Report to Congress on
International Economic and Exchange Rate Policies
April 2004

This report reviews developments in international economic policy, including exchange rate policy, focusing on the second half of 2003. The report is required under the Omnibus Trade and Competitiveness Act of 1988, which states 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."

For the purpose of assessing whether an economy is satisfying the terms of the Act, Treasury has traditionally undertaken a careful review of the trading partner's exchange rates, external balances, foreign exchange reserve accumulation, macroeconomic trends, monetary and financial developments, the state of institutional development, and financial and exchange restrictions. Isolated developments in any area do not typically provide sufficient grounds to conclude that exchange rates are being manipulated under the terms of the Act. A combination of factors, on the other hand, can and has in the past led Treasury to find that certain countries had satisfied the terms of the Act.

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

- Economies around the world continue to follow a variety of exchange rate policies, ranging from a flexible exchange rate with little or no intervention to currency unions and full dollarization. For example, Canada follows a flexible exchange rate regime with no intervention, twelve countries are members of the European Monetary Union, and El Salvador and Panama use the U.S. dollar as their "domestic" currency.

- A notable trend observed over the past several years is the move by many economies to adopt flexible exchange rates, combined with clear price stability goals and a transparent system for adjusting monetary policy instruments.

- The report finds that no major trading partner of the United States met the technical requirements for designation under the Omnibus Trade and Competitiveness Act of 1988 during the second half of 2003. The report notes that while a number of economies continue to use pegged exchange rates and/or intervene in foreign exchange markets, a peg or intervention does not in and of itself satisfy the statutory test. Treasury has consulted with the IMF management and staff, as required by the statute, and they concur with our conclusions. The Administration strongly believes that a system of flexible, market-based exchange rates is best for major trading partners of the United States.

- Treasury is continuing to engage actively with economies and to encourage, in both bilateral and multilateral discussions, policies for large economies that promote a flexible market-based exchange rate combined with a clear price stability goal and a transparent system for adjusting policy instruments. In this light, the communiqué of the G7 Finance Ministers and Central Bank Governors in February of this year stated: "…that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."

The United States International Accounts

The growth of the U.S. current account deficit over more than a decade has been linked to increasing levels of domestic U.S. capital formation. Perceived high rates of return on U.S. assets, based on strong productivity growth relative to the rest of the world, combined with an efficient U.S. capital market to attract foreign investment. This helped finance U.S. investment and worked to increase the current account deficit.

The current account deficit is conceptually equal to the gap between investment and saving as a matter of international accounting. When investment in the United States is higher than domestic saving, foreigners make up the difference, and the United States has a current account deficit. In contrast, if saving exceeds investment in a country, then that country has a current account surplus as its people invest abroad.

In the second half of 2003, for example, the U.S. current account deficit was $503 billion (at a seasonally adjusted annual rate and on a national income and product accounting, or NIPA, basis) or 4.5% percent of GDP. This $503 billion deficit equaled the gap between $2,079 billion in investment and $1,575 billion in saving[1]. That is, U.S. domestic investment was $503 billion more than domestic saving with net foreign investment making up the difference.

Viewed in these terms, the $55 billion increase in the U.S. current account deficit in 2003, measured on a NIPA basis, was caused by a $91 billion increase in investment outstripping a $36 billion increase in saving. The increase in investment was a key factor in the acceleration in U.S. economic growth during 2003. Overall, real GDP grew at an 8.2 % annual rate in the third quarter and 4.1% in the fourth. Consumer spending increased sharply, but growth became more balanced over the second half as business investment in equipment and software increased at double-digit rates.

The current account was $526 billion in deficit (at a seasonally adjusted annual rate and on a balance of payments basis[2]) in the second half of 2003. How has the deficit been financed? The largest single balance of payments component financing the current account deficit has recently been net private foreign purchases of U.S. securities, which reached $335 billion in the second half of 2003. (Included in these were net private foreign purchases of U.S Treasuries amounting

[1] Including the relatively small statistical discrepancy.
[2] Although the current account measures are conceptually the same, balance of payments statistics are compiled on a slightly different basis from national income statistics. Saving includes the statistical discrepancy between the income and product accounts.

to $141 billion.) In addition, foreign official institutions increased their U.S. assets by $219 billion.

