its financial sector are also part of a commitment to spur consumption and achieve long-term reversals in recent trade and current account trends. Progress on this front increased during the reporting period, but massive challenges remain.

While these developments suggest that progress is being made, China's advances are far too slow and hesitant given China's own needs, and its responsibilities to the international financial community. The delay in introducing additional exchange rate flexibility is unjustified given the strength of the Chinese economy and the progress in China's transition. China needs to move quickly to introduce exchange rate flexibility at a far faster pace than it has done to date. With a still rigid exchange rate, China lacks effective monetary policy tools to avoid the boom-bust

cycles it has experienced in the past. Given our strong disappointment and the importance of China to the world economy, the Treasury Department will closely monitor China's progress in implementing its economic rebalancing strategy, remain fully engaged at every opportunity with China, and continue actively and frankly to press China to quicken the pace of renminbi flexibility.

It is also important that reforming China's exchange rate regime be part of an international effort. China's exchange rate policies affect the entire world. Increased renminbi flexibility would greatly facilitate increased flexibility in other Asian currencies. In this regard, the G-7, IMF, and Asian Development Bank have all called for greater flexibility in China's exchange rate. The Treasury Department is supportive of the IMF Managing Director's commitment to strengthen IMF exchange rate surveillance, both bilaterally and multilaterally, as a means to assist materially this process.

Domestic Macroeconomic Conditions

The U.S. economy remained on a sustained upward growth track in 2005, with real GDP increasing by a solid 3.2 percent over the four quarters of 2005, despite modest growth in the fourth quarter. Growth rebounded at a strong 4.8 percent annual rate in the first quarter of 2006 – the largest quarterly increase in two and a half years.

The outlook for consumption growth remains sound. The fourth quarter slowdown in consumer spending was importantly influenced by reduced purchases of motor vehicles following strong increases in prior quarters when generous sales incentives were in play. However, consumer balance sheets are sound, with net worth up \$2.3 trillion during the second half of 2005 – the highest in nearly five years in relation to disposable personal income.

Improved labor markets (with one million new payroll jobs added during July-December and a decline in the unemployment rate to an average of 5.0 percent in those six months compared to 5.2 percent in the first half of 2005), as well as the rise in household net worth, also continue to provide support to consumer spending.

Business fixed investment grew at a 4.5 percent annual rate in the fourth quarter, with equipment and software investment up at a 5.0 percent pace. That was lower than the 10.6 percent gain at an annualized rate in the third quarter, as spending on selected transportation and equipment goods declined. Growth in equipment and software investment performed well over the entire year, increasing by 8.7 percent Q4/Q4.

The advances in the economy in the second half of 2005 occurred even as energy prices continued to rise. From June 2005 to December 2005, the overall consumer price index increased by 4.0 percent at an annual rate. Energy prices rose at a 23.7 percent pace over that six month span. Food prices and the core CPI (excluding food and energy) both grew at a benign 2.2 percent annual rate in the second half of 2005. The CPI increased 3.4 percent in December 2005 from a year earlier, while the core CPI increased 2.2 percent.

The Federal Open Market Committee (FOMC) – the Federal Reserve’s monetary policy-making body – raised the Federal funds target rate by 25 basis points at each of its four meetings in the second half of 2005. That brought the federal funds target (the rate that banks and other financial institutions charge each other for overnight loans) to 4.25 percent at its December 13, 2005, meeting. The target rate has since been raised twice in 2006 and at the end of March 2006 stood at 4.75 percent.

The 10-year Treasury yield rose to about 4.7 percent in May 2004 in anticipation of faster growth and monetary tightening, then trended lower through much of the rest of the year and into 2005. After dipping slightly below four percent in June 2005, the rate fluctuated in a slightly higher range of about 4.5 percent through the rest of 2005 and into the first two months of 2006. Mortgage interest rates have generally followed changes in the 10-year Treasury rate and have fluctuated in a fairly narrow band around a low level for more than two years. Low mortgage rates have contributed to record home sales, but also to mortgage refinancings, which have helped to free additional cash for consumption. Mortgage rates started trending upwards in the

second half of 2005, with the rate for a thirty-year, fixed-rate mortgage reaching an average of 6.22 percent in the final quarter of 2005, its highest level since the third quarter of 2002.

The Administration's FY2007 Budget contains policies that promote economic growth (low taxes, investment in research and development, and education incentives) and restrain federal spending (eliminating unnecessary programs and operating others more efficiently). In February, the Administration projected the FY2006 deficit to rise to \$423 billion, or 3.2 percent of GDP from 2.6 percent last year reflecting higher costs for reconstruction in the aftermath of hurricanes and funding to prosecute the war on terror. More recently, a Congressional Budget Office report estimates that the deficit will be significantly less than originally anticipated due to a surge in federal tax receipts, which will hold the deficit to around 2.5 percent of GDP.

The FY2007 Budget projects that the deficit will trend down further after 2006 and meet the President's goal of cutting the deficit in half by 2009, when it is projected to fall to \$208 billion, or 1.4 percent of GDP. The deficit is reduced because of continued economic growth, which supports revenues, and because of tight controls on non-security, discretionary spending.

World Economic Conditions

The world economy expanded an estimated 4.8 percent in 2005, the third consecutive year of better than four percent growth and well above the most recent eight-year average growth rate of 3.9 percent. Most forecasts for 2006 indicate strong growth momentum will carry forward into the current year. Solid growth is more widely distributed than has been the case in decades, but there are significant differences among economies. As noted above, U.S. growth remains robust. Developing Asia had by far the strongest performance in 2005 with growth of nearly nine percent. Growth amongst oil exporters also picked up, averaging better than six percent. The Japanese recovery remains on track, although the potential growth rate remains low. However, growth in the Euro-zone was only 1.3 percent. Among economically advanced countries, which comprise 52 percent of total world output (PPP-based), growth was 2.7 percent in 2005. Developing and emerging market economies, which account for the other 48 percent of global output, had growth of 7.1 percent.

This excellent overall global performance was underpinned by favorable financial conditions. Notwithstanding the rise in energy prices, with oil averaging \$55 bbl in 2005 (average of WTI and Brent), core rates of inflation remained generally low in most economies. Long-term real interest rates also remained unusually low for this stage of the business cycle, and spreads between corporate and government bonds and between emerging market external fixed-income issues and U.S. Treasuries were low and even declining (the EMBI+ spread fell to a historical low of 173 basis points on May 1, 2006). Above-average economic growth has, in general, enabled business balance sheets to strengthen. Balance sheet improvements mean businesses and economies are in better position to withstand and adapt to economic shocks.

Because of financial conditions, some concerns have arisen that investors may be increasing their risk exposure in search of higher returns. At the same time, however, many emerging market economies used 2005 to improve their fiscal and external payments positions and boost reserves – both absolutely and relative to short-term foreign currency debt obligations. Gross new issuance of sovereign and corporate emerging market bonds (debt issuance of \$182 billion in

2005) rose steeply in 2004 and 2005, reflecting in part the low-interest rate environment.³ New borrowing and gross issuance of bonds and equities by emerging markets and developing countries rose to \$406 billion in 2005, more than twice the level of 2003.

Some analysts believe that valuations, however, may be compressed and the favorable financial conditions that have supported declining spreads and increased investor positioning could change, especially if short-term policy interest rates continue to increase in certain markets. Current conditions may thus reflect exceptional financial circumstances.

Higher oil prices resulted in the oil export revenues of the 10 largest oil exporters increasing to more than \$600 billion in 2005, up from \$256 billion in 2002.⁴ The cumulative current account surpluses of oil exporters (Middle East, Russia, and Norway) rose 68 percent to \$331 billion. By comparison, the cumulative external surpluses of Asian economies (developing, emerging market, and Japan) rose 13 percent to \$399 billion.⁵ Non-oil commodity prices rose 10 percent, led by a 26 percent increase in metals. In general, the volume of global trade expanded seven percent in 2005, faster than the five percent average gain for 2001-04 but below 2004's trade volume expansion of nearly 11 percent. The external debt positions of developing countries and emerging markets, relative to their exports of goods and services, also continued to narrow and are now half their relative levels of 1998/99. IMF balance of payments data indicate that emerging market and developing country economies added reserves of \$535 billion in 2005, with developing Asia and the oil exporters accounting for 80 percent of the total increase.⁶

An important challenge to sustaining global economic momentum in 2006 and beyond is in getting better balanced growth of the global economy. There have been too few engines of growth and too few centers of economic dynamism over the last several years. For the period 2001-05, for example, average yearly growth of domestic demand of the U.S. economy was 3.1 percent. China also contributed importantly to robust global growth. But G7 partners had a considerably smaller economic expansion with domestic demand expanding a weighted-average of only 1.7 percent per year. A key feature of adjusting global imbalances will be expanding demand relative to output in Europe, Japan, and many parts of developing Asia.

The Euro currency zone is the world's second largest economic area. Over the last ten years, domestic demand in the Euro-area has expanded annually a full 1.8 percentage points more slowly than that of the United States. This gap in relative domestic demand growth rates turns out to be substantial, the equivalent to the U.S. adding an economy the size of France or the United Kingdom in just a little over 10 years.⁷

³ Table 1, page 51, of Annex on Emerging Market Financing Flows, of Global Financial Stability Report, April 2006.

⁴ McCown, T. Ashby, Plantier, L. Christopher, Weeks, John, *Petrodollars and Global Imbalances*, Department of the Treasury/Office of International Affairs Occasional Paper No. 1, February 2006.

⁵ Derived from Tables 26 and 28, World Economic Outlook, Statistical Annex, April 2006

⁶ Table 1.2 of World Economic Outlook, April 2006

⁷ The rate of real domestic demand growth for the United States over the period 1996-2005 was 3.8 percent and for the countries that comprise the current Euro-area it was 2.0 percent. Applying the 1.8 percent differential to 1995 real U.S. GDP (2000 U.S.\$) over 10 years yields an increase of \$1,578 billion. Real GDP of the French economy in 2005 (in 2000 dollars at the 2000 exchange rate) is calculated at \$1,438 billion. For the United Kingdom, the calculation is \$1,622 billion.

Although the Euro-area's current account position is in near balance, this is in part due to suppressed demand reflecting underemployment of existing resources. It has been argued that structural reforms to reduce this underemployment of resources would not only increase real income and imports but would also, by raising productivity in the tradeable goods sector, lower unit costs in the external sector and spur exports. There is some merit in this analysis, but there are additional factors that influence the current account position.

In the Euro-area, in particular, the services sector – which is largely a non-tradeable sector – plays a strong and significant role in economic activity. Structural reforms that boost the efficiency of the large services sector would undoubtedly raise European incomes and in turn, imports. In addition, investment growth in Europe has been weak, notwithstanding a period of low – if not negative – real interest rates in the Euro-area as a whole. This weakness in investment growth is associated with a range of country-specific economic factors, but has important implications for the pattern of global capital flows. Raising European productivity and strengthening European capital markets are critical steps for boosting growth and investment in Europe. Doing so would clearly affect Europe's external position and contribute to global adjustment. Europe is not only a part of the global current account equation, improved European economic performance is a part of the solution.

