Report to Congress on
International Economic and Exchange Rate Policies
November 2005

Summary

This report reviews developments in international economic policy, including exchange rate policy, focusing on the first half of 2005.[1] The report is required under the Omnibus Trade and Competitiveness Act of 1988 (the "Act").[2]

Global imbalances are being manifested in large and disparate growth rates, which in turn are mirrored in divergent current account positions, particularly among larger countries. Addressing global imbalances is a shared responsibility and should occur in an orderly manner that maximizes sustained global growth. This requires: 1) further reducing budget deficits and boosting national saving in the United States; 2) appreciably strengthening domestic demand-led growth in Europe and Japan and additional structural reforms to raise economic potential; 3) greater flexibility in the exchange rates of large Asian economies that lack such flexibility, particularly China; and 4) an ambitious Doha trade round and a concerted effort to resist protectionism.

This report finds that no major trading partner of the United States met the technical requirements for designation under the Act. This is consistent with the findings of this report for the past eleven years. Reaching judgments about countries' currency practices and their relationships to the terms of the Act for the purpose of designation is inherently complex, and there is no formulaic procedure that accomplishes this objective. Moreover, the Articles of Agreement of the International Monetary Fund allow countries enormous latitude in selecting and managing exchange rate systems. In this light, a special Appendix to this Report has been added that seeks to offer greater insights into the foreign exchange practices of countries and the implications of their policies. Treasury will continue to build on this work in future reports so that we can better illuminate behavior that, while falling short of a technical designation, is distortionary and potentially problematic.

The last report, issued on May 17, 2005, noted the importance of exchange rate flexibility in the adjustment of international imbalances. It also noted that China's fixed exchange rate created distortions and posed increasing risks to both China and the broader global economy, especially in constraining the flexibility of other Asian currencies. Since that report, the Treasury has engaged in an intensive dialogue with China and other key economies in the region to bring about needed adjustments.

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[1] Treasury has consulted with the IMF in preparing this report. This report focuses on the period January 1, 2005, through June 30, 2005.

[2] The Act states, among other things, that: "The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."

Accordingly, the United States applauded China's July 21st announcement that it had abandoned its eight-year peg to the dollar and committed to enhance the flexibility and strengthen the role of market forces in the exchange rate. Because of this action and China's stated – and repeatedly reaffirmed – commitment to enhanced, market-determined currency flexibility, Treasury has refrained from designating China at this time. China's commitment to put greater emphasis on sustainable domestic sources of growth, including by modernizing the financial sector, which will support and complement greater currency flexibility, also factored into this decision.

However, China's actual operation of its new system is highly constricted. Distortions and risks previously identified still persist, as do the constraints thus imposed on exchange rate flexibility in the region. This is troubling, and future reports will intensely scrutinize whether and to what degree China is practicing what officials have repeatedly committed to undertake. It is imperative that China fully utilize its new system to move towards greater flexibility as quickly as possible.

Malaysia also altered a long-held peg on July 21 by revaluing slightly. Still, its large, protracted and rising external surpluses suggest that current exchange rate policy may be contributing to macroeconomic imbalances and distortions in the economy. Treasury will begin discussions with the Malaysian government on its exchange rate policy.

Given the risks and distortions noted above and in previous reports, the United States calls on the International Monetary Fund to intensify its efforts to promote greater flexibility in exchange rates for China and other large emerging Asian economies and to recommend other policies, including financial sector reforms, to bolster domestic demand and reduce global imbalances. To this end, the United States also calls for a comprehensive report on these issues, including associated policy assessments, to the Executive Board and the International Monetary and Financial Committee on an expedited basis. Treasury will also explore possible proposals for reforms in IMF exchange rate surveillance procedures.

Domestic Macroeconomic Conditions

Growth in the U.S. economy continued at a solid pace in the first half of 2005, with real GDP rising at an annual rate of 3.6 percent on average in the first two quarters. Business investment continued to grow in the first half and a large increase in exports and a small decline in imports led to a sizable 1.1 percentage point net contribution to growth from foreign demand in the second quarter. Personal consumption expenditures maintained steady increases through the first half of the year. Even though household debt as a share of disposable personal income (DPI) is at a record high, household finances appear in good shape overall as net worth in relation to DPI is the highest in more than three years. Employment is growing, with the average monthly payroll job gain at 190,000 through the first half of 2005, and the number of jobs created since the May 2003 employment trough reaching 3.8 million through June of this year. Over the first half of the year, the unemployment rate declined from 5.4 percent to 5.0 percent – 1.3 percentage points below its June 2003 peak and the lowest since a similar reading in September 2001.

Consumer prices were generally contained over the 12 months ending in June 2005. The consumer price index rose 2.5 percent over that time span. Energy prices rose 7.3 percent over the year ending in June while the core consumer price index (CPI), excluding food and energy, rose 2.0 percent. Gasoline prices jumped sharply in the second quarter of 2005, and energy prices overall continued to rise in the third quarter, culminating in a 12.0 percent surge in September. Over the 12 months ending in September, energy prices at the consumer level were nearly 35 percent higher than a year ago, but excluding food and energy, the core rate of consumer price inflation remained low, rising a moderate 2.0 percent over the 12 months ending in September. The Federal Reserve continued to raise the target for the federal funds rate, raising it one full percentage point over the first half of the year to 3.25 percent and by an additional 25 basis points at each of its next three meetings on August 9, September 20, and November 1, to 4.0 percent. The Federal Reserve kept the balanced bias for both growth and inflation at each of those meetings. The November action marked the twelfth straight target increase of 25 basis points since the Federal Reserve began to remove accommodation in the middle of 2004.

Prior to Hurricane Katrina, estimates of the Federal budget deficit for fiscal year 2005, which in February had been projected at $427 billion, were revised substantially lower as growth in revenues was stronger than forecast. The Administration's Mid-Session Review lowered the deficit projection to $333 billion while the Congressional Budget Office projected a $331 billion deficit. In the actual budget results for the entire fiscal year, the deficit was even lower than expected, declining by $94 billion to $318 billion. In relation to the more than $12 trillion U.S. economy, the fiscal year 2005 deficit represented a 2.6 percent share of GDP. That is lower than the deficit shares in 16 of the last 25 years and only slightly above the 2.3 percent average over the past 40 years. The deficit is nevertheless too high, and the Administration is determined to do more to reduce it. While Federal outlays for hurricane relief are expected to raise the deficit in the short term, and will affect budget results in fiscal year 2006, in the medium to long term, the Administration is working to prevent the additional burden on the deficit from storm repair from undermining efforts at deficit reduction. Continued strong growth will lead to higher receipts, and the Administration is committed to restraint in non-security spending, which will lead to lower deficits in the future.

The United States International Accounts[3]

- *U.S. Balance of Payments Data*

U.S. Balance of Payments and Trade

($ billions, SA, unless otherwise indicated)

	2004	2004				2005	
		Q1	Q2	Q3	Q4	Q1	Q2
Current Account:							
Balance on goods	-665.4	-151.5	-164.0	-167.8	-182.2	-186.3	-186.9
Balance on services	47.8	12.6	11.9	10.3	13.0	13.3	13.6
Balance on income 1/	30.4	15.0	5.9	6.3	3.2	.6	-.5
Net unilateral current transfers	-80.9	-22.3	-20.5	-15.8	-22.4	-26.3	-21.9
Balance on current account	-668.1	-146.1	-166.6	-167.0	-188.4	-198.7	-195.7
Current Account as % of GDP	-5.7	-5.1	-5.7	-5.7	-6.3	-6.5	-6.3
Major Capital Flow Components (financial inflow +)							
Net Bank Flows	36.8	-4.1	12.5	2.2	26.2	-34.3	31.6
Net Direct Investment Flows	-145.2	-43.9	-27.4	-5.6	-68.4	8.1	-16.0
Net Securities Sales	698.3	187.3	177.6	115.1	218.3	159.0	132.7
Net Liabilities to Unaffiliated Foreigners by Non Banking	-24.6	-10.8	-1.5	1.3	-13.6	19.0	-10.2
Memoranda:							
Statistical discrepancy	85.1	18.6	-4.0	50.7	19.9	41.2	53.6
Change in Foreign official assets in the United States	394.7	147.4	77.0	75.8	94.5	25.3	82.3
Trade in Goods							
Balance	-665.4	-151.5	-164.0	-167.8	-182.2	-186.3	-186.9
Total Exports	807.5	193.8	200.1	204.8	208.9	213.8	223.5
of which:							
Agricultural Products	62.9	15.9	16.0	15.4	15.6	15.6	17.1
Capital Goods Ex Autos	331.5	80.7	82.3	84.2	84.3	85.4	90.2
Automotive Products	89.3	21.0	21.8	23.1	23.4	23.7	23.5
Consumer Goods Ex Autos and Food	103.1	24.5	25.5	26.0	27.1	28.3	28.5
Industrial Supplies and Materials 2/	204.0	47.9	50.1	51.9	54.0	55.9	59.0
Total Imports	1472.9	345.2	364.1	372.6	391.1	400.2	410.5
of which							
Petroleum and Products	180.5	40.0	41.5	45.1	53.8	52.9	57.4
Capital Goods ex Autos	343.5	80.8	85.5	87.8	89.4	90.7	95.9
Automotive Products	228.2	55.4	57.2	57.5	58.1	58.2	58.1
Consumer Goods Ex Autos and Food	373.1	89.6	94.0	92.6	96.9	102.1	102.1

