

Report to Congress on International Economic and Exchange Rate Policies

U.S. Department of the Treasury
Office of International Affairs

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This Report reviews developments in international economic and exchange rate policies and is submitted pursuant to the Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C. § 5305 (the “Act”).¹

¹The Treasury Department has consulted with the Board of Governors of the Federal Reserve System and International Monetary Fund management and staff in preparing this Report.

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Key Findings

The Omnibus Trade and Competitiveness Act of 1988 (the "Act") requires the Secretary of the Treasury to provide semiannual reports on the international economic and exchange rate policies of the major trading partners of the United States. Under Section 3004 of the Act, the Report must consider "whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade."

This report covers developments in the first half of 2013, and where pertinent and available, data through end-September 2013. This Report reviews the macroeconomic and exchange rate policies of economies accounting for 72 percent of U.S. foreign trade and of global economic developments more broadly in the first half of 2013. The Report concludes there has been some progress on the goal of achieving strong, sustainable and balanced growth and the necessary exchange rate adjustments, but the record is mixed, and further progress is needed.

The Administration's policies to promote growth and jobs are bearing fruit. U.S. real GDP grew by an annual rate of 1.8 percent during the first half of 2013, accelerating from the 1.5 percent pace in the second half of last year. A consensus of private forecasters expects growth to strengthen in late 2013 and to accelerate to 2.8 percent in 2014. Growth has been supported by consumer spending and residential investment in an environment of improved household balance sheets, accommodative credit conditions, and faster job creation. Nonfarm payrolls have been increasing by an average of 185,000 per month over the last year and 7.6 million private sector jobs have been created since February 2010. The unemployment rate has dropped to 7.2 percent as of September 2013, the lowest level since November 2008. The federal deficit has fallen rapidly this year, acting as a headwind to growth. In the fiscal year that just ended, the deficit is expected to decline from 7 percent of GDP to just over 4 percent, its lowest level since FY2008. Relative to GDP, this is nearly 6 percentage points of GDP smaller than the FY2009 deficit of 10.1 percent of GDP. The Administration remains committed to further reducing the deficit, consistent with economic conditions, and to placing public finances on a long-term sustainable path.

This year has seen stronger growth in advanced economies, coupled with a reassessment of the relative growth prospects of emerging economies. Overall, the IMF projects the global economy will expand by 2.9 percent in 2013, down from 3.2 percent in 2012. Looking forward, the IMF projects global growth will strengthen to 3.6 percent in 2014. There are signs that the lengthy recession in the euro area has come to an end, although unemployment remains very high in many countries. Growth has slowed in many emerging market economies due to the waning of post-crisis stimulus, slowing global export demand, including softer commodity demand from China, and tighter credit conditions. Many emerging market currencies have depreciated in 2013 due to global and local factors. After an initial market selloff in May, markets began to differentiate among emerging market countries according to the strength of their policy frameworks and their current account positions. Many emerging markets have strengthened their economic institutions and policy frameworks over the past decade and thus increased their resilience to shifts in capital flows. Generally, in those countries with stronger frameworks, currencies and financial markets have retraced earlier declines.

The policy requirements necessary to support global rebalancing vary.

Within the euro area, countries with large and persistent surpluses need to take action to boost domestic demand growth and shrink their surpluses. Germany has maintained a large current account surplus throughout the euro area financial crisis, and in 2012, Germany's nominal current account surplus was larger than that of China. Germany's anemic pace of domestic demand growth and dependence on exports have hampered rebalancing at a time when many other euro-area countries have been under severe pressure to curb demand and compress imports in order to promote adjustment. The net result has been a deflationary bias for the euro area, as well as for the world economy.

Among the major emerging market economies, many in Asia have tightly managed exchange rates with varying degrees of active management. This report highlights the need for greater exchange rate flexibility in these economies, most notably in China, as well as the need for greater transparency on exchange rate management, official intervention, and reserves, along with stronger discipline over actual and verbal intervention.

The RMB is appreciating on a trade-weighted basis, but not as fast or by as much as is needed, and intervention has resumed. RMB appreciation is not only good for the U.S. economy, but good for the economies of China, broader Asia, and the world. In the first nine months of the year, the RMB has appreciated 6.3 percent on a nominal effective basis, and 6.6 on a real effective basis, the most among the currencies covered in this report. This, in considerable part, reflects the yen's depreciation against the dollar and weakness in many EM currencies. However, the pace of nominal RMB appreciation against the dollar has been more modest (2.2 percent year-to-date as of October 18, 2013), with very little appreciation for several months.

Over the longer term, through mid-October 2013, the RMB has appreciated by a total of 12 percent against the dollar and 16 percent on a real, inflation-adjusted basis from June 2010, when China moved off its peg against the dollar, and has appreciated about 45 percent in inflation-adjusted terms since China initiated currency reform in 2005. In the most recent IMF Article IV consultation with China, the IMF concluded that the RMB was moderately undervalued against a broad basket of currencies and the IMF's *Pilot External Sector Report* estimates that the RMB was undervalued by about 5 to 10 percent on a real effective basis, as of July 2013.

Chinese authorities have a stated commitment to further reform of the exchange rate mechanism. At the February 2013 G-20 Finance Ministers and Central Bank Governors Meeting in Moscow, China joined other G-20 members in pledging "not to target exchange rates for competitive purposes," and reaffirmed its commitment "to move more rapidly toward more market-determined exchange rate systems and exchange rate flexibility to reflect underlying fundamentals, and avoid persistent exchange rate misalignment." China also committed at the 2012 G-20 Leaders Summit in Los Cabos, Mexico, to reduce the pace of reserve accumulation and increase the transparency of its exchange rate policy.

From late 2011 through early 2012, official intervention fell as concerns about a slowdown in China and the financial crisis in the euro area lowered capital inflows into China. As these concerns receded in late 2012 and in the first half of 2013, official intervention resumed on a

large scale. Official Chinese data show that the PBOC and Chinese financial institutions collectively purchased a record \$110 billion in foreign exchange in both January and September 2013. The evidence that China has resumed large-scale purchases of foreign exchange this year, despite having accumulated \$3.6 trillion in reserves, which are more than sufficient by any measure, is suggestive of actions that are impeding market determination and a currency that is significantly undervalued.

China still does not disclose its intervention in foreign exchange markets. As a result, market participants and other observers must resort to estimating Chinese intervention using published reserve levels. In line with the practice of most other G-20 nations, China should disclose foreign exchange market intervention regularly to increase the credibility of its monetary policy framework and to promote exchange rate and financial market transparency.

Japan has not intervened in the foreign exchange markets in almost two years, though the authorities issued numerous public statements regarding their desire to "correct the excessively strong yen" in the weeks following Prime Minister Abe's election. Shortly thereafter, the Japanese government joined the G-7 statement of February 2013 affirming that its economic policies would be based on domestic objectives using domestic instruments, and would not target the exchange rate. Since then, Japanese officials have clearly ruled out purchases of foreign assets as a monetary policy tool and have refrained from public comment on the level of the exchange rate. Japan was also part of the subsequent G-20 statement in February 2013 that countries would not target exchange rates for competitive purposes. This commitment was affirmed by G-20 Leaders in September 2013 at the St. Petersburg Summit.

We will continue to closely monitor Japan's policies and the extent to which they support the growth of domestic demand. In order to support a stronger economic recovery and increase potential growth, it is important that Japan calibrate the pace of fiscal consolidation to the recovery in domestic demand and take ambitious and effective steps to increase domestic demand. Monetary policy cannot offset excessive fiscal consolidation or be a substitute for structural reform that raises trend growth and domestic demand. It is critically important for the global economy that Japan's economic policies work primarily through an increase in domestic demand.

Although the Korean won depreciated at a moderate pace against the U.S. dollar in the first half of 2013, the IMF's July 2013 *Pilot External Sector Report* finds that Korea's real effective exchange rate remains undervalued in a range from 2 to 8 percent. While the Korean government does not publish intervention data, market participants estimate that the authorities intervened in early 2013 to limit the pace of won appreciation as the Japanese yen weakened, switched to limiting won depreciation in June, as financial market volatility increased, and then switched back again to limiting won appreciation in September 2013. As of end-September 2013, Korea's foreign exchange reserves stood at \$326 billion. The September 2012 IMF Article IV consultation report on Korea noted that reserves were adequate and there was "no need for further reserve accumulation beyond what would be needed to keep pace with rising foreign liabilities over time." We will continue to encourage Korean authorities to limit foreign exchange intervention to the exceptional circumstances of disorderly market conditions. In

addition, in line with the practice of most other G-20 countries, Korea should disclose foreign exchange market intervention shortly after it takes place.

Based on the analysis in this report, Treasury has concluded that no major trading partner of the United States met the standard of manipulating 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 as identified in Section 3004 of the Act during the period covered in the Report. Nonetheless, Treasury is closely monitoring developments in economies where exchange rate adjustment is incomplete and pushing for comprehensive adherence to recent G-7 and G-20 commitments. Treasury will continue to monitor closely exchange rate developments in all the economies covered in this report, with particular attention to the need for greater RMB appreciation, and press for further policy changes that yield greater exchange rate flexibility, greater transparency on intervention, a more level playing field, and support for strong, sustainable and balanced global growth.

Introduction

This Report focuses on international economic and foreign exchange developments in the first half of 2013. Where pertinent and when available, data and developments through end-September 2013 are included.

Exports and imports of goods to and from the ten economies analyzed in this Report accounted for 72 percent of U.S. merchandise trade in 2012.

U.S. Macroeconomic Trends

The U.S. Economy Continued to Grow at a Moderate Pace

Real GDP grew by 1.8 percent at an annual rate during the first half of 2013, accelerating slightly from a 1.5 percent pace in the second half of last year. The economy's performance improved in the second quarter of 2013, with growth picking up to a 2.5 percent annual rate from 1.1 percent in the first quarter, due primarily to stronger growth of fixed investment and a smaller drag on activity from declining government spending. Growth of private domestic demand – the sum of consumption, business fixed investment and residential investment – accelerated to a 2.6 percent pace from 1.5 percent in the first quarter. Although the economy continues to face challenges in 2013, the housing sector is showing clear signs of recovery, households are making progress repairing their balance sheets, firms are making capital investments, and labor market conditions are steadily improving. A consensus of private forecasters expects growth to strengthen in late 2013 and accelerate further in 2014.

Growth during the first half of 2013 reflected stronger growth of consumer spending as well as a larger build-up of inventories, which helped offset small negative contributions from the government sector and net exports. Consumer spending rose at a 2.0 percent annual rate during the first half of 2013, accelerating from a 1.7 percent pace during the second half of 2012. Business fixed investment was about unchanged in the first half of 2013, after rising at a 4.9 percent rate during the latter half of 2012. Growth of investment in equipment investment was little changed at a 2.4 percent pace in the first half of this year. However, investment in intellectual property products slowed, rising just 1.1 percent following a 4.2 percent increase during the second half of 2012, and structures investment declined 6.5 percent at an annual rate in the first half of 2013, after surging by nearly 12 percent in the latter half of last year. Inventories were a substantial drag on growth in late 2012, but they have made large positive contributions to growth thus far in 2013 of roughly 0.7 percentage point on average in each of the first two quarters.