The United States International Accounts⁸

- *U.S. Balance of Payments Data*

U.S. Balance of Payments and Trade						
(\$ billions, SA, unless otherwise indicated)						
	2004	2005	2005			
			Q1	Q2	Q3	Q4
Current Account:						
Balance on Goods (SA, Balance of Payments Basis)	-665.4	-781.6	-185.7	-186.3	-197.3	-212.4
Balance on Services	47.8	58.0	13.5	13.6	15.9	15.1
Balance on Income 1/	30.4	1.6	.6	-1.6	4.9	-2.4
Net Unilateral Current Transfers	-80.9	-82.9	-26.3	-22.6	-8.9	-25.1
Balance on Current Account	-668.1	-804.9	-197.7	-196.9	-185.4	-224.9
Current Account as % of GDP	-5.7	-6.4	-6.5	-6.4	-5.9	-7.0
Major Capital Flow Components (financial inflow +)						
Net Bank Flows	36.8	-18.1	-34.3	12.3	-28.4	32.3
Net Direct Investment Flows	-145.2	107.1	7.6	-6.9	73.7	32.7
Net Securities Sales	698.3	727.3	159.0	130.2	209.0	229.2
Net Liabilities to Unaffiliated Foreigners by Non Banking Concerns	-24.6	-56.3	19.0	10.1	-11.8	-73.6
Memoranda:						
Statistical Discrepancy	85.1	9.6	40.7	46.6	-68.0	-9.7
Change in Foreign Official Assets in the United States	394.7	220.7	25.3	82.6	38.2	74.6
Trade in Goods (SA)						
Balance	-665.4	-781.6	-185.7	-186.3	-197.3	-212.4
Total Exports	807.5	892.6	213.4	223.1	224.8	231.3
of which:						
Agricultural Products	62.9	64.8	15.3	16.9	16.6	16.0
Industrial Supplies 2/	204.0	231.8	55.7	58.8	58.9	58.4
Capital Goods Ex Autos	331.5	361.8	85.5	90.2	90.9	95.3
Automotive Products	89.3	97.8	23.6	23.4	24.6	26.1
Consumer Goods Ex Autos and Food	103.1	115.5	28.2	28.5	29.0	29.9
Total Imports	1472.9	1674.3	399.1	409.4	422.1	443.7
of which						
Petroleum and Products	180.5	251.6	53.0	57.4	67.5	73.7
Capital Goods Ex Autos	343.5	379.5	90.6	95.7	95.9	97.2
Automotive Products	228.2	240.0	58.1	58.0	60.5	63.3
Consumer Goods Ex Autos and Food	373.1	407.1	101.7	101.7	100.7	103.0

1/ Including compensation of employees

2/ Including Petroleum and Petroleum Products

Source: BEA, Bureau of Census

The U.S. current account deficit was \$821 billion (at a seasonally adjusted annual rate, or “saar”), or 6.5 percent of GDP, in the second half of 2005. 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. Then, after a cyclically induced narrowing in 2001, it resumed its decline to reach a seven percent deficit in the fourth quarter of 2005.

In the second half of 2005, the United States exported \$912 billion in goods (saar) and imported \$1,732 billion, with a resulting \$819 billion deficit on trade in goods.⁹ Exports of goods

⁸ 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 2005. The IMF Article IV Staff Report 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/2005/cr05257.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/2006/01/index.htm>.

increased 10.3 percent in the first half of 2005 compared to the first half of 2005, while imports increased 13.4 percent.

The challenge of external adjustment for the United States is highlighted by two characteristics of the U.S. trade accounts. First, as noted, the level of U.S. imports is twice that of U.S. exports. Even if U.S. exports and imports grew at the same pace, due to this base effect the trade gap would continue to widen. Second, statistical studies suggest that for every percentage point that U.S. GDP grows, imports grow somewhat less than twice as fast, while for every percentage point that foreign economies grow, U.S. exports grow only a little more than a percentage point.

Non-automotive capital goods constituted 40.8 percent of merchandise exports in the second half of 2005. Consumer goods constituted 23.5 percent and non-automotive capital goods constituted 22.3 percent of merchandise imports. Petroleum and petroleum product imports accounted for 16.3 percent of merchandise imports. The value of petroleum imports as a percent of total imports of goods has risen from 10 percent in the second half of 2003. The rise in the U.S. oil bill is an important factor in the growth in the U.S. trade and current account deficits.

Canada, Mexico, China, Japan, and Germany remain the largest trading partners of the United States. Canada purchased 23.4 percent of U.S. exports, Mexico 13.3 percent, Japan 6.1 percent, China 4.6 percent, and the U.K. 4.3 percent in 2005. Canada accounted for 17.2 percent of U.S. imports, China 14.6 percent, Mexico 10.2 percent, Japan 8.3 percent, and Germany 5.1 percent in 2005.

Country	Exports 2005 1/	Country	Imports 2005 1/
Total, All Countries (\$Bil)	904.3	Total, All Countries (\$Bil)	1671.1
	Percent of Total		Percent of Total
Canada	23.4	Canada	17.2
Mexico	13.3	China	14.6
Japan	6.1	Mexico	10.2
China	4.6	Japan	8.3
United Kingdom	4.3	Federal Republic of Germany	5.1
Federal Republic of Germany	3.8	United Kingdom	3.1
South Korea	3.1	South Korea	2.6
Netherlands	2.9	Taiwan	2.1
France	2.5	Venezuela	2.0
Taiwan	2.4	France	2.0
Singapore	2.3	Malaysia	2.0

1/ Bureau of the Census

Prices of imported goods (nsa) increased 11.5 percent (q4/q4) in 2005. Non-petroleum import prices rose 4.2 percent, while petroleum import prices increased 60.0 percent. Export prices rose 4.0 percent over the year. The most recent trough in import and export prices occurred roughly at the beginning of 2002. Since then non-petroleum import prices have risen 8.2 percent and export prices 10.7 percent.

Foreign demand for U.S. financial assets remains strong. A major item financing the U.S. current account deficit has been net private foreign purchases of U.S. securities, which reached \$914 billion in 2005. (Included in these were net private foreign purchases of U.S. Treasury

⁹ Sums may not be exact due to rounding.

securities amounting to \$289 billion.) In addition, foreign official institutions increased their holdings of U.S. assets by \$112 billion.

Foreigners owned \$2.2 trillion in Treasury securities at the end of December 2005, or 55 percent of the public debt not held in Federal Reserve and U.S. Government accounts. This compares with \$2.0 trillion, at the end of June 2005. Foreign official institutions held \$1.3 trillion in Treasury securities at the end of December 2005, compared to \$1.2 trillion at the end of June 2005.

Net International Investment Position

The net international investment position of the United States (with direct investment valued at the current stock market value of owners' equity) was a negative \$2.5 trillion as of December 31, 2004, the latest date for which data are available. This was only \$170 billion wider than the negative \$2.4 trillion position at the end of 2003, as a \$272 billion valuation adjustment due to exchange rate changes and a \$147 billion valuation adjustment due to other price changes offset much of the financial outflow associated with the 2004 current account deficit of \$665 billion.¹⁰ Despite the large negative net investment position, U.S. residents earned \$36 billion more on their investments abroad than they paid out on foreign investments in the United States in 2004 and \$7 billion more in 2005. Net earnings on direct investment in those years were slightly larger than net payments on other investment. Net investment earnings continued to decline, however, and were marginally negative in the second and fourth quarters of 2005

- *Perspectives on the Financial Account*

The autumn 2005 Report to Congress on International Economic and Exchange Rate Policies described different perspectives on the current account and showed that the characteristics of each perspective affect the interpretation of the factors influencing the current account and the implications of current account deficits. This section extends the analysis to the capital and financial accounts.

A surplus on the capital and financial accounts is, by balance of payments accounting definition, the counterpart to a current account deficit. These net inflows finance the excess of net domestic capital formation over net domestic saving. To the extent foreign investors acquire U.S. financial assets, it represents the foreign investors' assessment of the relative appeal of investing in U.S. assets versus investing in alternative assets, including assets in the home economy of the foreign investor as well as third countries. This perspective leads to a focus on broad economic and financial factors – such as prospective relative growth rates of output and productivity, the relative attractiveness and openness of investment environments, prospective inflation, the flexibility of factor markets, and exchange rates.

According to this perspective, 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

¹⁰ In principle the net financial and capital account flows should equal the current account balance, but in fact there was a statistical discrepancy of \$10 billion in 2005.

growth, especially relative to the rest of the world; sound U.S. economic performance; a welcoming U.S. investment climate; and the deepest and most liquid capital markets in the world have all combined to attract foreign investment. Portfolios worldwide are also becoming increasingly internationalized, and some studies point to the conclusion that the home bias of foreign investors is eroding and that they are underweight in U.S. dollar holdings.¹¹ In turn, sustained external demand for United States' assets has allowed the United States to achieve levels of capital formation and future growth potential that would have not been possible in the absence of net financial inflows into the United States. The robust growth in fixed investment has been critical to the non-inflationary growth of production and employment in the United States.

Some analysts have raised concerns about different features of international financial flows, suggesting that the financing of the U.S. current account deficit rests on precarious grounds. Below, these concerns are addressed.

- **While the large negative international investment position of the United States will probably generate outflows on investment income in the near future, these outflows are not likely to be massive.**

For 2005 as a whole, U.S. residents continued to receive slightly more income on their foreign investments than foreigners receive on their U.S. investments. This is surprising on its face, given that the value of foreign investment in the United States exceeds U.S. investment abroad by \$2½ trillion. As noted earlier this positive net inflow has, however, been declining.

Balance of payments data indicate the positive flow to the United States from net investment income is the result of relatively high earnings on U.S. direct investments abroad compared to foreigners' income from foreign direct investment in the United States. Net inflows of direct investment income have been sufficient to offset outflows of other investment income. These other investment income flows have also recently been affected by temporary factors, such as relatively low interest rates in the United States, which have risen in the last year. Most analysts generally believe that U.S. net income payments will become a net outflow as the negative U.S. net investment position widens. Direct investment income will probably, however, continue to cushion the growing outflow of portfolio investment income, in part because U.S. investment abroad is large and appears to be maintaining a relatively superior rate of return.