Viewed over a longer period, the U.S. current account deficit rose, as a percent of GDP, from the first quarter of 1991 to reach a temporary peak of 4.4% in the fourth quarter of 2000 before beginning to contract as domestic and foreign activity weakened. The current account deficit began to widen again in the first quarter of 2002 with the recovery of the U.S. economy although it appears to have reached at least a temporary plateau, in the neighborhood of 5% of GDP, over the last seven quarters.

Due to the current account deficit the net investment position of the United States (with direct investment valued at the current stock market value of owners' equity) fell to a negative $2.6 trillion as of December 31, 2002, the latest date for which data are available, from a negative $2.3 trillion at the end of 2001. Despite a large negative position, U.S. residents earned $22 billion more on their foreign investments in 2003 than foreigners earned on their U.S. investments. These positive net income receipts are the result of large net inflows of income from direct investment offsetting net outflows of income on portfolio investment.

The U.S. Dollar

The Federal Reserve Board's "broad" nominal dollar index declined 3.9% during the second half of 2003. The dollar declined 7.9% against the "major" foreign currencies (the currencies of seven industrialized economies) while rising 1.2% against "other important trading partners" (largely currencies of emerging market economies). The broad index declined 12.9% from February 27, 2002, when it reached its recent peak, through December 31, 2003.

Inflation remained subdued during this period. The consumer price index rose 1.9% over the 12 months of 2003 and the core inflation rate (excluding food and energy items) was 1.1%, the smallest increase in core consumer prices since 1966. The Federal Reserve has held the target federal funds rate at 1.0% since June.

As discussed below, the currencies of different economies showed varying degrees of flexibility relative to the dollar, as some monetary authorities sought to dampen or prevent movements of their exchange rates against the dollar while others did not intervene at all. The United States did not intervene in foreign exchange markets during the second half of 2003.

Western Hemisphere

Interest rate spreads between the Latin American component of the JPMorgan Emerging Markets Bond Index (EMBI+) and U.S. Treasury securities continued their downward trend, falling from 662 basis points at the end of June 2003 to 518 basis points by year end. The Latin American economies appear to be undergoing a recovery, with regional real GDP growth estimated at around 1.5% in 2003. The region's current account turned to an estimated surplus of 0.2% of GDP in 2003. Canada's economy slowed in 2003 with real GDP growth of 1.7%, while its current account remained relatively unchanged at a surplus of 2.1% of GDP.

Argentina

Argentina abandoned its convertibility law, which pegged the peso one-to-one with the U.S. dollar, at the end of 2001 and has had a flexible exchange rate since that time. Argentina's currency remained relatively steady in the second half of 2003, depreciating 4% from 2.81 pesos per dollar to 2.93 pesos per dollar. Argentina's trade surplus was $7.2 billion in the second half of 2003, with the value of exports rising 12% and the value of imports rising 68% compared with the same period the previous year. Argentina's bilateral trade surplus with the United States was $226 million during the second half of 2003. Argentina's gross foreign exchange reserves grew $1.9 billion during the second half of the year to $14.1 billion at the end of December as Argentina purchased foreign currency during periods of peso strengthening to rebuild reserves. The economic recovery continued after the severe contraction in the first half of 2002, with real GDP growing at an annual rate of over 10% in the fourth quarter of 2003. Consumer prices were nearly stable, with an increase of 1.6% from end-June 2003 to end-December 2003.

Brazil

Brazil has a floating exchange rate regime and relies on inflation targeting to guide monetary policy. Following a 35% nominal depreciation in 2002, and a 24% nominal appreciation in the first half of 2003, the *real* depreciated 2% in the second half of 2003 and ended the year at BRL2.89/US$. Market sentiment continued to improve and Brazil's sovereign risk, as measured by the Brazilian component of the EMBI+, declined 325 basis points in the second half of the year to 463 basis points over U.S. Treasuries at year-end. Monetary tightening in the fourth quarter of 2002 and the first half of 2003 helped lower inflation in the second half of 2003; year on year inflation through December fell to 9.3% from 16.7% in June. However, full year inflation of 9.3% exceeded the revised inflation target of 8.5%. The Central Bank began to ease monetary policy in the second half of 2003, cutting the monetary policy interest rate by 10 percentage points from June through December to 16.5%. Brazil registered a seasonally adjusted current account surplus of $3.14 billion (1.1% of GDP) for the second half of the year following a $862 million (0.4% of GDP) surplus in the first half of the year. The 2003 full-year current account surplus of $4.0 billion (0.8% of GDP) was driven by a $24.8 billion merchandise trade surplus. This performance compares with a $7.7 billion (1.6% of GDP) current account deficit and a $13.1 billion merchandise trade surplus in 2002. Brazil's bilateral merchandise trade surplus with the United States for the second half of the year was $3.4 billion. The Central Bank increased international reserves (net of IMF disbursements) to $17.4 billion at year-end from $14.6 billion in June 2003 and $14.2 billion at year-end 2002.

