

Report to Congress on International Economic and Exchange Rate Policies

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

December 10, 2008

This report reviews developments in international economic and exchange rate policies, focusing on the first half of 2008,¹ and is required under the Omnibus Trade and Competitiveness Act of 1988 (the “Act”).² This report includes two appendices. The first provides information on the status of the U.S. dollar as a reserve currency. The second updates issues related to Sovereign Wealth Funds.

¹ More recent significant developments are also discussed if information is available.

² The Treasury Department has consulted with IMF management and staff in preparing this report.

Table of Contents

| | |
|---|----|
| Major Findings..... | 2 |
| Introduction..... | 4 |
| U.S. Macroeconomic Trends | 4 |
| The Global Economy | 7 |
| The International Accounts for the United States..... | 10 |
| The U.S. Dollar | 13 |
| Country Analyses..... | 16 |
| Asia & Pacific | 16 |
| China..... | 16 |
| India | 19 |
| Japan | 20 |
| Malaysia..... | 21 |
| Singapore | 23 |
| South Korea | 24 |
| Taiwan..... | 25 |
| Australia..... | 26 |
| New Zealand | 27 |
| Europe | 28 |
| Euro area | 28 |
| Norway..... | 29 |
| Russia..... | 30 |
| Switzerland | 30 |
| United Kingdom..... | 31 |
| Middle East | 32 |
| The Gulf Cooperation Council Countries..... | 32 |
| Saudi Arabia..... | 32 |
| Western Hemisphere..... | 33 |
| Argentina..... | 33 |
| Brazil..... | 34 |
| Canada..... | 35 |
| Mexico | 35 |
| Venezuela..... | 36 |
| Appendix 1: Currency Composition of Foreign Currency Reserves | 38 |
| Appendix 2: Sovereign Wealth Funds | 40 |

Major Findings

- Global economic conditions deteriorated in the first half of 2008. The moderation in growth in the advanced economies that began in late 2007 became significantly more pronounced through the second and third quarters of 2008. By late-summer, growth in emerging market economies was also beginning to show the effects of the global financial crisis. Global economic growth is expected to slow sharply through 2008 and into 2009.
- U.S. economic growth was sluggish in the first half of 2008, following a slight contraction at the end of 2007. The economy contracted in the third quarter and labor market conditions deteriorated sharply. Headline inflation picked up but core inflation remained contained. Financial market volatility, which had increased in the second half of 2007, persisted in the first half of 2008 and reached unprecedented levels in October 2008.
- As the economy slowed both fiscal and monetary policy became expansionary. Congress enacted a fiscal stimulus program early in 2008 that supported consumption in the second quarter. The Federal Open Market Committee (FOMC) cut the federal funds interest rate target by 225 basis points in the first half of the year and a further 100 basis points to 1.0 percent in October. In response to unprecedented strains in financial markets, on October 3, the Emergency Economic Stabilization Act of 2008 (EESA) was signed into law. This legislation gives the Treasury Department the ability to design and deploy a number of tools to restore the flow of credit to consumers and businesses.
- After rising steadily between 2002 and 2006, global imbalances declined marginally in 2007 and are expected to decline further in 2008 and 2009. Thus, the U.S. current account deficit declined from 6.6 percent of GDP in the fourth quarter of 2005 to 4.8 percent at the end of 2007. The deficit edged up to 5.1 percent of GDP in the second quarter as the price of imported petroleum soared but is expected to decline through the remainder of the year.
- This report examines the exchange rate policies of 19 countries and the euro area. Collectively, these economies account for nearly 85 percent of U.S. foreign trade in goods and services.
- The dollar depreciated in foreign exchange markets in the first half of 2008, falling 3.2 percent on a nominal effective basis. Since mid-year, the dollar has appreciated against a broad range of currencies, rising by 14.5 percent on a nominal trade-weighted basis between mid-July and end-October. The dollar's appreciation reflects a weakening growth outlook in the rest of the world and heightened stress in financial markets along with a repatriation of funds from U.S. investments abroad.
- With respect to exchange rate developments in China, the pace of renminbi appreciation accelerated in the first half of 2008, with the currency rising by 6.2 percent against the dollar (a 12.4 percent annualized rate). The rate of appreciation against the dollar was faster than in any period since the end of the peg in July 2005. In contrast, between the end of June and the end of October the renminbi appreciated by only 0.2 percent against the dollar. The effective appreciation of the dollar since mid-summer, however, has resulted in a rise in the real effective exchange rate of the renminbi. On a real effective basis, the renminbi has

appreciated between 14 and 26 percent, depending on the measure used, since unpegging from the dollar in 2005. But, by several of these measures, the real effective exchange rate of the renminbi remains below its peak in early 2002.

- Persistently large current account surpluses, continued historically large interventions in foreign exchange markets as evidenced by the rapid accumulation of foreign currency reserves, and a weak real effective exchange rate provide ample evidence that the renminbi is substantially undervalued.
- China needs to rebalance its economy by relying more on domestic private consumption rather than exports and by further developing its financial markets. Expedient movement toward a market-determined exchange rate is an integral part of this process. As a first step, the pace of appreciation in early 2008 needs to be resumed. Treasury continues to use every opportunity to impress upon Chinese authorities the importance and urgency of exchange rate reform.
- Other countries in East Asia would also benefit from moving toward more market-determined exchange rates. This would help reduce persistently high current account surpluses and provide for greater monetary policy autonomy to stabilize inflation and economic growth.
- Treasury has not found that any major trading partner of the United States met the standards identified in Section 3004 of the Act during the reporting period, January 2008 – June 2008.³

³ The Act states, *inter alia*, that: “The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade.”