Residential investment had grown at a double-digit pace in each of the last four quarters; the pace moderated to a 13.4 percent annual rate during the first half of 2013 from a 17.0 percent pace during the second half of last year. Residential investment grew by 15.5 percent over the four quarters of 2012, the strongest yearly increase since 1983, and has contributed positively to GDP growth in each of the past eleven quarters following a five-year period of subtracting from GDP growth.

Export growth slowed sharply during the final two quarters of 2012, reflecting a general slowdown in the global economy, but import growth was negative on average. In 2013, exports fell slightly in the first quarter (the first decline in exports since the recovery began), but rebounded sharply in the second quarter of this year. However, import growth advanced notably, especially in the second quarter, and offset the growth of exports during the first half of the year. As a result, net exports subtracted an average 0.1 percentage point from real GDP growth in the first and second quarters of 2013 after adding roughly 0.3 percentage point on average to growth in the final two quarters of 2012.

Ongoing fiscal contraction at all levels of government weighed further on growth during the first half of 2013, with government spending falling by 2.3 percent at an annual rate following a decline of 1.7 percent during the final two quarters of last year. Even so, the drag on economic activity from declining government spending eased. Altogether, the public sector subtracted less than 0.1 percentage point per quarter from GDP growth on average in the first two quarters of 2013 compared with a subtraction of 0.3 percentage point per quarter in the second half of 2012.

The economy is expected to expand at a moderate pace through the end of 2013 and gradually accelerate over the course of 2014. A consensus of private forecasters currently expects real GDP to grow at an average annual rate of roughly 2.2 percent in the second half of 2013 and 2.8 percent over the four quarters of 2014.

Recovery in the Housing Sector Continued

Activity in the housing market has picked up notably over the past two years, supported by improving house prices, loosening credit conditions, a faster pace of job creation in the economy, and relatively low mortgage rates. A variety of indicators continued to show improvement in the first half of 2013, albeit at a more tempered pace than in late 2012. Single-family housing starts stood at a 628,000 annual rate in August 2013, slightly below four and one-half year highs recorded earlier in the year and up 17 percent from a year earlier. Sales of new single-family homes rose 12.6 percent over the year ending in August to 421,000 at an annual rate, and sales of all existing homes (including single-family homes, as well as condos and co-ops; 94 percent of all home sales) increased 10.7 over the year ending in September percent to nearly 5.3 million at an annual rate. The stock of homes on the market remains relatively lean, and the pace of household formation remains below its historical trend.

Interest rates and house prices are rising: the benchmark 30-year mortgage rate rose over a full percentage point from early May to August before retracing partially, and is now in the 4.25 percent range; and house prices have been rising on a year-over-year basis since early 2012, with gains now approaching those seen prior to the housing downturn. As a result, housing affordability has fallen just over 20 percent from its peak in early 2012. Even so, affordability is still high by historic standards, as mortgage rates remain relatively low and house prices are well below their peaks. Higher home prices have pushed more homes into positive equity and lessened the strains on mortgage markets coming from distressed loans. The outlook for housing remains favorable: home builder and home buyer confidence are the highest they've been in several years, and both new residential construction and sales are expected trend up over the rest of the year.

Labor Market Conditions Improved

Job creation proceeded at a steady pace through the first eight months of 2013. On average, nonfarm payrolls increased by 185,000 per month over the nine months through September 2013, comparable to the 180,000 average monthly pace during the second half of last year. Nearly 7.0 million jobs have been created since February 2010, including 7.6 million in the private sector. Between June 2012 and June 2013, the unemployment rate fell by 0.6 percentage point to 7.6 percent, and dropped further in September 2013 to 7.2 percent, the lowest level since November 2008. Despite these gains, private employment is still 1.3 million lower than at the start of the recession in December 2007 and the unemployment rate is 2.2 percentage points higher. Some progress has been made in reducing long-term unemployment, but the share of the unemployed out of work for 27 weeks or more remains high. This rate stood at 36.9 percent as of September 2013, down from a record level of 45.3 percent in March 2011 but more than double the 17.5 percent share averaged prior to the start of the last recession in 2007.

Inflation Remained Moderate

Energy prices have increased a bit from their early 2013 lows. The front-month futures price of West Texas Intermediate (WTI) crude oil averaged \$106.57 per barrel in September 2013, up from a low of \$91.50 per barrel in April 2013 and almost \$12 higher than its year-earlier average. The U.S. average retail price for regular gasoline rose sharply during the fall of 2012, peaking at \$3.88 per gallon in mid-September, but as of October 7, 2013, stood at \$3.37 per gallon.

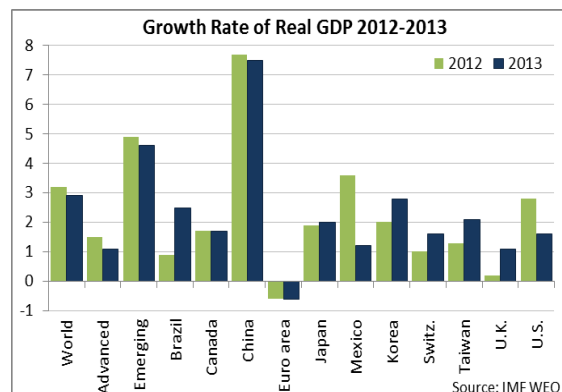
While headline inflation rates mainly reflected fluctuations in energy prices in recent months, core inflation has generally trended lower. The consumer price index rose 1.5 percent during the year ending in August 2013, slower than the 1.7 percent increase in the previous twelve months. Core consumer inflation moderated to 1.8 percent over the year ending in August from 1.9 percent over the year-earlier period. Slack in labor markets, as well as low capacity utilization, have contained inflationary pressures. Compensation cost growth as measured by the Employment Cost Index (ECI) for private-industry workers rose 1.9 percent during the year ending in June 2013, compared with a 1.8 percent rise in the twelve months through June 2012.

Putting Public Finances on a Sustainable Path Remains a Priority

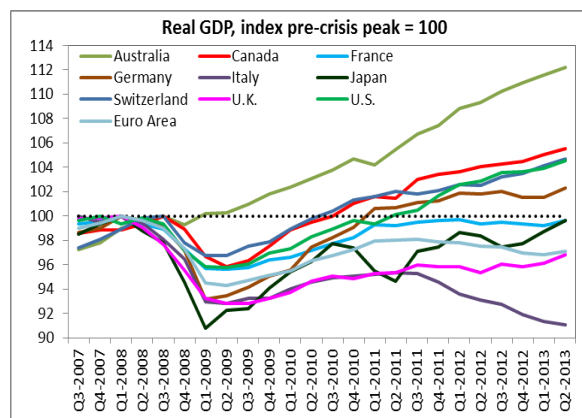
The federal deficit has fallen rapidly this year, acting as a headwind to growth. In the fiscal year that just ended, the deficit is expected to decline from 7 percent of GDP to just over 4 percent, its lowest level since FY2008. Relative to GDP, this is nearly 6 percentage points of GDP smaller than the FY2009 deficit of 10.1 percent of GDP. The Administration remains committed to further reducing the deficit, consistent with economic conditions, and to placing public finances on a long-term sustainable path. The Administration's FY 2014 Budget proposal would replace the sequestration with \$1.8 billion in well balanced deficit reduction measures. Along with the \$2.5 trillion in deficit reduction measures put in place since FY 2011, that would bring the total amount of deficit reduction over the next decade to \$4.3 trillion. The Administration's budget plan would cut the deficit to less than 3 percent of GDP by 2017 and roughly 2 percent by 2023 and put Federal debt on a declining path as a share of the economy.

The Global Economy

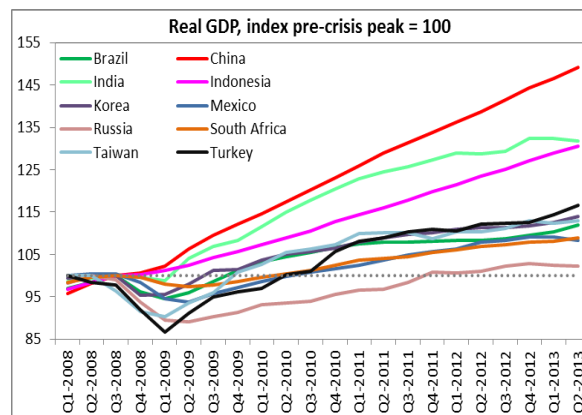
Global economic growth has slowed in 2013. The IMF projects the global economy will expand by just 2.9 percent in 2013, down from 3.2 percent in 2012, with growth declining in both advanced and emerging market economies. Real GDP in the advanced economies is projected to expand by 1.2 percent in 2013 compared with 1.5 percent in 2012 and 1.7 percent in 2011, mostly the result of the recession in the euro area carrying over into the first part of 2013. Real GDP is projected to expand by 4.5 percent in the emerging market and developing economies, down from 4.9 percent in 2012 and 6.2 percent in 2011, led by a moderation in growth in China. The IMF expects that the pace of global growth will pick up in 2014 to 3.6 percent, mostly reflecting a pick-up in growth in the advanced economies, led by the United States, and the euro area emerging from recession with positive growth on a year-on-year basis.



Nonetheless, four years after the recovery from the financial crisis began, output in many advanced economies has yet to return to its pre-crisis level. Even among the countries where output has moved above pre-crisis levels, growth remains far below levels implied by pre-crisis trends. Only Australia, which saw the mildest recession among the advanced economies, has seen a robust recovery. As noted, there are some encouraging signs as real GDP growth in the United States is expected to increase to near 3 percent in 2014, growth will accelerate in the United Kingdom and Canada, and there are signs that the lengthy recession in the euro area has come to an end.



Output in all the major emerging market economies has expanded beyond pre-crisis levels, but growth is slowing in many due to the waning of post-crisis stimulus in their own economies, lower commodity prices, and limited progress on key reforms. The IMF expects China will experience slower growth over the medium-term as it rebalances demand away from investment. Real GDP growth in emerging market economies is projected to increase modestly to 5.1 percent in 2014.



The strength of U.S. private demand growth has been a pillar of support to the global economy, and the expectation of increasing U.S. growth

over the coming year is a major factor in the IMF's more optimistic outlook for 2014. As a result of the improving economic outlook for the United States, the Federal Reserve has begun to consider tapering the pace of its quantitative easing. Although the process of normalization of U.S. macroeconomic policy, when it occurs, could have spillover effects on other economies, the benefits of a stronger U.S. economy to the global economy will outweigh any such impacts.

In May, many emerging market currencies depreciated and their bond and equity markets sold off as U.S. Treasury yields rose and questions emerged about the strength of activity in a range of emerging economies. In subsequent months, financial markets have been increasingly differentiating pricing on the basis of various countries' fundamentals. This volatility stems from a variety of factors, some of which were global and some that were local. Some emerging economies have seen a widening of their external deficits and face difficult policy challenges as growth has slowed while inflation has remained above target. Other economies have considerably stronger fundamentals and larger policy toolkits than in years past, including having more scope for implementing countercyclical fiscal and monetary policies as needed and more flexible exchange rate regimes. Stronger policy frameworks, including through greater exchange rate flexibility; monetary policy easing, consistent with inflation dynamics; and strong regulatory and supervisory policies, will enable emerging market economies to better deal with the challenges that lie ahead. At the G-20 Leaders' Summit in St. Petersburg in early September, leaders stated that they would continue to monitor financial market conditions carefully, while G-20 central banks have committed to carefully calibrating and clearly communicating future changes to monetary policy settings.

