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Report to Congress on International Economic and Exchange Rate Policies

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

This report reviews the effects that significant international economic developments have had on the United States and foreign economies and evaluates the factors that underlie those developments. For the specific purpose of assessing whether an economy is manipulating the rate of exchange between its currency and the U.S. dollar according to the terms of the Act, Treasury has traditionally undertaken a careful review of the trading partner's exchange rates, external balances, foreign exchange reserve accumulation, macroeconomic trends, monetary and financial developments, the state of institutional development, and financial and exchange restrictions. Attention is given to both the changes and interactions of significant variables. Isolated developments in any one area do not typically provide sufficient grounds to conclude that exchange rates are being manipulated under the terms of the Act. A combination of factors, on the other hand, can and has in the past led Treasury to find that certain countries had satisfied the terms of the 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) Sub-Saharan Africa, (4) North Africa, 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, Ecuador 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 first half of 2004. 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 communiqués of the G-7 Finance Ministers and Central Bank Governors in February, April and October 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[1]

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.

The growth of the U.S. current account deficit over more than a decade has been linked to high levels of domestic U.S. capital formation compared to domestic U.S. saving. Perceived high rates of return on U.S. assets, based on sustained strong productivity growth relative to the rest of the world, attract foreign investment.

In the first half of 2004, for example, the U.S. current account deficit was $594 billion (at a seasonally adjusted annual rate and on a national income and product accounting, or NIPA, basis) or 5.1 percent of GDP. This $594 billion deficit equaled the gap between $2,246 billion in investment and $1,652 billion in saving[2]. That is, U.S. domestic investment was $594 billion more than domestic saving with net foreign investment making up the difference.

Overall, rapid growth in real GDP over the latter part of 2003 extended into the first quarter of 2004 when real GDP rose at a strong 4.5 percent annual rate. That was followed by a softening in the second quarter, with real GDP rising at a 3.3 percent pace, leaving growth in the first half, however, at a solid 3.9 percent annual rate. The second-quarter slowdown was concentrated in personal consumption expenditures, inventory investment and net exports. In contrast, business fixed investment strengthened considerably in the second quarter, rising at a 12.5 percent pace following a 4.2 percent increase in the first quarter, supported by growing profits and a profit margin that has been holding near a six-year high.

The current account was $627 billion in deficit (at a seasonally adjusted annual rate and on a balance of payments basis[3]) in the first half of 2004. A major item financing the current account deficit has been net private foreign purchases of U.S. securities, which reached an annualized $503 billion in the first half of 2004. (Included in these were net private foreign purchases of U.S. Treasury securities amounting to $202 billion.) In addition, foreign official institutions increased their U.S. assets by $403 billion.

Viewed over a longer period, the U.S. current account balance declined, as a percent of GDP, from a 1 percent surplus in the first quarter of 1991 to a 4 percent deficit in the fourth quarter of 2000, to a 5 percent deficit in the first half of 2004.

Due to the current account deficit the net investment position of the United States (with direct investment valued at the current stock market value of owners' equity) fell to a negative $2.7 trillion as of December 31, 2003, the latest date for which data are available, from a negative $2.6 trillion at the end of 2002. A $398 billion valuation adjustment due to exchange rate changes offset much of 2003's financial outflow. Despite a large negative position, U.S. residents earned $39 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. current account deficit is the counterpart of the aggregate surplus of other economies in the world. The policies of all countries affect the global pattern of current account balances. It is important that policies that the United States follows to reduce global imbalances keep the United States and the world economy strong. There are three types of economic policies that the Bush Administration is pursuing and will continue to pursue which relate directly to the current account. First are policies aimed at increasing saving of the public sector and the private sector as the U.S. economy continues to expand. A second group of economic policies are those that will raise global growth. A third area of policy relates to exchange rate flexibility for certain Asian economies that lack such flexibility.

The U.S. Dollar

The Federal Reserve Board's "broad" nominal dollar index increased 2.2 percent during the first half of 2004. The dollar rose 2.9 percent against the "major" foreign currencies (seven other industrialized economy currencies) while rising 1.4 percent against "other important trading partners" (largely currencies of emerging market economies). The broad index declined 11.0 percent from February 27, 2002, when it reached its recent peak, through June 30, 2004. Over this latter period the dollar depreciated 22.6 percent against the major currencies while appreciating 5.8 percent against the currencies of other important trading partners.