This has led some observers to argue that the U.S. net international investment position is in considerably better shape than the available data suggest – that there is some kind of “dark matter” in U.S. direct investment abroad. They use this argument to throw doubt on common inferences about the future sustainability of U.S. current account deficits. This analysis is based on an assumption that, if every country earned the same underlying rate of return on its assets and then using this rate of return to capitalize the value of assets, it would be “as if” the U.S. net international investment position is positive rather than the negative \$2.5 trillion that the official data record.¹² There is some suggestion that this makes the U.S. current account deficit

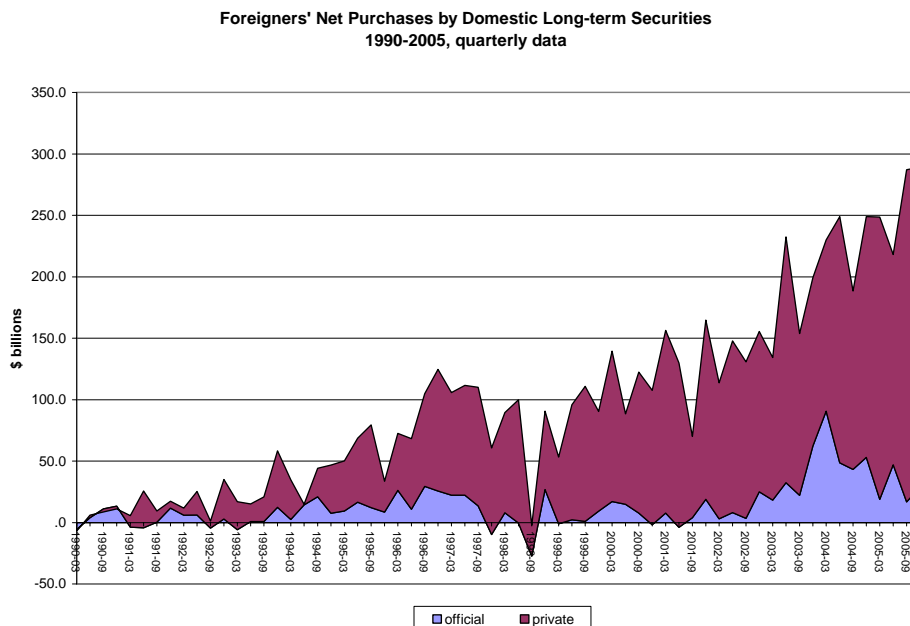
¹¹ Bertaut, Carol C. and Grier, William L., “Recent Developments in Cross-Border Investment in Securities”, Federal Reserve Bulletin, Winter 2004.

¹² Hausmann, Ricardo and Sturzenegger, Federico, ‘Dark matter’ makes the US deficit disappear, The Financial Times, Thursday December 8, 2005.

disappear and that there are no serious global imbalances. While this view of the U.S. international investment position is interesting, it has not gained acceptance with most analysts of the U.S. balance of payments. This line of thinking would require that national income accounting definitions of saving be revised since U.S. spending does exceed U.S. income, under current definitions, and this difference is equal to the current account balance. Moreover, even if unidentified assets had existed in the past, that would not mean that they could be counted on to keep the international investment income balance positive in the future, since the relatively high rates of return on U.S. foreign direct investment could ease in time.

- **The current account deficit is being financed predominantly by private sources, and not by official sources or by Asian reserve accumulation.**

Much of the information in the financial account of the U.S. balance of payments is from data collected by the Treasury International Capital Reporting System (the “TIC”). The TIC reports that net purchases of long-term U.S. securities by foreign official institutions declined to \$111.5 billion in 2005 from \$235.6 billion in 2004. The decline coincided with the cessation of Japanese intervention in the foreign exchange markets in the first quarter of 2004. The TIC data, albeit imperfect (see below), indicate that nearly 90 percent of the long-term securities that foreigners purchased in 2005 came from non-official foreign investors. Net private purchases of long-term securities in 2005 totaled \$914 billion. These percentages should be read with some perspective on the accuracy of the data. As described below, there are well known qualifications that need to be made in assessing the relative size of foreign official and private net purchases of long-term securities. The percentage for private purchases might well be lower, but the description of trends continues to be valid.



The current account deficit is financed by many items other than purchases of long-term securities. Sources of financial inflows include, among other things, net foreign purchases of short-term U.S. securities, increased liabilities to foreigners of banking and non-banking enterprises, and increased foreign direct investment in the United States. Financial outflows in the form of such items as U.S. acquisition of foreign securities, increased claims on foreign

banking and non-banking enterprises and increased U.S. direct investment abroad offset some of the inflows.

The Department of Commerce's Bureau of Economic Analysis (BEA) makes some adjustments to the TIC data on official purchases of long-term securities and combines these adjustments with other information (e.g., on short-term securities and U.S. banking liabilities) before publishing the data in the U.S. balance of payments accounts. However, taking these adjustments and additions into account, the balance of payments accounts indicate that the increase in foreign official assets in the United States, of all kinds, was only slightly more than a quarter of the U.S. current account deficit in 2005, down from over half in 2004.

- **While the TIC data face limitations, they provide a good picture of U.S. portfolio capital flows.**

It has been asserted, from an examination of a limited set of published data, that the TIC only presents data on foreign transactions in long-term securities.¹³ The monthly press notice issued by Treasury announcing the release of TIC data only discusses transactions in long-term securities. A much more complete data set is, however, posted on the TIC web site concurrent with the press notice. These data include, among other things, statistics on international banking assets, holdings of short-term Treasury securities, estimates of unrecorded prepayments of principal on asset-backed securities, and estimates of foreign holdings of Treasury securities. These statistics do not include information on direct investment since the BEA is responsible for collecting those data. As the BEA presentation of official capital flows cited above demonstrates, the qualitative conclusions derived from an analysis of transactions in long-term securities are the same when account is taken of all of these other factors.

There are documented limitations to the Treasury data.¹⁴ TIC reports on transactions in long-term securities can, in particular, misclassify the country of residence of a foreign purchaser and mistakenly identify official transactions in long-term securities as private transactions. Misclassification of a foreign investor's residence, often called a "geographical bias", typically arise when transactions take place in foreign financial centers, and the TIC attributes the transaction to the country where the financial center is located instead of the country where the investor resides. However, the TIC system carries out annual surveys of custodians of securities that correct for many of these misclassification errors and help verify the accuracy of the data.

Recently released preliminary results of the survey of foreign holdings of U.S. securities as of June 2005¹⁵ illustrate the geographical bias in transactions data as well as some corrections. Before the new survey results were available, estimates of foreign holdings of Treasury securities were calculated by adding accumulated net transactions in Treasury securities to data derived from the June 2004 survey. Using the results of the June 2005 survey means that net transactions, with their geographical bias, are accumulated only since June 2005 instead of since June 2004. There is only a modest difference between using the two benchmarks in calculating

¹³ For example Martin Feldstein, "Why Uncle Sam's bonanza might not be all that it seems", *The Financial Times*, January 10, 2006. This was a small part of the article.

¹⁴ A more complete discussion can be found in FAQ numbers 4 and 7 on the TIC web site.

¹⁵ Preliminary data from an annual survey of foreign portfolio holdings of U.S. securities at end-June 2005 were released April 28, 2006. They are posted on the U.S. Treasury web site at (<http://www.treas.gov/tic/fpis.html>).

total foreign holdings of Treasury securities. The old estimate indicated that foreign investors held \$2.2 trillion in Treasuries, compared with the new estimate of \$2.1 trillion. As the following table illustrates, individual countries show greater differences.¹⁶

Select Foreign Holdings of Treasury Securities (end-February 2006, \$ billions)		
	Old Estimates	New Estimates
All Countries	2,232.3	2,081.7
U.K	250.8	162.7
Japan	673.1	658.3
China	265.2	319.8
Caribbean Banking Centers	94.1	54.4
Foreign Official Institutions	1,282.0	1,326.4

There are, of course, gaps in the survey data as well that arise from the ability of investors both to carry out transactions and to place securities in custody overseas, beyond the reach of the TIC data collection system. These gaps will affect estimates of individual country holdings rather than overall foreign holdings of U.S. securities. Although there are limitations to TIC data, particularly in their ability to identify the precise geographic origin and destination of portfolio flows, the overall picture that private investors, rather than official foreign investors, dominate net purchases of U.S. securities remains valid.

- **There is little evidence of significant foreign central bank reserve diversification out of dollars.**

The best available information indicates that significant aggregate diversification is not happening. The IMF publishes data on the currency composition of official reserves on a quarterly basis. These data were just released through the end of 2005. The data are affected to some degree by valuation adjustments in translating foreign currencies into dollars. Nonetheless, according to official IMF data the share of the U.S. dollar in official foreign exchange reserves has remained constant for the last few years at around two thirds, a figure similar to that in the mid-1990s.¹⁷

- **There is also little evidence to support the argument that foreign central banks might sell off their stock of dollar holdings, that such sales would result in substantial upward pressure on U.S. interest rates, or that foreign official purchases of dollars are substantially holding down the U.S. yield curve.**

The record is not supportive of either a sell off or substantial upward pressure on U.S. interest rates. In the first instance, to give some perspective on flows, total net official purchases of long- and short-term Treasury securities averaged around \$1½ billion per month in 2005.

Further, in considering this issue, it is worthwhile to distinguish between the existing stock of foreign official holdings, and newly accumulated dollars and the earnings on the stock. Many of

¹⁶ There are, of course, other reasons to revise estimated geographical allocation of foreign holdings besides correcting for the geographical bias.

¹⁷ The data cover reserves for which the currency of denomination is known. See <http://www.imf.org/external/np/sta/cofer/eng/index.htm>.

the largest official holders of U.S. dollar portfolios (China, Korea, and Japan) have repeatedly emphasized that they do not intend to sell the stock of their U.S. dollar portfolios. Notwithstanding much discussion over past years about the potential for diversification, as well as a rising current account deficit, the U.S. dollar has remained well bid in foreign exchange markets.