Global current account imbalances have declined in recent years, but much of the decline reflects a contraction in demand on the part of current account deficit countries rather than strong domestic demand growth in current account surplus countries. Several very large and persistent surpluses have seen no adjustment in some cases (Germany, Taiwan) or have widened further in others (Korea). The euro area's overall current account, which was close to balance in 2009-2011, increased to a surplus of 2.3 percent of GDP in the first half of 2013. Germany's current account surplus rose above 7 percent in the first half of 2013, while the current account surplus for the Netherlands was almost 10 percent. Ireland, Italy, Portugal and Spain are all now running current account surpluses as import demand in those economies has declined. Thus, the burden of adjustment is being disproportionately placed on peripheral European countries, exacerbating extremely high unemployment, especially among youth in these countries, while Europe's overall adjustment is essentially premised on demand emanating from outside of Europe rather than addressing the shortfalls in demand that exist within Europe.

China's current account surplus has declined from a peak of 10.1 percent of GDP in 2007 to 1.9 percent of GDP in 2011 and 2.5 percent in the first half of 2013. The appreciation of China's real effective exchange rate has been an important factor in reducing the current account surplus. At the same time, cyclical factors, such as weakness in demand from advanced economies, and shifts in terms of trade have also played a role. As discussed later in the report, the RMB remains significantly undervalued.

Achieving strong, sustainable, and balanced global growth requires further adjustments to occur across many different parts of the world economy. Most immediately, where demand is weak or

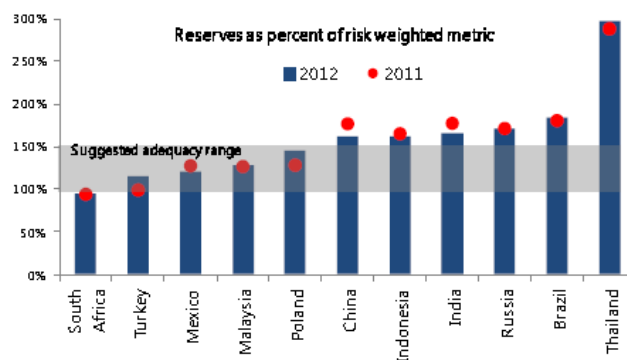
external surpluses excessively large, macroeconomic policies need to promote stronger levels of demand support. This is most especially true given the continuing need of deficit countries to boost their respective levels of national saving. In the absence of stronger domestic demand in the larger surplus economies, global growth has suffered and will continue to suffer if global adjustment continues to occur mainly through weakened demand in the deficit economies. This should go hand-in-hand with a strong follow-through on past G-20 commitments to move more rapidly to market-determined exchange rates, where such exchange rate regimes do not exist.

Global foreign currency reserve accumulation slowed in the first nine months of 2013, with China accounting for most of the increase, as shown in the table to the right. China's foreign currency reserves rose at an average monthly rate of \$39 billion in the first nine months of 2013, an average increase of \$130 million a day. Saudi Arabia's reserves also rose in the first nine months of 2013 at an average monthly pace of \$6.4 billion, above its February 2009 to December 2012 average. Japan, Switzerland, Taiwan, Korea and Singapore also accumulated reserves, but the pace of accumulation was comparatively muted.

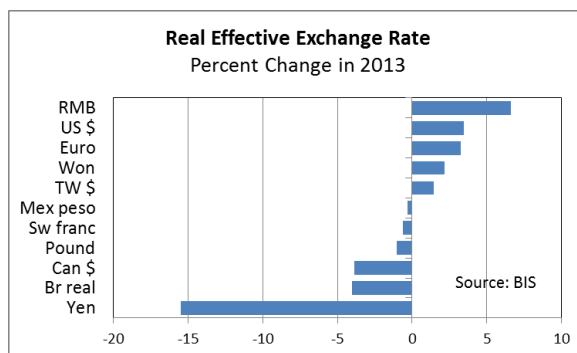
Foreign Currency Reserve Accumulation Major Holders			
	Sept 2013	Average Monthly increase, \$ millions	
	Reserves \$ billions	Feb 2009 to Dec 2012	Dec 2012 to Sep 2013
Global	11,168	84,409	30,982
China	3,663	30,424	39,008
Japan	1,206	4,629	1,473
Saudi Arabia*	692	4,702	6,400
Russia	466	2,303	-776
Switzerland	478	9,231	1,139
Taiwan	413	2,369	1,049
Brazil	359	3,863	-394
Korea	326	2,523	1,023
Hong Kong*	292	2,921	-1,806
Singapore	266	2,044	968
India	248	507	-1,565

* data through August 2013, ** data through July 2013

In recent years, the IMF has developed a reserve adequacy metric, as shown in the table to the right. It currently shows that, as of end-2012, China, Indonesia, India, Russia, Brazil and Thailand had reserve levels in excess of the adequacy range. China's reserves, which now total \$3.7 trillion, exceeded the midpoint of the IMF's reserve adequacy metric by almost 30 percent. Excess reserve accumulation is an impediment to the smooth functioning of the international monetary system.



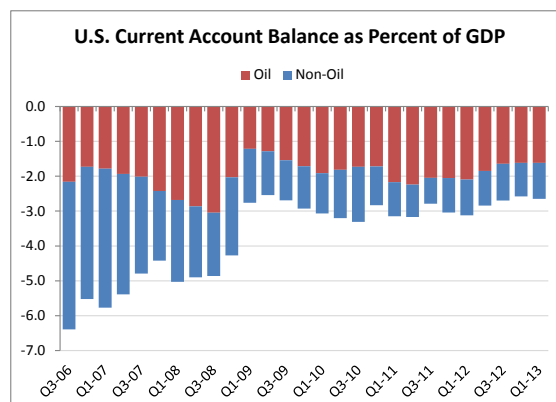
On a real effective basis, the renminbi has appreciated the most in the first nine months of 2013 among the currencies covered in this Report, followed by the U.S. dollar and the euro. The yen and Brazilian real have weakened the most during this period.



U.S. International Accounts

Current Account

The U.S. current account deficit was 2.7 percent of GDP in 2012, a 3 percent of GDP decline from its peak in 2006 of 5.8 percent of GDP. The deficit declined to 2.4 percent of GDP in the second quarter of 2013, the smallest deficit in fifteen years. Since the recession's trough in the second quarter of 2009, the value of exports has increased by 48.9 percent, while the value of imports has increased by 48.3 percent – through the second quarter 2013. As of end June 2013, the U.S. net international Investment position was -\$4.5 trillion, or -27.0 percent of GDP. The value of U.S.-owned foreign assets was \$21.0 trillion, and the value of foreign-owned U.S. assets was \$25.5 trillion.



U.S. Balance of Payments and Trade							
(\$ billions, seasonally adjusted unless indicated)							
	2011	2012	Q2-12	Q3-12	Q4-12	Q1-13	Q2-13
Current Account							
Balance on goods (for details, see lower half of table)	-744.1	-741.5	-186.5	-179.0	-182.4	-179.5	-175.7
Balance on services	187.3	206.8	51.2	50.0	55.0	56.8	57.9
Balance on income (including employee compensation)	232.6	223.9	57.5	54.6	57.0	50.9	53.1
Net unilateral current transfers	-133.5	-129.7	-32.7	-32.3	-31.9	-33.1	-34.2
Balance on current account	-457.7	-440.4	-110.5	-106.7	-102.3	-104.9	-98.9
Balance on current account as % of GDP	-3.0	-2.7	-2.7	-2.6	-2.5	-2.5	-2.4
Capital and Financial Account (financial inflow = +)							
Net official assets	134.3	474.8	70.7	122.1	87.7	125.5	-5.6
Net bank flows	506.2	-6.9	50.4	-127.5	-23.9	98.7	282.2
Net direct investment flows	-178.8	-221.9	-36.7	-54.8	-53.1	-55.5	-57.7
Net sales of securities	-10.2	208.5	-67.1	76.1	104.0	-94.0	-110.5
Net liabilities to unaffiliated foreigners by nonbank concerns	10.2	-65.2	-8.8	1.6	-4.1	-43.3	-48.4
Other *	88.8	57.0	9.3	10.6	26.5	8.9	13.0
Balance on capital and financial account	550.5	446.3	17.8	27.9	137.1	40.4	73.1
Memo Items							
Statistical discrepancy**	-92.8	-5.9	92.7	78.8	-34.7	64.5	25.8
Change in foreign official assets in the United States	253.8	393.9	57.4	107.7	84.4	126.9	-9.7
Current Account Detail: Trade in Goods							
Exports of goods							
Agricultural products	126.2	132.8	32.8	36.7	33.3	33.1	29.9
Industrial supplies and materials (including petroleum)	518.8	518.9	131.6	126.5	128.6	131.2	129.1
Capital goods except autos	493.3	527.7	131.7	133.0	131.6	130.9	135.0
Automotive products	132.8	146.1	37.1	36.5	36.2	36.6	38.4
Consumer goods except autos and food	175.0	181.7	45.7	45.6	46.0	45.7	49.0
Other goods	49.8	54.0	13.0	13.2	14.7	13.2	13.3
Total exports of goods	1,495.9	1,561.2	391.9	391.5	390.3	390.7	394.7
Imports of goods							
Agricultural products	108.3	111.1	27.6	27.7	27.9	28.7	29.2
Industrial supplies and materials (including petroleum)	782.0	752.3	189.6	182.1	183.2	181.8	173.2
Capital goods except autos	513.5	551.7	139.3	137.1	137.7	137.2	137.4
Automotive products	255.2	298.5	74.3	75.7	75.3	73.0	77.0
Consumer goods except autos and food	517.5	519.6	129.9	130.2	131.7	131.8	134.4
Other goods	63.6	69.5	17.6	17.5	17.0	17.7	19.1
Total imports of goods	2,240.0	2,302.7	578.4	570.5	572.7	570.2	570.4
Balance of trade in goods	-744.1	-741.5	-186.5	-179.0	-182.4	-179.5	-175.7

Source: Bureau of Economic Analysis (BEA) via Haver Analytics.

Notes: *Latest quarter calculated by inference; this line contains items with a longer reporting lag than other lines.
 **Amount needed to make the current account balance with the capital and financial account; by definition, current account + capital and financial account + statistical discrepancy = 0.

The Dollar in Foreign Exchange Markets

Through September, the trade-weighted value of the U.S. dollar has appreciated by 2.1 percent in 2013. The dollar has risen by 2.8 percent against advanced economy currencies and by 1.9 percent against emerging market currencies. By quarter, the dollar appreciated 1.4 percent in the first quarter of 2013, 2.0 percent in the second quarter, and depreciated by 0.1 percent in the quarter ending September 30. The real trade-weighted value of the dollar is 3.2 percent below its 20-year average, though it was judged by the IMF in the July 2013 U.S. Article IV report to be mildly overvalued.

Analyses of Individual Economies

Asia

China

After a broad-based slowdown in the first half of 2013, China's economy has recently shown signs of stabilizing, with GDP growth rising to 7.8 percent in Q3, from 7.5 percent in Q2. In 2012, GDP growth declined to 7.7 percent – China's lowest rate in more than a decade.² Investment continued to drive output in Q3, reflecting an increase in project approvals by the central government and rapid growth in infrastructure spending. External demand this summer was also stronger than expected, leading to a moderate recovery in export growth. However, recent high frequency indicators, such as industrial production and fixed asset investment, have begun to slow on sequential basis, suggesting that any growth recovery is likely to be limited. Consensus forecasts project real GDP growth of 7.6 percent in 2013 and 7.4 percent in 2014.