Over the year ending in June 2004, the consumer price index rose 3.3 percent, the largest 12-month increase since mid-2001. Energy prices were a primary factor, up 17.0 percent over the year ending in June. The core CPI (excluding food and energy) increased 1.9 percent over the twelve months through June 2004 compared to 1.1 percent in the twelve months through December 2003, the latter being the smallest increase in core consumer prices since 1966. The Fed increased the federal funds target rate by 25 basis points to 1.25 percent at the end of June from the 1 percent where it had been held for the preceding 12 months. There were additional 25-basis point increases in August, September and November.

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 first half of 2004.

Western Hemisphere

Nominal exchange rates in the region on average depreciated against the U.S. dollar in the first half of the year. Interest rate spreads between the Latin American Emerging Market Bond Index (EMBI+) and U.S. Treasury securities increased from 518 basis points at the end of 2003 to 600 basis points by end June. The region's growth outlook remains positive for 2004, with the major economies posting solid growth rates in the first half of the year.

Argentina

Argentina has had a flexible exchange rate since the end of 2001 when it abandoned its convertibility law, which pegged the peso one-to-one with the U.S. dollar. Argentina's currency remained relatively steady in the first half of 2004, depreciating 1.0 percent from 2.93 pesos per dollar to 2.96 pesos per dollar. Argentina's trade surplus was $5.9 billion in the first half of 2004, compared with

$8.3 billion for the same period the previous year, with exports rising 13 percent and imports rising 71 percent. The seasonally adjusted current account surplus narrowed to 2.1 percent in the first half of 2004 compared to 7.5 percent in the first half of 2003. Argentina's gross foreign exchange reserves grew by $3.3 billion during the first half of the year to $17.4 billion at the end of June 2004 as Argentina intervened during periods of peso strengthening in order to rebuild reserves. The economic recovery continued after the severe contraction in the first half of 2002, with real GDP growing 6.7 percent at a seasonally adjusted annualized rate in the first half of 2004 over the second half of 2003. Consumer prices accelerated somewhat, with the year-on-year increase reaching 4.8 percent in June 2004 compared with 3.8 percent in December 2003. Conditions in the banking system continued to improve. Interest rates on saving deposits of 30-44 day maturities fell from 3.6 percent at end-December 2003 to 2.4 percent as of end-June 2004.

Brazil

Brazil has a floating exchange rate regime and relies on inflation targeting to guide monetary policy. Following a 22 percent nominal appreciation in 2003, the *real* depreciated 6.3 percent in the first half of the year to BRL3.08/US$. Brazil's sovereign risk spread stood at 646 basis points over U.S. Treasuries at end-June 2004 versus 463 basis points at the end of 2003. Year-on-year inflation stood at 6.0 percent in June, slightly above the center of the central bank's 5.5 percent target for 2004 but within the target band. Brazil had seasonally adjusted current account surpluses of 1.2 percent and 2.2 percent of GDP in the first and second quarters of 2004, respectively. The United States had a bilateral trade deficit with Brazil of $2.4 billion in the first half of 2004 compared to a $3.3 billion deficit during the same period in 2003. Foreign direct investment inflows grew in the first half of the year to $4.0 billion compared with $3.5 billion during the same period in 2003. Net international reserves increased to $25 billion at the end of June 2004 compared to $20.5 billion at the end of December 2003, in part due to central bank purchases of foreign exchange. The economic recovery continued in the first half of the year with annualized GDP growth rates of 7.5 percent and 5.5 percent in the first and second quarters, respectively.

Canada

Canada has a floating exchange rate regime. It has not intervened in the foreign exchange market since 1998, except to make a small contribution to the brief G-7 intervention in support of the euro in September 2000. During the first half of 2004 the Canadian dollar depreciated 3.6 percent, from 0.77 US$/C$ to 0.75 US$/C$. The J.P. Morgan trade-weighted index for the real exchange rate for Canada depreciated 5.6 percent while the J.P. Morgan trade-weighted index for the nominal exchange rate for Canada depreciated 3.2 percent. Canada's current account surpluses during the first and second quarters of 2004 were 2.6 percent and 3.5 percent of GDP, respectively. The merchandise trade surplus with the U.S. was $32.5 billion during the first half of 2004. Canada's international reserves declined by 2.3 percent in the first half of 2004 to $35.4 billion. M3 grew 8.1 percent year-on-year in June 2004 compared to 6.8 percent year-on-year in December 2003. Year-on-year headline inflation in June 2004 was 2.5 percent. The economy expanded in the first half of 2004, with annualized real GDP growth of 2.7 percent and 3.9 percent in the first and second quarters, respectively.