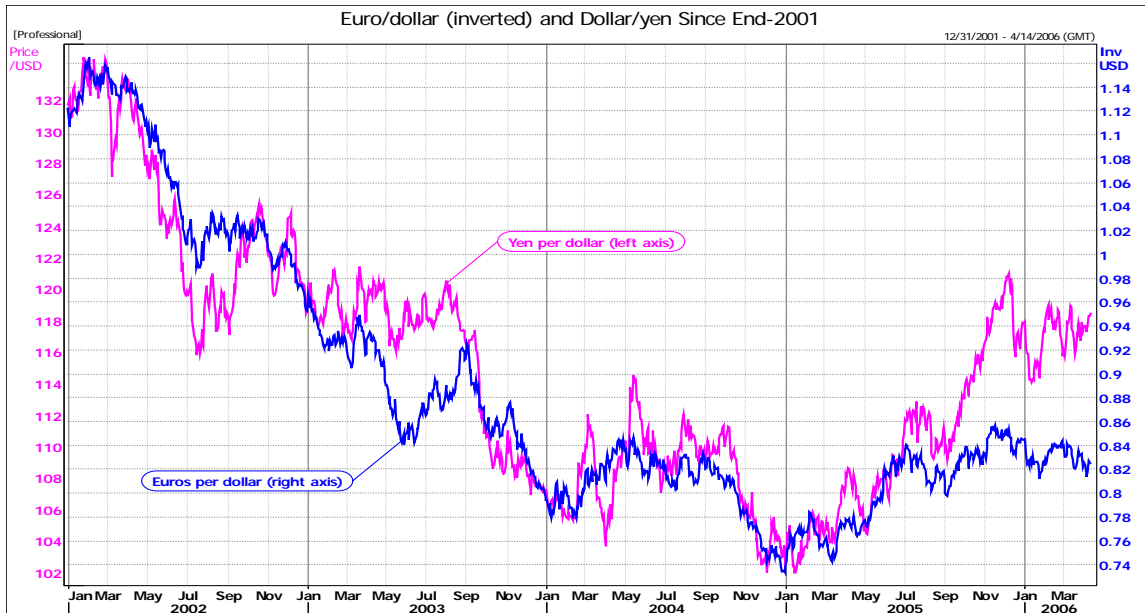
Some analysts have suggested that foreign central banks, even if they do not sell their stock of dollar assets, may pare back at the margin the percentage of newly acquired reserves allocated to dollars. But assume that foreign official holders hypothetically accumulated \$500 billion next year, and decided to hold 50 percent rather than 65 percent of these accumulations in dollars. This would imply that, over a year's time, \$75 billion less in foreign official holdings would be placed into dollar assets and instead into non-dollar assets. Although there would be marginally less demand for dollars in the foreign exchange market, this would be a very small amount compared to the market's \$2 trillion a day turnover. Similarly, although the demand for Treasuries, or other U.S. securities, might ease, the decline would be small compared to the \$11 trillion monthly trading volume in the Treasuries market. Moreover, demand for Treasuries is only a part of the total credit demand in the U.S. financial market.

- **There is little evidence suggesting that oil-producing countries are less willing to hold their assets in US dollars.**

A review of TIC data and investment patterns shows no anomalies in the pattern of investment activity in U.S. assets on the part of oil exporters. Although the Bank of International Settlements (BIS) is only able to identify thirty percent of the investable funds of OPEC, the data that are available show that oil exporter deposits with BIS reporting banks continue to be predominantly in dollars.

The U.S. Dollar

In the second half of 2005, the dollar traded in a moderate range against the euro and appreciated against the yen. In terms of the euro, the dollar moved from \$1.20898 to \$1.1842 over the second half. That is, there was a euro depreciation of 2.1 percent. During that period, the dollar/yen rate moved from ¥111.7 to ¥117.9, a yen depreciation of 5.3 percent. Although the direction of euro and yen movements diverged after mid-summer 2005, the two currencies have, on balance, moved in a broadly similar manner since the dollar's most recent peak in February 2002.



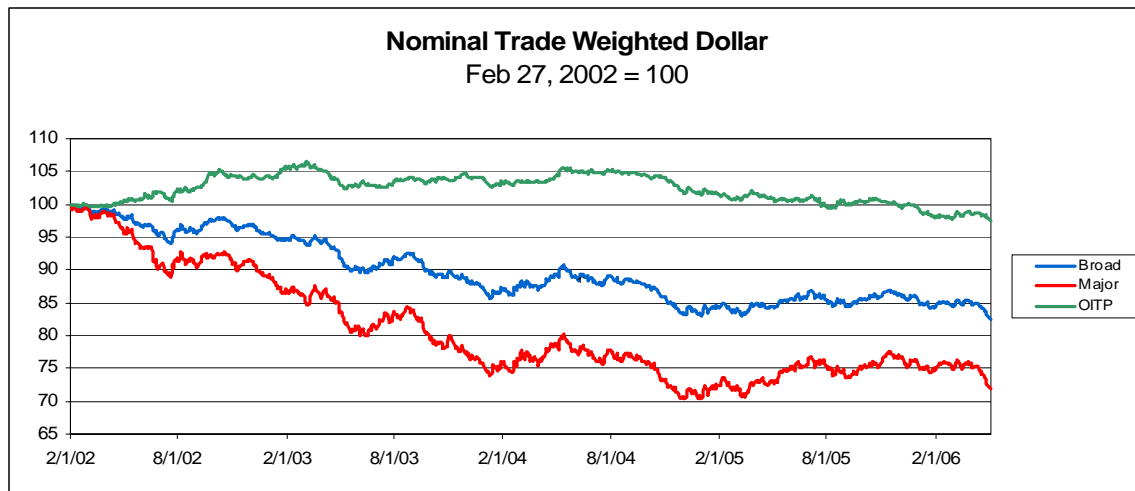
Dollar movements in the second half of 2005 were influenced by a range of factors:

- Market participants were particularly focused on the rise in short-term U.S. interest rates and widening global interest rate differentials, and expressed little day-to-day concern about the financing of the large U.S. current account deficit, although the deficit tempered overall dollar demand. Changing market perceptions of U.S. economic growth prospects in light of Hurricanes Katrina and Rita and fluctuations in energy prices, and their implications for the outlook for U.S. monetary policy, also impacted trading. In particular, in the wake of the hurricanes, perceptions that underlying U.S. growth remained strong, notwithstanding the fourth quarter slowdown, added to expectations that the FOMC would raise the Fed Funds rate more than previously thought and supported dollar demand.
- The yen's depreciation reflected in part the so-called "global carry trade." Given Japan's very low interest rates, global investors increasingly borrowed yen to fund investments in higher-yielding assets. Also, even though foreign inflows, especially into Japanese stocks, have increased as the Japanese recovery has taken hold, Japanese investors have stepped up their overseas investment in light of increased global risk appetite. The yen was subject to upward pressure at times when market participants anticipated further Chinese renminbi appreciation, but this factor diminished in the latter months of the year. Yen trading, more generally, was affected by the Japanese monetary policy outlook, as the Bank of Japan began to end its quantitative easing policy and consider the future of its zero-interest rate policy.
- After depreciating substantially in the first half of 2005, the euro generally fluctuated within 3-4 cents of \$1.20 for the remainder of the year. Toward the end of the year, the euro received some support from increased market expectation that the European Central Bank would raise Euro-zone interest rates by up to 50 basis points during the first half of 2006, around a time when participants also felt the cycle of FOMC rate hikes may reach an end.

The Federal Reserve's broad nominal trade-weighted dollar index was little changed in the second half of the year – the dollar appreciated by 0.9 percent vs. the major currencies and

depreciated by 1.3 percent against the currencies of other important trading partners of the United States. The major currencies portion of the index accounts for 53 percent of the broad index. The other important trading partner (OITP) portion of the index accounts for the remaining 47 percent; roughly two thirds of this portion is accounted for by emerging Asian economies.

Between its peak in early 2002 and the beginning of 2004, the dollar fell 25 percent against major currencies measured by the Federal Reserve Board's nominal trade-weighted index. Since then, the dollar has risen less than three percent against the major currencies. The economies comprising this portion of the index grew over the last four years by a weighted-average of only 1.6 percent. The dollar appreciated against the OITP index by four percent from early 2002 to the beginning of 2004 and has since declined by a similar amount. Though the exchange rate movement against the currencies of these economies was much less than that against the major currencies, the countries comprising the OITP index grew a weighted average of 6.6 percent over the last four years. These developments underscore the importance of the call for greater flexibility in exchange rates, particularly in emerging Asian economies.



Movements in the foreign exchange value of the dollar reflect a wide range of factors in extremely large and deep international financial markets. The latest BIS-coordinated central bank survey of activity in the global foreign exchange market, undertaken in April 2004, estimated that average total daily turnover in the market was nearly \$2 trillion dollars equivalent per day. A large majority of these trades involve the dollar, either as one of the two currencies in the underlying transaction or as the vehicle currency in a trade between two foreign currencies. Although current account transactions are an important factor affecting currency markets, these transactions are often small by comparison to global capital flows.

The United States has not intervened in foreign exchange markets since September 2000.

Country Analyses

Brazil

Brazil has a flexible exchange rate regime and relies on inflation targeting to guide monetary policy. The *real* appreciated 1.0 percent during the second half of 2005 from BRL 2.36/US\$ to BRL 2.33/US\$. Brazil's sovereign debt traded at 305 basis points over U.S. Treasuries at end-2005 versus 411 basis points at the end of June. Year-on-year inflation stood at 5.7 percent in December, above the center of the central bank's 5.1 percent target for 2005 but within the target band of two percent to seven percent. Brazil had a seasonally adjusted \$7.3 billion current account surplus in the second half of 2005 compared to \$6.9 billion in the first half. The United States had a trade deficit with Brazil of \$4.4 billion in the second half of 2005 compared to a \$4.7 billion deficit in the first half. Foreign direct investment fell to \$6.6 billion in the second half of 2005 compared with \$8.6 billion in the first half. The Central Bank increased net international reserves to \$53.7 billion by December 2005 compared to \$40.5 billion in June, in part due to central bank purchases of foreign exchange for reserve accumulation in November and December. In December, Brazil announced that it would pre-pay its entire remaining obligations to the IMF totaling \$15.5 billion. Real GDP decreased 3.4 percent at a seasonally adjusted annualized rate and increased 3.4 percent at a seasonally adjusted annualized rate in the third and fourth quarters, respectively. For the full-year 2005, GDP posted a 2.3 percent increase over the previous year.

Mexico

Mexico has a flexible exchange rate regime. Its central bank targets an inflation rate of three percent with a +/-1 percent band. The Bank of Mexico also follows a transparent rule for selling foreign exchange accumulated by state enterprises. During the second half of 2005 the Mexican peso appreciated by 1.4 percent, from 10.8 pesos/dollar to 10.6 pesos/dollar. The J.P. Morgan trade-weighted effective exchange rate index for the peso appreciated by 1.7 percent. Mexico's seasonally adjusted current account deficit was 0.4 percent of GDP during the second half of 2005. Mexico's merchandise trade surplus with the U.S. from July through December 2005 was \$25.7 billion. Foreign direct investment in the second half of 2005 was \$9.0 billion, versus \$8.8 billion in the first half of the year. International reserves grew by \$6.9 billion during the second half of the year, reaching \$68.7 billion by the end of December. Year-on-year headline inflation was 3.3 percent in December, compared to 4.4 percent in June. Real GDP increased at seasonally adjusted annual rates of 8.7 percent and 2.4 percent during the third and fourth quarters of 2005, respectively. For the full-year 2005, GDP posted a 2.7 percent increase over the previous year.