1/ Including compensation of employees
2/ Including Petroleum and Petroleum Products
Source: BEA, Bureau of Census

The U.S. current account was $789 billion (at a seasonally adjusted annual rate, or "saar") in deficit, or 6.4 percent of GDP, in the first half of 2005. Viewed over a longer period, the U.S. current account balance declined, as a percent of GDP, from a one percent surplus in the first quarter of 1991 to a four percent deficit in the fourth quarter of 2000, to a six percent plus deficit in the first half of 2005.

In the first half of 2005, the United States exported $875 billion in goods (saar) and imported $1,621 billion, with a resulting $747 billion deficit on trade in goods.[4] Exports of goods increased 5.7 percent in the first half of 2005 compared to the second half of 2004, while imports increased 6.2 percent. Non-automotive capital goods constituted 40.1 percent of merchandise

[3] The IMF annually reviews U.S. economic performance and policies through the so-called IMF Article IV surveillance process. The last Article IV surveillance review took place in July 2005. The IMF Working 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/2005/cr05257.pdf. In addition, the IMF discusses U.S. economic policies and performance in the context of its twice yearly World Economic Outlook reports. These can be found at http://www.imf.org/external/pubs/ft/weo/2005/cr05258.pdf.

[4] Sums may not be exact due to rounding.

exports in the first half of 2005. Consumer goods imports constituted 25.2 percent, non-automotive capital goods imports 23.0 percent, and petroleum and petroleum product imports 13.6 percent of merchandise imports.

Canada, Mexico, China, Japan and Germany remain the largest trading partners of the United States. Canada accounted for 13.7 percent of U.S. exports, Mexico 13.0 percent, Japan 6.0 percent, the U.K. 4.5 percent and China 4.3 percent in the first half of 2005. Canada accounted for 17.4 percent of U.S. imports, China 13.8 percent, Mexico 10.4 percent, Japan 8.6 percent, and Germany 5.2 percent in the first half of 2005.

Country	Exports Jan-Jun 2005 1/	Country	Imports Jan-Jun 2005 1/
Total, All Countries	**444.6**	**Total, All Countries**	**793.2**
	Percent of Total		**Percent of Total**
Canada	23.7%	Canada	17.4%
Mexico	13.0%	China	13.8%
Japan	6.0%	Mexico	10.4%
United Kingdom	4.5%	Japan	8.6%
China	4.3%	Federal Republic of Germany	5.2%
Federal Republic of Germany	3.8%	United Kingdom	3.1%
South Korea	3.1%	South Korea	2.8%
Netherlands	3.0%	Taiwan	2.1%
France	2.6%	France	2.1%
Taiwan	2.5%	Venezuela	2.0%

1/ Census, NSA

Prices of imported goods (nsa) increased 8.3 percent in the twelve months through June 2005. Non-petroleum import prices rose 2.1 percent. Export prices rose 2.9 percent over the year. The most recent trough in import and export prices occurred roughly at the beginning of 2002. Since then non-petroleum import prices have risen 5.9 percent and export prices 9.4 percent.

Foreign demand for U.S. financial assets remains strong. A major item financing the current account deficit has been net private foreign purchases of U.S. securities, which reached an annualized $552 billion in the first half of 2005. (Included in these were net private foreign purchases of U.S. Treasury securities amounting to $162 billion.) In addition, foreign official institutions increased their U.S. assets by $215 billion.

Foreigners owned $2.0 trillion in Treasury securities at the end of June 2005, or 53 percent of the public debt not held in Federal Reserve and U.S. Government accounts. This compares with $1.9 trillion, at the end of December 2004. Foreign official institutions held $1.2 trillion in Treasury securities at the end of June 2005, only marginally greater than at the end of December 2004.

- *Net International Investment Position*

The net international investment position of the United States (with direct investment valued at the current stock market value of owners' equity) was a negative $2.5 trillion as of December 31, 2004, the latest date for which data are available. This was only $170 billion less than the negative $2.4 trillion position at the end of 2003, as a $272 billion valuation adjustment due to

exchange rate changes and a $147 billion valuation adjustment due to other price changes offset much of the financial outflow associated with the 2004 current account deficit of $665 billion.[5] Despite the large negative net investment position, U.S. residents earned $52 billion on their investment position in 2003, $36 billion in 2004, and $6.1 billion at an annual rate in the first half of 2005 as net receipts from the U.S. direct investment position offset net income payments on the portfolio investment position.

- *Perspectives on the Current Account*

The U.S. current account deficit can be examined from different analytic perspectives. Each perspective focuses on different characteristics of normal current account balances and different adjustment patterns. The perspective can affect interpretations of which domestic and global factors give rise to a given current account deficit and the implications of deficits.

A current account deficit is conceptually equal to the gap between domestic investment and domestic saving, as a matter of *ex post* 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 economic analysis of this relationship is more complex, so that when *ex ante* saving, investment and net export plans are not satisfied *ex post,* economic adjustment processes come into play seeking to reconcile plans with outcomes. The simple *ex post* accounting saving and investment perspective has led some analysts to focus heavily on the components and determinants of saving and investment in the concerned country. National saving reflects the sum of net private and net public saving. Some analysts, giving little weight to the dynamics of private saving and investment, focus on net public saving, and hence on fiscal policy as the best way to affect national saving.

Although an increasing federal budget deficit, from this perspective, would tend to widen the current account deficit, the evidence for a simple correlation between the budget and the current account deficit (the so called "twin deficits" view) is very weak. More generally, in a recent Federal Reserve staff paper, it was argued that a $1 decline in the fiscal deficit would only result in a 20 cent reduction in the current account deficit because fiscal reduction, *inter alia*, could be associated with crowding-in of investment.[6, 7]

The current account deficit can also be seen as the excess of what a country purchases over what it produces, or the excess of what it buys from abroad over what it sells abroad. This perspective leads to a focus on broad macroeconomic factors and their implications for the current account balance – such as relative growth rates among the major economies, broad cost and productivity

[5] In principle the net financial flows should equal the current account balance, but in practice there was a statistical discrepancy of $85 billion in 2004.
[6] Erceg, Christopher, Luca Guerrieri, and Christopher Gust (2005). "Expansionary Fiscal Shocks and the Trade Deficit." International Finance Discussion Paper 2005-825. Washington: Board of Governors of the Federal Reserve System (January). The paper can be found at http://www.federalreserve.gov/pubs/ifdp/2005/825/ifdp825.pdf.
[7] IMF staff report a higher estimate, using an alternative methodology, in Section V of the IMF Selected Issues Paper of the July 2005 Article IV Consultation, IMF Report No. 05/258. The paper can be found at http://www.imf.org/external/pubs/ft/scr/s005/cr05258.

differences in domestic traded and non-traded goods sectors, inflation and interest rate differentials among economies, and exchange rate movements. Some analysts have used this approach to estimate, employing complex models, the amount that an economy's real trade-weighted exchange rate needs to adjust in order to bring its current account balance to what they perceive to be a "normal" level.[8]

At the microeconomic level, this perspective places a focus on specific features of productive processes and the comparative advantage of given countries – the United States has an edge in producing, among other goods and services, certain financial services and leading high tech products; other economies may have an advantage in producing certain low-value consumer goods. The mix of specific purchases and sales of goods and services, in turn, depends on many millions of microeconomic decisions made by consumers and producers. Specific trading aggregates are also subject to both very specific long-term effects, such as industry productivity growth, and short-term effects, such as supply disruptions.