Mexico

Mexico has a floating exchange rate regime. Its central bank targets an inflation rate of 3 percent with a +/-1percent band. The Bank of Mexico also follows a transparent rule for selling foreign reserves accumulated by state enterprises. During the first half of 2004 the Mexican peso depreciated 2.6 percent, from 11.2 pesos/dollar to 11.5 pesos/dollar. J.P. Morgan's Narrow Nominal Effective Exchange Rate Index of the peso depreciated 1.0 percent while the J.P Morgan real effective index of the peso appreciated by 1.8 percent. Mexico's current account deficits during the first and second quarters of 2004 were 1.2 percent and 0.9 percent of GDP, respectively. The merchandise trade surplus with the U.S. was $22.3 billion during the first half of 2004. Foreign direct investment during the period was $11.0 billion, versus $6.8 billion in the comparable period in 2003.

International reserves grew $1.7 billion during the first half of the year, reaching $59.1 billion by the end of June. M3 grew 13.9 percent year-on-year in June 2004 compared with 13.6 percent year-on-year in December 2003. Year-on-year headline inflation was 4.4 percent in June. The economy grew robustly in the first six months of 2004, with real seasonally adjusted GDP increasing at annual rates of 5.5 percent and 4.5 percent during the first and second quarters, respectively.

Europe and Eurasia

The European Monetary Union

The euro depreciated 3.3 percent against the dollar in the first half of 2004. The real effective exchange rate depreciated 2.0 percent over the period. The ECB did not intervene in foreign exchange markets during the first half of 2004.

The countries in the Euro-zone taken together had a current account surplus during the first half of 2004 equal to $41.1 billion (sa) or 0.9 percent of GDP, up from $7.2 billion and $20.5 billion in the first and second halves of 2003, respectively. Goods exports increased 8.0 percent while goods imports increased 4.6 percent in the first half of 2004 over the same period in 2003. The trade surplus of the Euro-zone vis-à-vis the U.S. was $35.2 billion, which is about the same level as in the second half of 2003.

Euro-zone growth was an estimated 2.3 percent (annualized) in the first half of 2004. Germany and Italy have held back Euro-zone growth, but France had annualized growth of 3.3 percent in the second quarter, led by strong domestic demand. For the region, final consumption expenditure rose 0.8 percent in the first half of 2004 while investment declined 0.1 percent. The harmonized consumer price index rose at an annual rate of 2.8 percent in the first half of 2004 while the index excluding energy, food, alcohol and tobacco rose 2.0 percent.

Central Europe

The currencies of the major central European economies weakened slightly against the dollar during the first half of 2004. This largely resulted from the dollar's appreciation against the euro. Each of the currencies strengthened against the euro, their main reference currency, supported by expectations of higher domestic interest rates.

In Hungary, shorter term yields of 11.0 percent helped the forint appreciate 3.5 percent against the euro (and decrease 0.4 percent against the dollar), despite continued concern about large fiscal and current account deficits. The National Bank of Hungary's index of the real value of the forint rose 7.8 percent during the first half due to higher inflation.

Expectations of upcoming interest rate increases also led to appreciation of the Polish zloty and the Czech koruna. The koruna appreciated 2.0 percent against the euro (a decrease of 1.6 percent against the dollar), while the zloty rose 3.8 percent against the euro during the first half of 2004 (a decrease of 0.2 percent against the dollar). The koruna was little changed in real terms, but the National Bank of Poland's index of the real zloty appreciated 7.6 percent.

In Slovakia, the koruna appreciated 3.0 percent against the euro (and decreased 0.2 percent against the dollar) supported by strong export growth and expectations of large FDI inflows. High inflation contributed to a real koruna appreciation of 6.6 percent. Separately, the Bulgarian lev weakened against the dollar as its value was fixed to the euro as part of Bulgaria's successful currency board arrangement.

Russia

The large net inflows resulting from high oil prices and high foreign borrowing by Russian corporations in 2003 continued during the first half of 2004. Russia's current account surplus in the first half of 2004 was $22.6 billion, or 8.1 percent of

GDP, compared to $17.4 billion, or 7.6 percent of GDP, in the second half of 2003. The ruble appreciated 0.6 percent against the U.S. dollar in the first half 2004 compared to 3.8 percent in the second half of 2003. According to the J.P. Morgan Broad Real Effective Exchange Rate Index, the ruble appreciated 6.0 percent in the first half of 2004 compared to 3.3 percent in the second half of 2003. The Russian monetary authorities continued to intervene to moderate the appreciation of the ruble against the dollar, and foreign exchange reserves increased $11.3 billion to a record high of $88.2 billion. M2 grew 40.4 percent in the year through June 2004 compared to 51.6 percent in the year through December 2003. Consumer prices rose 10.1 percent in the year through June 2004 compared to 12.0 percent in the year through December 2003.