Argentina

Argentina intervenes frequently in the foreign exchange market to manage the value of the peso and build international reserves. The peso depreciated five percent during the second half of 2005 from ARS2.89/US\$ to ARS3.03/US\$. Over the full 2005 the peso depreciated two percent from, ARS2.97/US\$ to ARS3.03/US\$. The stock of Central Bank international reserves increased to \$28.1 billion by end-December compared to \$23.0 billion at end-June and \$19.6

billion at end-2004. In December, Argentina announced that it would tap Central Bank reserves to pre-pay its entire remaining obligations to the IMF totaling \$9.9 billion. Annual inflation reached 12.3 percent at end-2005 compared to 6.1 percent at end-2004. The Central Bank's monetary policy response remained accommodative in the face of the rise in inflation; while nominal interest rates on Central Bank repo transactions rose by 200-300 basis points in 2005 to 5-6 percent, the increase was outpaced by the acceleration in inflation, producing a decline in the real interest rate. Argentina's sovereign debt traded 498 basis points over U.S. Treasuries at end-December versus 464 basis points at end-June. Argentina had a \$3.5 billion current account surplus in the second half of 2005, equivalent to 3.7 percent of GDP, versus 2.1 percent of GDP in the first half of 2005. Argentina's current account surplus for the full 2005 was \$5.4 billion, equivalent to 3.0 percent of GDP. For the full 2005 the U.S. trade deficit with Argentina increased to \$472.2 million, compared to \$357.4 million the year prior. During the second half of 2005 the U.S. trade deficit with Argentina was \$374.3 million compared to \$97.8 million in the first half of the year. Real GDP increased at seasonally adjusted annual rates of 10.7 percent and 8.8 percent during the third and fourth quarters of 2005, respectively. For the full-year 2005, GDP posted a 9.2 percent increase over the previous year.

The Euro-zone

The euro depreciated 2.1 percent against the dollar in the second half of 2005. The European Central Bank's broad index of the euro's real effective exchange value declined 1.1 percent over the period. The Bank did not intervene in foreign exchange markets during the second half of 2005. The harmonized consumer price index rose 2.2 percent year-on-year as of December 2005 while the index excluding energy, food, alcohol, and tobacco rose 1.4 percent. Broad money (M3) grew 8.0 percent annualized in the second half of 2005.

The countries in the Euro-zone taken together had a current account deficit during the second half of 2005 equal to \$39.5 billion (sa) or 0.8 percent of GDP, down from a surplus of \$6.2 billion and \$19.6 billion in the first half of 2005 and second half of 2004, respectively. Goods exports increased 10.6 percent while goods imports increased 15.6 percent in the second half of 2005 over the same period in 2004. The trade surplus of the Euro-zone vis-à-vis the United States was \$48.6 billion in the second half of 2005, which is about \$4.9 billion higher than in the same period of 2004.

Euro-zone growth was an estimated 2.0 percent (annualized) in the second half of 2005. Final consumption expenditure rose 1.5 percent (annualized) in the second half of 2005 while gross fixed capital formation increased 2.6 percent (annualized).

Germany

Germany had a current account surplus during the second half of 2005 equal to \$50.3 billion (sa), or 3.4 percent of GDP. Goods exports increased 9.8 percent while goods imports increased 10.4 percent in the second half of 2005 over the same period in 2004. The trade surplus of Germany vis-à-vis the U.S. was \$26.2 billion, which is \$2.0 billion higher than the same period of 2004.

German growth was 1.6 percent (annualized) in the second half of 2005. Consumption and investment grew 0.2 percent and 9.3 percent (annualized), respectively, in the second half.

Germany's fiscal deficit is expected to exceed the three percent of GDP Stability and Growth Pact limit for the fourth straight year in 2005. German inflation was 2.2 percent yr/yr in December 2005 while core inflation was 1.1 percent.

Netherlands

The Netherlands had a current account surplus during the second half of 2005 equal to \$19.0 billion (sa), or 6.2 percent of GDP. The current account surplus for 2004 was 8.9 percent of GDP (with a five percentage point upward revision late in the year), with a substantial contribution from increased earnings of foreign subsidiaries of Netherlands companies. Goods exports increased 9.6 percent while goods imports increased 10.4 percent in the second half of 2005 over the same period in 2004. The trade deficit of the Netherlands vis-à-vis the U.S. was \$5.0 billion, which is \$717 million lower than the same period of 2004.

Dutch growth was an estimated 3.6 percent (annualized) in the second half of 2005, driven by domestic demand. Consumption and investment grew 2.9 percent and 6.7 percent (annualized), respectively, in the second half of 2005. Dutch CPI inflation was 2.1 percent yr/yr in December 2005 while core inflation was 0.9 percent.

Spain

Spain's current account deficit was \$43.3 billion, or 7.8 percent of GDP, in the second half of 2005. Goods exports increased 5.9 percent while goods imports increased 11.1 percent in the second half of 2005 over the same period in 2004. The trade surplus of Spain vis-à-vis the U.S. in the second half was \$940 million, which is \$615.7 million higher than in the same period of 2004.

Spanish growth was an estimated 3.6 percent (annualized) in the second half of 2005, driven entirely by domestic demand. Consumption and investment increased 4.9 percent and 5.7 percent (annualized), respectively, in the second half. Spanish CPI inflation was 3.7 percent yr/yr in December 2005 while core inflation was 2.8 percent.

Switzerland

Switzerland's current account surplus in the third quarter of 2005 was \$10.9 billion or 12.1 percent of GDP. Goods exports increased 8.1 percent while goods imports increased 10.0 percent in the second half of 2005 over the same period in 2004. The trade surplus of Switzerland vis-à-vis the U.S. in the second half of 2005 was \$1.1 billion, which is \$24.3 million lower than in the same period of 2004.

Swiss growth was an estimated 3.1 percent (annualized) in the second half of 2005. Consumption and investment increased 1.8 percent and 2.3 percent (annualized) respectively in the second half while net exports increased by 12.0 percent (annualized). The Swiss franc depreciated 2.5 percent against the dollar in the second half and declined 0.8 percent against the currencies of Switzerland's trading partners. JP Morgan's index of the real effective exchange rate of the Swiss Franc declined 2.3 percent over the second half. Broad money (M3) increased

1.8 percent over the second half. Inflation remained low at 1.0 percent yr/yr as of December 2005. Core inflation was 0.3 percent.

Norway

Norway's current account surplus in the second half of 2005 was \$27.4 billion or 18.3 percent of GDP. Goods exports increased 22.9 percent while goods imports increased 9.4 percent in the second half of 2005 over the same period in 2004. The trade surplus of Norway vis-à-vis the U.S. was \$2.3 billion, which is \$438.7 million lower than in the same period of 2004.

After 3.0 percent growth in the first half of 2005, Norway's GDP grew 3.1 percent (annualized) in the second half of 2005. Consumption grew 3.9 percent (annualized) while investment increased 24.6 percent. The Norwegian Kroner depreciated 3.2 percent against the dollar in the second half. The trade-weighted exchange rate increased 0.5 percent. Broad money (M2) increased 2.3 percent over the second half. Inflation was 2.0 percent yr/yr as of December 2005. Core inflation was 1.3 percent.

Russia

High oil prices continued to contribute to strong growth as well as large external and fiscal surpluses. Russia's current account surplus in the second half of 2005 was an estimated \$42.7 billion, or 10.7 percent of GDP, compared to \$25.9 billion, or 9.9 percent of GDP, in the second half of 2004. The bilateral trade surplus with the U.S. was \$5.4 billion in the second half of 2005 compared with \$5.4 billion in the second half of 2004.

The fiscal surplus for 2005 was a record 7.5 percent of GDP which helped raise the balance of the oil stabilization fund to \$43 billion at end-2005. Foreign exchange market intervention by the Central Bank resulted in a slight easing of the ruble vis-à-vis the dollar in the second half (0.4 percent). Official reserve assets increased 20.2 percent from \$151.6 billion at end-June 2005 to \$182.2 billion at end-December 2005. Russia's current account surpluses and foreign exchange reserve accumulation have been very large over recent years. The ruble's bilateral exchange rate with the dollar has, however, not varied greatly. From the end of 1999 to the end of 2005, the ruble depreciated on net 4.1 percent against the dollar. On the other hand, the real value of the ruble, measured by the JP Morgan broad index of the real effective exchange rate, appreciated 75 percent consonant with the high levels of Russian inflation over most of this period.

Inflation decelerated marginally with consumer prices rising 11.3 percent yr/yr at end-December 2005 compared to 11.7 percent at end-December 2004. Inflation has been running in the low teens for over three years. M2 grew 38.6 percent over the twelve months through December 2005 compared to 35.8 percent in the comparable period through December 2004. A more flexible exchange rate would allow better control over monetary conditions and assist materially in controlling inflation.

Ukraine

The hryvnia depreciated by 0.7 percent against the dollar during the second half of 2005. This followed an appreciation of 5.9 percent during the first half of the year, resulting in a cumulative appreciation of 5.2 percent for the year as a whole.

Downward pressure on the exchange rate during July-December reflected a sharp slowdown in export growth that shifted the current account to a deficit of \$0.4 billion in the second half of 2005 from a surplus of \$2.9 billion in the same period of 2004. For the year as a whole, the surplus narrowed to \$1.4 billion (two percent of GDP) in 2005 from \$6.8 billion (10.5 percent of GDP) in 2004.

Foreign exchange reserves rose from \$12.9 billion at the end of June to \$19.1 billion at the end of December. This reflected in large part receipts from the privatization of a major steel mill (Kryvorizhstal, sold to Mittal) for \$4.8 billion. In addition, after allowing the exchange rate to appreciate in the first half of the year, the central bank resumed intervention to maintain an informal exchange rate peg of UAH5/\$ during July-December. Most of this intervention was unsterilized, contributing to acceleration in broad money growth to 54 percent in December (yr/yr) from 37 percent in June.

Real GDP growth continued to slow in the second half of 2005, falling to 1.1 percent yr/yr from four percent yr/yr in January-June. For the year as a whole, real GDP growth fell to 2.4 percent in 2005 from 12.1 percent in 2004, as weaker steel demand contributed to a marked decline in exports.

Sub-Saharan Africa

Overall, Sub-Saharan Africa's current account deficit narrowed to 0.7 percent of GDP in 2005 from 1.8 percent in 2004. An improvement of more than six percentage points of GDP, on average, in the current account balances of the regions main oil exporters drove the overall change. The U.S. merchandise trade deficit with Sub-Saharan Africa continued to widen in 2005 to \$40 billion, from \$27 billion in 2004, due to a large increase in the value of crude oil imports.

Roughly half of Sub-Saharan African countries officially peg their currencies to other currencies, primarily the euro. The currencies of the United States' two largest trading partners in sub-Saharan Africa, Nigeria and South Africa, both appreciated about five percent in nominal terms against the U.S. dollar in the second half of 2005. The IMF classifies Nigeria's foreign exchange rate regime as a managed float. The South African Rand floats relatively freely.

Higher oil prices buoyed the Nigerian Naira and drove a significant increase in the country's current account surplus to 14 percent of GDP in 2005 from four percent in 2004. Primarily due to the large current account surplus, Nigeria's foreign exchange reserves increased from \$24.4 billion at the end of June 2005 to \$28.3 billion at the end of December. Capital inflows benefited the South African Rand and financed a widening of South Africa's current account deficit to 4.2 percent of GDP in 2005 from 3.4 percent in 2004. Capital inflows also boosted South Africa's foreign exchange reserves from \$16.6 billion at the end of June 2005 to \$18.3 billion at the end of December.