Introduction

This report focuses on international economic and foreign exchange developments in the first half of 2008. However, where pertinent and when available, data through the end of October 2008 are included and discussed in this report.

Exports and imports of goods and services to and from the countries whose economies and currencies are discussed in this report accounted for about 85 percent of total U.S. trade in the first half of 2008.

U.S. Macroeconomic Trends

U.S. economic growth was sluggish in the first half of 2008, following a small contraction in late 2007, as the economy continued to weather a number of headwinds, including a weakening housing market, high and rising energy prices and heightening stress in financial markets. Labor market conditions deteriorated. Nonfarm payroll employment began to decline in January and the unemployment rate moved higher. Headline inflation picked up sharply as energy prices reached new highs and food prices continued to increase rapidly. Core inflation remained contained, however. Financial market volatility, which had increased in the second half of 2007 persisted in the first half of 2008, and reached unprecedented levels in October. The Federal Reserve cut the federal funds interest rate target by 225 basis points in four moves between January and April 2008, bringing the total reduction since easing began in September 2007 to 325 basis points. In response to deteriorating economic conditions after mid-year, the Federal Reserve reduced its target rate an additional 100 basis points in two moves during the month of October. Yields on long-term securities declined in the first three months of 2008, partly in response to safe-haven buying, but then rose through June.

Subdued Economic Growth

The economy expanded by 0.9 percent at an annual rate in the first quarter, and 2.8 percent in the second quarter. Growth in both quarters was supported in large part by a narrowing trade deficit. Imports declined in the first half of the year while exports continued to post solid gains. Outside of trade, growth was relatively subdued. Consumer spending moderated in the first two quarters of the year compared to the second half of 2007, although growth of personal consumption did pick up slightly in the second quarter as households received their fiscal stimulus payments. Business investment slowed notably in early 2008 as outlays for equipment and software declined. Residential investment continued to fall, extending a trend that began in early 2006.

The ongoing contraction in housing weighed on growth once again in the third quarter and is expected to remain a drag on the economy well into 2009. Home sales remain sluggish, and inventories of unsold homes are at an historically high level. The current pace of new residential construction is the slowest in nearly two decades and is not expected to recover in the near term, given the slow pace of building permit issuance, historically low level of builder confidence, and tight credit conditions. House prices continued to fall below year-earlier levels through mid 2008. Mortgage delinquencies and foreclosures rose to new highs in the second quarter. The steep rise in foreclosures is expected to put additional downward pressure on home prices.

Exports remained a bright spot in early 2008, helping to offset the drag on growth from the housing sector. Real exports rose 11.0 percent over the year ended in the second quarter. Export growth has been consistently solid since early 2004 due in large part to strong growth abroad. The performance of U.S. exports helped narrow the real trade deficit from a record \$617 billion in 2005 to roughly \$422 billion at an annual rate in the first half of 2008. Slower real import growth has also contributed to the improvement in the U.S. trade balance. In the first quarter of 2008, real imports fell below their year-earlier level for the first time since early 2002. They continued to fall in the second quarter by 1.9 percent compared to a year-earlier. The shrinking real trade deficit contributed about 2 percentage points on average to real GDP growth in the first half of 2008. Net exports could provide less of a boost to real growth going forward, however, as economic growth abroad falls.

Labor Markets Deteriorated

Labor market conditions weakened notably in the first half of 2008. Nonfarm payrolls began to shrink in January, the first decline since August 2003. The cumulative job loss through June totaled 461,000. Declines continued through October, with an additional 718,000 jobs cut from payrolls. The unemployment rate rose 0.5 percentage point, reaching 5.5 percent in June. The jobless rate climbed further in subsequent months and in October stood at a 14-year high of 6.5 percent. Real wages continued to fall as consumer price inflation accelerated. Over the twelve months ended in September, real hourly earnings for production workers declined by 1.9 percent. Real wages have been falling on a year-over-year basis since November 2007.

Headline Inflation Accelerated, but Core Inflation Remained Contained

Headline inflation continued to rise in early 2008 as energy prices climbed higher. Consumer prices jumped 4.9 percent over the twelve months ended in June, up from 4.1 percent in the twelve months ended in December. Energy prices shot up 24 percent for the year that ended in June, accelerating from the 18 percent increase over the twelve months of 2007. Food price inflation also accelerated in the first half of 2008, contributing to the pickup in overall inflation. Core consumer inflation (a measure that excludes food and energy prices) remained contained in the first half of 2008, staying within the narrow range that has prevailed over the past four years. Over the year that ended in June, core consumer prices rose 2.4 percent. Headline consumer inflation peaked in July at 5.5 percent, largely reflecting the run-up in energy prices. With the decline in energy prices the inflation rate has fallen to 3.7 percent in October, on a year-over-year basis. Core inflation edged down to 2.2 percent in October.

Financial Markets Remained Stressed

Financial market turmoil that began in the second half of 2007 persisted into the first half of 2008, reflecting continued concerns about the solvency of several major U.S. financial institutions. Equity markets in the United States posted steep losses in the first half of the year. The S&P 500 tumbled 13 percent from the end of December to the last trading day of June, more than eliminating the 3.5 percent gain posted over the course of 2007. Volatility reached unprecedented levels in September, when it became clear that several major U.S. financial institutions were on the brink of failure. The S&P stock market volatility index (VIX), often used as a measure of financial market uncertainty, shot up to an all-time high of 80 on October

27. The VIX had been hovering around 20 in August. When financial markets closed on October 31, the S&P500 was down 34 percent from the end of 2007.