Sub-Saharan Africa

Many African countries maintain pegged exchange rates. The currencies of the CFA zone depreciated against the dollar during the period, in line with the euro to which these currencies are pegged. Sub-Saharan African currencies with more flexible regimes saw their currencies generally appreciate against the U.S. dollar on a nominal basis in the first half of 2004. The South African rand, which is close to freely floating, continued to strengthen, appreciating by 9.2 percent on a nominal effective basis and 5.2 percent on a real effective basis. The rand has now appreciated by over 60 percent in real terms from lows reached in December 2001. This strength reflects unwinding of the undershooting in 2001, rising commodity prices, strong economic fundamentals, and improved investor sentiment toward emerging markets in general. In Zimbabwe, the introduction of new foreign exchange regulations including a managed foreign exchange auction, together with a government clampdown on parallel market activities, led to an appreciation of the Zimbabwe dollar in the early part of the year. Later in the period, in an effort to encourage exporters and overseas workers to remit foreign exchange earnings through formal channels, the government allowed the auction rate to depreciate. Nevertheless, the depreciation of the Zimbabwe dollar has not kept pace with inflation, which stood at 363 percent in the year to end-July.

Real GDP growth in sub-Saharan Africa is expected to rise to around 4 ½ percent in 2004 from 3 1/2 percent in 2003. This pickup in growth reflects improving macroeconomic stability in many countries, easing external debt burdens, large increases in oil production, higher global commodity prices, and improved security situations in several countries. Sub-Saharan Africa's overall current account deficit is projected to be 1.4 percent of GDP in 2004, compared to a deficit of 2.4 percent in 2003, due largely to higher oil and other commodity prices. Africa's trade surplus with the United States increased to $22.6 billion during the first three quarters of 2004, compared to $16.5 billion during the same period of 2003, due in large part to higher oil prices.

North Africa, the Middle East and South Asia

Growth continues to be very strong across the Middle East and North Africa, supported by record high oil prices. GDP in the oil-exporting countries of the Gulf Cooperation Council countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE), in particular, increased significantly. Current accounts across the Gulf remain largely in balance or surplus, and have increased significantly, along with holdings of official reserves, mainly due to higher oil prices. Oil-exporting GCC countries tie their currencies directly to the U.S. dollar.

Many other countries in the region, such as Jordan and the countries of North Africa, also maintain pegged exchange rate regimes. Egypt returned to a *de facto* peg after the Egyptian pound depreciated 23 percent in nominal terms in the six months following its official float in January 2003. In the first six months of 2004, the pound depreciated 0.7 percent in the official market, while at the same time very strong export receipts (primarily due to high oil export revenues, Suez Canal receipts, and a rebound in tourism) and a tightening of monetary policy helped the pound to appreciate nearly 10 percent on the black market, virtually eliminating the spread between the two rates. Net international reserves increased by $60 million to $14.8 billion during that period.

Turkey, however, maintains a floating exchange rate regime. The Turkish lira depreciated 5.5 percent in nominal terms against the U.S. dollar in the six months to June, but the lira's real trade-weighted value fell a more modest 2.2 percent. Real GNP in the first half of 2004 grew by 13.5 percent compared to the first half of 2003, a significant increase from the 5.9 percent growth rate recorded in 2003. Despite the strong growth, the inflation rate continued to decline, falling to 8.9 percent year-on-year in June 2004 from 18.4 percent in 2003. The current account deficit for the first half of 2004 widened to 4 percent of GNP from its 2.8 percent level in 2003 on the back of the strong domestic economy and consumer demand. In the first six months of 2004, imports and exports increased 47 percent and 32 percent, respectively, compared with the same period in 2003. Imports of capital and consumption goods grew by 84 percent and 109 percent, respectively, in the same period, but intermediate goods continue to account for 67 percent of imports. The growing current account deficit is still mostly financed through short-term capital inflows. As a result, gross foreign exchange reserves changed little to June 2004, continuing to hover around $33 billion compared to $33.6 billion at end-December 2003.

In Israel, which also maintains a floating exchange rate, the shekel depreciated during the first half of 2004, falling 2.7 percent against the dollar in nominal terms and 3.0 percent in real trade-weighted terms. This followed a 5.8 percent trade-weighted depreciation in the last half of the 2003. Foreign exchange reserves remained nearly unchanged at around $25.7 billion at end-June, as compared with the 4.9 percent growth in reserves in the second half of 2003. A weaker currency and rising demand in major export markets helped boost exports, and as a result GDP growth increased to 2.5 percent for the first half of 2004 compared to 1.2 percent for 2003 as a whole.