Canada

Canada has a flexible exchange rate regime and has not intervened in the foreign exchange market since 1998, except to make a small contribution to the brief G-7 intervention in support of the euro in September 2000. During the second half of 2003 the Canadian dollar appreciated 4.9% from 1.36 C$/US$ to 1.29 C$/US. The J.P. Morgan trade-weighted real effective exchange rate for Canada appreciated 1.1%. During this time, Canada ran a current account surplus of 2.4% of GDP. The United States ran a US$28.6 billion bilateral merchandise trade deficit with

Canada during the second half of 2003. Economic conditions remained soft in the middle of 2003, but accelerated to 3.8% (saar) growth in the fourth quarter.

Mexico

Mexico has a flexible exchange rate and targets inflation at 3% with +/-1% band. The Bank of Mexico also follows a rule-based mechanism whereby half of the foreign reserves acquired in the previous quarter are auctioned in the foreign exchange market. During the second half of 2003 the Mexican peso depreciated 6.9% from 10.46 pesos/dollar to 11.23 pesos/dollar. The J.P. Morgan trade-weighted nominal effective exchange rate depreciated 7.8%, and the J.P. Morgan trade-weighted real effective exchange rate depreciated 4.4%. During this time, Mexico's current account deficit was 1.3% of GDP. Mexico's bilateral merchandise trade surplus with the United States was $19.6 billion during the second half of 2003. International reserves grew $3.2 billion during the second half of the year, reaching $56.1 billion by year-end. Economic conditions strengthened during this period with real GDP growing at an annual rate of 2.1% between the first and second half of 2003 compared with the 0.5% growth between the second half of 2002 and the first half of 2003.

Europe and Eurasia

The European Monetary Union

The euro appreciated 9.5% against the dollar in the second half of 2003 although, according to the Eurostat index, the real effective exchange rate appreciated only 2.0%. The European Central Bank did not intervene in exchange markets during this period.

The countries in the Euro-zone as a whole had a current account surplus during the second half of 2003 equal to $26 billion (sa), or 0.6% of GDP, up from $6.8 billion, or 0.2% of GDP, in the first half of 2003. Goods exports increased 1.4% in the second half of 2003 from the first half of 2003, and goods imports fell 0.6%. For the year, the surplus was 0.4% of GDP. The strong euro appeared to moderate the increase in the current account surplus in fourth quarter of 2003. The trade surplus of the Euro-zone vis-à-vis the U.S. was relatively constant at $31.4 billion in the first half of 2003 and $32.2 billion in the second half.

Euro-zone growth was an estimated 0.6% in 2003. The largest economies have been a drag on overall Euro-zone growth. Growth was strongest in the area of government consumption, as private consumption growth remained at 1%. Year-end inflation was 2.0% (yoy), near the ECB's 2% ceiling.

Central Europe

After exhibiting nominal weakness against the dollar in the first half of 2003, the currencies of the major Central European economies appreciated in the second half of the year. However, several currencies continued to exhibit nominal weakness against the euro (the most important currency for trade) and saw a decline in their respective trade-weighted real exchange rates.

In Poland and the Czech Republic, continued large budget deficits and declining export competitiveness contributed to currency weakness. Despite the nominal appreciation against the dollar, the zloty and the koruna depreciated 5.5% and 2.6%, respectively against the euro. In Hungary, the forint strengthened both in nominal (12% against the dollar and 1.5% against the euro) and real trade-weighted (2.3%) terms as the National Bank raised interest rates by 6 percentage points.