Persistent financial market turmoil spurred safe-haven buying early in the year, putting downward pressure on interest rates on U.S. government securities, across the maturity spectrum. The yield on the 3-month Treasury bill fell from 3.4 percent at the end of 2007 to a low of 0.6 percent in mid-March. Similarly, the yield on the 10-year Treasury note fell from 4.0 percent at the end of 2007 to 3.3 percent in mid-March. Treasury yields moved higher through mid-June, with the 3-month rate peaking at 2.1 percent and the 10-year rate peaking at around 4.3 percent. Since then yields have trended downward. The 3-month rate averaged 0.7 percent in October and the 10-year rate averaged 3.8 percent in October.

Despite the decline in interest rates early in the year, credit conditions for households and businesses remained tight. The spread between the Baa corporate bond rate and the 10-year Treasury reached 350 basis points in March, more than double the level that prevailed prior to the beginning of the subprime crisis in the summer of 2007. While the spread narrowed somewhat in the second quarter of 2008, it remained relatively wide at around 300 basis points in late June. The interest rate for conforming mortgages dipped to a 4-year low of 5.48 percent in late January from just over 6 percent at the start of the year. However, the sharp drop quickly reversed and mortgage rates rose fairly steadily through the first half of 2008, peaking at 6.63 percent in late July. Interbank lending also became increasingly stressed in 2008. The rate on 3-month interbank loans relative to the risk-free 3-month T-bill rate (the TED spread) surpassed 200 basis points in early March but retreated to around 100 basis points by May.

Credit conditions deteriorated rapidly at the end of the summer. The TED spread shot up to 457 basis points in early October, and spreads over Treasuries for corporate debt reached 560 basis points by late month. Mortgage rates eased off their mid-year peaks, however, partly reflecting the Federal government's early-September move to place Fannie Mae and Freddie Mac into conservatorship. The interest rate on a 30-year fixed rate mortgage eased to around 6.0 percent in early October but rose above 6.5 percent by month's end.

In the first half of 2008, the Federal Reserve continued to provide liquidity to financial institutions through traditional open market operations as well as through other recently-developed facilities. The Federal Open Market Committee (FOMC) reduced its target for the federal funds rate by 225 basis points in four moves between January and April. That followed three cuts in late 2007 totaling 100 basis points. The FOMC paused between its April and September meetings, but on October 8 voted to cut the target an additional 50 basis points to 1.50 percent in response to signs of weakening economic activity and widespread concerns about financial market stability. This cut occurred between meetings and was coordinated with several other central banks, including the Bank of England, Bank of Canada, European Central Bank, the Swiss National Bank, and Swedish Riksbank. At the conclusion of their next regularly scheduled meeting on October 29, the FOMC announced that it would reduce the target rate by an additional 50 basis points to 1.0 percent. Along with traditional monetary tools, the Fed has also employed a variety of new tools to increase liquidity in credit markets, including the Term Auction Facility and the Term Securities Lending Facility.

In response to unprecedented strains in financial markets, on October 3, the Emergency Economic Stabilization Act of 2008 (EESA) was signed into law. Under the legislation Treasury

was granted the authority and flexibility to use up to \$700 billion to quickly stabilize the financial system. As a first step, Treasury implemented a program to inject much-needed capital into the financial system to restore confidence in the system and restore the flow of credit. The new law also gives the Federal Reserve the authority to pay interest on reserves and temporarily increases FDIC and NCUA deposit insurance from \$100,000 up to \$250,000. These measures are intended to boost liquidity and add capital to the financial system, thereby restoring confidence and stability in financial institutions so they can fuel continued economic growth.

Federal Budget Deficit Rising

The Federal fiscal situation deteriorated in FY2008 as a result of the slowing economy and the economic stimulus package enacted early in 2008. The Federal budget deficit widened by \$292 billion to \$455 billion (3.2 percent of GDP) in FY2008, following 3 years of improvement that trimmed the deficit to \$162 billion (1.2 percent of GDP) in FY2007. Outlays grew by 9.1 percent in FY2008 compared to FY2007, while receipts fell by 1.7 percent.

Economic Growth Slowed in the Third Quarter of 2008

Real GDP declined by 0.5 percent at an annualized rate in the third quarter. Consumer spending fell for the first time since 1991, subtracting 2.7 percentage points from GDP growth. The drop in consumption was the largest since 1980. Business investment declined slightly as outlays for structures slowed and spending for equipment and software fell for a third straight quarter. Residential investment subtracted 0.7 percentage point from third-quarter real GDP growth. Weakness in these sectors was partly offset by continued growth of net exports, which contributed 1.1 percentage points to third-quarter growth. Inventory investment added another 0.9 percentage point to real GDP growth, and government spending added 1.1 percentage points.

The Global Economy

Global economic conditions deteriorated in the first half of 2008. The moderation in growth in the advanced economies that began in late 2007 became more pronounced. In the second quarter of 2008, output fell in Canada, the euro area, and Japan, and was stagnant in the United Kingdom. In contrast, growth in many emerging markets remained strong giving some initial credence to the view that emerging markets had decoupled from the advanced economies.⁴ Consumer price inflation accelerated in the first half of 2008 as a result of rising food and energy prices. Many countries, particularly in the emerging markets saw inflation, rather than slowing output, as the main policy challenge, and tightened monetary policy.

⁴ Emerging market growth has subsequently slowed and emerging market financial markets have been hit hard, suggesting emerging markets are much less immune to developments in the advanced economies than some have posited.