In South Asia, India targets a Real Effective Exchange Rate (REER) benchmark based on cross-border inflation differentials and currency movements. Although the Reserve Bank of India does not intervene to curtail short-term volatility relative to the U.S. dollar, the exchange rate has not been allowed to stray too far from its REER benchmark. The rupee depreciated by less than 1 percent in the first half of 2004. The U.S. bilateral merchandise trade deficit with India rose to $4.8 billion for the first half of 2004, compared to $4.1 billion for the first half of 2003. Foreign exchange reserves stood at $114.15 billion at the end of June, up from $96.5 billion at the end of 2003. Real GDP grew by 7.4 percent year-on-year in the second quarter of 2004.

East Asia

After picking up speed in the last half of 2003, East Asian GDP growth accelerated in the first quarter of 2004, fueled by buoyant export markets, the recovery of the global IT sector, and strong growth in domestic demand, most notably in China and Japan. Economic growth has been widespread across the economies of East Asia, increasing at the fastest rate since the 1997 financial crisis.

After a very strong first quarter, East Asian growth rates dropped off in the second quarter, particularly in Japan. Higher oil prices, and the expectation that they might persist for some time, were clearly part of the reason. But efforts to slow the growth of the Chinese economy also had an impact, since rapidly growing Chinese import demand had provided a major boost to growth throughout the region.

Rising interest rates in the United States; a sharp, although relatively brief, widening of emerging market spreads; and higher oil prices all appear to have reduced portfolio investment inflows to East Asia in the second quarter of 2004. As a result, monetary authorities that faced large foreign exchange inflows and upward pressures on their currencies in the second half of 2003 and first quarter of 2004 saw diminished inflows in the second quarter.

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. APEC Finance Ministers took a significant step in this direction in their statement of September 3, welcoming steps taken by member economies to facilitate the move to greater exchange rate flexibility.

Japan

Japan's economic recovery, which began in the second quarter of 2002, continued in the first half of 2004. Strong growth carried over into the first quarter but slowed markedly in the second quarter. Japan also made some progress in its long struggle to overcome deflation. In the first half of the year, consumer prices, excluding fresh food, declined at the rate of 0.1 percent year-over-year, compared to a deflation rate of about 0.6 percent a year ago. However, if the effect of higher oil prices and other special factors are excluded, underlying consumer price deflation appears to remain close to half a percent per year, and other measures of price change show greater and undiminished deflation.

As in past recoveries, exports have contributed to this recovery, with particularly strong growth of exports to China in this case. In the first half of 2004, exports grew by 6.5 percent and imports by 4.8 percent. Japan's global current account surplus grew to $88.9 billion (3.8 percent of GDP) in the first half of 2004, up from $75.8 billion (3.4 percent of GDP) in the second half of 2003. Japan's bilateral merchandise trade surplus with the United States totaled $36.2 billion in the first half, up from $33.8 billion in the second half of 2003.

However, private spending, notably private investment and consumer spending, has played an important role in this recovery, and contributed most of first half 2004 growth.[4] In contrast to past recoveries, expansionary fiscal policy has not contributed to output growth this time, as the government continues with its medium-term fiscal consolidation program. The persistent Japanese global current account surplus reflects the high rate of Japanese domestic saving relative to domestic investment. Despite the recent recovery of investment, expectations of slower trend growth have meant lower investment, and the share of private investment in GDP has fallen from 26 percent in the 1960s, to 22 percent in the 1980s, to 19 percent in the last three years. Rates of return on domestic investment have been generally low, although the Prime Minister's program of structural reform and deregulation and the recent acceleration of corporate restructuring and mergers and acquisition activity hold out the prospect of higher returns. Japan's surplus of private saving over private investment has been only partially absorbed by government deficits, leading to a persistent current account surplus and capital outflows to the rest of the world.

The Japanese recovery and the prospects of higher stock market prices led to large net portfolio capital inflows in Japan, starting in May 2003. These inflows strengthened over the course of 2003 and into the first quarter of 2004. Expectations of yen appreciation also contributed to first quarter 2004 inflows. International Monetary Market (IMM) data on short and long futures positions show that market expectations of an appreciation of the yen were particularly strong at the beginning of 2004. This net portfolio capital inflow slowed and then reversed in the second quarter in response to changing expectations of U.S. growth relative to Japanese growth and higher U.S. interest rates. About one-third of the net capital inflows during the first quarter were subsequently reversed in the second quarter. Following the end of the Japanese fiscal year March 30, pension fund reinvestment overseas surged in April and May. Japanese investors also began diversifying into overseas equities and shifted funds into U.S. bonds.