In Slovakia, the koruna appreciated 0.2% against the euro in nominal and 7.4% in real terms. Separately, the Bulgarian lev continued to appreciate against the dollar as its value was fixed to the euro as part of Bulgaria's successful currency board arrangement.

Russia

The trend of large net inflows of foreign exchange resulting from high oil prices and high foreign borrowing by Russian corporations witnessed in the first half of 2003 continued during the second half. Russia's current account surplus in the second half of 2003 was 6.7% of GDP ($15.3 billion) compared with 10.0% in the first half ($20.5 billion). This led to a 3.1% appreciation of the ruble against the U.S. dollar in July-December compared to a 5.3% appreciation in January-June. The Russian monetary authorities intervened to moderate the appreciation of the ruble against the dollar, and foreign exchange reserves increased $12.5 billion to a record high of $76.9 billion.

Africa

Nearly all major currencies in Africa appreciated against the U.S. dollar on a nominal basis during the second half of 2003. The South African rand posted the largest gain, appreciating 12.1%, as a result of favorable interest rate differentials, strong commodity prices, sound economic fundamentals, and improved investor sentiment toward emerging markets in general. The currencies of the CFA zone also strengthened against the dollar, in line with the euro, to which these currencies are pegged. The Zimbabwe dollar was the continent's weakest performer, reflecting the country's severe economic crisis.

Real GDP growth in Africa rose to 3.8% in 2003 from 3.5% in 2002. The continent's overall current account deficit narrowed slightly to 0.5% of GDP in 2003, though a number of sub-Saharan countries experienced much larger deficits. Net capital inflows, including from private sources, increased, leading to a $13.3 billion increase in foreign exchange reserves. North Africa accounted for two-thirds of this reserve accumulation, due mainly to higher oil prices.

Middle East and South Asia

Growth in the Middle East and South Asia was robust in 2003, supported by high oil prices and a quick resolution of economic uncertainties stemming from the conflict in Iraq. Oil exporting countries accounted for much of the growth, although non-oil exporting countries also experienced modest growth. With the substantial increase in the average oil price and export production volume for 2003 relative to 2002, current account surpluses skyrocketed in the oil exporting nations. Saudi Arabia's current account surplus, for example, more than doubled from

2002 to 2003 to reach close to 13% of GDP. The majority of countries in the region maintain pegged exchange rate regimes, with many, including the Gulf Cooperation Council countries, explicitly tying their currencies to the dollar.

The Indian rupee appreciated 1.9% in nominal terms against the dollar and 1.3% on a real trade-weighted basis in the second half of 2003. India's overall economy grew by an estimated 8.1% in 2003, compared to 4.2% in 2002, while inflation remained low at 5.4%. Despite a significant trade deficit, the current account showed a small surplus of $1.7 billion (0.4% of GDP) in the first three quarters of 2003, due to robust services earnings and transfers, compared to a surplus of $4.3 billion (1.3% of GDP) during the same period in 2002. The U.S. bilateral merchandise trade deficit with India for the second half of 2003 totaled approximately $4 billion – matching the trade deficit for the first half of the year. Foreign exchange reserves continued to increase. Foreign exchange reserves were $96.5 billion at the end of 2003, up from $78.2 billion at the end of June 2003. Indian authorities have also taken a number of steps to reduce upward pressures on the currency. In February 2004, Reserve Bank controls on capital outflows were loosened to allow resident individuals to invest up to $25,000 per year abroad without prior approval. Authorities also used growing reserves to prepay over $3 billion in external debt in 2003.

Turkey and Israel have flexible exchange rates. The Turkish lira was relatively flat between the end of June 2003 and the end of December 2003, but appreciated 17.9% in nominal terms against the U.S. dollar and 6.4% in real trade-weighted terms in 2003, due primarily to large capital inflows as confidence in the government's economic program increased. Real GNP grew 5.9% in 2003, and inflation fell to 18.4% from 29.7% in 2002. The current account deficit in 2003 increased to 2.9% of GNP from 0.8% of GNP in 2002, with the strong real appreciation of the Lira helping import growth in intermediate and capital goods outpace strong export growth. Gross foreign exchange reserves grew $4.5 billion in the last six months of 2003, reaching $33.6 billion by end-December (or 79% of short-term external debt, residual maturity basis) as the lira's strength gave the central bank an opportunity to build up reserves.