By the fall of 2008, the financial crisis had become a global phenomenon. Financial markets in both the advanced and emerging market economies experienced historically high levels of stress. At the end of October, the Morgan Stanley equity index for advanced economies had fallen by 40 percent since the start of the year and the index for emerging markets had declined by 54 percent.

| Morgan Stanley Equity Indexes | | |
|-------------------------------|----------------|----------|
| 10/31/2008 | | |
| | Percent Change | |
| | 1- year | end-2007 |
| World | -45 | -41 |
| Advanced Economies | -43 | -40 |
| Emerging Markets | -57 | -54 |
| Source: Bloomberg | | |

| Emerging Market Bond Index Plus Spreads (basis points) | | | |
|--|----------------------|----------------|----------|
| | Spread 10/31/2008 | Percent Change | |
| | | 1- year | end 2007 |
| Global | 629 | 443 | 390 |
| Asia | 489 | 314 | 274 |
| Africa | 739 | 445 | 395 |
| Europe | 628 | 471 | 437 |
| Latin America | 663 | 460 | 395 |
| Note: The spread is the difference between yields on emerging market foreign currency denominated bonds and US Treasury bonds. | | | |
| Source: Bloomberg | | | |

Borrowing costs in emerging markets have increased substantially. The spread between yields on emerging market debt and U.S. Treasury bonds increased by more than 390 basis points in the first ten months of 2008, with the increase most pronounced in emerging Europe.

By the fall, it was also clear that the crisis would have a profound effect on economic growth. The International Monetary Fund (IMF) is now forecasting global growth in 2008 to fall to 3.7 percent, down from 5.0 percent in 2007.⁵ Growth is

forecast to further slow to 2.2 percent in 2009. As growth has slowed, commodity prices have fallen, reducing inflationary concerns in many countries. As inflationary concerns receded and economic growth prospects deteriorated, governments and central banks around the globe took aggressive action to boost domestic demand. Central banks in many countries slashed interest rates and their fiscal counterparts announced stimulus programs. Further policy actions are likely, as endorsed by the G-20 leaders' summit in mid-November.

Output in the advanced economies is expected to rise by 1.4 percent in 2008, down from 2.6 percent in 2007, and fall by 0.3 percent in 2009, as recessionary conditions prevail in most countries. The IMF expects growth in the euro area to fall to 1.2 percent this year and decline by 0.5 percent next year. Economic growth is expected to be especially hard hit in the United Kingdom, falling by 1.3 percent next year, ending its longest postwar economic expansion. Japan's economy is expected to grow by 0.5 percent this year and decline by 0.2 percent in 2009. The Canadian economy is expected to be the least affected of the G-7, with anemic but still positive growth forecast for 2009 (0.3 percent).

The IMF expects inflation to average 3.5 percent in the euro area this year and 3.8 percent in the United Kingdom. In 2009, euro area inflation is expected to fall to 1.9 percent, below the upper bound of the ECB's target. Inflation in the United Kingdom is expected to decline to 2.9 percent. In Japan, rising food and energy prices pushed inflation above 2 percent for the first time in 10 years. Core inflation, however, remains non-existent and IMF expects headline inflation to fall below 1 percent next year.

⁵ See the IMF's *World Economic Outlook - Update*, November 2008, <http://www.imf.org/external/pubs/ft/weo/2008/update/03/index.htm>. Forecasts of aggregate world GDP growth use purchasing power parity weights.

Talk of decoupling has ceased as economic growth in emerging markets has been affected both by the deterioration in financial markets and slowing demand in the advanced economies. The IMF expects growth in the emerging markets to decline to 6.7 percent this year, from 8.0 percent in 2007. Growth is expected to fall further in 2009 to 5.1 percent. Growth is expected to weaken in all regions this year except for the Middle East, which is still benefiting from high, albeit falling, oil prices. In 2009, growth is forecast to slow throughout the emerging markets.

Private net capital inflows to the emerging markets have slowed and are expected to decline sharply next year. Emerging markets have continued to accumulate reserves at a record pace, but this too is expected to slow as some countries tap their reserves to support their currencies and as the current account surpluses of many countries decrease.

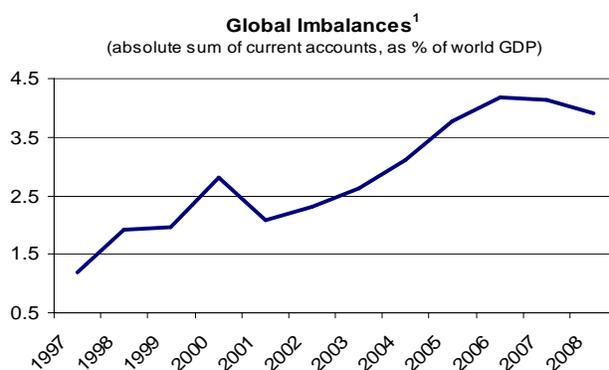
Capital Flows of Emerging Market and Developing Economies

| | 2006 | 2007 | 2008f | 2009f |
|--------------------------------------|-------|---------|---------|-------|
| Net Private Capital Inflows (\$ Bil) | 223.0 | 632.8 | 528.6 | 286.6 |
| Current Account (\$ Bil) | 709.9 | 745.5 | 869.6 | 695.6 |
| Increase in Reserves (\$ Bil) | 754.3 | 1,256.1 | 1,270.1 | 920.2 |

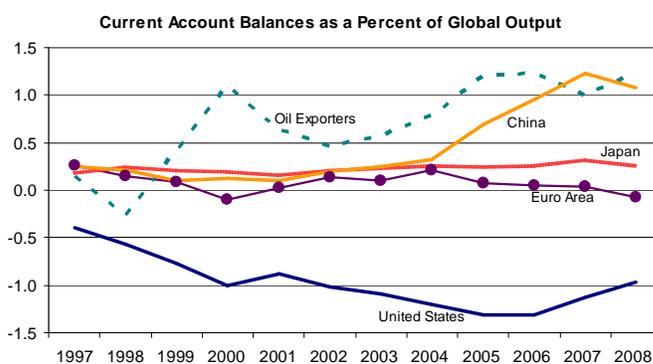
Note: "f" indicates forecast.