Saudi Arabia

Saudi Arabia is one of the most oil-dependent economies in the world, with oil accounting for 45 percent of GDP, almost 90 percent of export revenue, and 85 percent of the government's revenue. With the price of West Texas Intermediate oil averaging \$56 a barrel in 2005, real GDP growth exceeded six percent, and nominal GDP grew by 25 percent. Despite this strong growth, 2005 CPI inflation remained contained at 1.2 percent year over year due to minor price changes of imported goods and the large share of administered prices in the CPI basket.

Oil export revenues continued to increase on the back of high oil prices, rising to \$153 billion in 2005 from \$110 billion in 2004. The surge in oil export revenue led to an increase in the current account surplus from 20.5 percent of GDP in 2004 to 30 percent of GDP in 2005. Finally, the bilateral trade surplus with the United States reached \$20.4 billion in 2005, compared with \$15.7 billion in 2004.

The government's financial position improved as revenue from oil rose by \$43 billion to \$131 billion in 2005. The budget surplus was approximately \$57 billion in 2005 (18 percent of GDP), and the government used much of that surplus to reduce government debt to 41 percent of GDP. Based on historical experience, these surpluses are likely to diminish over time as the government increases spending; the government projects domestic spending to rise by 20 percent in 2006.

The Riyal has been unofficially pegged to the dollar since 1986 (officially since 2003), so interest rates largely followed recent increases in the United States. The Gulf Cooperation Council¹⁸ has set a goal of establishing a formal monetary union by 2010.

Due to its large current account surplus and fixed exchange rate, the net foreign assets of the Saudi Arabian Monetary Agency rose to \$150.3 billion from \$108.6 billion during the last six months of 2005, providing approximately 30 months of import cover. Gross liquid reserves rose by a much smaller amount over the same period, rising to \$23.7 billion from \$22 billion.

Singapore

Since 1988, Singapore has had a large and growing current account surplus, which reached about 31 percent of GDP in the second half of 2005. Primarily due to the large current account surplus, official foreign reserves increased \$1.4 billion to \$116.6 billion in the second half of 2005, equal to seven months of imports. Singapore was the 16th largest trading partner of the United States in 2005. It had a deficit of \$2.5 billion on trade in goods with the United States in the second half of 2005, compared to a \$1.8 billion deficit a year earlier.

The current account surplus has risen because investment has fallen while both public saving and private saving have remained high. Factors accounting for the decline in investment include the slowdown in the technology sector in 2001-02, the 2003 outbreak of Severe Acute Respiratory Syndrome (SARS) and Singapore's declining productivity growth relative to that of other less

¹⁸ GCC member countries are Kuwait, Qatar, Oman, Saudi Arabia, Bahrain, and the United Arab Emirates.

developed Asian economies. Gross national saving was 47 percent in 2005, among the highest in the world. Despite income tax cuts last year, the government continues to register large fiscal surpluses, which it argues are a necessary safeguard against external shocks and to help prepare for the costs of an ageing population.

Private saving makes up about two-thirds of total saving and is dominated by saving of private corporations and government-linked corporations, which pay limited dividends. Household saving has been boosted by demographic and income changes (an ageing, but not yet old, population; declining birth rates; high and volatile GDP growth). The government's mandatory saving program through the Central Provident Fund has also supported household saving, although to a lesser extent since the government allows residents to borrow against the fund for housing.

Singapore is a small, open economy, with imports and exports three and a half times GDP. As a result, inflation and inflationary expectations are heavily influenced by movements in the exchange rate. Singapore uses its exchange rate as the operational policy tool for monetary policy by maintaining a heavily managed exchange rate linked to an undisclosed basket of currencies of its major trading partners. Since April 2004, the Monetary Authority of Singapore (MAS) has had a stated policy of a modest and gradual nominal appreciation against this basket. The Singapore dollar appreciated 1.4 percent against the U.S. dollar in the second half of 2005, while JP Morgan's nominal and real trade-weighted indexes of the exchange rate appreciated 2.8 percent and 2.3 percent, respectively.¹⁹ In recent years, MAS has been reluctant to allow for a faster appreciation out of concern that this could increase the risks of a deflationary spiral. However, in 2005, the strengthening economy and rising oil prices caused consumer prices to increase 1.3 percent in December compared to a year earlier and wholesale prices to rise 11.4 percent.

In the first quarter of 2006, the Singapore dollar appreciated 2.8 percent against the U.S. dollar and its NEER and REER rose 2.3 percent and 7.0 percent, respectively. CPI rose 1.8 percent year on year in January 2006 and 1.2 percent in February 2006. Wholesale prices have been little changed so far in 2006.

Under Secretary for International Affairs Tim Adams traveled to Singapore in February 2006 to discuss economic issues with officials from MAS and the Finance Ministry. Treasury staff continue to discuss economic developments and their implications for the exchange rate regime with officials from Singapore.

India

India's current account deficit widened to \$20 billion, or 2.5 percent of GDP in 2005, from 0.6 percent of GDP in 2004, mainly due to stronger domestic demand and deteriorating terms of trade due to higher oil prices. The economy grew about eight percent yr/yr in the second half of the year. Private investment continued on an upswing dating back to 2004, driven by lower real interest rates and ample liquidity in the banking system (credit growth of 30 percent yr/yr and

¹⁹ The JP Morgan index of the real value of the Singapore dollar is calculated using the price of manufactured goods in Singapore. Indexes for the Singapore dollar that use CPI indexes can give significantly different results.

robust capital expenditures). Saving rose slightly, due mainly to corporate saving from higher profits. Public dissaving remained large despite some progress in reducing the public sector deficit currently about eight percent of GDP. Capital inflows continued to increase, particularly as foreign institutional investors' assessment of India's economic prospects improved, and they put more funds into stock and bond markets. The U.S. bilateral merchandise trade deficit with India climbed to \$5.9 billion in the second half of 2005, \$1 billion more than the first half.

The monetary policy of the Reserve Bank of India (RBI) relies on targeting short-term interest rates to achieve price stability while monitoring the trade-weighted exchange rates over the medium term. The Indian rupee depreciated by about 3.5 percent against the dollar in the second half of 2005 and by about two percent in real terms against a basket of the currencies of India's major trading partners, driven largely by a growing current account deficit. Despite this, on a real, trade-weighted basis, the rupee is about six percent over its average for the last 15 years. Overall, the accumulation of foreign exchange reserves by the RBI slowed considerably from previous periods with foreign exchange reserves for the six months almost unchanged at \$131 billion (which, at about seven times external debt on a residual maturity basis, is high). To date foreign exchange purchases have risen again in 2006.

The government in March 2006 announced its intention to move India gradually toward full capital account convertibility, which would reduce capital controls significantly, particularly on outflows. It could also lead to the liberalization of the financial services sector to allow additional foreign participation, providing additional capital and expertise to the Indian financial system. Such moves would bolster Indian efforts to extend the yield curve on domestic financial assets and attract financing for infrastructure investment.

Japan

Japan's economy appears to finally be exiting its long post-bubble slump after several false starts over the past few years. Following disappointing growth during the last three quarters of 2004, the Japanese economy grew at 2.7 percent in 2005, with domestic demand contributing 2.5 percentage points. The financial health of Japan's major banks has greatly improved, corporate restructuring has mostly eliminated large excesses of capacity and workers, and employment of permanent fulltime workers has begun rising. Business investment and private consumption drove 2005 growth, though net exports picked up in the fourth quarter of 2005. A continued economic recovery based on domestic demand should allow Japan to make a greater contribution to global growth and the orderly adjustment of global imbalances.

Japan has struggled with low but stubborn deflation since 1998. Core consumer prices (the measure that the Bank of Japan uses as its gauge of underlying inflation) fell by 0.1 percent during 2005 as a whole, but increased by 0.1 percent in the last half of 2005 over the previous year, raising hopes for an end to deflation. Following three months of positive year-over-year growth in core CPI, the Bank of Japan announced on March 9, 2006 that it would change its monetary policy from providing substantial excess liquidity ("quantitative easing") to a policy of targeting interest rates. Even with the new policy, interest rates are expected to remain very low for some time. The BOJ also announced a non-binding medium-term 0-2 percent CPI inflation definition of its target of price stability.

Japan has had a persistent current account surplus and corresponding capital outflows to the rest of the world, a consequence of a surplus of Japanese saving over domestic investment. Rates of return on domestic investment have been generally low, although the recent acceleration of corporate restructuring and mergers and acquisition activity holds out the prospect of higher returns. Since the early 1990s, a decline in Japan's household saving rate and a widening fiscal deficit have been offset by rising corporate net saving as firms paid off debt in order to strengthen their balance sheets following the collapse of the late-1980s asset "bubble." The net result of these offsetting factors is that Japan's current account surplus has fluctuated in the three percent range in recent years.

In 2005, Japan's global current account surplus fell slightly to \$166 billion (3.6 percent of GDP), from \$172 billion (3.8 percent of GDP) in 2004. Japan's overall trade surplus declined \$31 billion to \$79 billion in 2005 as imports grew by 15.7 percent, due primarily to higher prices for oil and other commodities, while exports grew by 7.3 percent. Japan's bilateral merchandise trade surplus with the United States totaled \$83 billion in 2005, up slightly from \$76 billion in 2004. Increased outward direct investment by Japanese firms and larger portfolio investment outflows by Japanese residents seeking higher returns abroad, particularly as interest rates in the U.S. and other major economies rose relative to Japanese rates, contributed to a shift in Japan's private net capital flows to net outflows of \$123 billion in 2005 from net inflows of \$21 billion in 2004.

Japanese authorities did not intervene in the foreign exchange market in the second half of 2005, and have not intervened in the foreign exchange market since March 16, 2004.²⁰ Japanese foreign exchange reserves rose by \$5 billion in the second half of 2005 to \$829 billion, primarily due to interest earnings. This contrasts with an increase in Japanese foreign exchange reserves of \$146 billion in the first half of 2004.

During the July 1 to December 31, 2005 reporting period, the yen depreciated 6.3 percent against the dollar, reaching a level of 117.88 at year-end. Nominal depreciation of the yen versus the dollar was 14.8 percent for the year as a whole. Rising capital outflows from Japan contributed to a relatively weaker yen. Since the beginning of 2006, the yen has fluctuated within a 4.3 percent range, and as of April 25 had appreciated 2.5 percent since end-2005.