The Israeli shekel was relatively stable against the dollar in nominal terms, but depreciated 5.8% in real trade-weighted terms, during the second half of 2003, following 8.9% nominal dollar and 1.9% real trade-weighted appreciation in the first half of the year. GDP in Israel grew only 1.2% in 2003, following a slight contraction in 2002. Meanwhile, prices contracted 1.9%. Foreign exchange reserves climbed steadily in the same period, up 4.9% to $25.6 billion by end-December (or 88.6% of short-term external debt) from $24.4 billion at end-June. The increase in reserves was largely a result of an improved current account position and the issuance of dollar-denominated bonds guaranteed by the U.S government. The current account ended the year nearly balanced for the first time since 1990.

The Egyptian pound depreciated 23% in nominal terms against the dollar from January to June 2003, following the Egyptian government's announcement that the pound would float. The pound has remained close to LE6.2/$ since June. The differential between the official and parallel market rates reported in the press widened by 10 percentage points to approximately 15% by year-end. The current account surplus continued to expand during the second half of 2003, reaching 1.9% of GDP in the third quarter compared to 0.1% in the same quarter the year before. The growing current account surplus was due to a strong upswing in tourism receipts and the narrowing of the trade deficit, which resulted from increased oil and gas revenues and the depreciation of the Egyptian pound.

East Asia

After a sluggish start at the beginning of 2003, East Asian GDP growth accelerated sharply in the latter half of 2003. Several factors were behind the ratcheting up of growth rates. The economic impact of SARS proved to be short-lived, and affected economies rebounded in the second half. The quick resolution of oil market uncertainties stemming from the conflict in Iraq also raised confidence in the economic outlook. Finally, strengthened external demand, principally from the United States and China, bolstered growth throughout the region.

These factors have also led to increased current account surpluses and foreign direct investment inflows into East Asia. This has been most striking in Korea and Thailand. But the greater effect on flows in the foreign exchange market have come from a sharp rise in net portfolio capital inflows – especially into China and Japan, as well as Korea and Taiwan. Portfolio capital inflows have been lured by and fueled equity market rallies in the region, but they also reflected expectations of exchange rate appreciation in selected economies.

Monetary authorities in these economies intervened, purchasing foreign exchange, in order to limit upward pressure on their currencies, often citing speculative capital inflows and, in Japan and Taiwan, concerns about deflation. Intervention did not prevent appreciation in several economies over the review period.

Trade flows among East Asian economies have increased sharply in recent years, reflecting increased integration of economies in the region. But increased intra-regional trade also reflects the increasing diffusion of component production among economies in the region, often for products that are exported outside East Asia. As a result, monetary authorities appear to be increasingly concerned about the effect of currency appreciation on their competitiveness relative to other economies in East Asia. While noting these concerns, the Administration has encouraged increased exchange rate flexibility for East Asian economies generally, both in bilateral discussions and in regional fora such as APEC.

Japan

Japan's economic recovery, which began in the second quarter of 2002, gathered momentum in 2003. GDP grew 2.7% in 2003, and at an annual rate of 6.4% in the fourth quarter. In the second half of 2003, personal spending picked up slightly, and business investment grew strongly (notably in the fourth quarter). Net exports played an important role in the recovery, both directly, and through increased investment in many export industries.

Japan's current account surplus grew to $75.5 billion (3.4% of GDP) in the second half of 2003, up from $62.8 billion (3.0% of GDP) in the first half. Japan's bilateral merchandise trade surplus with the United States was $33.8 billion in the second half of 2003, up from $32.2 billion in the first half of 2003, but below its level a year earlier ($36.8 billion in the second half of 2002).

The persistent Japanese global current account surplus reflects the high rate of Japanese domestic saving relative to domestic investment, and the transition of Japan from being one of the fastest growing economies in the industrial world to one of the slowest. Slower growth over a longer period has meant lower investment, and the share of private investment in GDP has fallen from 26% in the 1960s, to 22% in the 1980s, to 19% in the last 3 years. Notwithstanding a decline in personal saving to cushion consumption in the downturn and in view of the aging of the economy, excess private saving has been partially absorbed by larger government deficits and by persistent capital exports to the rest of the world.