Source: IMF, *World Economic Outlook*, October 2008

After rising steadily between 2002 and 2006, global imbalances declined marginally last year. This year, global imbalances are expected to decline further, led by a 0.2 percent reduction in the U.S. current account deficit as a share of global output and a similar reduction in China's current account surplus as a share of global output. China's current account imbalance (nearly 11 percent of its GDP in 2008) now accounts for a larger share of global output than that of the United States. The combined current account surplus of the oil exporting economies is expected to rise this year but decline in 2009.⁶



1. Absolute sum of current account balances of the Euro area, Japan, United States, Emerging Asia, and Oil Exporters, weighted by purchasing power share of world GDP.
Source: International Monetary Fund WEO database and U.S. Treasury



Source: International Monetary Fund WEO Database and U.S. Treasury

⁶ The oil exporters consist of Algeria, Angola, Azerbaijan, Bahrain, Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Syria, Turkmenistan, United Arab Emirates, Venezuela and the Republic of Yemen.

The global economic downturn is likely to reduce global imbalances over the next year. A sustained reduction in imbalances, however, will require increased saving on the part of deficit countries and a reorientation of growth toward domestic consumption, supported by more flexible exchange rates, on the part of surplus countries.

The International Accounts for the United States

U.S. Current Account

The U.S. current account deficit in 2007 was \$731.2 billion or 5.3 percent of GDP. The current account deficit accumulated at a slightly slower pace in the first half of 2008, compared with the same period in 2007. In the second quarter of 2008, the deficit was \$732.6 billion at a seasonally adjusted annual rate (5.1 percent of GDP), compared to \$669.0 billion (4.8 percent) in the fourth quarter of 2007. The increase was largely due to the rising cost of petroleum imports. The current account deficit has narrowed significantly compared to its recent peak at the end of 2005. In the fourth quarter of 2005, the deficit reached a high of \$832.9 billion (6.6 percent of GDP). Since then, the current account deficit has narrowed almost \$100 billion or 1.5 percentage points of GDP.

U.S. balance of payments and trade

(\$b, seasonally adjusted unless otherwise indicated)

| | 2006 | 2007 | 2007 | 2007 | 2008 | 2008 |
|--|--------|--------|--------|--------|--------|--------|
| | | | Q3 | Q4 | Q1 | Q2 |
| Current Account: | | | | | | |
| Balance on Goods | -838.3 | -819.4 | -201.2 | -208.9 | -211.0 | -216.3 |
| Balance on Services | 85.0 | 119.1 | 33.1 | 35.1 | 33.9 | 35.8 |
| Balance on Income 1/ | 57.2 | 81.8 | 23.0 | 36.3 | 33.2 | 27.3 |
| Net Unilateral Current Transfers | -92.0 | -112.7 | -27.8 | -29.8 | -31.7 | -29.9 |
| Balance on Current Account | -788.1 | -731.2 | -173.0 | -167.2 | -175.6 | -183.1 |
| Balance on Current Account as % of GDP | -6.0 | -5.3 | -5.0 | -4.8 | -5.0 | -5.1 |
| Major Capital Flow Components (financial inflow +) | | | | | | |
| Net Bank Flows | -27.3 | -111.9 | -34.8 | 8.1 | -142.2 | -7.9 |
| Net Direct Investment Flows | 0.7 | -95.7 | 43.9 | -55.2 | -8.7 | 28.2 |
| Net Securities Sales | 724.9 | 728.3 | -60.1 | 251.6 | 205.6 | 223.4 |
| Net Liabilities to Unaffiliated Foreigners by Non-banking Concerns | 78.1 | 155.6 | 135.6 | -11.8 | 165.9 | -36.7 |
| Memoranda: | | | | | | |
| Statistical Discrepancy | -47.1 | -41.3 | 71.6 | -45.6 | -14.1 | 47.1 |
| Change in Foreign Official Assets in the United States | 487.9 | 411.1 | 13.5 | 145.5 | 173.5 | 144.4 |
| Trade in Goods | | | | | | |
| Balance | -817.3 | -794.5 | -688.3 | -712.9 | -204.8 | -211.2 |
| Total Exports | 1036.6 | 1162.5 | -194.9 | -203.1 | 320.0 | 339.4 |
| of Which: | | | | | | |
| Agricultural Products | 66.0 | 84.3 | 22.5 | 23.7 | 27.3 | 29.9 |
| Capital Goods Ex Autos | 415.0 | 447.4 | 114.4 | 117.2 | 116.5 | 120.1 |
| Automotive Products | 107.0 | 121.0 | 31.6 | 31.4 | 30.6 | 31.0 |
| Consumer Goods Ex Autos and Food | 129.1 | 146.1 | 37.4 | 37.6 | 39.2 | 41.0 |
| Industrial Supplies and Materials 2/ | 276.0 | 316.3 | 81.5 | 84.3 | 93.1 | 103.6 |
| Total Imports | 1853.9 | 1957.0 | 493.5 | 509.8 | 524.8 | 550.6 |
| of Which | | | | | | |
| Petroleum and Products | 1853.9 | 1957.0 | 160.5 | 174.6 | 190.0 | 207.9 |
| Capital Goods ex Autos | 418.3 | 444.5 | 112.4 | 113.3 | 113.6 | 117.3 |
| Automotive Products | 256.6 | 258.9 | 66.2 | 65.0 | 64.3 | 62.5 |
| Consumer Goods Ex Autos and Food | 442.6 | 474.9 | 117.7 | 120.0 | 119.6 | 123.4 |