Other perspectives on the current account deficit focus on net foreign financial flows into the United States. A surplus on the capital and financial accounts is, by balance of payments accounting definition, the counterpart to a current account deficit. These flows finance the net capital formation that is equal to the excess over domestic saving. This perspective also leads to a focus on broad macroeconomic factors – such as relative growth of output and productivity and relative attractiveness of investment environments among the major economies, inflation and differentials, exchange rate movements, etc. According to this perspective, the growth of the U.S. current account deficit over more than a decade has been linked to high levels of domestic U.S. capital formation compared to domestic U.S. saving. Perceived high rates of return on U.S. assets, based on sustained strong productivity growth especially relative to the rest of the world, sound U.S. economic performance, a welcoming U.S. investment climate, and the deepest and most liquid capital markets in the world have all combined to attract foreign investment. In turn, sustained external demand for United States assets has allowed the United States to achieve levels of capital formation that would have otherwise not been possible, and robust growth in investment has been critical to non-inflationary growth of production and employment.

All of these analytic perspectives offer insights into an understanding of the U.S. external position. More broadly, the distribution of global current accounts must be seen as the product of economic and financial policies of all economies spanning the world. For example:

- Saving rates in many emerging market economies, especially those in Asia, are very high compared to investment rates, resulting in correspondingly large current account surpluses. These high saving rates, in turn, may be partly associated with the demographic consequences of aging and the need to save for retirement in the

[8] Indexes of the foreign exchange value of a currency seek to summarize the often divergent movements in bilateral exchange rates into a single measure. A nominal effective exchange rate (NEER) index is a weighted average of bilateral exchange rates. A real effective exchange rate (REER) index multiplies each bilateral exchange rate by relative costs or prices in each economy. Movements in the REER reflect movement in prices or costs of production of domestically produced goods and/or services relative to the prices or costs of goods and/or services produced by foreign competitors. The weights of these indexes are typically based on trade flows, both bilateral trade flows and, in some cases, competitors' trade with third markets.

absence of well developed public pension systems, and also with the lack of well developed financial systems allowing consumers to diversify and hedge against risks (including through insurance products) or to borrow (for example, mortgages).

- Investment rates across the globe have been dampened by a range of factors, including low growth in many economies, the emergence of large service sectors which are less capital intensive than many industries, and excess capacity after the Asia crisis and the bursting of the IT bubble, more efficient financial intermediation, and strong corporate profitability coupled with a low propensity to reinvest earnings.

- A mark of the increasing globalization of the world economy – reflecting in part the effects of greater internationalization of financial markets and diminishing "home bias" in patterns of investment – is a decline, in recent years, of the correlation between national saving and investment rates.

- With rising oil prices, large current account surpluses of oil exporting countries have reemerged with rising oil prices. Ten major oil exporters[9] had a combined $213 billion current account surplus in 2004.

The adjustment of global imbalances is a shared responsibility that must be undertaken in a way that maximizes sustained global growth. Toward this end, domestic demand-led growth from other parts of the world simply must increase. Slowing U.S. growth to match low growth elsewhere would constitute a major setback for the global economy, would be harmful to the efforts of many low-income countries throughout the world to alleviate poverty, and would hurt U.S. workers. Against this background, all major economies must play their part. In the United States, policies aimed at increasing saving by the public sector and the private sector should contribute to global adjustment and reinforce the continuing stability of the international financial system. In Europe and Japan, policies for further structural reforms are needed to boost sustainable growth. Greater flexibility of exchange rates is needed, particularly in emerging Asian economies that lack such flexibility. Finally, an ambitious outcome from the Doha Round is essential to enhancing global growth.

The U.S. Dollar

Movements in the foreign exchange value of the dollar reflect a wide range of factors in extremely large and deep international financial markets. The latest Bank of International Settlements-coordinated central bank survey of the global foreign exchange market estimated that average daily turnover in the market was nearly $2 trillion dollars per day. A large majority of these trades involve the dollar, either as one of the two currencies in the underlying transaction or as the vehicle currency in a trade between two foreign currencies.

The real trade-weighted value of the dollar has fluctuated considerably over past decades, as have the trade-weighted exchange values of other major currencies. In particular, the dollar's real effective exchange rate peaked in early 1985 and then declined. It rose again in the second

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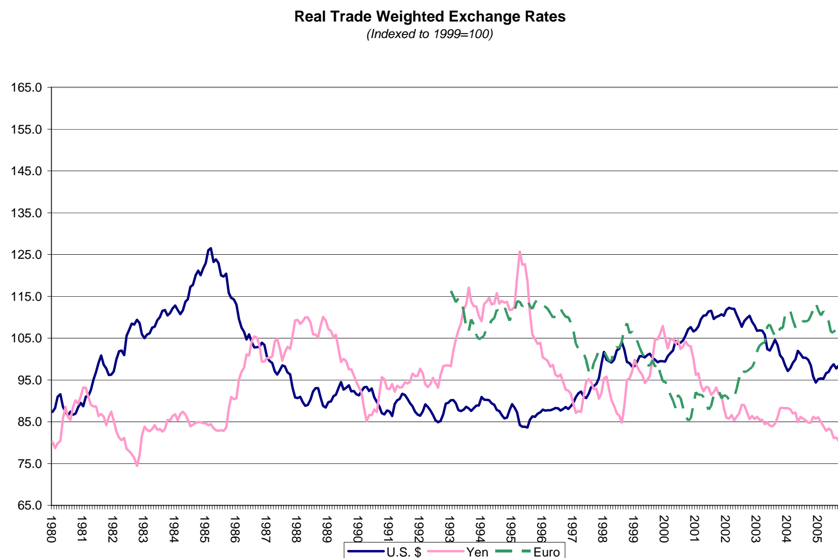
[9] Iran, Kuwait, Libya, Nigeria, Norway, Qatar, Russia, Saudi Arabia, United Arab Emirates, and Venezuela.

half of the 1990s through early 2002, after which it has fallen back. The euro, after depreciating following its introduction in 1999, has appreciated in recent years, while the yen has fallen relative to its mid-1990 peaks.



Between its peak in early 2002 and the beginning of 2004, the dollar fell 25 percent against major currencies measured by the Federal Reserve Board's nominal trade-weighted index.[10] Since then, the dollar has risen less than three percent against the major currencies.

Another Federal Reserve Board index also provides a measure of the dollar's performance against the currencies of the other important trading partners (OITP) of the United States; these economies account for 45 percent of the broad dollar's trade-weighted basket, and about two-thirds of the OITP index is accounted for by Asian emerging market economies. The OITP index did not follow the dollar's decline against major currencies. The OITP index of the dollar's value rose four percent from early 2002 to the beginning of 2004 and has since declined by a similar amount.