China's current account surplus was 2.5 percent of GDP in the first half of this year, essentially unchanged from 2.3 percent of GDP in 2012. This represents a significant decline since 2007 when the current account surplus was more than 10 percent of GDP. However, China's basic balance (the sum of its current account balance and net FDI inflows) was still elevated at 4.3 percent of GDP in the first half of 2013. According to IMF projections, without continued currency appreciation and further structural reform, China's current account surplus will more than double as a share of global GDP by 2018.

The fall in China's external imbalance has come largely through a sharp increase in domestic investment rather than a greater emphasis on consumption, leading to a worsening of internal imbalances. In 2012, China's investment share of GDP was 48 percent, essentially unchanged from record highs in 2011 and 2010. Meanwhile, the household consumption share has remained near record lows, at 35 percent of GDP. There are currently few signs that this pattern will reverse this year despite an increased policy focus on China's internal imbalances. While the pace of investment growth has slowed in the first half of 2013, consumption growth may have slowed even further. China's household survey data suggests that household income

² In September 2013, China revised 2012 GDP growth to 7.7 percent, from 7.8 percent initially. Seven to eight percent annual growth may in fact be China's current potential growth rate as labor force expansion slows and the economy rebalances towards more sustainable sources of long-term growth.

growth continued to trail GDP growth in the first half of this year, implying a further deterioration in household consumption's share of GDP.

Heavy reliance on credit and investment to maintain growth since the global financial crisis has led to significant vulnerabilities in the Chinese economy, including weaknesses in the financial system, rising local government debt, and an overheated housing market. China's investment rate is extremely high by historical standards and international experience suggests that sharp increases in credit and investment are often followed by financial sector problems and a sharp correction in growth. Unwinding China's massive internal imbalances will not be easy, but delaying structural adjustment would allow for the further build-up of risk in the system and could lead to sharp correction to growth in the future. In the short run, China still has the policy tools needed to support growth as it shifts to more balanced growth, including substantial fiscal space to increase social spending.

While China's leadership has made progress in some specific areas, it will need to pursue far more decisive structural policies to promote internal rebalancing and to ensure that the reduction in the current account surplus is durable. To support household consumption, it is essential for China to pursue policies that increase household incomes and purchasing power. Strengthening China's social safety net will improve household income security and reduce the need for households to accumulate large amounts of precautionary savings. Also critical is removing distortions that lead to the under-pricing of factor inputs – such as energy, water, land, labor, and capital– which tilt the balance of investment toward capital intensive industries and manufacturing, and away from the more labor-intensive services sector. Finally, interest rate and exchange rate reform are essential for improving the purchasing power of households and the development of a more market-based financial system. China's policy of controlled interest rates has been a major driver behind China's unbalanced pattern of growth. For households, administratively-set interest rates have led to lower financial income from bank savings and therefore reduced consumption. Since low deposit rates feed into low interest rates on loans, these interest rate controls encourage investment in projects with lower expected returns. They have also shifted a greater share of credit toward manufacturing and tradable goods, and away from non-tradable services and the more dynamic private sector. Controls that keep real returns on bank deposits low also introduce financial sector risks, as they encourage investment in riskier assets with higher yields, such as property and less regulated “wealth management” financial products.

China's new leaders have signaled their desire for a more balanced economy that can deliver more sustainable growth in the long run, and has taken a number of potentially important steps toward this objective. In February 2013, the State Council released its long-delayed income distribution reform plan, which lays out a comprehensive framework to improve income distribution and double household income by 2020. The plan also recommends important structural policies, such as liberalizing interest rates, raising dividend payments of SOEs, and increasing social spending. In March this year, the government began the process of energy price reform, adjusting oil prices more regularly to better reflect international prices, and in July it raised the wholesale price of natural gas by 15 percent.

There has also been renewed momentum for interest rate reform. In July 2013, the PBOC announced the end of administrative controls on bank lending rates. While this measure is unlikely to influence lending behavior in the short run because very little lending takes place below the benchmark rate, it is an important sign that China remains committed to financial reform. In September, the PBOC said it will introduce a market-based prime lending rate and will allow commercial banks to launch certificates of deposit with market-determined pricing.

At the Fifth U.S.-China Strategic and Economic Dialogue (S&ED) in July 2013, China reaffirmed its commitment to rebalance its economy and outlined several measures to promote greater domestic demand. In particular, authorities committed to reduce the tax burden on services firms by extending its VAT-for-Business tax pilot program beyond Shanghai to cover the entire country and to cover additional sectors in 2014.³ Once the pilot program is rolled out nationwide, the value added tax (VAT) applied to the services sector should lower taxation on services firms to rates comparable to those of manufacturing and other industries, removing a major policy distortion that raises the profitability of the tradable goods sector relative to services. China also committed to increase the dividends paid by its SOEs and to increase the SOE dividend revenue transferred to the central government budget for social welfare spending. This should lower earnings retained within the SOE sector and increase the resources available to support social welfare and other programs for households. The IMF estimates that China's central government SOEs earned RMB 917 billion in profits in 2011, but paid only RMB 77 billion in dividends, of which just RMB 4 billion went to the budget. In addition, China pledged to increase social security and employment spending; ensure that enterprises of all forms of ownership have equal access to production inputs; and develop a market-based mechanism for determining the price of those inputs.

Renminbi (RMB) appreciation is consistent with China's goals of rebalancing and financial reform. A stronger RMB can help support domestic consumption by increasing the purchasing power of households. This would help reduce distortions that promote investment in tradable goods rather than domestically-oriented production. Reducing intervention in the foreign exchange markets and allowing the value of the RMB to be determined more by supply and demand would also give Chinese authorities greater control over liquidity creation and domestic monetary policy, making it easier for authorities to meet their inflation objectives and more effectively target potential asset bubbles.

Chinese authorities have a stated commitment to further reform of the exchange rate mechanism. At the July 2013 S&ED, China pledged to "continue exchange rate reform, increase flexibility of the RMB exchange rate, and let [the] market play a more fundamental role in exchange rate formation." At the February 2013 G-20 Finance Ministers and Central Bank Governors Meeting in Moscow, China joined other G-20 members in pledging "not to target exchange rates for competitive purposes," and reaffirmed its commitment "to move more rapidly toward more market-determined exchange rate systems and exchange rate flexibility to reflect underlying fundamentals, and avoid persistent exchange rate misalignments." China also committed at the 2012 G-20 Leaders Summit in Los Cabos, Mexico, to reduce the pace of

³ The VAT-for-Business tax pilot program was first launched in Shanghai. Chinese authorities announced plans to expand the program to nine additional provinces and cities, including Beijing and Guangdong, in July 2012.

reserve accumulation and increase the transparency of its exchange rate policy. At the National People's Congress in March 2013, China's new leadership pledged to "steadily carry out reforms to make interest rates and the RMB exchange rate more market-based." The State Council reiterated these commitments to financial reform in May 2013, underlining that "[t]he RMB exchange rate regime should be optimized to let market supply and demand play a basic role in the formation of the exchange rate."

Regulators have taken further steps this year to loosen China's extensive capital controls and gradually free up channels for cross-border capital and investment. In March, regulators announced that its RMB Qualified Foreign Institutional Investor (R-QFII) scheme – which initially allowed only Hong Kong-based companies to purchase RMB offshore and invest in Mainland securities markets – would be opened to all foreign financial firms domiciled in Hong Kong, expanding the program beyond Mainland Chinese firms for the first time. As significantly, authorities removed constraints on asset allocation under R-QFII, giving managers greater flexibility to design and launch products in response to market demand. In July, regulators again increased the amount that foreigners can invest in China's stock and bond markets under the original QFII program, increasing the quota to \$150 billion. Also this year, China established new RMB clearing arrangements with Taiwan and Singapore, and expanded the R-QFII scheme to Singapore and London. These policies represent steps in the direction of greater opening of China's financial sector, though significant restrictions still remain in place.

In May 2013, the government announced it will publish an "operational plan" within the year for capital account liberalization, including the creation of a system that will allow domestic Chinese investors to invest overseas. Finally, in July 2013, the State Council approved the establishment of the Shanghai Free-Trade Zone (SFTZ). The SFTZ is expected to offer a testing ground for financial sector reform, with plans to allow trials of liberalized interest rates, capital account opening, currency convertibility, and lower entry barriers for financial institutions within the zone. Though the details of the SFTZ are still to be clarified, if successful, the program could speed up China's financial reforms and provide a model for policies that could be eventually implemented nationwide.

Widening the RMB's trading band would be an important sign of China's commitment to market-based exchange rate reform. Chinese authorities have publicly indicated their intention to widen the RMB's +/- 1 percent trading band against the dollar in the near future. Conditions for such a move have improved as global markets have stabilized. A wider band should promote the two-way foreign exchange flows Chinese authorities have long desired. By contrast, if China does not allow greater flexibility and expectations of stability are allowed to develop, it will be difficult to spur Chinese firms to develop and expand the use of hedging instruments. A wider band that allows larger intra-day fluctuations around the fix would allow the spot rate to better reflect market conditions. Moreover, allowing the market to clear within a wider band without ongoing intervention would help China's transition to increased flexibility.

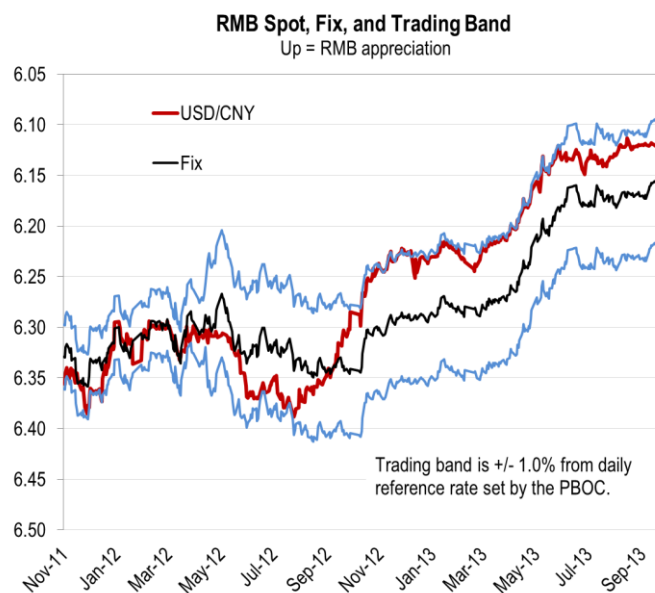
The RMB is appreciating on a trade-weighted basis, but not as fast or by as much as is needed, and intervention has resumed. RMB appreciation is not only good for the U.S. economy, but good for the economies of China, broader Asia, and the world. China has allowed the RMB exchange rate to partially adjust over the last several years. This is reflected in the real

appreciation of the RMB and the decline of the current account surplus. Through mid-October 2013, the RMB has appreciated by a total of 12 percent against the dollar and 16 percent on a real, inflation-adjusted basis from June 2010, when China moved off its peg against the dollar, and has appreciated about 45 percent in inflation-adjusted terms since China initiated currency reform in 2005. China’s real effective exchange rate (REER) – a measure of its overall cost-competitiveness relative to its trading partners – has appreciated about 15 percent since June 2010 and 38 percent since July 2005.