A net outflow of private capital throughout 2002 and in the beginning of 2003 partially offset Japan's current account surplus. But, starting in May 2003, net private capital moved into Japan in large amounts, with particularly large flows at the end of the year and into 2004. Two factors were behind this shift. The first was large foreign flows into the Japanese equity market, as the recovery increased confidence in Japan's near-term prospects. The second was sales of foreign bond holdings by Japanese residents after the rise in Japanese domestic interest rates in the summer of 2003. Expectation of yen appreciation may have also added to net capital inflows.

During the June 30 to December 31 reporting period, the yen appreciated by 11.9% against the dollar, from ¥119.9 to ¥107.1. The yen appreciated nearly 5% in the week of September 15-22 around the time of the meeting of G7 finance ministers and central bank governors in Dubai and then appreciated gradually during the remainder of the reporting period.

So far in 2004 the exchange rate between the yen and the dollar has swung broadly, against the backdrop of strong capital inflows into Japan and large official Japanese intervention. On balance, the dollar continued to depreciate against the yen through the first months of 2004, reaching ¥104.2 at the end of March. Looked at over a slightly longer period, the dollar – as measured by the Federal Reserve's broad trade-weighed index – reached its peak in late February, 2002. Since then through the end of March, 2004, the dollar has depreciated by 22.6% against the yen, in line with its 24.4% depreciation against the major currency component of the index over the same period.

Japanese authorities continued to intervene in the foreign exchange market in the second half of 2003. Intervention totaled $60 billion in the first half of 2003, and $119 billion in the second half[3]. Japan's foreign exchange reserves grew by 24% to $652.8 billion at the end of December, up from $526.6 billion at the end of June 2003 and $451.5 billion at end-December 2002.

The Japanese foreign exchange intervention came at the same time as a shift in monetary policy toward more rapid growth in base money in order to overcome persistent Japanese deflation. The provision of yen in the course of foreign exchange intervention has been an important component of monetary base growth, as it has been only partially absorbed ("sterilized") by the sale of government securities. This shift in monetary policy has had some success, with yearly average consumer price deflation moderating to -0.3% in 2003 from -0.9% in 2002.

[3] Published Japanese Ministry of Finance data on intervention in all currencies converted to dollars with exchange rates as published in Federal Reserve Release H10.

Even though the dollar-yen foreign exchange market is huge, with transactions estimated at $230 billion per day, the scale of Japanese intervention has been extremely large. Japanese authorities have stated that their "intervention is carried out when excess volatility or over-shooting is observed in the markets," and that they do not target particular values of the exchange rate.

The Treasury is actively engaged in discussions with Japanese authorities on these issues, both bilaterally and through the meetings of the G-7 finance ministers and central bank governors. At the G-7 meetings in Dubai and more recently in Boca Raton, the Treasury worked with the G-7 to promote a strong consensus in support of flexible exchange rates. Japan joined the United States and other G-7 nations in these declarations.

China

In the second half of 2003, China's overall trade surplus (not seasonally adjusted) was $21 billion (2.6% of GDP), compared with $17 billion (2.5% of GDP) a year earlier. China's overall trade account turned from surplus in 2003 to a deficit in January-February 2004 of $8 billion. China's bilateral merchandise trade surplus with the United States grew to $70 billion in the second half of 2003, up from $60 billion in the second half of 2002.

More than half of China's exports come from foreign-funded operations in China, many Asian-owned. Exports to the U.S. from other Asian economies are increasingly routed through China for final assembly and processing before shipment from Chinese ports. In the last three years, as the U.S. trade deficit with China has increased, the U.S. trade deficit with the other emerging economies of East Asia has fallen.

Given the Chinese exchange rate peg, balance of payments inflows into China are absorbed by the Chinese central bank and reflected in an increase in Chinese reserves. China's official foreign exchange reserves grew by a net $57 billion during the last half of 2003, or by 16% of end-June foreign exchange reserves, to reach $403 billion. Chinese authorities, however, transferred $45 billion of reserves in December to recapitalize two large state-owned financial institutions thereby reducing net reserve accumulation over the period. China's accumulation of foreign exchange reserves created monetary pressures that fueled domestic credit growth and inflation. China's real GDP officially increased 9.1% in 2003, with official fourth-quarter growth put at 9.9%. Rapid acceleration of China's import demand growth in 2003 reflects this rapid GDP growth and potential overheating and over-investment.