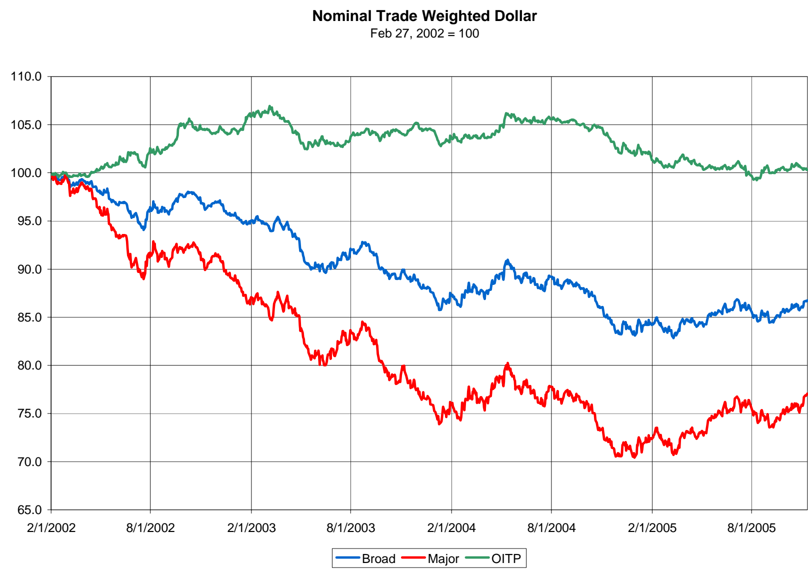
After its depreciation between early 2002 and early 2004, the dollar has moved in a broad range against the major currencies through the first half of the year, roughly speaking between $1.20 and $1.35 against the euro and between 102 and 111 yen per dollar. Fluctuations within the range have been influenced by a host of factors, including market perceptions about so-called "cyclical" factors such as relatively strong U.S. growth, which have tended to boost the dollar, and "structural" factors such as concerns about the ability of the U.S. to attract capital inflow to finance its current account deficit which have tended to weaken the dollar. On balance, the euro and yen have moved in a broadly similar manner against the dollar since early 2002.

During the first half of 2005, the euro and the yen, the most important of the other major currencies, depreciated against the dollar by 10.6 percent and 7.4 percent, respectively, in

[10] Descriptions of the Federal Reserve Board's summary indexes for the foreign exchange value of the dollar can be found at http://www.federalreserve.gov/releases/h10/Summary/.

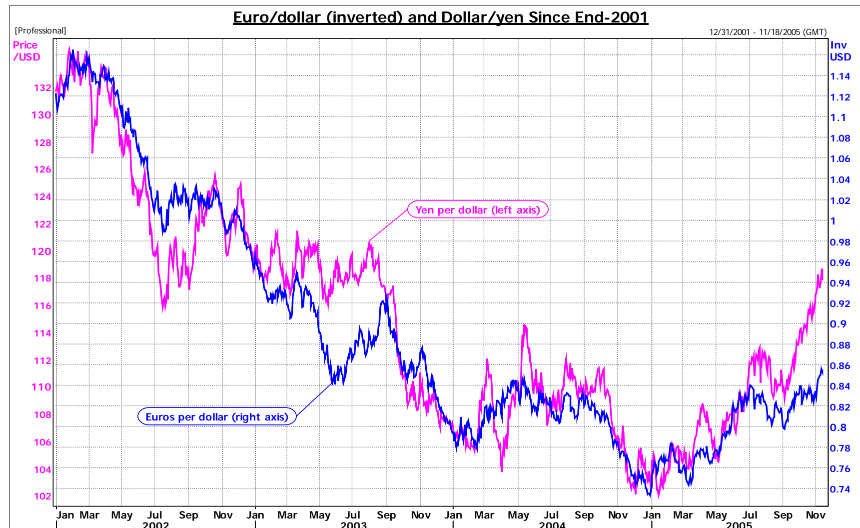
nominal terms. The trade-weighted value of the dollar appreciated by 7.5 percent vs. major currencies and depreciated by 1.0 percent vs. currencies of other important trading partners.

The dollar's appreciation in 2005 reflected a shift in the market's focus away from concerns about the financing of the U.S. current account deficit toward recognition of the brighter relative U.S. growth outlook. In addition, interest rate differentials widened in favor of dollar assets, given the rise in the Fed Funds interest rate and market expectation of further increases.



The Japanese yen has been affected by cross-cutting considerations. Market perceptions this year that Japan's economic turnaround is taking hold have strengthened foreign demand for Japanese equities, and the Nikkei has firmed substantially. Also, market expectations about the prospects for a revaluation of the Chinese renminbi stimulated demand for yen at times. In contrast, rising oil prices weighed on the yen during the period as did the substantial widening in the differential between short-term dollar and yen interest rates. Further, Japanese investors have stepped up purchases of foreign assets in view of the increased confidence in the economic turnaround and higher foreign interest rates.

The euro was held down by the outlook for continued low growth in key parts of the Euro-zone and shifts in interest differentials. In addition, the French and Dutch votes on the EU constitution also contributed to negative euro sentiment. Demand for sterling eased over the course of the year as the U.K. economy slowed and the Bank of England reduced its official policy interest rate. Firm dollar demand against the euro and yen has been reflected in Chicago Mercantile Exchange futures and options reports showing a net-increase in non-commercial long dollar positions against both currencies.



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

Analysis of Exchange Rates Pursuant to the Act

For the specific purpose of assessing "whether countries manipulate the rate of exchange between their currency and the United States dollar" according to the terms of the Act, the Treasury has traditionally undertaken a careful review of the trading partner's exchange rates, external balances, foreign exchange reserve accumulation, macroeconomic trends, monetary and financial developments, institutional development, and financial and exchange restrictions among other things.[11]

The Appendix of this Report provides a detailed analysis of such considerations relating to the Act, amplifying on Treasury's report to Congress of March 11, 2005. The Appendix reviews the importance of a wide range of economic indicators in rendering judgments pursuant to the Act. and assesses a large number of economies throughout the world against that background. This review shows that the use of numerical indicators of economic performance provides valuable information and insights, including insights into the operation of economies and their interactions with the world economy and financial system.

The Appendix also highlights that many economies – including several oil exporting countries, China, and Malaysia – have significant current account surpluses, increasing reserves, and relatively rigid exchange rate regimes. But other countries – Germany, Japan, and Switzerland – with floating currencies also have significant current account surpluses. Given that the United States is the world's largest economy and has a large current account deficit, it is to be expected that some other economies around the world would have large current account surpluses, which

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[11] These issues are discussed more completely in Treasury's March 11, 2005, Report To The Committees on Appropriations on Clarification Of Statutory Provisions Addressing Currency Manipulation (http://www.treas.gov/press/releases/reports/js2308.pdf).

are the counterpart to the U.S. deficit. In addition, these surpluses reflect a range of factors – including cyclical considerations and saving and investment trends.

The Appendix reaffirms the basic conclusions that rendering judgments pursuant to the Act is inherently complex, that there is no mechanistic or formulaic approach to doing so, and that any judgment must be undertaken in the context of the specific economic circumstances and characteristics of a given economy. A more complete assessment requires additional analysis of the interactions of indicators among themselves and other economic variables, specific factors affecting economies, and current policy formation and implementation.

Country Analyses

Mexico

Mexico has a flexible exchange rate regime. Its central bank targets an inflation rate of 3 percent with a plus or minus one percent band. The Bank of Mexico also follows a transparent rule for selling foreign reserves accumulated by state enterprises. During the first half of 2005 the Mexican peso appreciated by 3.6 percent, from 11.14 pesos/dollar to 10.75 pesos/dollar. The J.P. Morgan trade-weighted index for the broad real exchange rate for the peso appreciated by 5.0 percent in the first six months of the year. Mexico's current account deficit during the first half of 2005 was $3.8 billion, versus $4.6 billion in the second half of 2004. The U.S. bilateral trade deficit with Mexico in the first half of 2005 was $24.5 billion, versus $22.7 billion in second half of 2004. Foreign direct investment in Mexico increased to $7.5 billion in the first half of the year compared with $5.7 billion in the second half of 2004. International reserves grew by $278 million during the first half of the year, reaching $61.8 billion by end-June. Year-on-year (yr/yr) headline inflation was 4.3 percent in June, versus 5.2 percent in December 2004. Real GDP grew 0.7 percent in the first quarter of 2005 and fell 1.7 percent in the second quarter, on a seasonally adjusted annualized basis.

Brazil

Brazil has a flexible exchange rate regime. Its central bank targets a 2005 inflation rate of 5.1 percent with a band of 4 to 7 percent. The real appreciated 12.6 percent during the first half of 2005 from BRL2.66/dollar to BRL2.36/dollar. The Central Bank increased net international reserves to $40.5 billion by June compared to $27.5 billion in end-December, in part due to Central Bank purchases of foreign exchange for reserve accumulation in January-March. Brazil had a $6.5 billion current account surplus in the first half of 2005, compared to $6.3 billion in the second half of 2004. The United States had a trade deficit with Brazil of $4.7 billion in the first half of 2005, compared to a $4.9 billion deficit in the second half of 2004. Foreign direct investment in Brazil decreased to $8.6 billion in the first half of the year compared with $14.1 billion in the second half of 2004. Year-on-year inflation stood at 7.3 percent in June, versus 7.6 percent in December 2004. Real GDP grew 1.5 percent in the first quarter and 5.8 percent in the second quarter, on a seasonally adjusted annualized basis.