In the first nine months of the year, the RMB has appreciated 6.3 percent on a nominal effective basis, and 6.6 on a real effective basis, taking into account differences in inflation. This, in considerable part, reflects the yen’s depreciation against the dollar and weakness in many EM currencies. The pace of nominal RMB appreciation (2.2 percent year-to-date as of October 18, 2013) has been more modest, with very little appreciation for several months. Still, the RMB’s relative stability over recent months stands in sharp contrast to the depreciation of many other emerging market currencies this year, and the RMB has appreciated on a broad basis in 2013.

From late 2011 through early 2012, official intervention fell as concerns about a slowdown in China and the financial crisis in the euro area lowered capital inflows into China.

As these concerns receded in late 2012 and in the first half of 2013, official intervention resumed at a large scale. Official Chinese data show that the PBOC and Chinese financial institutions collectively purchased a record \$110 billion in foreign exchange alone in both January and September 2013, more than it accumulated in all of 2012. It also added \$53 billion to the People’s Bank of China’s (PBOC) “other foreign assets”, which can be viewed as another form of intervention. China slowed the pace of reserve accumulation to \$47 billion in Q2 of this year, with the vast majority of intervention concentrated in April.



Several factors contributed to the slowdown in foreign exchange inflows in the second quarter: (1) the government began clamping down on the false invoicing of trade used to channel “hot money” onshore for speculation, and regulators introduced new rules that set minimum requirements on the net open foreign exchange positions of domestic banks; (2) continued signs of weakness in China’s activity indicators over the summer tempered expectations that GDP growth would rebound later in the year; and (3) for several weeks in June the PBOC set stronger daily fixing rates, despite weaker trading in the spot, creating more upside room in the band and reducing the need for foreign exchange intervention. Complete data for the third quarter is not yet available, but China’s headline foreign exchange reserves data suggests that authorities engaged in significant intervention in Q3. The quarterly increase of \$166 billion was three times

the Q2 increase, and the largest in over two years. After adjusting for valuation effects, China's Q3 intervention was likely well over \$100 billion. The PBOC's monthly breakdown of reserve changes in Q3 suggests that China intervened most heavily in September, with reserves increasing about \$110 billion as noted above.

There are strong indications that the RMB adjustment process has substantially further to run before it reaches equilibrium. China's current account remains in surplus and China continues to attract net inflows of foreign direct investment. China's GDP growth remains stronger than in the advanced economies, and its equilibrium interest rate is higher. The PBOC continues to accumulate reserves and to intervene in the market to prevent appreciation, though the scale of the needed intervention varies from month to month in response to the scale of market flows. Moreover, if the future pace of appreciation does not keep pace with China's rapid productivity growth, there is a risk that the degree of undervaluation could increase, resulting to another widening of external imbalances. The IMF concluded in its recent Article IV consultation with China, that the RMB was "moderately undervalued" against a broad basket of currencies, and the IMF's 2013 *Pilot External Sector Report* shows the RMB was undervalued by about 5 to 10 percent on a real effective basis.

The PBOC holdings of \$3.66 trillion in total reserves is equivalent to 44 percent of China's GDP in 2012, or about \$2,704 for every Chinese citizen.⁴ This is an exceptionally large amount compared to those of other economies, and well beyond established benchmarks of reserve adequacy. China's stock of reserves is almost as large as the total amount of foreign exchange reserves held by all advanced economies combined, and accounts for nearly half of all of the foreign exchange reserves held by emerging and developing economies. The evidence that China resumed large-scale purchases of foreign exchange this year, despite having accumulated \$3.6 trillion in reserves, which are more than sufficient by any measure, is suggestive of actions that are impeding market determination and a currency that is significantly undervalued.

China still does not provide transparent disclosure of its foreign exchange activities. As a result, market participants and other observers must resort to estimating Chinese intervention using published reserve levels. It is one of only two G-20 members that do not report reserves under the IMF's Special Data Dissemination Standard (SDDS) template, the international standard for public reporting of reserves data. Many of the largest emerging market countries – including India, Russia, and Brazil – disclose their monthly intervention in the foreign exchange market *as well as* reporting their reserves data in the SDDS template. Greater disclosure of its activities in the currency market through participation in the SDDS and the IMF's aggregate Currency Composition of Foreign Exchange Reserves (COFER) database would be consistent with China's commitment at the 2012 G-20 Los Cabos Summit to increase the transparency of its exchange rate policy. China stated at the 2013 S&ED that it is "actively considering" subscription to the SDDS. In line with the practice of most other G-20 nations, China should

⁴ In addition, China has transferred (or swapped) some of its accumulated foreign exchange reserves to commercial banks, as well as capitalizing the China Investment Corporation (CIC), its sovereign wealth fund. China's state sector as a whole – including the PBOC, state-owned banks, and CIC – holds roughly \$4 trillion in foreign currency assets.

disclose foreign exchange market intervention regularly to increase the credibility of its monetary policy framework and to promote exchange rate and financial market transparency.

Japan

The yen foreign exchange market is one of the largest and most liquid in the world, accounting for about 23 percent of the roughly \$5 trillion in daily global foreign exchange transactions, according to surveys by the Bank for International Settlements (BIS).⁵ Japan maintains a floating exchange rate regime.

Japan has not intervened in the foreign exchange markets in almost two years, although the authorities issued numerous public statements regarding their desire to “correct the excessively strong yen” in the weeks following Prime Minister Abe’s election on December 16, 2012. Shortly thereafter, the Japanese government joined the G-7 statement of February 2013, affirming that economic policies would be based on domestic objectives using domestic instruments and would not target exchange rates. Since then, Japanese officials have clearly ruled out purchases of foreign assets as a monetary policy tool and have largely refrained from public comment on the desired level of the exchange rate. Japan was also part of the subsequent G-20 consensus and statement at the February 2013 Finance Ministers and Central Bank Governors Meeting in Moscow that countries would not target exchange rates for competitive purposes. This commitment was affirmed by G-20 Leaders in September 2013 at the St. Petersburg Summit. It is important that these commitments be maintained by all G-7 and G-20 members.

The yen started to depreciate against the dollar in October 2012 as market expectations built for more aggressive monetary easing by the Bank of Japan. After the April 4, 2013, announcement of “Quantitative and Qualitative Easing” in which the Bank of Japan committed to double the monetary base to achieve a 2 percent inflation target, the yen depreciated as far as ¥/\$ 103.2 on May 17. This represented a 32 percent depreciation from the beginning of October 2012. The yen has since traded in the ¥/\$ 96 – 100 range. On a real trade-weighted basis, the yen has depreciated by 22.4 percent since the beginning of October 2012 as of September 2013. In its latest Article IV Consultation Report for Japan (August 2013), the IMF assessed the yen’s real effective exchange rate to be moderately undervalued, while noting the very large uncertainty about its assessment given the major changes to Japan’s economic framework. Since September 2012, Japan’s foreign currency reserves have increased by \$8.2 billion on valuation changes. As of September 2013, reserves were \$1.2 trillion, the second-largest stock of reserves in the world.

Gradual but persistent deflation has plagued Japan for the last 15 years. As of August 2013, core consumer prices (excluding food and energy) were flat year-over-year, but headline consumer prices were up 0.8 percent, driven by increased energy costs stemming from the weaker yen.

⁵ The 2013 BIS Triennial Central Bank Survey, released in September, showed that a significant expansion in yen trading between October 2012 and April 2013, was driven by expectation of a regime shift in Japanese monetary policy. In the last triennial BIS Central Bank Survey of Foreign Exchange Turnover, the yen foreign exchange market accounted for 19 percent of the roughly \$4 trillion in daily global foreign exchange transactions.

The Japanese economy continues to recover from the earthquake and tsunami of March 2011, and has been supported in the short term by Prime Minister Abe's "three arrow" economic policy, which combines monetary stimulus, an initial fiscal easing followed by a large consolidation, and planned structural reforms. The IMF projects that GDP growth will be 2.0 percent in 2013, slowing to 1.2 percent in 2014 as fiscal consolidation kicks in. Japanese Q2 quarter-on-quarter annualized growth was 3.8 percent, with final domestic demand contributing 3.8 percentage points thanks to strong private consumption and government spending from tsunami reconstruction and fiscal stimulus, a 0.7 percentage point offset from inventory destocking and a 0.7 percentage point contribution from net exports. In the first half of 2013, net exports contributed 1.2 percentage points to growth and domestic demand contributed 2.6 percentage points.

In 2011, Japan's goods trade balance fell into deficit for the first time since 1980 as exports slowed following production disruptions stemming from the March 2011 disaster, while imports increased due to higher commodity prices and rising demand for reconstruction materials. Japan's nominal trade deficit continued to rise in 2012 and 2013, due in large part to the rise in import prices driven by the weaker yen and increased demand for fossil fuel imports due to the ongoing shutdown of most of Japan's nuclear power generators. The nominal trade deficit reached 2.2 percent of GDP in the first half of 2013. However, as Japan's terms of trade have deteriorated with the weaker yen, the evolution of Japan's nominal and real trade balance has diverged, with the real trade balance improving as a result of rising export volumes even as the nominal deficit increased. During the first and second quarters of 2013, real exports grew by 1.5 and 3.6 percent, respectively, on a quarterly basis.

The current account remains in surplus due to positive net income flows, but it has narrowed substantially from almost 4 percent in 2010 to 1.2 percent for the first half of 2013. Japan's bilateral trade surplus with the United States totaled \$43.2 billion during the seven months ending on July 2013, down slightly from \$45.9 billion during the same period in 2012.

Going forward, it is critically important for the global economy that Japan's economic policies ("Abenomics") work primarily through an increase in domestic demand. In particular, the planned shift toward fiscal consolidation in 2014 needs to be carefully calibrated so as to preserve the underlying momentum of internal demand growth. Sustaining growth in demand will depend on a rise in business investment, housing investment and especially growth in nominal wages. In Japan's revised data for second quarter GDP, business investment increased for the first time in six quarters, by 5.1 percent on a seasonally-adjusted basis. However, scheduled cash earnings, a key gauge of the underlying trend in earnings, continued to fall through July, although bonus payments and overtime pay have started to increase.

The Japanese authorities have affirmed their commitment to returning Japan's public finances to more sustainable footing. The Abe fiscal stimulus, which centered on reconstruction and disaster-preparedness spending, would maintain the deficit at roughly 10 percent of GDP in 2013, unchanged from 2012. In August, the IMF projected that Japan's general government gross debt will reach 247 percent of GDP – the highest among advanced economies – in 2013. As a result, medium-term fiscal consolidation remains a key priority for the Japanese authorities. However, Japan also needs to take care that its deficit-reduction strategy does not result in too

rapid a consolidation that stalls Japanese growth and prevents escape from deflation. If Japan proceeds on schedule with the legislated 3 percentage point increase in the consumption tax, it is important that its short-term negative impact be moderated through temporary, high multiplier fiscal measures to support demand.

In March 2013, Prime Minister Abe announced Japan's intention to join the Trans-Pacific Partnership (TPP) trade negotiations, and Japan joined the negotiations in July 2013. The announcement has been interpreted as launching the third arrow of Mr. Abe's economic reform strategy, in so far as joining the TPP would lead to internal reforms such as deregulation in areas like agriculture and medical services. Additionally, the Abe Administration has begun to unveil a growth strategy, to focus on industrial competitiveness, regulatory reform, and science and technology policy. An outline on implementation was presented by Abe in June with assurances of deeper and more specifically detailed reforms to come after the Japanese Upper House election this past July.