During the December 31, 2003 to June 30, 2004 reporting period, the yen depreciated 2.1 percent against the dollar, and 2.7 percent on a real trade-weighted basis, as measured by the J.P. Morgan Broad Real Effective Exchange Rate index. The yen appreciated by 2.8 percent to ¥104.2 during the first quarter, a period in which its value fluctuated fairly widely.[5] The yen subsequently weakened by 4.8 percent during the second quarter. Over a more extended period, since late

February 2002 through the end of June 2004, the dollar has depreciated by 18.7 percent against the yen, similar to its 22.6 percent depreciation against the major currency component of the index over the same period. Since June 30, the yen has traded more narrowly against the dollar, ending October at ¥106.04, or 3.2 percent stronger than at end-June.

Japanese authorities intervened in the foreign exchange market during the first quarter of 2004, with yen sales totaling approximately $138 billion. Japanese authorities publicly report their foreign exchange market intervention at the end of each month, and have not reported any intervention since March 16, 2004. 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 G-7 meetings in Dubai, Boca Raton and more recently Washington, 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

China's economic growth rate accelerated in 2003 and into the first half of 2004, with particularly rapid growth in investment. The officially reported growth figure for 2003 was 9.3 percent, but estimates based on expenditure suggest that growth in 2003 was over 11 percent. This led to bottlenecks in several sectors and rising prices. Macroeconomic policy during 2004 has primarily been directed at slowing credit and investment growth in order to dampen inflationary pressures and assure sustained growth.

China's fixed exchange rate regime has made carrying out macroeconomic policy more difficult during this period. China's accumulation of foreign exchange reserves continues to create monetary pressures that have fueled domestic credit and investment growth and inflation. Chinese policymakers took administrative measures over the last year to curb lending, but, until October 2004, hesitated to raise domestic interest rates.

These macroeconomic policy measures have had some success in cooling off the economy. Recent data suggest that the growth of several economic indicators has moderated from the rapid pace of 2003. Industrial production, broad money growth, and total loan growth slowed during the third quarter of this year compared to the same period in 2003. Reported real GDP growth slowed to a year-over-year rate of 9.1 percent in the third quarter of this year, down from 9.7 percent in the first half. But the risk of an inflationary boom followed by the hard landing that has characterized past Chinese cycles remains. Fixed asset investment is still growing at a double digit pace. Moreover, headline consumer price inflation rose to 5.2 percent year-on-year in September 2004, compared to 1.2 percent year-on-year one year ago.

Reflecting strong import demand driven by investment growth, China's overall trade balance recorded a (seasonally unadjusted) deficit in the first half of 2004 of $7 billion (1.0 percent of GDP), compared to a $4 billion surplus in the same period in 2003. China's exports rose 36 percent in the first half of 2004 compared to the first half of 2003 on strong external demand. China's imports grew by 43 percent during the same period. China's import growth has been driven by its rapid economic growth and integration into the world trading system following accession to the World Trade Organization (WTO). Growth rates for both Chinese imports and exports have also been driven by increasing use of China as a locale for assembly and final processing for East Asian manufacturing components into products destined for other markets, often the United States. As a result of the latter factor, China's trade surplus with the United States has been much larger than its overall trade balance. China's bilateral surplus on trade in goods with the United States in the first half of 2004 reached

$68.5 billion compared to $53.9 billion in the comparable period of 2003.

China kept its fixed exchange rate of 8.28 renminbi to the U.S. dollar throughout the reporting period, a rate it has maintained since 1995, through periods of both upward and downward pressures on the balance of payments. Its real trade-weighted exchange rate, a more important determinate of competitiveness, has fluctuated considerably. With faster domestic inflation, the renminbi appreciated 3.0 percent in real trade-weighted terms, as measured by the J.P. Morgan Broad Real Effective Exchange Rate Index, in the first half of 2004.

China's official foreign exchange reserves grew by a net $67 billion to $471 billion during the first half of 2004.[6] This growth in Chinese reserves is the counterpart of China's current account balance and net financial and capital inflows to the nonofficial sector. Foreign direct investment inflows in the first nine months of 2004 were $48.7 billion, up 21 percent from the comparable period in 2003. As in 2003, net non-FDI financial inflows to the non-official sector continue to be large and positive in 2004, due mainly to a sharp increase in portfolio capital inflows reflecting investors' expectations of continued strong growth and possible change in the exchange rate regime.

The Administration has urged Chinese leaders to move as soon as possible to greater flexibility, and has initiated an unprecedented level of engagement with the Chinese government and other major trading partners of the United States to help bring this about. In September 2004, the Treasury held the 16th U.S.-China Joint Economic Committee (JEC) meeting in Washington to discuss progress on a broad range of economic and financial issues, including exchange rates and how greater flexibility would better enable China to conduct monetary policy. In the JEC Joint Statement, China strengthened its commitment to move to a market-based, flexible exchange rate. In early October, G-7 Finance Ministers and Central Bank Governors met for the first time as a group with their Chinese counterparts; China's exchange rate policy was an important component of the discussions.