The European Monetary Union

The euro depreciated 10.6 percent against the dollar in the first half of 2005. The real effective exchange rate depreciated 6.2 percent over the period. The ECB did not intervene in foreign exchange markets during the first half of 2005. The harmonized consumer price index rose 2.1 percent year-on-year as of June 2005 while the index excluding energy, food, alcohol, and tobacco rose 1.3 percent. Broad money, M3, grew 8.2 percent annualized in the first half of 2005.

The countries in the Euro-zone taken together had a marginal current account surplus during the first half of 2005 equal to $10.0 billion (sa) or 0.2 percent of GDP, down from $38.0 billion and $15.9 billion in the first and second halves of 2004, respectively. Goods exports increased 3.6 percent while goods imports increased 4.9 percent in the first half of 2005. The trade surplus of the Euro-zone vis-à-vis the U.S. was $42.8 billion in the first half of 2005, which is about $4.1 billion higher than in the same period last year.

Euro-zone growth was an estimated 1.4 percent (annualized) in the first half of 2005. Final consumption expenditure rose 0.8 percent (annualized) in the first half of 2005 while investment increased 0.7 percent. Euro Area countries taken together ran a fiscal deficit of 2.7 percent of GDP in 2004.

Germany

Germany had a current account surplus during the first half of 2005 equal to $61.6 billion (sa) or 4.3 percent of GDP. Goods exports increased 4.1 percent while goods imports increased 3.2 percent in the first half of 2005. The trade surplus of Germany vis-à-vis the U.S. was $24.4 billion, which is $2.8 billion higher than the same period last year.

German growth was an estimated 1.5 percent (annualized) in the first half of 2005, driven entirely by exports. Consumption and investment contracted 0.6 percent and 2.0 percent (annualized), respectively in the first half. Germany's fiscal deficit was 3.7 percent of GDP in 2004, and it was recently revised up from 2.9 percent to 3.7 percent for 2005. German inflation was 1.8 percent yr/yr in June 2005 while core inflation was 0.5 percent.

Belgium

Belgium had a current account surplus of $2.3 billion, or 1.2 percent of GDP, during the first half of 2005 compared to $14 billion (sa) or 3.4 percent of GDP for 2004 as a whole. Goods exports increased 9.2 percent while goods imports increased 12.5 percent in the first half of 2005 over the same period in 2004. The surplus in trade in goods declined to $8.0 billion in the first half of 2005 compared to $11.1 billion in the comparable period of 2004. The trade deficit of Belgium vis-à-vis the U.S. was $3.2 billion, which is $1.1 billion higher than the same period last year.

Belgian growth was an estimated 0.7 percent (annualized) in the first half of 2005, driven by domestic demand. Belgium's fiscal deficit was 0.3 percent of GDP in 2004, and the European

Commission forecasts a deficit of 0.2 percent of GDP in 2005. Belgian CPI inflation was 2.7 percent yr/yr in June 2005 while core inflation was 1.3 percent.

Spain

Spain had a current account deficit of $43.0 billion, or 7.6 percent of GDP, during the first half of 2005 compared to a $55.4 billion (sa), or 5.3 percent of GDP, deficit for 2004 as a whole. Goods exports increased 3.8 percent while goods imports increased 12.4 percent in the first half of 2005 over the same period in 2004. The trade surplus of Spain vis-à-vis the U.S. in the first half of 2005 was $743 million, which is $355 million lower than the same period last year.

Spanish growth was an estimated 3.5 percent (annualized) in the first half of 2005, driven entirely by strong domestic demand. Consumption and investment increased 4.1 percent and 5.2 percent (annualized) respectively in the first half. Spain's fiscal deficit was 0.3 percent of GDP in 2004, and the European Commission projects Spain to have a balanced budget for 2005.

Switzerland

Switzerland had a current account surplus of $26.5 billion (sa), or 14.1 percent of GDP, during the first half of 2005 compared with $52.3 billion (sa) or 14.6 percent of GDP for 2004 as a whole. The trade in goods surplus was $3.9 billion in the first half of 2005 compared with $7.5 billion for 2004. The substantial current account surplus arises from surpluses in trade in services, particularly financial services, and in investment income. The trade in goods surplus of Switzerland vis-à-vis the U.S. was $1.2 billion in the first half of 2005, which is $74 million lower than in the same period last year.

After 2.1 percent growth in 2004, Swiss growth fell to 1.0 percent (annualized) in the first half of 2005 due to weak investment in the first quarter and a lower trade surplus. Switzerland's fiscal deficit was 0.4 percent of GDP in 2004. The Swiss franc appreciated 12.4 percent against the dollar in the first half of 2005, but declined 2.7 percent overall against major trading partners. Inflation remains low at 0.7 percent yr/yr as of June 2005, while core inflation was 0.4 percent.

The Swiss National Bank maintained an operational 0.25 to 1.25 percent target range for the three-month Libor rate throughout the first half of 2005 compared to a 0.00 to 0.75 percent range though most of the first half of 2004.

Russia

High oil prices continued to dominate the dynamics of Russian external accounts. The price for Russian "Urals" blend crude increased 42 percent in the first half of 2005. Russia's current account surplus in the first half of 2005 was an estimated $44.7 billion (nsa), or 13.4 percent of GDP, compared to $26.3 billion, or 10.2 percent of GDP, in the first half of 2004. The bilateral trade surplus with the U.S. reached $5.9 billion in the first half of 2005 compared to $3.5 billion in the first half of 2004. After hitting a 5-year high against the dollar in April, the ruble eased somewhat, with a net 3.2 percent nominal depreciation against the U.S. dollar for the entire first half.

However, inflation continued to accelerate with consumer prices rising 13.6 percent yr/yr at end-June 2005 compared to 10.2 percent at end-June 2004. As a result, JP Morgan's trade-weighted index of the real exchange rate rose 10.6 percent yr/yr at the end of June 2005 compared to 8.4 percent at the end of June 2004. The Russian monetary authorities intervened in the foreign exchange market during the period, and official reserve assets increased 21.7 percent from $124.5 billion at end-December 2004 to $151.6 billion at end-June 2005 compared with a 14.7 percent increase in the first half of 2004. The broad monetary aggregate M2 grew 39.7 percent over the twelve months through June 2005 compared to 35.4 percent in the comparable period through June 2004.

Gulf Cooperation Council Countries

GDP growth and current account surpluses remain high in the oil-exporting countries of the Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE) due to high oil prices (e.g., Saudi Light Crude finished above $50 a barrel at the end of June). All of the GCC countries maintain exchange rates pegged to the dollar because the price of their major export, oil, is denominated in dollars.

Saudi Arabia

With oil export revenues increasing by 35 percent in 2004, Saudi Arabian real GDP grew by 5.2 percent in 2004, and it is expected to grow by a further 6 percent in 2005. The overall current account balance posted a surplus of 20.5 percent of GDP in 2004 compared to 13.1 percent in 2003 and 0 percent in 1999, while the bilateral trade surplus with the United States reached $18.6 billion in the year to June 2005. CPI inflation remains contained at 0.6 percent growth yr/yr to June 2005 because of relatively subdued import price inflation, and price subsidies on utilities and petroleum products. Nevertheless, the government's financial position improved with the government posting a budget surplus of approximately $26 billion (or 10 percent of GDP) in 2004, and using some of that surplus to reduce outstanding debt. The riyal has been unofficially pegged to the dollar since 1986 (officially since 2003), so short-term interest rates largely followed recent increases in US interest rates. Net foreign assets of the Saudi Arabian Monetary Agency rose 36 percent to $117 billion from $86 billion during the first 6 months of 2005, due to Saudi Arabia's large current account surplus. Saudi Arabia had $13.3 billion of short-term external debt at the end of 2004.