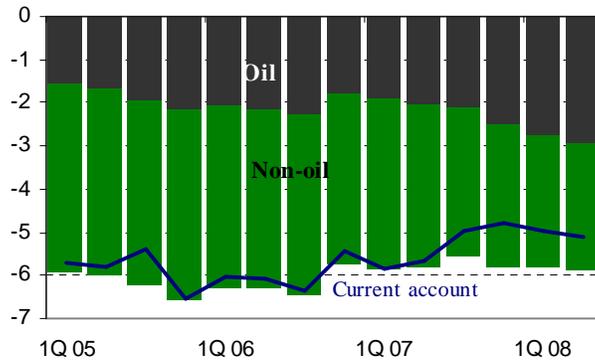
1/ Including compensation of employees

2/ Including petroleum and petroleum products

Source: BEA, Bureau of Census

Over the first half of 2008, the current account balance consisted of a deficit in the balance of trade in goods of \$427.4 billion split almost equally between oil and non-oil deficits; a surplus in the balance of trade in services of \$69.7 billion, a surplus in net factor income of \$60.6 billion and a deficit in net transfer payments of \$61.7 billion.

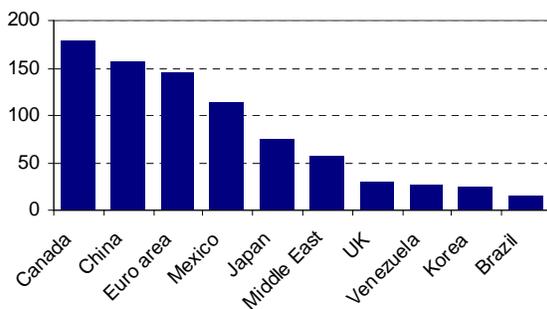
Current account, oil and non-oil deficits
(percent of GDP)



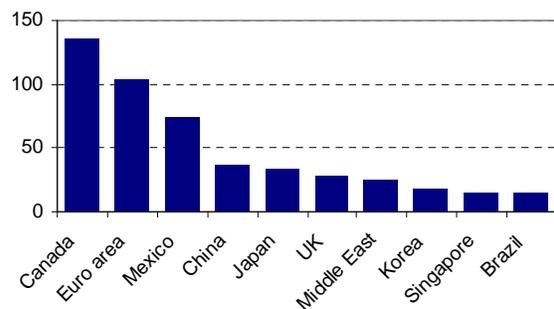
In the second half of 2007, the value of exports of goods totaled \$605.4 billion. Exports rose to \$659.4 billion in the first half of 2008, an increase of 8.9 percent. The value of imports of goods totaled \$1003.3 billion in the second half of 2007 and \$1075.4 billion in the first half of 2008, an increase of 7.2 percent. Oil imports increased to \$397.9 billion from \$335.2 billion. U.S. exports of services totaled \$271.3 billion in the first half of 2008 and \$261.7 billion in the second half of 2007, an increase of 3.7 percent.

The largest exporters of goods and services to the United States as well as the largest export markets (goods and services) of the United States are shown below. The five largest exporters to the United States (Canada, China, euro area, Mexico and Japan) accounted for 62.3 percent of all imports into the United States in the first half of 2008. The second five largest accounted for a combined 14.2 percent of total imports. The five largest export markets for the United States in 2007 were Canada, the euro area, Mexico, China and Japan, accounting for a combined total of 58.3 percent of total U.S. exports. The second five accounted for an additional 15.5 percent of all U.S. exports in the first half of 2008.

Major exporters to the U.S. (1H 2008)
(\$b)

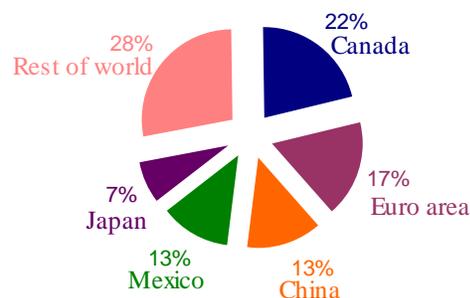


Major U.S. export markets (1H 2008)
(\$b)



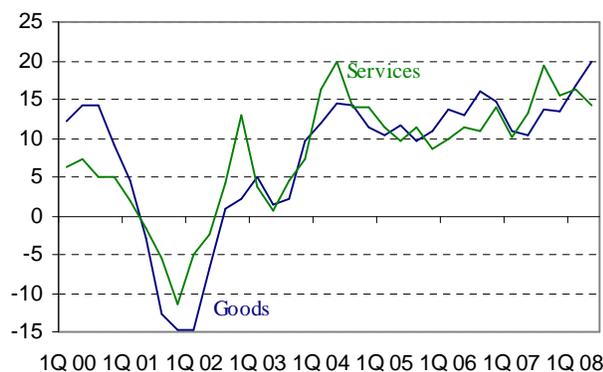
The five largest trading partners (based on the sum of exports of goods and services plus imports of goods and services) of the United States in the first half of 2008 were: Canada (\$315.9 billion); the euro area (\$249.6 billion); China (\$193.9 billion); Mexico (\$187.2 billion); and Japan (\$109.3 billion).

Largest trading partners of the U.S. (1H 2008)



The last few years have seen the strongest U.S. export performance in a decade. Exports of both goods and services declined in 2001 and 2002, but since then both have averaged more than 10 percent annual growth. In the second quarter of 2008, exports of goods increased 19.9 percent while service exports expanded 14.1 percent.

Exports of goods and services
(percent y-o-y)



In the first half of 2008, exports (BOP basis) totaled \$659.4 billion. Of this, exports of capital goods accounted for 36 percent, exports of industrial supplies 29 percent and exports of consumer goods 12 percent. Imports (BOP basis) in the first half of 2008 totaled \$1075.4 billion, of which 37 percent were industrial supplies (which includes petroleum and petroleum products), 23 percent were consumer goods and 22 percent were capital goods. Imports of petroleum and petroleum products totaled \$235.8 billion in the first half of 2008 compared to \$182.1 billion in the second half of 2007, an increase of 29.5 percent.