We will continue to closely monitor Japan's policies and the extent to which they support the growth of domestic demand. In order to support a stronger economic recovery and increase potential growth, it is important that Japan calibrate the pace of fiscal consolidation to the recovery in domestic demand and take ambitious and effective steps to increase domestic demand, including by easing regulations that unduly deter competition and labor force participation in its domestic economy. Monetary policy cannot offset excessive fiscal consolidation or be a substitute for structural reform that raises trend growth and domestic demand. We will continue to stress the importance of Japan's continued adherence to the commitments made in the G-7 and G-20, to remain oriented towards meeting respective domestic objectives using domestic instruments and to refrain from competitive devaluation and targeting its exchange rate for competitive purposes.

South Korea

South Korea officially maintains a market-determined exchange rate, and its authorities intervene with the stated objective of smoothing won volatility. The Korean won has remained relatively stable in the recent market turbulence despite the sharp depreciation of a number of emerging market currencies. The won's relative strength can be credited to a combination of factors, including: a high and growing current account surplus, low levels of short-term external debt, a strong fundamental fiscal position, and favorable terms of trade.

The won's nominal trade-weighted value depreciated moderately in the first half of 2013, but strengthened in July and again in August as global investors increasingly differentiated among emerging market economies and net portfolio flows to Korea increased. From its 2013 low of 1161 won per dollar on June 24, the won appreciated 7.6 percent by end September. As of end September, the won was 1 percent below its level at the beginning of the year. Although the Korean won depreciated at a moderate pace against the U.S. dollar in the first half of 2013, the IMF's July 2013 *Pilot External Sector Report* finds that Korea's real effective exchange rate remains undervalued in a range of roughly 2 to 8 percent.

In its September 2012 Article IV Consultation Report on Korea, the IMF noted that foreign exchange reserves were adequate and that there was "no need for further reserve accumulation

beyond what would be needed to keep pace with rising foreign liabilities over time.” Korea’s foreign exchange reserves were \$326 billion at the end of September. Korea does not publicly report foreign exchange market intervention, although the Administration has encouraged them to do so. Instead, market participants derive estimated intervention from changes in Korean foreign exchange reserves and forward positions. During the first half of 2013 the Korean authorities are believed to have intervened on both sides of the market. Many market participants speculate that the Korean authorities intervened in early 2013 to limit the pace of won appreciation as the Japanese yen weakened, then subsequently to limit won depreciation. It is generally believed that Korea has resumed intervention to limit the won’s appreciation. In January 2013, foreign exchange reserves increased \$1.9 billion. From January to June, reserves declined \$3.3 billion. And since June, reserves have increased \$10.5 billion through September. Korea’s net forward position also has increased to \$44.6 billion.

In early 2013, following eight months of won appreciation, the Korean authorities publicly warned they were contemplating further tightening of macroprudential measures on foreign exchange exposure of the banking system. The Korean banking system relies heavily on wholesale funding, much of it external. This leaves Korea vulnerable to external funding risk, as both the Asian financial crisis of 1997-98 and the 2008-9 global financial crisis revealed. However, the timing of the potential strengthened macroprudential measures and official commentary fed widespread speculation that the intent was to limit won appreciation. As the won depreciated, no additional macroprudential measures were signaled or introduced.

GDP growth in Korea has rebounded this year, with first and second quarter GDP rising by 3.4 and 4.4 percent, respectively, on an annual basis. Growth has been driven by buoyant exports, front-loaded government spending, and fiscal stimulus of 1.3 percent of GDP, delivered in April. Personal consumption has lagged overall GDP growth this year, and investment slowed significantly in the second quarter. Korean household debt – currently at an OECD high of 136 percent of disposable income – weighs on spending.⁶ The IMF projects Korean GDP growth will be 2.8 percent in 2013 and 3.7 percent in 2014.

After exceeding the Bank of Korea’s target range of 2-4 percent in 2011, headline price inflation subsided to 1.4 percent in 2012 and 1.5 percent on a year-on-year basis as of August 2013. Citing the slow recovery in the global economy, the Bank of Korea lowered its policy rate in May, to 2.5 percent from 2.75 percent in May 2013. The policy rate has remained unchanged since May.

Korea has benefited from improved terms of trade this year on falling commodity prices, and energy imports constitute around 40 percent of Korean imports. Korea’s trade surplus widened during the first half of 2013 relative to the same period in 2012 as export growth outpaced imports. Goods and services exports totaled \$339 billion in the first half of 2013, 2 percent more than the same period in 2012, while imports – at \$306 billion – were down 3 percent from 2012. Korea’s current account surplus as a share of GDP rose sharply to 3.7 percent of GDP in 2012 compared to 2.3 percent in 2011, and the surplus has continued to rise this year. Private analysts

⁶ Korean households borrow to support very large expenditure on college-preparatory education and an apartment-rental system that involves large, interest-free loans from renter to landlord, among other reasons.

forecast that the surplus will reach 5 percent of GDP this year, the highest since 1999. In February 2013, Korea joined the rest of the G-20 in committing to refrain from competitive devaluation and resolving not to target its exchange rate for competitive purposes.

We will continue to encourage Korean authorities to limit foreign exchange intervention to the exceptional circumstances of disorderly market conditions. In addition, in line with the practice of most other G-20 countries, Korea should disclose foreign exchange market intervention shortly after it takes place, similar to Japan and emerging markets such as Brazil, India, and Russia. We will continue to press Korean authorities to ensure that macroprudential measures are clearly directed to reducing financial sector risks – in design, timing, and description – rather than aimed at limiting capital inflows or reducing upward pressure on the exchange rate. We are concerned at reports Korea is intervening in the market to resist appreciation in the context of a large and widening current account surplus. More generally, we will strongly urge Korea to take bold measures to reduce reliance on net exports as an engine of growth.

Taiwan

Taiwan maintains a managed float exchange rate regime, and the central bank states that the New Taiwan Dollar (NTD) exchange rate is determined by the market, except when the market is disrupted by seasonal or irregular factors. Taiwan's foreign exchange reserves grew by \$9.4 billion (2.3 percent) in the first nine months of 2013 and stood at \$412.6 billion as of end-September 2013. Taiwan's foreign exchange reserves are equivalent to 85 percent of GDP, 18 months of imports, and 3.2 times the economy's short-term external debt.

Taiwan has been relatively little affected by recent capital outflows from emerging markets, with positive net foreign equity inflows in July and August. The NTD depreciated 4.2 percent against the dollar in the first half of 2013, followed by a 1.1 percent appreciation during July and August. The real and nominal effective exchange rates appreciated by just 0.3 percent in the first half of 2013, then appreciated 0.6 percent and 0.8 percent, respectively, over July and August. Market participants indicated that the Taiwan authorities intervened regularly to resist NTD appreciation in foreign exchange markets during the year so far. Taiwan does not publish official intervention data, nor does it subscribe to the IMF's SDDS template for international reserves. The SDDS template would help publicly clarify the extent to which the authorities take positions in the forward market, if at all. Taiwan already uses the SDDS framework for many of its other financial and external accounts.

Taiwan's real GDP growth remained little changed in the first half of 2013 from 1.3 percent in 2012. Stronger contributions from net export and investment will likely lift GDP growth moderately in the second half of 2013. The IMF is projecting growth of 2.1 percent in 2013 and 3.8 percent in 2014. Taiwan's year-on-year inflation has fallen steadily since February due to base effects, and was -0.8 percent in August. The central bank has kept its target rediscount rate on hold at 1.875 percent since June 2011.

Taiwan's current account surplus remained remarkably high in the first half of 2013 at 10.3 percent of GDP on a strong trade surplus, compared to 10.4 percent of GDP in 2012 and 8.9 percent in 2011. The second quarter current account surplus of \$14 billion is the second highest

in absolute terms historically and, apart from the post-crisis boom in 2009, the highest as a percent of GDP since 1988. Taiwan's goods and services trade surplus totaled \$19 billion in the first half of 2013, up 32 percent from the same period last year, as exports to other Asian economies increased and import prices declined along with global commodity prices. At the same time, the income surplus declined on reduced investment income from foreign exchange assets and non-resident equity dividend payments.

Taiwan has a largely open capital account, but maintains some restrictions to avoid large inflows or outflows of capital, including measures to discourage foreign investors from holding local currency deposits. The financial account showed a net outflow of \$19 billion in the first half of 2013, reflecting greater investment abroad by insurance companies and an increase in lending by off-shore banking units.

We will continue to press the Taiwan authorities to limit their foreign exchange interventions to the exceptional circumstances of disorderly market conditions and to commit to greater foreign exchange market transparency through the publication of intervention data and by reporting foreign exchange reserve data using the SDDS template.

Europe

Euro Area

The exchange rate of the euro is freely determined in the foreign exchange market. The euro has experienced large fluctuations since the financial crisis resulting from ebbs and flows in risk aversion associated with financial stresses in the euro area. In the first half of 2013, the euro depreciated by 1.3 percent against the dollar but subsequently appreciated by 4.4 percent through the end of September. On a real effective basis, the euro appreciated by 2.7 percent in the first half of 2013 and by a further 0.6 percent in the third quarter of 2013.

The euro area economy expanded by 1.2 percent, on a seasonally adjusted, annualized basis (saar), in the second quarter of 2013, marking the first expansion of economic activity in the euro area in seven quarters. Expansion was supported by domestic demand growth in Germany - though growth in Germany still continues to rely on positive net exports, which continues to delay the euro area's external adjustment process - and on domestic demand in France. Economic conditions across the euro area remain uneven with the countries in the periphery remaining in recession overall. Ireland and Portugal expanded on a quarter-on-quarter saar basis in the second quarter, but this may have been the result of transitory factors such as weather, and the economies of Greece, Italy, and Spain continued to contract during the same period, albeit at a more moderate pace.

The euro area's recovery has substantially lagged other developed countries, leaving economic activity at a low level. Euro area GDP still remains 3 percent below its peak in the first quarter of 2008, private demand is almost 6 percent below pre-crisis levels, unemployment is running at 12.0 percent, and the periphery remains in recession overall. While euro area leaders have put in place important measures to stabilize the economy, significant macroeconomic and financial headwinds remain. The fiscal impulse in 2013, albeit more moderate than 2012, remains negative. Private consumption, by far the largest component of domestic demand, could

continue to be constrained as real disposable incomes remain under pressure from elevated unemployment, low real wage growth, and higher taxes. Meanwhile investment, which has made a significant contribution to weak domestic demand, is showing nascent signs of recovery but remains weak overall. Further, while financial fragmentation has eased on the back of ECB actions, lending conditions remain tight in many countries and, together with deleveraging, will act as drags on growth. Both the European Commission (EC) and IMF forecast that the euro area economy will contract in 2013 by 0.4 percent, with GDP expected to grow at the slow pace of 1 percent in 2014.