Singapore

Singapore is a small and open economy. Its inflation and inflationary expectations are largely determined by movements in the Singapore dollar. As a result, Singapore uses a heavily-managed float against an undisclosed basket of currencies within a target band as its primary monetary policy tool. The Monetary Authority of Singapore (MAS) currently maintains "a policy of modest and gradual appreciation" of the Singapore dollar against the basket. The Singapore dollar depreciated 2.9 percent against the U.S. dollar in the first half of 2005, while J.P. Morgan's nominal trade-weighted index of the exchange rate appreciated 0.9 percent. The CPI fell 0.2 percent yr/yr in June despite rising oil prices, although domestic wholesale prices rose 8.5 percent yr/yr. According to the MAS, it intervened in the first quarter "to moderate

excessive upward pressure" on the currency, which would have been deflationary. Total reserves increased about 2 percent to $115 billion in the first half of the year.

Gross national saving is high – 46 percent of gross national income – and investment has been reduced domestically and increased abroad in recent years in response to adverse external shocks to the Singapore economy including the Asian Financial Crisis, the tech slowdown, and the 2003 outbreak of Severe Acute Respiratory Syndrome (SARS). Singapore's small open economy experiences relatively volatile income growth, which results in high precautionary saving. With one of the fastest aging populations in the world, Singapore has also put an emphasis on saving for the future. The government and government-linked corporations are significant contributors to domestic saving, but the bulk of saving is done by the private sector, through mandatory saving programs and other means. The current account surplus increased to 29.6 percent of GDP in the first half of the year from 26.1 percent in 2004 on the back of an improvement in the goods balance due to a rebound in the manufacturing sector and the rising value of refined petroleum exports. As the 19th largest trading partner of the United States, Singapore is a net importer of U.S. goods, resulting in a U.S. bilateral trade surplus of about $3 billion in the first half of 2005. The current account surplus is projected to decrease in future years as the population continues to age. GDP growth moderated sharply in the first quarter to 2.7 percent yr/yr (down from 8.4 percent in 2004) on a slowdown in the pharmaceuticals sector but rebounded 5.2 percent yr/yr in the second quarter.

India

The Indian rupee fluctuated within a narrow band in the first half of 2005, ending largely unchanged against the US dollar. Although the rupee depreciated 0.4 percent against the U.S. dollar, the JP Morgan index of the real value of the rupee against the currencies of India's major trading partners appreciated about 5.5 percent. According to the central bank, India's exchange rate policy in recent years has been guided by "…broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene if and when necessary." Despite strong exports of services and remittances from overseas Indians, increases in international crude oil prices and robust domestic demand resulted in a current account deficit of 2.2 percent of GDP in the first half of 2005, following a balanced current account in all of 2004. The economy maintained its strong momentum in 2005, with GDP growing at 7.0 percent in the first quarter, and consumer prices rising 3 percent yr/yr in June. The U.S. bilateral merchandise trade deficit with India was steady at $4.9 billion in the first half of 2005. Strong capital inflows supported the rupee. Foreign investors, for example, poured $4.5 billion into Indian equity markets in the first half of 2005, compared to $3.5 billion in the first half of 2004. India continues to use reserves to pre-pay external debt by about $3 billion per year. Nonetheless, the Reserve Bank of India built reserves to $132 billion by the end of June, up from $125 billion in December 2004.

Japan

After stagnating in the second half of 2004, Japan's economy picked up speed in the first half of 2005. GDP growth in the first half of 4.5 percent was well above forecasts and market expectations. Business investment and private consumption were primary contributors to

growth. Core consumer prices (the Japanese CPI less fresh foods) fell by 0.2 percent year-on-year during the first half of 2005, the same as during the last half of 2004.

After more than a decade of sluggish growth subsequent to the bursting of Japan's huge stock and land price bubble and after eight years of battling to overcome deflation, Japan finally appears to be in position to achieve sustained, normal growth. The financial health of Japan's major banks has greatly improved, companies no longer feel they have large excesses of capacity or workers, and employment of regular fulltime workers has begun rising. Prices are still falling modestly, but many, including the Bank of Japan, expect deflation to come to an end in 2006. Should Japan finally exit deflation, this would be a major turnaround in the world's second largest economy, and would allow Japan to concentrate on policies to encourage greater domestic growth to deal with the fiscal challenges it faces with an aging population. This would also allow Japan to make a greater contribution to global growth and the adjustment of global imbalances.

Japan's current account surplus fell to $82.8 billion (3.4 percent of GDP) in the first half of 2005, from $85.9 billion (3.7 percent of GDP) in the second half of 2004. Japan's overall trade surplus showed a more dramatic decline of $6.4 billion to $45.3 billion as imports grew by 4.2 percent, while exports grew by only one percent, although much of the growth of imports was the result of higher prices for oil and other commodities. Japan's bilateral merchandise trade surplus with the United States totaled $41.6 billion in the first half of 2005, up from $39 billion in the second half of 2004. For the first eight months of 2005, Japan's trade surplus with the United States was $54.8 billion, up 12 percent from the same period in 2004. In 2004, Japanese residents bought large amounts of foreign bonds, drawn by higher interest rates overseas. These outflows were partially, but not fully, offset by large foreign purchases of Japanese equities in the first half of 2005 on the prospect of an improving Japanese economy. As a result, Japan's financial account recorded net outflows of $18.1 billion in the first half of 2005, down from $51.5 billion in the second half of 2004.

The yen's real effective exchange rate against a broad range of currencies depreciated by 3.3 percent during the first half of 2005. The yen depreciated against the U.S. dollar by seven percent during that period, possibly reflecting expectations of rising U.S. interest rates. Japanese authorities did not intervene in the foreign exchange market during the first half of 2005, and in fact have not intervened since March 16, 2004.[12] Japanese foreign currency reserves remained virtually flat, rising by less than $1 billion, or about 0.1 percent, to $825 billion in the first half of 2005.

China

China retained its fixed exchange rate of 8.28 yuan to the U.S. dollar throughout the first half of 2005. The report issued on May 17, 2005, concluded that China had completed preparations and was ready to move to a more flexible exchange rate and should act without delay. On July 21, 2005, China altered the fixed dollar peg that it had maintained for eight years, revaluing the

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

renminbi by 2.1 percent against the dollar.[13] The People's Bank of China explained that the action was intended to "enable the market to fully play its role in resource allocation as well as to put in place and further strengthen the managed floating exchange rate regime based on market supply and demand."

The new exchange rate mechanism the Chinese authorities have adopted allows for considerable flexibility and reflection of market forces. In the Joint Statement issued after the U.S.-China Joint Economic Committee meeting in Beijing on October 17, 2005, the Chinese authorities committed "to enhance the flexibility and strengthen the role of market forces in their managed floating exchange rate regime."[14]

This has not occurred yet. Since July 21, the renminbi exchange rate has fluctuated in a very narrow trading range against the dollar. The July 21 action was an important first step, but the initial adjustment and the subsequent movement of the renminbi are not sufficient and do not represent fulfillment of the Chinese authorities' commitment. Chinese monetary authorities have not fully utilized the flexibility allowable by the regime, with intra-day movements of the RMB against the U.S. dollar much less that the allowable +/- 0.3%.

China's economy showed many signs of overheating in 2004, as a credit-fueled investment boom – in large part due to the capital inflows and low real interest rates that resulted from the fixed exchange rate China maintained – spurred growth but also threatened an outburst of inflation. In response, Chinese policymakers implemented a variety of administrative and some market-based tightening measures to curb lending activity and investment, particularly in overheated sectors of the economy, including the property sector. These policies had some success, as investment growth slowed and inflation moderated from its 2004 peak. Although investment growth slowed, the slowdown in overall GDP growth has been less pronounced. China's real GDP grew by a stronger than expected 9.5% in the first half of 2005 (down only 0.2 percentage points from same period last year) and by 9.4% in the third quarter. While the contribution of investment to growth has fallen, the contribution of net exports has increased significantly this year.[15] Even though consumer inflation has declined as food prices have eased (CPI rose by 0.9% yr/yr in September off the 5.3% peak in August, 2004), inflation remains constrained by price controls, notably on oil, which has led to sporadic shortages.[16] Producer prices are still growing at a more rapid rate (4.5% yr/yr in September, compared to a peak of 8.4% yr/yr in October, 2004).