The United States continues to work actively with China in identifying and overcoming impediments to greater exchange rate flexibility. Treasury held three sessions with Chinese officials in 2004 focused on the mechanics of a flexible currency regime, as part of its Technical Cooperation Program. In February, meetings dealt with assessing and supervising currency risk in banking systems and developing financial instruments to manage that risk. The session in June discussed banking supervision, credit analysis, international accounting standards, and resolution of non-performing loans. In September, Chinese central bank officials met with Treasury and other U.S. government agencies to discuss foreign reserve management and supervision and regulation of a currency derivatives market.

China has publicly stated its commitment to move to a flexible exchange rate regime. In September 2004, Chinese Premier Wen said China "will further advance the reform and forge a mechanism which is more adapted to the changes in market supply and demand, with still better flexibility." In the communiqué of the 16th U.S.-China Joint Economic Committee (JEC) meeting, China "reaffirmed its commitment to further advance reform and to push ahead firmly and steadily to a market-based flexible exchange rate." Governor Zhou of China's central bank has referred to the movement to a flexible exchange rate as a top priority issue for China.

China is laying the groundwork for a shift to a market-based, flexible exchange rate. The People's Bank of China, the central bank, recently liberalized certain interest rates, which is consistent with a move towards a flexible exchange rate. China has taken steps to reduce barriers to capital flows, which will help to deepen markets involving foreign exchange transactions. In July, China announced it would allow its national social security fund to invest in overseas capital markets. China is working to strengthen its banks and bank supervision, and to prepare these institutions for exchange rate flexibility. In addition, China has taken steps to develop financial products and systems to support foreign exchange trading and hedging of exchange rate risk.

The U.S. Government will pursue persistently and firmly its approach to promote economic, financial and market reforms in China and assist China to move as soon as possible to a flexible exchange rate regime.

Korea

Like the other economies in East Asia, Korea benefited greatly from growing Chinese and U.S. import demand and the recovery of the global IT sector. But domestic private demand in Korea has been much weaker than in other economies in the region, as Korea has struggled with the after-effects of a credit card boom and bust that has depressed household spending. Although Korea's economy was strong in the second half of 2003, growth decelerated to a 4.9 percent annual rate in the first half of 2004, largely due to a decline in private consumption of 0.7 percent. While inflation increased to 3.6 percent year-on-year by June 2004, this was mainly due to higher oil prices. Citing a slowdown in the pace of economic recovery, particularly in domestic demand, the Korean central bank reduced its benchmark call rate a quarter-point in August and again in November, bucking the global trend towards interest rate stabilization or increase.

External demand continued to support Korean growth in the reporting period. Exports in the first half of 2004 were up 38.4 percent year-on-year, continuing the strong pace set in the second half of 2003. Export growth to China was particularly strong, rising 57 percent. The growth of imports did not nearly match that of exports, although imports did rise 27 percent over the year. The difference in import and export growth rates was reflected in Korean external balances. Korea's current account surplus was 4.4 percent of GDP for the first half of 2004, compared to 0.2 percent in the first half of 2003. The U.S. bilateral trade deficit with Korea for the first half of 2004 totaled $9.0 billion, up from $2.1 billion for the same period in 2003, as U.S. imports from Korea grew by 21 percent, and exports to Korea by 5 percent. Total capital and financial flows, exclusive of reserve accumulation, registered a net deficit (outflow) of $0.6 billion (nsa) for the first half of 2004, down from a surplus of $13.2 billion for 2003, as investors become more concerned about Korea's growth prospects.

Korea maintains a managed floating exchange rate regime. Consistent with maintaining a relatively accommodative monetary stance in light of weak domestic demand, the Korean authorities continued to intervene in the first half of 2004, although the pace of reserve accumulation slackened. Official foreign reserves increased by $11.7 billion over the first half of 2004 to $166.2 billion, roughly equivalent to the total external debt of Korea, and equal to 2.8 times short-term external debt. In April, the government partially removed restrictions that were imposed in January 2004 limiting positions that domestic financial institutions could take in the foreign exchange non-deliverable forwards market. These measures had been imposed in an attempt to curb upward speculation on a won appreciation. Despite the Korean authorities' intervention, by end-June 2004 the won had risen 3.1 percent against the dollar since end-2003. Korea's real effective exchange rate appreciated 5.5 percent over the course of the first half of 2004.