Capital and Financial Accounts

The counterpart to the balance on the current account, by balance of payments accounting definition, is the balance on the capital and financial account. By definition the current account balance is the difference between domestic capital formation and domestic saving. Therefore, the net of flows in the capital and financial account are equal to the excess of net capital formation over saving.

Data for the first half of 2008 show that U.S. residents invested less abroad in the form of direct investment than foreign residents invested in the United States. Net inflows of FDI were \$19.6

billion; consisting of \$174.2 billion of FDI in the United States by non-residents and \$154.6 billion in outbound FDI in foreign countries by U.S. residents. Foreign investors also purchased more U.S. securities than U.S. investors purchased of overseas securities, resulting in an inflow of portfolio investment of \$429.0 billion. There was an additional net inflow of \$129.2 billion by non-banks to non-affiliates. Increases in foreign assets of U.S. banks, however, exceeded increases in their foreign liabilities by \$150.1 billion.

The U.S. Treasury's International Capital Reporting System (TIC), which records cross-border transactions data, shows continued demand for U.S. financial assets, with some evidence of a flight to quality. Total net foreign demand for U.S. long-term securities was \$472.8 billion over the first eight months of 2008 compared to \$690.5 billion over the same period in 2007.

*Net International Investment Position*⁷

The U.S. Net International Investment Position (NIIP) widened to minus \$2441.8 billion at the end of 2007 from minus \$2225.8 billion at end-2006 when direct investment is valued using the current cost of tangible assets.⁸ The value of U.S. assets held abroad rose to \$17,640.0 billion while the value of foreign-held assets in the U.S. increased to \$20,081.8 billion. As a share of GDP, the NIIP widened to 17.6 percent from 16.9 percent. When direct investment is valued using the market value of owner's equity, the NIIP narrowed to minus \$1727.5 billion (12.5 percent of GDP) from minus \$1849.3 billion (14.0 percent).

| | NIIP (percent of GDP) | |
|------|---------------------------|--------------|
| | Current cost | Market value |
| 2000 | -13.6 | -15.6 |
| 2001 | -18.5 | -22.6 |
| 2002 | -19.5 | -23.0 |
| 2003 | -19.0 | -20.9 |
| 2004 | -19.2 | -20.2 |
| 2005 | -15.5 | -14.9 |
| 2006 | -16.9 | -14.0 |
| 2007 | -17.7 | -12.5 |

Financial flows, largely strong net purchases of U.S. securities by overseas investors, were the primary driver behind the widening of the NIIP. Net financial flows reduced the NIIP by \$774.3 billion. Valuation changes, primarily due to changes in asset prices and exchange rates, meanwhile, helped narrow the NIIP by \$558.3 billion. The depreciation of the dollar against foreign currencies contributed \$438.7 billion to offset the widening of the NIIP.

While the current account deficit in 2007 was \$731.2 billion, the NIIP widened by only \$216.0 billion on a current cost basis and actually improved by \$121.8 billion on a market cost basis due in large part to the increase in value of U.S. holdings of foreign securities.

The U.S. Dollar

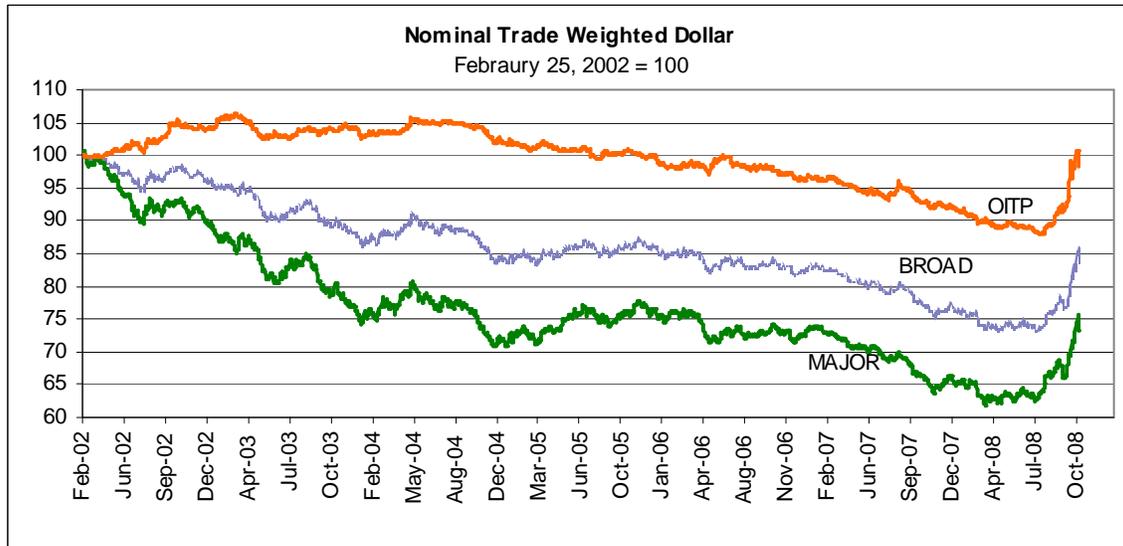
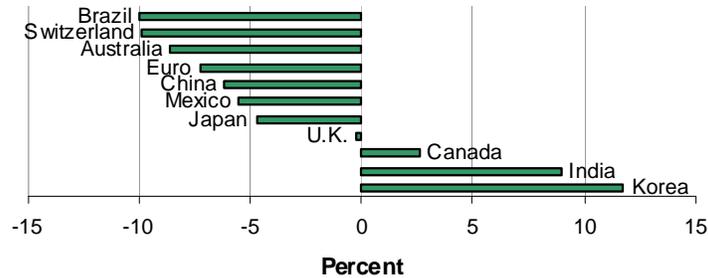
The dollar depreciated against many currencies during the first half of 2008 as evidence of a sharp slowdown in U.S. economic growth emerged and concerns about U.S. financial conditions grew. On a nominal trade-weighted basis, the dollar declined 3.2 percent during the first half of 2008. The decline was nearly equal against the "major currencies" and the currencies of "other important trading partners" (OITP).