China maintains controls on capital flows, tariff and non-tariff trade barriers not yet addressed by WTO accession, and a variety of export incentive programs. These controls are largely asymmetrical, restricting outflows more than inflows, and hence provide upward pressure on the currency's value.

The renminbi remained pegged to the dollar throughout the reporting period and in the first three months of 2004 at 8.28 renminbi per dollar, the same rate that China has maintained since 1995. China's effective exchange rate, averaged across its trading partners, has moved with the dollar, depreciating by 3.9% in the last half of 2003, and by a further 0.3% in the first three months of this year. In real terms, the renminbi depreciated by 2.7% in the last half of 2003, but appreciated by 2.1% in the first quarter of this year.

Since 1994, when it unified its exchange rates and adopted its current pegged exchange rate system, the Chinese economy has grown rapidly, as has China's participation in world trade. A pegged exchange rate policy is not appropriate for a major economy in the global system such as China, and the Chinese government has indicated publicly and at senior levels that it will move to a flexible exchange rate regime. The Administration has urged China to move as soon as possible toward greater flexibility. President Bush, in his meeting with Premier Wen in December, raised the issue of China's exchange rate policy as well as liberalization of trade and capital markets. At the September 2003 G-7 meeting in Dubai, the ministers and central bank governors endorsed flexibility in exchange rates for large economies. This position was reiterated at the February 2004 G-7 meeting in Boca Raton. A regular series of talks between senior financial officials from the G-7 and senior financial officials from China has been established. During discussions last month with the Chinese central bank governor, Secretary Snow stressed that a flexible market-based exchange rate regime and reduced controls on capital flows are the best system for China and all major world economies. Secretary Snow will meet also with Vice Premier Huang Ju in Washington in the next few months on this topic.

The United States is actively assisting the transition to flexible rates. Treasury has appointed a senior financial expert to serve as Secretary Snow's emissary in Beijing. The financial expert will ensure close communications on exchange rate and other pressing financial issues. Under the leadership of the Secretary of the Treasury and the governor of the central bank of China, a technical cooperation program was launched last year. A Treasury-led delegation was in Beijing in February to discuss the creation of market mechanisms necessary for a flexible exchange rate regime. Among other subjects, techniques for supervision of banks' currency risk and for regulation of foreign exchange derivative markets under a flexible exchange rate regime were discussed.

China will need to lay the groundwork for a shift to a floating exchange rate. In this regard, China has taken many steps to prepare for a flexible exchange rate regime. It has liberalized FDI outflows, is preparing for renminbi trading in Hong Kong and has allowed insurance companies to invest a portion of their portfolio in foreign assets. China is also preparing to allow, within limits and through qualified institutions, investments in securities traded on foreign markets. China is also strengthening its financial architecture. China recapitalized two of its four largest state-owned financial institutions in December 2003 and has continued to write off non-performing loans in the banking system. It has introduced new regulations to allow banks to raise capital through subordinated debt, and it has announced measures to allow foreign banks a greater share in joint venture banks. In addition, in December the central bank announced measures to liberalize certain domestic interest rates.

Treasury will continue its efforts to encourage and assist China to move as soon as possible to a flexible exchange rate regime.

Korea

After contracting in the first half of 2003, the Korean economy rebounded in the second half of last year. Real GDP increased at a 6.7% annual rate in the third quarter and an 11.4% annual rate in the fourth quarter. The first half slowdown was due to both contracting domestic demand and slowing external sales; the second half rebound was the result of strong export growth, up 21% over the same period in 2002.

Korea's current account surplus increased to $11.4 billion (3. 8% of GDP) in the second half of 2003, up from $0.9 billion (0. 2% of GDP) in the first six months of 2003 and $2.4 billion (1.0% of GDP) in the last half of 2002. The U.S. bilateral trade deficit with Korea rose to $7.5 billion in the second half of 2003, up from $6.9 billion in the same period of 2002. Net portfolio capital inflows also increased sharply, to $15.3 billion in the second half, compared to $2.7 billion in the first half and $0.7 billion for all of 2002. Much of this inflow went into the Korean stock market, where the broad share price index increased by 31% over the course of the year and 21% in the last half alone.