Euro area deficit countries have sharply reduced their current account deficits, but euro area surplus countries have not reduced their current account surpluses. The euro area's overall current account swung into surplus in 2012, and the surplus has increased further in the first half of 2013 to almost 2.3 percent of GDP. The Netherlands and Germany have continued to run substantial current account surpluses since 2011, while the current accounts deficits of Italy and Spain and the smaller economies in the periphery have contracted significantly, primarily as a result of a collapse of domestic demand and falling wages. Ireland, Italy and Spain have run surpluses in recent quarters, and Portugal moved into surplus in the second quarter of 2013. Germany's current account surplus, meanwhile, rose above 7 percent of GDP in the first half of 2013, with net exports still accounting for a significant portion (one-third) of total growth in the second quarter, suggesting that rebalancing is not yet occurring domestically. To ease the adjustment process within the euro area, countries with large and persistent surplus need to take action to boost domestic demand growth and shrink their surpluses. Germany has maintained a large current account surplus throughout the euro area financial crisis, and in 2012, Germany's nominal current account surplus was larger than that of China. Germany's anemic pace of domestic demand growth and dependence on exports have hampered rebalancing at a time when many other euro-area countries have been under severe pressure to curb demand and compress imports in order to promote adjustment. The net result has been a deflationary bias for the euro area, as well as for the world economy. Stronger domestic demand growth in surplus European economies, particularly in Germany, would help to facilitate a durable rebalancing of imbalances in the euro area. The EU's annual Macroeconomic Imbalances Procedure, developed as part of the EU's increased focus on surveillance, should help signal building external and internal imbalances; however, the procedure remains somewhat asymmetric and does not give sufficient attention to countries with large and sustained external surpluses like Germany.

In 2012, the euro area, in aggregate, undertook one of the most aggressive fiscal consolidations of the advanced economies despite having the smallest cyclically-adjusted fiscal deficit and weak growth prospects. While the pace of consolidation has moderated somewhat this year, the euro area structural fiscal deficit is expected to decrease by another 0.9 percent of GDP in 2013. Under the Excessive Deficit Procedure, most of the major euro area economies initially had committed to reducing their general government budget deficits to less than 3.0 percent of GDP by 2013. The EC, however, has adopted some flexibility in enforcing country targets, focusing on a country's structural effort even if annual headline targets are not met due to weaker than expected growth. Germany met the 3 percent target in 2011 and achieved a small surplus in 2012. Ireland, Greece, and Portugal have been given more time under their reform programs, and recently, Spain and France were given two more years (Spain through 2016 and France through 2015) and the Netherlands an additional year to meet this 3 percent target. Nonetheless,

we remain concerned about the appropriate pace of consolidation and the need to provide room for countercyclical policy responses while ensuring credible paths to fiscal sustainability over a time frame that is sensitive to cyclical developments.

In 2013, the European Central Bank (ECB) has continued to take both conventional as well as unconventional policy actions to support activity and improve monetary policy transmission. The ECB eased monetary policy by reducing its main refinancing rate by 25 basis points to 0.5 percent in May 2013. The ECB also employed forward guidance in July 2013 to provide greater clarity about the expected path of policy, noting that ECB interest rates would remain at or below current levels for an extended period of time. The ECB continues to provide full allotments of liquidity against eligible collateral to euro area financial institutions. The announcement of the Outright Monetary Transactions (OMT) developed by the ECB in September 2012 has dramatically lowered financial stress and funding costs within the currency area.⁷

The ECB's provision of over €1 trillion in three-year funding via longer-term refinancing operations (LTRO) in December 2011 and February 2012 helped to alleviate funding pressures in the banking sector over the course of 2012. Repayment by financial institutions of over one-third of the three-year LTROs, however, has resulted in reduced excess liquidity, which could place upward pressure on interest rates.

Overall, recent policy actions and commitments undertaken by the ECB and euro area governments have reduced concerns about a euro area systemic event and eased severe market pressures, providing additional time for the difficult multiyear adjustment at the country and regional levels. But risks of policy setbacks in addressing the underlying vulnerabilities of peripheral economies and the institutional structure of the euro area and EU remain significant. Further stresses could emerge from political uncertainty, adjustment fatigue, and disagreement within the euro area on how to address new challenges to the currency union. Over the medium term, delays in financial, economic, and fiscal integration could entrench the large economic disparities that have developed across the euro area, leaving the region vulnerable to new shocks. A key priority for the euro area is to solidify and accelerate the recovery in growth, which will support a reduction of heavy debt burdens, lower high unemployment rates, and help maintain political support for the adjustment process within the core and periphery. The European Commission forecasts a contraction of 0.4 percent across the euro area in 2013, and headwinds to growth include substantial fiscal drag, private sector deleveraging, and a weak external environment. The periphery faces greater uncertainty over medium-term trend growth, given continued fiscal consolidation, banking sector deleveraging, and mixed efforts to date to address challenges to competitiveness and productivity.

⁷ Under the OMT the ECB will stand ready to buy sovereign bonds, potentially in unlimited amounts, of countries that request support from the European Financial Stability Fund or the European Stability Mechanism and adhere to agreed conditions.

Switzerland

In September 2011, in an environment of significant market concerns about tail risks in the euro area, the Swiss National Bank (SNB) established a minimum exchange rate (“floor”) of 1.20 Swiss francs per euro, temporarily changing the exchange rate regime from a floating to a managed rate. Through 2012 the SNB intervened repeatedly to prevent the franc from appreciating. However, as European authorities implemented measures to reestablish financial stability, and concerns about tail risks subsided, pressures on the Swiss franc subsided and SNB interventions have ceased. In June 2013, the SNB reaffirmed its commitment to a managed rate, noting that it is prepared to buy foreign currency in unlimited quantities and to take further (unspecified) measures to enforce the 1.20 exchange rate floor.

Switzerland is a small open economy surrounded by the euro area, and has been disproportionately affected by the financial stresses in Europe, resulting in disorderly movements in the exchange rate. The Swiss authorities faced a constrained policy environment as external forces pushed the economy into deflation and potentially recession in the summer of 2011. The exchange rate floor was established after a number of alternate policy measures failed to achieve the SNB’s monetary policy objectives.

Since establishing the exchange rate floor, the SNB’s reserve assets have increased \$166 billion on a headline basis, and now total \$478.2 billion as of September 2013. Most of this change is attributable to SNB purchases of reserve assets, while a smaller portion is due to valuation changes of reserves. Through September this year, SNB’s reserve assets increased by \$10.3 billion on a headline basis in 2013. Given the lack of foreign exchange intervention this year, the total change is attributable to valuation effects. While the currency composition of reserves fluctuates on a monthly basis as a result of interventions and valuation changes, the SNB rebalances its portfolio over time to keep the euro share around 50 percent of reserves and the U.S. dollar share between 25 and 30 percent.

After remaining close to the 1.20 exchange rate floor through the end of 2012, the franc has depreciated in 2013 against the euro by 1.4 percent (to 1.22) through September 2013. Against the U.S. dollar the franc has depreciated by 1.1 percent this year (also through September), and on a real trade weighted basis the franc has depreciated 0.5 percent (through August, based on BIS data). In 2012, the current account surplus was 13.4 percent of GDP, of which the goods surplus was 2.5 percent. The large current account surpluses traditionally run by Switzerland must be interpreted with caution. The IMF notes that (a) the activities of international commodity trading companies could add up to 4 percent of GDP to the surplus even though some have limited operations in Switzerland; (b) Swiss multinationals partly owned by foreigners artificially raises the surplus and is estimated to have added 2 percent of GDP to the surplus in 2011; and (c) cross-border shopping direct purchases and deliveries may not be reflected in import statistics and overstate the current account by non-trivial amounts. Finally, Switzerland’s role as an international banking center generates fee and investment income that contribute to the overall current account surplus but cannot be attributed to Swiss citizens.

In the IMF’s 2013 *Pilot External Sector Report*, the Swiss external position is assessed to be “moderately stronger than the level consistent with medium-term fundamentals and desirable

policy settings.” The real effective exchange rate is assessed to be “moderately overvalued because of safe-haven capital inflows, but the overvaluation is eroding over time given negative inflation differentials with trading partners.”

Economic growth in Switzerland is slowly reviving and deflationary pressures appear to be subsiding. The year-on-year economic growth rate has steadily increased from 0.5 percent in the second quarter of 2012 to 2.1 in the second quarter of 2013. This compares to flat year-on-year growth in European Union in the second quarter of this year. Economic growth in Switzerland over the last year (from the second quarter of 2012 to the second quarter of 2013) has been broad based, with real net exports contributing 0.9 percentage points of growth and domestic demand contributing 1.2 percentage points. The SNB has recently revised up its growth forecast for 2013 from 1-1.5 percent to 1.2-2.0 percent. Consumer prices on a year-on-year basis were flat in August 2013, following a 21-month period of year-on-year deflation. The SNB forecasts a 0.2 percent decrease in consumer prices this year. With low unemployment (3.2 percent) and high capacity utilization (around 80 percent) there appears to be little “slack” in the economy. The SNB estimates the output gap in the first quarter of 2013 at around 1 percent of potential GDP.

United Kingdom

The United Kingdom (UK) has a freely floating exchange rate. The pound appreciated by 4.3 percent against the U.S. dollar on a nominal basis in 2012. It reversed course in the first half of 2013, depreciating by 6.5 percent against the dollar, but recovered most of that by the end of September, appreciating by 6.4 percent from July through September. On a real effective basis, the pound appreciated by 3.5 percent in 2012, reflecting its nominal appreciation against other currencies, notably the euro. This trend reversed in 2013, during which the pound depreciated by 3.3 percent on a real effective basis in the first half of the year. The pound depreciated by an additional 1.2 percent in July, but appreciated in August by 1.5 percent.

The UK economy expanded by 0.2 percent in 2012 and has gained momentum in 2013. Economic activity expanded by 1.1 percent on a seasonally-adjusted annualized basis in the first quarter of 2013, and accelerated to 2.9 percent in the second quarter.

The fiscal deficit fell from its post-war peak of 11.2 percent of GDP in fiscal year 2009-10 to 7.9 percent of GDP in 2011-12, primarily resulting from the tax increases and public spending cuts announced by the current and previous governments. The headline deficit narrowed to 5.6 percent of GDP in 2012-13, but most of the consolidation reflected one-off factors. Excluding these factors, the underlying fiscal deficit was little changed from 2011-12 at 7.8 percent of GDP.

Monetary policy remains accommodative. The Bank of England (BOE) has maintained its historically low policy rate at 0.5 percent and, since October 2011, has increased the size of its quantitative easing program three times – each time by £50 billion – to reach £375 billion at its July 2012 meeting. The Monetary Policy Committee (MPC) of the BOE in its August 1 statement made the decision of providing explicit guidance regarding the future conduct of monetary policy. Specifically, the MPC stated that it intends not to raise the policy rate from its current level at least until the unemployment rate has fallen to a threshold of 7 percent, provided

that this does not entail material risks to price stability or financial stability. The unemployment rate in August was 7.7 percent, and the MPC does not expect unemployment to fall to the 7 percent threshold until 2016. Consumer prices peaked at 5.2 percent in September 2011 on year-on-year basis, but have fallen to 2.7 percent as of August 2013. The MPC projects that the rate of inflation will decrease to around the target rate of 2.0 percent in approximately two-to-three years.

The current account deficit in 2012 widened to 3.8 percent of GDP – the largest deficit since 1989 (4.6 percent of GDP) – reflecting a widening trade deficit and modest income deficit. On a quarterly basis, the current account deficit peaked at 4.6 percent of GDP in the second quarter of 2012, and then narrowed to 3.9 percent and 3.5 percent in the third and fourth quarters, respectively. In the first quarter of 2013, the current account deficit widened to 3.6 percent of GDP, reflecting a shift in the income balance from surplus to deficit that outweighed a drop in the trade deficit. In the IMF’s 2013 *Pilot External Sector Report*, the UK’s external position is assessed to be “moderately weaker than implied by medium-term fundamentals and desirable policy settings.”