South Korea

South Korea shares many characteristics with other major Asian emerging markets, a large share of trade in GDP, strong links to the global technology market, and a high degree of integration in the Asian manufacturing system. Yet South Korea maintains substantial exchange rate flexibility, with average daily fluctuations of the won of roughly the same size as the yen and the euro. Despite a nine percent nominal effective appreciation of the won over the course of 2005 and the slowing of Chinese import demand, Korea still managed GDP growth of 4.0 percent for the year. Growth for 2006 is expected to be in the five percent range. In addition, the exchange

²⁰ 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>.

rate flexibility allowed Korea to direct monetary policy towards stimulating domestic demand, while still keeping inflation within its target range.

South Korea's current account surplus declined substantially during 2005 to \$16.6 billion (2.1 percent of GDP), from \$28.2 billion in 2004. The fall in the current account surplus was due in part to a sharp deceleration in export growth (12 percent growth in 2005 compared to 31 percent in 2004) as a result of decelerating export growth to China. Korean imports also increased significantly, due both to higher prices of oil and other raw materials as well as rising domestic demand (particularly household consumption and corporate investment) as the effects of a household credit boom/bust dissipated. The U.S. bilateral trade deficit with Korea narrowed to \$7.6 billion for the second half of 2005, down almost 30 percent from the same period a year earlier, as U.S. imports from South Korea decreased and exports to South Korea rose by five percent.

Along with other Asian emerging markets, South Korea experienced a reversal of portfolio investment flows during the reporting period, due in part to rising U.S. interest rates. Capital and financial account outflows, net of increases in official reserves, totaled \$4.5 billion in the second half of 2005, almost canceling the net inflow of \$5 billion in the first half. While officials from the Ministry of Finance and the Economy made public statements expressing concern about won appreciation, the Bank of Korea reduced its foreign exchange intervention significantly during 2005. For the year, reserve assets increased by only \$20 billion, compared to an increase of almost \$40 billion in 2004. By end-2005 reserves stood at \$210 billion, equivalent to 110 percent of the gross external debt of Korea.

South Korea maintains a managed floating exchange rate in the context of an inflation targeting monetary policy framework. Finance Minister Han (who is also South Korea's Deputy Prime Minister) has stated that the exchange rate should not be used as a policy tool, and has emphasized that exchange rates should be determined in the market. At the same time, he said that the South Korean Government may intervene "if abnormal factors such as foreign exchange speculation are in action." Despite the rise in oil prices, the won's rise of 9.1 percent on a nominal trade weighted basis during 2005 enabled the Bank of Korea to lag behind the Federal Reserve in raising interest rates, while keeping core inflation within the 2.5 to 3.5 percent target band. The won appreciated 2.3 percent versus the dollar over the course of 2005 (1.3 percent within the second half of the year), and during 2005 the won/dollar exchange rate varied over a range of 6.4 percent. In the three years through end-2005, the won has appreciated about 15 percent against the U.S. dollar and 12 percent on a nominal effective basis.

South Korea also implemented a liberalized system for capital transfers starting January 1, 2006. The system replaced a permit requirement with a reporting requirement for a number of capital transactions. In addition, regulations on cross boarder borrowing were eased, and asset management companies are now allowed to issue certain foreign currency-denominated investment securities.

China

Rapid Chinese economic growth continued during 2005, despite a series of administrative and market-based measures imposed by the Chinese authorities in late 2004 to reduce the growth of

investment in order to reduce the risk of overheating and a hard landing. This tightening cycle was followed by steps to ease monetary policy following the July 21, 2005 exchange rate adjustment. Growth for the year was 9.9 percent, down only slightly from the 10.1 percent growth in 2004.²¹ Investment growth did fall from 2004's torrid pace, but fixed asset investment still grew by 26 percent, well in excess of overall GDP growth. China recorded larger-than-expected growth in the first quarter of 2006 of 10.2 percent, and the Chinese leadership has once more expressed concerns about excessive investment and credit extension, and raised domestic lending rates on April 28.

Macroeconomic imbalances increased significantly. The growth of net exports in the latter half of 2005 brought China's global trade surplus to \$102 billion (5 percent of GDP) for the year, three times the \$32 billion surplus in 2004.²² The widening of the surplus came from slower import growth. After expanding by 36 percent in 2004, imports of goods grew by only 14 percent year-over-year in the first half, before picking up to 21 percent year-over-year growth in the last half of 2005. Chinese imports decelerated due to lower investment growth and the displacement of imports by domestic supply in some sectors. In the first quarter of 2006, China's trade surplus widened further by \$23 billion (nsa). The U.S. bilateral trade deficit with China rose 25 percent to \$202 billion in 2005 from \$162 billion in 2004. The increase in China's trade surplus drove a sharp increase in China's current account surplus, which rose to \$161 billion (seven percent of GDP), a more than doubling of the \$67 billion surplus in 2004.²³

Net foreign direct investment was lower in 2005 than in the previous year, and net portfolio capital inflows slowed sharply during the second half of 2005. After a period of strong net portfolio capital inflows, the falloff in the second half of 2005 was likely the result of the change in the Chinese exchange rate regime that occurred on July 21, tax measures to discourage speculative holdings of property, and wider interest rate differentials favoring U.S. dollar-denominated financial assets. The sharp increase in the current account surplus accounted for most of the increase in reserves in the balance of payments. The stock of China's foreign exchange reserves rose \$209 billion during 2005, a slight increase from 2004.²⁴ As of March 31, 2006, Chinese foreign exchange reserves totaled \$875 billion, about three times its external debt, and far in excess of amounts needed to cushion against adverse shocks.

After maintaining a pegged exchange rate for eight years, the movement to a new exchange rate mechanism on July 21, 2005, was a significant event. But the Chinese authorities have been very slow in introducing exchange rate flexibility and in allowing the renminbi to adjust to

²¹ The Chinese government revised upward its official estimates of production-based GDP for the years 1993 to 2005 in December of 2005 to account more accurately for output attributable to the growing services sector. The authorities did not release revised expenditure-based GDP. As a result, we do not yet know by how much it will change the investment, consumption, or net exports figures, leading to revisions in the contributions of these GDP components to real growth rates. A better counting of the services sector, which tends to be less capital intensive, should contribute to a larger estimated consumption share in the economy.

²² These trade figures are on FOB-CIF basis. If China's imports were measured on the same basis as its exports (fob), China's adjusted global merchandise trade balance in 2005 would be \$134 billion. (This calculation assumes a 4.8 percent c-i-f (cost, insurance, and freight) adjustment factor.)

²³ Current account statistics for all of 2005 in China were published by SAFE on May 1, 2006.

²⁴ The PBOC used \$6 billion to execute a swap transaction with local banks – both to establish the swap instrument and to soak up renminbi liquidity. The PBOC must mop up (“sterilize”) domestic liquidity created by accumulating foreign exchange reserves. The FX swap provides an alternative way to absorb renminbi funds from the market.

market forces. Since July 2005 and through the end of last year, the renminbi appreciated gradually against the dollar, closing at 8.011 yuan per dollar as of May 1, an additional appreciation of only 1.2 percent since the initial change on July 21, 2005. While appreciating only modestly against the U.S. dollar, the renminbi strengthened (along with the dollar) against other currencies since last July, rising by about 2.4 percent on a nominal trade-weighted basis as of April 30, 2006. Daily fluctuations since the new mechanism was introduced have averaged only 0.025 percent, with a maximum one-day change of 0.13 percent, far less than the allowable daily movements of 0.3 percent. So far, the role of the reference basket of currencies has been extremely limited, as monetary authorities have maintained effectively a tightly managed crawling peg against the U.S. dollar.

Chinese leaders' statements of their commitment to move to a flexible exchange rate have been clear, and repeated at the highest level, most recently by President Hu in Seattle in April 2006, when he said China would "continue to develop the foreign exchange market and increase the flexibility of the renminbi exchange rate." But Chinese leaders have consistently expressed a strong preference for a gradual adjustment in their exchange rate. This view may reflect the caution of the Chinese leadership in adopting fundamental policy changes in an economy undergoing rapid transformation and the shedding of millions of workers annually from agriculture and state-owned enterprises.²⁵ It may also reflect the diversity of advice that Chinese leaders receive.²⁶

The Chinese authorities continued taking steps to enhance the market infrastructure to support a more flexible exchange rate regime. They introduced an interbank foreign currency trading system in early January; previously, the State Administration for Foreign Exchange (SAFE) had been the counterparty on all foreign exchange transactions. The authorities have also introduced new financial products to hedge against currency risk, such as forwards. But the barriers to greater foreign exchange rate flexibility are no longer technical. China has the means to introduce a much greater degree of exchange rate flexibility. Loosening management of the exchange rate will in fact spur the development of the market for hedging instruments when participants have greater incentive to hedge their exposure to exchange rate risk, and it will facilitate China's transition to a more market-oriented economy.

China has taken steps to liberalize controls on capital movements to increase the depth and liquidity of foreign exchange markets. Chinese authorities have continued to expand the program that allows foreign institutional investors to buy shares in locally listed companies. In mid-April, the central bank announced a series of measures to liberalize foreign exchange regulations that will allow Chinese residents and institutional investors to acquire more overseas assets. These capital account liberalization steps will offer opportunities for higher returns and portfolio diversification to Chinese households and thus should contribute to reduced saving. Despite this recent liberalization, China still maintains more extensive controls over flows of capital out of China than it does on inflows of foreign capital.

²⁵ This fundamental caution is also evidenced by the fact that China maintained a fixed exchange rate throughout the Asian Financial Crisis in 1997-98, despite the fact that many Asian currencies depreciated sharply against the U.S. dollar, and thus against the renminbi.

²⁶ At least one prominent economist has argued that China should maintain its fixed exchange rate and risks falling into deflation similar to what Japan experienced should its currency appreciate.

China's leaders have also recognized that the country's growth cannot be maintained through continued reliance on net exports. They have expressed their clear intent and commitment to reduce China's current account surplus and shift the sources of Chinese growth away from foreign demand and investment, in particular to increased consumption expenditure. When President Hu came to Washington in April, he outlined China's intent to boost domestic demand and reduce China's trade surplus. To spur domestic demand, China has placed strong emphasis on consumption and rural development in its most recent Five-Year Plan. To boost disposable incomes of the rural poor, the government has recently decided to cut agricultural taxes and eliminate fees for rural primary education. It also plans to direct more capital and social spending to the rural sector.

The counterpart to China's high investment and its current account surplus is a saving rate of roughly 50 percent of GDP, which may be the highest in the world. Household saving reflects a weak social safety net and limited access to financing and insurance; households need high saving in the event of serious illness, disability, or to pay for children's education. The "iron rice bowl" of cradle to grave wages and benefits has disappeared and a modern social safety net has not yet been erected. Chinese state and private firms also save heavily – and re-invest the profits they earn rather than paying out dividends.

There are a number of additional steps that China could take to lower saving and boost domestic demand. Policies to encourage China's state-owned enterprises to distribute some of their earnings as dividends to the government would reduce their saving and their inefficient investment, and could contribute to greater social welfare expenditure or reduced taxes. Strengthening and increasing enrollments in public pension and health insurance systems, particularly in rural areas, are also important steps.