Korean authorities intervened to counter upward pressure on the won exchange rate over the course of the year. Official foreign reserves increased by $23.6 billion in the second half of 2003, and by $33.7 billion for the year as a whole, to reach $154.5 billion by end-December (or more than three times short-term external debt). Reserves have increased another $8.2 billion through end-March 2004.

The nominal dollar/won rate ended 2003 essentially unchanged from a year earlier; although over the course of 2003 the rate fluctuated over a range of 8%. On a real trade-weighted basis, the won depreciated 0.5% during 2003. In the first three months of 2004 the won has appreciated by 4.0% vis-à-vis the US dollar. Over the past five years the won has been more stable against the Japanese yen than against the dollar, suggesting that the authorities may be more concerned with Korea's competitiveness with Japan than with the United States.

Taiwan

After contracting by 0.5% at an annualized, seasonally adjusted rate in the first half of 2003, Taiwan's economy rebounded by 10.2% in the second half. This GDP growth was driven by export growth and a strong recovery in household consumption and business investment.

Total foreign exchange reserves increased by nearly $30 billion in the second half of 2003, twice the amount of first half reserve growth, to reach $207 billion (almost five times short-term external debt). Rapid reserve growth has continued through the first three months of 2004, with an almost $20 billion increase. The current account surplus in the second half of 2003 was 10% of GDP (or $14.2 billion), a proportion that has remained relatively constant for the last two years. Taiwan's bilateral trade surplus with the United States decreased from $7.3 billion in the first half of 2003 to $6.8 billion in the second half of 2003. The increase in Taiwan's balance-of-payments position in the second half, which in turn fueled the reserve growth, was primarily due to the strong financial inflows, including a net portfolio inflow of $7.4 billion in the second half of 2003 compared with net outflows of $12.6 billion in the first half of 2003. This turnaround followed a decision by the Taiwan government in July to scrap a rule restricting foreign fund investments in Taiwanese shares to $3 billion per fund, and very large net inflows occurred in the third quarter of 2003.

Taiwan has been in deflation since the third quarter of 2001, and prices in June 2003 were about 0.5% lower than the previous year. Despite falling prices, the authorities let base money contract into mid-2002, before reversing course to provide for growth in the monetary base. Money base growth continued during the last half of 2003 and into this year, and by early 2004 prices had begun to rise again. Foreign exchange intervention, not fully sterilized, provided growth of base money during the last half of 2003 and into 2004.

Deflation abated, but continued during the reporting period, with consumer prices declining 0.1% in December 2003 compared to the previous year versus 0.5% year over year in June. Taiwan continues to pursue an easy money policy. Narrow money grew 21%, year-on-year, in 2003, and much of the growth was in the second half as a result of reserve accumulation.

While the Taiwanese central bank maintains that "the NT dollar exchange rate is in principle determined by market forces", the bank also notes that it will respond to "excessive volatility" in order to maintain the "dynamic stability of the NT dollar exchange rate." The nominal Taiwan dollar vs. U.S. dollar exchange rate appreciated 1.8% in the second half of 2003 after appreciating a slight 0.3% in the first half of 2003. In the first three months of 2004, the Taiwan dollar has appreciated by a further 3.0% vs. the dollar. According to JP Morgan's real trade-weighted index, the Taiwan dollar declined 0.8% during the second half of 2003.

Malaysia

Malaysia's economy grew 5.2% in 2003 (after growing 4.1% in 2002), with growth accelerating to an annual rate of almost 8% in the second half, as personal spending picked up and investment growth turned positive. The external contribution to Malaysian growth was negative in the last half, due to strong growth in imports.

The current account surplus decreased slightly to 12.2% of GDP in the second half of 2003 from 12.3% in the first half (and 9.6% in the second half of 2002). Malaysia's bilateral trade surplus with the United States increased, to $7.9 billion in the second half of 2003, up from $7.7 billion in the same period in 2002.

Malaysia has maintained a fixed peg to the dollar since September 1998, when it also expanded capital controls. Controls on capital flows have since been relaxed, but offshore trading of the ringgit remains prohibited, and foreign portfolio investment by residents continues to be restricted. The ringgit depreciated 3.2% over the second half of 2003 on a real trade-weighted basis, as measured by the JP Morgan index. At the end of December, reserves stood at $44.9 billion, about five times short-term external debt, up from $37.1 billion at end-June 2003.