Taiwan

Accommodative monetary policy, along with higher oil and commodity prices, succeeded in halting three years of deflation as the headline consumer price index rose 3.1 percent saar in the six months through June 2004. Taiwan's GDP growth slowed to 3.6 percent in the first half of 2004 relative to the second half of 2003, after having rebounded at an annualized, seasonally adjusted rate of 10.7 percent in the second half of 2003 due to a sharp recovery of domestic demand (in particular business investment) and strong export growth (particularly to China). The slowdown was the result of both a slowing of investment from the very high growth of the second half of 2003 and a modest slowdown in government consumption.

Taiwan's exports grew by 25.5 percent in the first half of 2004, compared to the first half of 2003, with growth of exports to China particularly strong. Imports expanded by 34.6 percent, resulting in a decline of the overall trade surplus from $12.0 billion to $9.9 billion. Taiwan's bilateral trade surplus with the United States decreased from $7.4 billion in the first half of 2003 to $5.8 billion in the first half of 2004.

The current account surplus in the first half of 2004 was 7.5 percent of GDP (or $11.4 billion), marking a decline from a surplus of nearly 10 percent of GDP in 2003. Taiwan's high domestic saving relative to domestic investment make it a substantial net exporter of capital, contributing to continued current account surpluses.

Taiwan experienced strong portfolio capital inflows in the last half of 2003 and the first quarter of 2004. These followed the decision by the Taiwan government in July 2003 to scrap a rule restricting foreign fund investments in Taiwanese shares to $3 billion per fund. However, portfolio capital inflows turned negative in the second quarter due to tensions with China and several weeks of uncertainty following the presidential election.

Taiwan maintains a managed floating exchange rate regime. Total foreign exchange reserves increased by $23 billion in the first half of 2004, compared to a $30 billion increase in the latter half of 2003. By end-June, total foreign exchange reserves had reached $230 billion, or 80 percent of GDP and four times short term external debt. Most (roughly four-fifths) of the first half growth in reserves occurred in the first quarter. Reserve growth due to intervention diminished along with capital inflows in the second quarter of 2004. Reserve growth has continued at this slower pace since mid-year, with reserves rising by 1.3 percent in the third quarter to $233 billion.

The NT dollar appreciated gradually against the U.S. dollar during the first quarter of 2004, reaching a peak of NT32.93/USD in mid-April, up 3.8 percent from its end-2003 value. It depreciated during the latter part of the reporting period, ending June only slightly above its December 31 level. While Taiwan's central bank maintains that "the NT dollar exchange rate is determined by market forces," the bank also notes that "when the foreign exchange market is disrupted by seasonal or irregular factors the Bank will step in."

Malaysia

Malaysia's economic recovery continued to accelerate in the first half of 2004, growing at an 6.8 percent saar pace from the second half of 2003 after growth of 5.3 percent in 2003 and 4.1 percent in 2002. Personal spending picked up, and private investment strengthened. Fiscal consolidation continued, as total public sector spending grew moderately and public investment contracted.

The current account surplus was 13.1 percent of GDP in the first half of 2004, compared with 14.4 percent in the first half of 2003. Malaysia's bilateral trade surplus with the United States totaled $7.5 billion in the first half of 2004, up 13.7 percent from its level a year earlier.

Malaysia has maintained a fixed peg to the dollar since September 1998, when it also expanded capital controls. Although unchanged against the dollar in nominal terms, the ringgit depreciated 0.7 percent over the first half of 2004 on a real trade-weighted basis, as measured by the JP Morgan index. At the end of June, total foreign exchange reserve holdings stood at $53.9 billion, about five times short-term external debt and up from $44.9 billion at end-December 2003.

Controls on capital flows have been relaxed since 1998, but offshore trading of the ringgit remains prohibited, and foreign portfolio investment by residents continues to be restricted. However, Malaysia implemented a number of capital account liberalization measures in the first half of 2004. On March 26, the central bank raised the ceilings on foreign currency holdings by residents, relaxed reporting requirements for exporters, allowed domestic institutional investors and mutual funds to invest up to 10 percent of their assets abroad, made it easier for non-residents to borrow in ringgit, and allowed forward foreign exchange contracts.

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

[2] Including a relatively small statistical discrepancy.

[3] 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.

[4] That is, 4.2 percentage points of the 5.3 percent annualized growth.

[5] The yen varied over a range of 8-10 percent between its highs and lows against the dollar during the first quarter.

[6] The Chinese government used $45 billion of its foreign exchange reserves to recapitalize two Chinese banks at the end of 2003. This figure is not included in the $471 billion foreign exchange reserves total.