In the first half of 2005, China's global trade surplus grew to a (seasonally unadjusted) total of $39.6 billion (5.0 percent of GDP), already exceeding the $32.1 billion surplus for all of 2004.[17] In the third quarter China's trade surplus widened further, and for the first nine months of 2005

[13] The name of the Chinese currency is the renminbi, and the unit of account is the yuan.
[14] See http://www.treas.gov/press/releases/js2987.htm.
[15] China publishes data on GDP by expenditure components, which is needed to compute the contributions of various demand sources to growth, only on an annual basis with a lag of one year. The observation that the contribution of net exports has increased significantly is based on first half current account data released by the Chinese authorities and on private sector estimates.
[16] In early November, 2005, the Chinese authorities announced they would ease price controls on utilities.
[17] These trade figures are on an FOB-CIF basis. If China's imports were measured on the same basis as its exports (fob), China's adjusted global merchandise trade balance would be $54.1 billion. [Note: this calculation assumes a 4.8% c-i-f (cost, insurance, and freight) adjustment factor.]

totaled $68.3 billion. Chinese goods exports rose 31% in the first nine months of 2005, about the same as the 35% rate of growth last year. The sharp rise in net exports is largely due to a deceleration in the growth of China's imports. China's total imports grew by only 14 percent yr/yr in the first half of 2005 over the same period last year, a much slower pace than the 36 percent increase in imports during all of 2004. Administrative measures imposed last year helped to slow investment growth, which in turn reduced demand for imports of capital equipment. In addition, in certain sectors that experienced rapid expansion of capacity (such as steel, aluminum, cement, and automobiles) domestic production to some extent substituted for imported goods. The increase in the trade surplus was reflected in China's current account surplus, which was an estimated $67.3 billion (8.3 percent of GDP) in the first half of 2005, nearly matching the $68.7 billion current account surplus for all of 2004.[18]

After deducting the $15 billion in foreign exchange transferred to recapitalize one of China's major banks, China's official foreign exchange reserves grew by $101 billion during the first half of 2005 to reach $711 billion at the end of June. In addition to the current account surplus, net financial and capital inflows were an estimated $38.3 billion, compared to a net inflow of $111 billion for all of 2004. For the first time in several years China's current account surplus accounted for the majority of its reserve accumulation instead of net capital inflows. Reserve accumulation continued in the third quarter, with reserves growing an additional $58 billion to reach $769 billion at end September. The central bank continued to "sterilize" the foreign exchange inflows by issuing central bank bills, and net issuance picked up in the first half of 2005.[19]

On July 21, 2005, China changed its exchange rate to a new value of 8.11 yuan per dollar. This was a 2.1 percent revaluation, a small initial movement in response to the market pressures China has faced over the past several years. China also abandoned the U.S. dollar peg, adopting "a managed float exchange rate regime, based on market supply and demand with reference to a basket of currencies." Thus far, however, the currency basket does not appear to have played a significant role in determining the daily closing level of the renminbi, and trading behavior since July 21 strongly suggests that the new mechanism remains, in practice, a tightly managed currency peg against the U.S. dollar.

The Chinese authorities also took steps during the year to prepare market participants for greater exchange rate flexibility and provide some financial products to hedge foreign exchange risk. China expanded the list of participants in the inter-bank spot market, allowed market makers in renminbi, expanded the number of banks that can handle foreign exchange forward transactions, expanded the types of transactions that can be hedged using forwards, and offered currency swaps. However, there is still substantial scope to expand the depth and liquidity of the foreign exchange market in China. In addition, the tight management of the exchange rate itself diminishes the need for development of the market, since participants have much less incentive to hedge. By allowing the exchange rate to fluctuate more widely according to the market, the

[18] Preliminary current account statistics for the first half of 2005 in China were published by the State Administration of Foreign Exchange (SAFE) on October 31, 2005.
[19] The People's Bank of China (PBOC) issued $97 billion on a net basis in the first half of 2005, compared to $33 billion in the last six months of 2004.

authorities would create demand for products that could help firms manage the risks associated with currency exposure more effectively.

China has taken steps to liberalize its controls on capital movements in order to increase the depth and liquidity of foreign exchange markets. But its capital controls still maintain greater restrictions on capital outflows than on inflows. Chinese authorities recently allowed foreign investors to acquire a greater number of shares in locally listed Chinese companies. This move coincides with government efforts to introduce trading for previously non-traded shares owned by the state.

But while the new exchange rate mechanism allows for greater flexibility, China's exchange rate since July 21 has been very tightly controlled. The renminbi-dollar exchange rate has fluctuated up and down on a daily basis within very narrow ranges and has gradually strengthened from 8.11 yuan per dollar to 8.0815 per dollar as of November 25, a cumulative appreciation of 0.35 percent against the dollar. Even though China had pegged its exchange rate to the dollar prior to July 21, and has allowed for modest fluctuation since, this has not prevented China's currency from fluctuating against currencies of other trading partners. On a trade-weighted basis, the RMB appreciated during the reporting period: the nominal and real effective exchange rates, as measured by the J.P. Morgan Narrow Nominal and Broad Real Effective Exchange Rate Indices, appreciated by 2.9 percent and 3.5 percent, respectively, reflecting in large measure the dollar's appreciation.

China's exchange rate is not yet sufficiently flexible to meet the needs of the Chinese economy or those of the global economy. A significant increase in flexibility is necessary to give China a sufficiently autonomous and effective monetary policy to sustain growth and avoid inflation. The inability to set domestic interest rates limits monetary control and also hinders efforts to encourage more efficient bank lending. In addition, speculative capital continues to flow into China on the expectation that the renminbi will appreciate further. Furthermore, a rigid exchange rate hinders China's ability to move away from its current dependence on exports and continued rapid increases in investment to a more balanced and sustainable pattern of growth in which households have a greater share. Nor has the Chinese government introduced flexibility sufficient to contribute to the orderly reduction of global imbalances that is needed to assure continued strong global growth.

Treasury has continued to engage China in active bilateral and multilateral discussions on macroeconomic, financial sector and exchange rate reform issues. This year, Treasury facilitated the invitation of Chinese economic leaders to several G7 meetings where these topics featured prominently. In addition, the APEC economies, including China, acknowledged their joint responsibility in bringing about an orderly adjustment of global imbalances, including, where appropriate, greater exchange rate flexibility.[20] Secretary Snow traveled to China in mid-October 2005 for intensive talks with Chinese leaders, including through the U.S.-China Joint Economic Committee (JEC) with broad and active participation from key economic and financial ministries and financial regulators in China and the United States. A separate meeting of a U.S.-China financial regulatory working group was also held in October. Finally, Secretary Snow just

[20] See http://www.apec.org/apec/ministerial_statements/sectoral_ministerial/finance/2005_finance.html for the statement from the September 2005 Finance Ministers meeting.

appointed a full-time, permanent resident Treasury Financial Attaché who will move to Beijing in the first half of 2006.

The Chinese authorities have said clearly that the July 21 action is the first step in a process of introducing greater exchange rate flexibility. In the Joint Statement following the U.S.-China Joint Economic Committee meetings in Beijing on October 16-17, they said that they would enhance the flexibility and strengthen the role of market forces in their managed floating exchange rate regime, and President Hu told President Bush that China would unswervingly press ahead with reform of its exchange rate mechanism. The Chinese authorities should do so by the time this report is next issued. Treasury will monitor movements of the renminbi and the authorities' progress in allowing significant exchange rate flexibility before the next report.

Taiwan

Taiwan's economy slowed considerably during the first half of 2005, growing at a seasonally adjusted annual rate of only 1.7 percent, after growing at a seasonally adjusted annual rate of 4.1 percent in the second half of last year. A lull in electronics exports contributed to weak export performance. Consumer price inflation remained low, with consumer prices up 1.9 percent year-on-year in the first half of 2005. Nevertheless, the central bank has raised interest rates during each of its last four policy meetings, in an effort to head off inflationary pressures, in part related to rising oil prices.