Western Hemisphere

Brazil

Since 2011, Brazil has experienced only modest growth, despite an aggressive 14-month monetary policy easing cycle that brought the official policy rate (SELIC) to an all-time low of 7.25 percent in October 2012. The accommodative monetary policy during this period also was supported by an array of fiscal stimulus measures, especially targeting durable consumer goods to boost flagging industrial production. Despite these policy conditions, in 2012 the economy grew only 0.9 percent. The country has faced an extended decline in industrial production, attributable in part to weak global demand and domestic supply-side constraints, including a high unit cost of labor and underdeveloped infrastructure.

Brazil’s growth in the second quarter of 2013 surprised on the upside, as the economy expanded at a 6 percent annualized rate. The forecast for the second half of 2013 is much weaker though, resulting in a full-year growth forecast by the IMF of 2.5 percent for 2013. Annual inflation reached 5.8 percent in 2012, close to the upper limit of the central bank’s target band of 4.5 percent \pm 2 percent, and accelerated to 6.7 percent year-over-year in the first half of 2013. As a result, in April 2013 the Banco Central do Brasil (BCB) once again began to raise interest rates to combat inflation, increasing the policy rate 2.25 percentage points to 9.5 percent as of October.

Brazil maintains a floating exchange rate regime, although over the past two years there have been, at times, increased official efforts to manage the *real*. The authorities have used foreign exchange market intervention – primarily through foreign exchange derivatives markets – as well as verbal guidance and capital flow management measures, to dampen directional movements of the currency. On a real effective basis, Brazil’s exchange rate as of September 2013 had depreciated 4.0 percent since the beginning of the year. However, Brazil’s real effective exchange rate has fluctuated during that period, appreciating during January to March, but

depreciating to an even greater extent during May to August, before appreciating again in September.

From the beginning of 2013 until the end of September the *real* depreciated on a nominal basis against the dollar, weakening by 8.1 percent. In response to sharp depreciation pressures on the *real*, at the end of May the BCB began to provide onshore dollar swaps and started to build up a short dollar position in the foreign exchange futures market, as it sought to support the *real* by providing insurance against the risk of further depreciation. This short dollar position continued to increase due to regular BCB activity in the futures market, reaching \$54 billion by the end of September. In addition, from June through September, the BCB sold \$7.4 billion in the spot market using repurchase contracts.

Following these frequent but unscheduled interventions, on August 22 the BCB announced a plan that would provide \$60 billion in dollar swaps and repurchase contracts through December 2013, with a stated objective of providing hedging and liquidity to the foreign exchange market. The announced plan includes minimum weekly offerings of \$2 billion in dollar swaps through the foreign exchange futures market, as well as \$1 billion in offerings of dollar repurchase contracts in the spot market. The repurchase operations will cause a temporary fall in foreign exchange reserves until the operations are reversed, whereas the dollar swaps are settled in local currency. Since the August 22 announcement of the BCB's foreign exchange intervention, the *real* rebounded 9.3 percent against the dollar through end-September. Brazil's headline foreign exchange reserves totaled \$368.7 billion as of end-September.

In June 2013, the authorities removed a series of measures which they previously had implemented, beginning in 2009, to control capital inflows and limit upward pressures on the *real*. From 2010 through early 2012, the authorities had gradually broadened the scope of a financial operations tax (IOF) on capital inflows to include portfolio inflows, short dollar positions in the futures market, and medium-duration external borrowing (between two and five years). The authorities reduced the measures to some extent later in 2012 as capital inflows slowed. Then, in June 2013, the authorities effectively eliminated the IOF on portfolio inflows by reducing the taxation rate to zero, as they sought to attract new portfolio inflows amidst currency depreciation pressures. The authorities, however, have reserved the option to change the IOF rate again in the future if economic conditions change.

Brazil's current account deficit reached 4.0 percent of GDP in the first quarter of 2013, its largest deficit since 2001—before declining to 3.3 percent in the second quarter. The widening current account deficit over the past year has resulted from a declining merchandise trade surplus, combined with a rising deficit in services trade and income payments on foreign investment in Brazil.

Canada

The IMF expects Canada's real GDP is expected to grow at 1.6 percent in 2013, roughly the same rate as in 2012. Private consumption is relatively weak due to slower disposable income growth and sluggish consumer credit growth, as high levels of household debt have induced more caution in borrowing. House sales and construction are also moderating, particularly in

large metropolitan areas. Growth is projected by the IMF to increase to 2.2 percent in 2014, driven by stronger external demand.

Fiscal policy is aimed towards consolidation as the recovery takes hold. The fiscal deficit was 3.2 percent of GDP in 2012, and the authorities have indicated they will seek to achieve fiscal balance by the 2015-2016 fiscal year. Headline inflation decelerated to 0.8 percent for the first half of 2013 on a year-over-year basis, down from 1.1 percent in the second half of 2012, with core inflation of 1.2 percent. The government forecasts inflationary pressures to remain contained in 2013, with core inflation flat at 1.8 percent and the CPI rising slightly to 1.7 percent for the year.

Canada maintains a flexible exchange rate and employs an inflation-targeting monetary policy regime. The Canadian dollar fluctuated against the dollar during 2013 but has generally been on a depreciating trend for the year. In nominal terms, the Canadian dollar has depreciated by 3.6 percent against the U.S. dollar year-to-date as of the end of September. On a real effective basis, in 2013 the Canadian dollar has depreciated by 3.9 percent year-to-date as of September.

Canada's current account has moved into deficit in recent years, with the deficit reaching 3.7 percent of GDP in 2012, driven by weaker external demand and a strong currency. The current account deficit is expected to narrow to 3.5 percent of GDP in 2013 and to shrink further in 2014 as demand for Canada's exports, particularly from the United States, recovers.

Mexico

Mexico's economy posted three years of sustained growth since the 2008-09 global financial crisis, but growth has been gradually slowing and the IMF expects only 1.2 percent growth in 2013. Soft external demand and a fall in domestic investment have been the proximate causes of the slowdown. Mexico recorded a 1.9 percent current account deficit in the first half of 2013, up from 1.4 percent in 2012. Still, Mexico stands to gain from stronger economic activity in the United States, and the implementation of the Mexican government's reform agenda could lead to stronger consumption and investment. As a result, the consensus forecast among private sector analysts is for Mexican growth to pick up to about 3.6 percent in 2014; the IMF expects growth of 3.0 percent.

Mexico has a flexible exchange rate and employs an inflation-targeting monetary policy regime. Overall, in nominal terms the peso has depreciated by 1.5 percent against the dollar year-to-date as of the end of September. After strengthening steadily during the first four months of 2013, the peso began to reverse course in May, depreciating by 8.5 percent against the U.S. dollar between May 8 and the end of September. On a real effective basis, the peso has depreciated by 0.3 percent year-to-date as of September.

In April 2013, the Bank of Mexico suspended its system of daily dollar auctions by which it would sell U.S. dollars on days when the peso was weakening significantly. The system had been in place since November 2011, and involved an auction of up to \$400 million in foreign exchange on any day in which the peso depreciated against the dollar by more than 2 percent. Although authorities had discontinued the system during a period of peso strength in the first

four months of 2013, authorities did not re-institute the system during the subsequent period of peso depreciation.

Mexico's foreign exchange reserves increased by \$3.8 billion in the first half of 2013, reaching a total of \$157 billion, driven by foreign exchange inflows from the state-owned oil company, Pemex. In November 2012, the IMF renewed a precautionary Flexible Credit Line (FCL) arrangement for Mexico, equivalent to \$73 billion. Mexico's first FCL arrangement, equivalent to \$47 billion, was approved in April 2009. It previously was renewed in March 2010, and in January 2011 was renewed again with access augmented to its current level. As of September 2013, Mexico had not drawn on this line.

The Bank of Mexico has maintained an accommodative monetary policy stance since early 2009. At its October 2013 meeting, the Bank of Mexico cut its target interest rate by 25 basis points to 3.5 percent. Headline inflation has recently moderated to 3.4 percent in September and has fallen into the central bank's target band of 3 percent plus or minus 1 percent. Core inflation dropped to 2.9 percent in the first half of 2013 from 3.4 percent in the second half of 2012.

Glossary of Key Terms in the Report

Bilateral Real Exchange Rate – The bilateral exchange rate adjusted for inflation in the two countries, usually consumer price inflation.

Exchange Rate– The price at which one currency can be exchanged for another. Also referred to as the bilateral exchange rate.

Exchange Rate Regime –The manner or rules under which a country manages the exchange rate of its currency, particularly the extent to which it intervenes in the foreign exchange market. Exchange rate regimes range from floating to pegged.

Floating (Flexible) Exchange Rate – A regime under which the foreign exchange rate of a currency is fully determined by the market with intervention from the government or central bank being used sparingly.

International Reserves– Foreign assets held by the central bank that can be used to finance the balance of payments and for intervention in the exchange market. Foreign assets consist of gold, Special Drawing Rights (SDRs), and foreign currency (most of which is held in short-term government securities). The latter are used for intervention in the foreign exchange markets.

Intervention – The purchase or sale of a country’s currency in the foreign exchange market by a government entity (typically a central bank) in order to influence its exchange rate. Purchases involve the exchange of a country’s foreign currency reserves for its own currency, reducing foreign currency reserves. Sales involve the exchange of a country’s own currency for a foreign currency, increasing its foreign currency reserves. Interventions may be sterilized or unsterilized.

Managed Float– A regime under which a country establishes no predetermined path for the exchange rate but the central bank frequently intervenes to influence the movement of the exchange rate against a particular currency or group of currencies. Some central banks explain this as a policy to smooth fluctuations in exchange markets without changing the trend of the exchange rate.

Nominal Effective Exchange Rate (NEER) – A measure of the overall value of a currency relative to a set of other currencies. The effective exchange rate is an index calculated as a weighted average of bilateral exchange rates. The weight given to each country’s currency in the index typically reflects the amount of trade with that country.

Pegged (Fixed) Exchange Rate – A regime under which a country maintains a fixed rate of exchange between its currency and another currency or a basket of currencies. Typically the exchange rate is allowed to move within a narrow predetermined (although not always announced) band. Pegs are maintained through a variety of measures including capital controls and intervention.

Real Effective Exchange Rate (REER) – The effective exchange rate adjusted for relative prices, usually consumer prices.

Sterilized Intervention – An action taken by the central bank to offset the effect of intervention on the domestic money supply. Intervention in which the central bank sells domestic currency increases the domestic money supply, and is, in essence, expansionary monetary policy. To neutralize the effect of the intervention on the money supply, the central bank will sell domestic government securities, taking an equivalent amount of domestic currency out of circulation. If the intervention involved the purchase of domestic currency, the central bank will buy government securities, placing an amount of domestic currency equivalent to the size of the intervention back into circulation. An intervention is partially sterilized if the action by the central bank does not fully offset the effect on the domestic money supply.

Trade Weighted Exchange Rate – see Nominal Effective Exchange Rate

Unsterilized Intervention –The purchase of domestic currency through intervention in the exchange market reduces the domestic money supply, whereas the sale of domestic currency through intervention increases the money supply. If the central bank takes no action to offset the effects of intervention on the domestic money supply, the intervention is unsterilized.