Financial sector modernization is a critical element of improving the efficiency of investment and facilitating increased consumption. Increasing the range of financial products available to households could reduce household precautionary saving for disability and catastrophic illness, reduce the need to save in advance to finance education and other major expenses, and make higher return investments available to households. All of these would allow households to save less and spend more, boosting Chinese domestic demand.

China has been working to modernize its financial system, tightening its risk classification system for bank loans, deregulating bank lending rates, and developing financial-sector infrastructure. Foreign entry and expertise is an important part of China's strategy for modernizing the financial system. Foreign strategic investors have invested more than \$17 billion in Chinese banks in the last 18 months. In addition, international institutional investors have invested around \$11 billion in the public listings of two of China's five largest banks. These investors will subject the management of these institutions to tighter surveillance and market forces. In the capital markets, China has made progress converting all shares to tradable shares, expanding access to locally listed shares for foreign institutional and strategic investors.

Despite this progress, much needs to be done to improve China's financial markets. Deeper bond markets would reduce corporate reliance on state-controlled lenders and more active derivatives trading would allow firms to manage risk better. On the banking side, the state-owned banks still account for most credit. China needs to increase competition including by

raising foreign ownership caps on securities firms and purchases of existing state-owned companies, which would increase competition as well as provide capital, risk management, and new products. The more flexible interest rates that would result from a more market-based exchange rate would also improve the financial sector's ability to allocate credit through market forces to investment with the highest return.

Rebalancing the sources of Chinese growth and improving the efficiency of Chinese financial markets will be requirements for sustaining future Chinese growth. But greater exchange rate flexibility, through changing internal prices of domestic and internationally traded goods will be a fundamental part of that rebalancing. While the hesitancy of the Chinese leadership to introduce greater exchange rate flexibility may be real; its concerns about the effects of an accelerated introduction of flexibility and market determination of the renminbi exchange rate are unfounded. Chinese export growth accelerated in the final quarter of 2005 and into 2006, despite the strengthening of the exchange rate. In fact, first quarter 2006 GDP growth at over 10 percent has again raised questions of overheating. The experience of South Korea, described above, illustrates that a substantial degree of exchange rate flexibility and an exchange rate appreciation far greater than China has experienced can be incorporated in a growing economy.

Chinese leaders have also expressed concerns about the effects of a fully floating exchange rate on the Chinese banking system. However, we are not asking China for an immediate full float of the currency with full liberalization of controls on capital movements. China can introduce a much greater degree of exchange rate flexibility without risk to its financial system. In fact, the current slow pace of moving towards flexibility carries its own risks to the financial system, as People's Bank of China Governor Zhou has noted. It has led to large capital inflows that have fueled rapid credit growth and property market speculation. Low real interest rates and rapid loan growth in turn weaken bank lending discipline, risking the creation of a new generation of non-performing loans.

China's tightly managed exchange rate regime has become an increasingly significant systemic risk, both in China's domestic economy and the global economy. Its peg constrains monetary authorities' ability to adjust interest rates and the growth of monetary aggregates and credit at a time when credit growth is fueling a re-acceleration of investment. The expanded scope to vary interest rates with a more flexible currency regime would promote more efficient and prudent financial intermediation, and help avoid credit-fueled investment booms and resulting buildups of excess productive capacity and non-performing loans in the banking system. Moreover, as China proceeds in its transition toward a market economy, command-and-control tools are losing their effectiveness, and exchange rates, interest rates, and other price mechanisms will become more important to achieve and maintain macroeconomic stability. The price signals that come from a more flexible exchange rate would be a critical part of readjusting China's economy to produce more balanced and sustainable growth and contributing to an orderly reduction of global imbalances. Greater exchange rate flexibility in China would make other Asian governments' authorities, concerned about their relative external competitiveness vis-à-vis China, less reluctant to allow their exchange rates to adjust.

Treasury will continue to intensify its bilateral and multilateral efforts to encourage China to move more rapidly to a market-based, flexible exchange rate. In what have now become regular meetings with the leaders of the People's Bank of China, the Chinese Ministry of Finance, and

the National Development and Reform Commission, Treasury officials consistently emphasize the necessity of more rapid introduction of exchange rate flexibility under China's new exchange rate mechanism. The G7, the IMF, the Asian Development Bank, and the OECD have all called on China to introduce greater exchange rate flexibility. Discussions begun under the Technical Cooperation Program on foreign exchange market issues have developed into a broader discussion of strengthening China's financial and foreign exchange markets to support greater exchange rate flexibility. U.S. and Chinese financial regulators conducted their second Financial Sector Working Group talks on April 24. Also in April, Treasury's Financial Attaché assumed full-time permanent residence in Beijing. Treasury will continue to encourage Chinese economic leaders to interact with leaders of the major economies that share systemic responsibility, with the clear understanding that the role China now plays in global trade carries responsibilities for contributing to an orderly reduction of external imbalances and global conditions conducive to continued support for open trade and investment.

Taiwan

Robust global high-tech demand and an increase in Taiwan's exports led to stronger growth in the second half of 2005. Taiwan's current account surplus in the second half of 2005 was \$10.7 billion (6.3 percent of GDP), up from a surplus of \$5.5 billion in the first half. Even with the second half increase, the current account surplus for 2005 as a whole was the lowest annual figure since 2000. Taiwan's bilateral trade surplus with the United States was \$7.0 billion in the second half of 2005, down very slightly from the same period a year earlier. The U.S. bilateral deficit with Taiwan peaked at \$16.1 billion in 2000, and has declined since then, to reach \$12.8 billion in 2005. The decline in the U.S. bilateral deficit with Taiwan, in a period in which the U.S. global trade deficit rose substantially, reflects increasing Taiwanese investment in China and the use of China as a final assembly point for exports destined for the United States and other third country markets.

Portfolio capital outflows in the second half of 2005 offset most of the inflows from the first half of 2005, resulting in a very small net inflow with regard to the capital and financial accounts for the year. Taiwan residents' investment in foreign securities in 2005, \$36 billion, was a record-high, spurred by the gap between the interest rates for New Taiwan Dollar (NTD) deposits and U.S. dollar deposits.

Taiwan maintains a heavily managed exchange rate. However, in the second half of 2005, the central bank's foreign exchange intervention declined significantly. Taiwan's foreign exchange reserves at end-2005 were \$253 billion, unchanged from their end-June level. In the first quarter of 2006 reserves have risen slightly, to \$257 billion at the end of March. Nevertheless, by end 2005, Taiwan's ratio of foreign exchange reserves to GDP (78.2 percent) was the second largest in the world and the ratio of reserves to short-term external debt was over four.

After appreciating by 6.6 percent against the dollar over the course of 2004, the NTD remained virtually flat in the first half of 2005, and then depreciated by 3.5 percent by year-end. In the first three months of this year, the NTD has appreciated by 2.4 percent against the dollar.

Malaysia

Malaysia's current account surplus increased to 15.3 percent of GDP (\$19.9 billion), from 12.6 percent of GDP in 2004. Large current account surpluses have been a striking feature of the Malaysian economy in the last few years, even before higher oil prices (Malaysia is a net oil exporter) expanded the surplus. Malaysia's current account surplus is driven in large part by the low level of domestic investment, which dropped off sharply after the Asian financial crisis and continues to decline (20.0 percent of GDP in 2005). Part of this decline was expected after the investment boom just prior to the 1997 Asian financial crisis, but Malaysia's investment rate is almost 15 percentage points below its level in the early 1990s, and there have been sharp declines in both domestic private and foreign direct investment. The reasons for the sharp fall in investment are not clear; reasons that have been suggested include declining competitiveness of Malaysia vis-à-vis other Asian economies, shortages of complementary inputs (particularly skilled labor), policy efforts to shift towards a more service-oriented economy, and the effect of excessive government regulation.

Despite the rise in the annual current account surplus in 2005, the surplus for the second half of 2005 was \$9.7 billion, or 14.1 percent of GDP, down from the 16.5 percent in the first half of 2005. This drop in the surplus was due entirely to a fall in investment income; the goods and services trade balance rose slightly in the second half of the year (not seasonally adjusted). Malaysia's bilateral trade surplus with the United States totaled \$12.8 billion in the second half of 2005, compared with \$9.7 billion in the second half of 2004.

Within hours of China's revaluation on July 21, Malaysia abandoned its peg of 3.8 ringgit per dollar and adopted a managed float that is "determined by economic fundamentals." Over the next few days of trading the ringgit appreciated by 1.3 percent. Through the rest of 2005 the ringgit exchange rate gradually depreciated slightly, ending the year at 3.78, an appreciation of 0.5 percent from its previous pegged rate. Since the end of 2005, however, the ringgit has appreciated steadily, reaching 3.59 per dollar by May 8, a cumulative appreciation of over 5.4 percent. The pace of appreciation has accelerated markedly since April 18, with over one third of total appreciation occurring since that time. The magnitude of average daily fluctuations, around 0.1 percent, is still small, but a marked increase over 2005.

Speculation leading up to the change in exchange rate policy and a gradual reversal of some of the initial appreciation during the remainder of the year strongly influenced Malaysian capital flows. After strong net capital inflows prior to the change in exchange rate regime, Malaysia's financial account saw surging outflows in the fourth quarter of 2005. The financial account deficit for the second half of 2005 spiked to \$10 billion (compared to a surplus of \$1 billion in the first half of the year). This is due in large part to the unwinding of speculative positions on ringgit appreciation. Bank Negara Malaysia intervened to slow the ringgit's depreciation, and foreign exchange reserves declined by about \$5.6 billion in the fourth quarter.

Inflation, while still moderate, rose measurably in 2005 to three percent from 1.4 percent the year before. This was due in large part to high global oil prices, cuts in domestic fuel subsidies, and increased communications costs. Inflation spiked in March 2006 to 4.8 percent, on the heels of another government increase in fuel prices. Bank Negara Malaysia has raised the overnight policy rate three times since November, 80 bps to 3.5 percent in an effort to curb rising inflation.

Malaysia had already relaxed most of its controls on capital flows imposed when the ringgit was pegged in 1998. There are a few remaining controls: offshore trading of the ringgit remains prohibited, and foreign portfolio investment by residents continues to be limited.

Malaysia's move to a managed floating exchange rate regime was an important step to address the external and domestic imbalances suggested by the large and rising current account surplus. Malaysia could benefit from a greater degree of exchange rate flexibility, to better manage domestic demand and inflation and to allow changes in internal prices and resource reallocation to support growth. Since the last report, Under Secretary Adams and other Treasury officials initiated consultations with the Malaysian authorities on exchange rate policy in the context of overall Malaysian macroeconomic policy. The additional ringgit flexibility introduced since the beginning of 2006, in particular the increased flexibility that has been observed during the past month, is welcome.