Taiwan's trade surplus was $1.7 billion in the first half of 2005, down substantially from the $5 billion recorded in the first half of 2004, as imports climbed 11.1 percent, due in large part to higher oil prices, and exports rose by 6.6 percent. Taiwan's bilateral trade surplus with the United States dropped slightly to $5.7 billion in the first half of 2005 from $5.8 billion in the year earlier period. Reflecting the fall in the overall trade surplus, Taiwan's current account surplus dropped to $5.8 billion (3.5 percent of GDP) in the first half of 2005, down from $11.3 billion (7.4 percent of GDP) in the first half of 2004 and 4.8 percent of GDP in the second half of last year.

Net financial inflows to Taiwan were $9.6 billion in the first half of 2005, reversing an outflow of $7.8 billion in the second half of 2004. The main component was a $13.5 billion inflow of other investments, as the New Taiwan (NT) dollar appreciation during the first quarter of 2005 led enterprises to remit home their export proceeds retained overseas and banks to reduce their lending or deposits abroad as well as bring in capital from abroad.

After rapid growth in reserves between 2000 and 2004, Taiwanese intervention and reserve accumulation have slowed markedly so far in 2005. Reserves at the end of June were $254 billion, 5% higher than at the end of 2004, and remained at that level at end-September. After appreciating by 6.0% in the last half of 2004, the NT dollar was roughly stable over the reporting period, closing June at 31.64 per U.S. dollar, an appreciation of 0.3 percent since December 31, 2004. Since June 30, the NT dollar depreciated by 4.6 percent to end-September and an additional 1.1 percent in October.

South Korea

The South Korean economy grew briskly in late 2003 and early 2004 on strong growth of net exports, but slowed in the last half of 2004. Growth in the second half of 2004 slowed to 4.0 percent (year-over-year), and slowed further to 3.0 percent in the first half of 2005. There are signs of a pickup in the third quarter, and growth for 2005 as a whole is expected to be about four percent, as a cautious rebound in private consumption and business investment is offsetting slowing net exports. In fact, domestic demand is expected to overtake external demand as the main contributor to growth for the first time since 2002. However, the recovery in consumption is still limited by slow progress in reducing the high level of unemployment and remaining high levels of household debt in the aftermath of South Korea's credit card bubble of 2002. The Bank of Korea has taken advantage of South Korea's exchange rate flexibility by pursuing an accommodative monetary policy to support growth, at a time when U.S. interest rates have been rising. The Bank of Korea left interest rates unchanged during the first half of the year, as both the CPI and core inflation remained well within the 2.5 – 3.5 percent target range, despite rising oil prices.

Export growth decelerated in the first half of 2005, rising 11 percent year on year, compared with a 25 percent increase year-on-year in the second half of 2004. Exports to China remained an especially significant contributor. Import growth outpaced export growth, rising 14.8 percent over a year ago, reflecting the impact of rising oil prices on the cost of imports. As a result, South Korea's overall trade surplus shrank 6.0 percent from a year earlier. The U.S. bilateral trade deficit with Korea fell to $8.5 billion for the first half of 2005, down $0.4 billion and 4.8 percent from the same period in 2004. Korean exports to the U.S. grew by less than one percent, and Korean imports from the U.S. grew by 4.1 percent compared to the same period last year. South Korea's current account surplus moved in line with its shrinking trade surplus, dropping from $14.4 billion (3.8 percent of GDP) in the second half of 2004 to $8.7 billion (2.4 percent of GDP) in the first half of 2005 on a seasonally adjusted basis.

The net inflow in the capital and financial account of $4.7 billion in the first half of 2005 was a marked decrease from the $7.5 billion inflow in the second half of 2004. Both foreign direct investment of Koreans abroad and foreign direct investment into South Korea fell sharply in the first half of 2005, as did net inward portfolio investment. Foreign exchange reserves increased by $6 billion (3 percent) to $205 billion during the reporting period.

After appreciating over 10 percent in the second half of 2004, the South Korean won fluctuated against the dollar within a relatively narrow band during the first half of 2005, ending the first half at 1,034.5 won per dollar, virtually unchanged from the end of 2004. South Korea's real effective exchange rate appreciated by about 5 percent, reflecting appreciation of the dollar against other currencies during the first half of 2005.

Malaysia

Malaysia's economy grew at a 4.9 percent annual rate during the first half of 2005, slowing from the 8.1 percent rate for the same period last year. Although the economy grew 7.1 percent in 2004, it significantly slowed down in the second half of the year due in part to a moderation in

global growth. Economic activity picked up a bit in the first half of this year with increases in private consumption and private investment. Growth in 2005 is expected to be around 5 percent. Fiscal consolidation continued, as public works spending declined and total public sector spending fell moderately as part of the government's overall goal to bring the fiscal deficit down to 3.8 percent of GDP. The government also has gradually cut oil subsidies as global oil prices continue to rise, creating a slight drag on consumption.

The current account surplus was $10.2 billion, or 16.5 percent of GDP, in the first half of 2005, up from 12.7 percent in the second half of 2004. Malaysia's bilateral trade surplus with the United States totaled $10.4 billion in the first half of 2005, compared with $7.5 billion in the first half of 2004. Large current account surpluses have been a striking feature of the Malaysian economy in the last few years, even before higher oil prices (Malaysia is a net oil exporter) expanded the surplus. After running substantial external deficits prior to the Asian Financial Crisis, Malaysia has had significant and growing trade and current account surpluses. The current account surplus in 2004 was $14.9 billion (12.6 percent of GDP). Malaysia's current account surplus is in large part the counterpart to a sharp fall in domestic investment that took place in the aftermath of the Asian Financial Crisis. After rising to over 40 percent of GDP in 1995-97, total investment dropped sharply in 1998, and has declined gradually to 20.5 percent of GDP in 2004. The decline in private investment has been even more striking, falling from over 30 percent of GDP in 1997 to just below 8 percent in 2003. Part of this decline was expected after the investment boom just prior to the 1997 Asian Financial Crisis, but Malaysia's investment rate is almost 15 percentage points below its level in the early 1990s, and there have been sharp declines in both domestic private and foreign direct investment. The reasons for the sharp fall in investment are not clear; reasons that have been suggested include declining competitiveness of Malaysia vis-à-vis other Asian economies, shortages of complementary inputs (particularly skilled labor), policy efforts to shift towards a more service-oriented economy, and the effect of government regulation.

Through the first half of 2005, Malaysia maintained a fixed peg to the dollar (3.80 ringgit to a dollar), as it had since September 1998. However, immediately following China's revaluation on July 21, Malaysia announced that it was abandoning the ringgit's peg to the dollar and moving to a managed float against a trade-weighted basket. The Central Bank plans to monitor the exchange rate to ensure that it "remains close to its fair value." In the first two weeks after the revaluation, the ringgit appreciated by only 1.4 percent, before falling to a level of about 3.77 (a cumulative appreciation of 0.8 percent from the original pegged rate), with small fluctuations in the daily rate.

Preceding this move, Malaysia relaxed most of its controls on capital flows which were imposed when the ringgit was pegged in 1998. As of April 1, 2005, Malaysia further relaxed the controls to allow: increased investment abroad; maintenance of currency export proceeds with licensed banks onshore; and hedging on any committed or anticipatory current account transaction or on any committed capital account payments. However, offshore trading of the ringgit remains prohibited, and foreign portfolio investment by residents continues to be limited.

Malaysia's financial account surplus contracted to $1 billion in the first half of 2005 from $1.7 billion in the last half of 2004, due in part to a decline in net portfolio investment inflows. At the

end of June 2005, foreign exchange reserves stood at $70.4 billion, up from $61.7 billion at the end of 2004.

Although Malaysia has taken important step to remove the capital controls it imposed during the Asian Financial Crisis in 1997, and has made a small alteration in the ringgit exchange rate, its currency remains essentially fixed, despite the substantial rise in the current account and trade balances. Malaysia is a relatively small and highly open economy, where domestic prices rapidly reflect changes in international prices. In these circumstances, Malaysia's exchange rate policy may be appropriate. At the same time, the large and rising current account surplus suggests that there are both external and domestic imbalances in which the exchange rate plays a role. Treasury will begin bilateral discussions with the Malaysian government on its exchange rate policy and the role that it plays in the Malaysian economy.