⁷ NIIP is a critical measure in analyzing the sustainability of the current account deficit. A growing negative NIIP must stabilize as a percent of national output in the long-run or it will become impossible to service the external debt out of current or future production.

⁸ Data for year-end NIIP 2008 will be released in June 2009.

Change in U.S. Dollar's Value

First Half of 2008



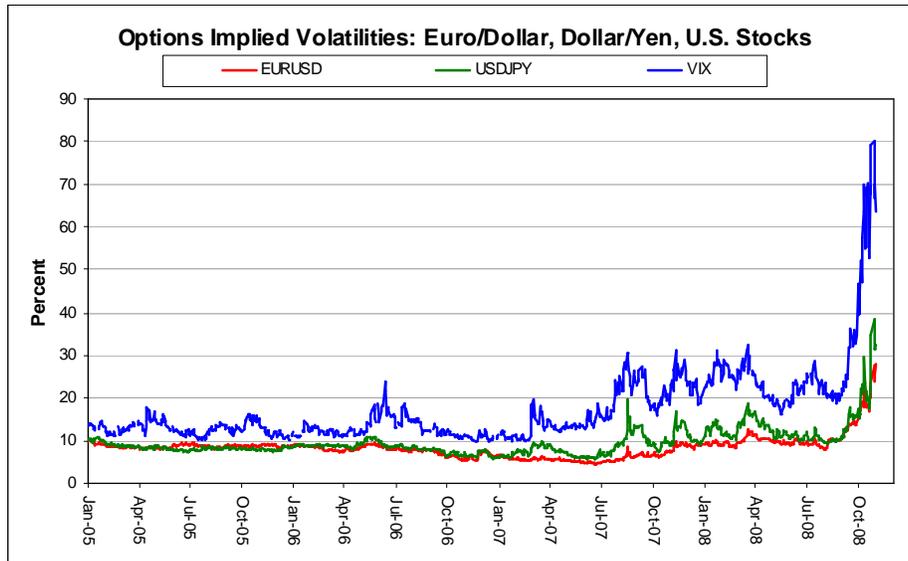
Major Currencies

In the first quarter of 2008, amid deteriorating credit market conditions, disappointments in U.S. economic data releases were viewed in the markets as indicative of a broad-based decline in U.S. economic growth prospects. There was particular concern about downside risks to household consumption and to the labor market. By contrast, European economic indicators remained robust, and Japanese indicators showed only a modest softening in economic activity. Through most of April, this divergence in growth expectations weighed on the dollar. By late April, the dollar had reached a record intra-day low of \$1.60 against the euro, for a year-to-date decline against the euro of 9 percent. The dollar/yen exchange rate bottomed out at around ¥ 97 in mid-March, a year-to-date decline of 13 percent, after rising exchange rate volatility contributed to liquidation of risk positions financed by yen borrowing.

- Volatility in the euro/dollar and dollar/yen currency pairs increased as financial conditions worsened in February and March. The spike was particularly pronounced in March and in the dollar/yen pair. In April, G-7 Finance Ministers and Central Bank

Governors noted “at times sharp fluctuations in major currencies” and their concern about possible implications for economic and financial stability.

- Over the first half of 2008, the dollar depreciated by 7 percent to \$1.5755 against the euro and by 5 percent to ¥106.09 against the yen.



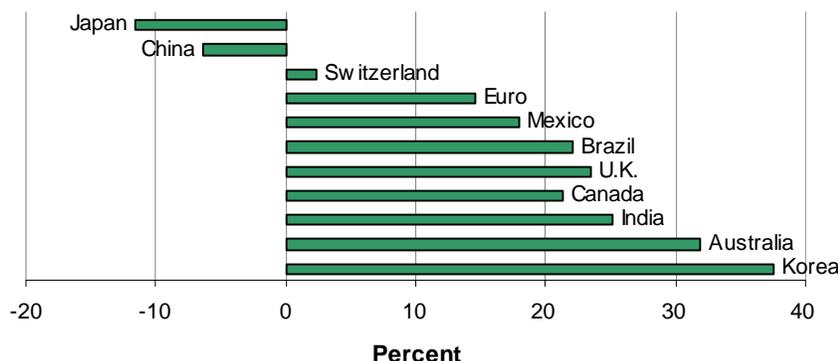
Funding market conditions remained strained but reasonably stable, and price volatility across asset classes was limited after mid-May. This was a relief from spikes in credit spreads and stock market and exchange rate volatility that had occurred in preceding months. The calmer conditions prevailed through the end of the first half and most of the summer. There was only a limited deterioration in funding market conditions in mid-July when the Treasury said that it was important to support Fannie Mae and Freddie Mac.

In late May and early June, foreign exchange market conditions calmed following public statements by Secretary Paulson and Federal Reserve Chairman Bernanke. Subsequently, however, market conditions became more volatile as market participants adjusted their expectations upwards regarding the outlook for euro area interest rates. Indeed, in early July, the ECB raised its refinancing rate 25 basis points to 4.25 percent.

Dollar Appreciation

By late summer, euro area data came in much lower than expected with negative growth rates recorded in a number of large euro area economies in the second quarter and growing expectations of continued sluggish growth throughout 2008 and into early 2009. The euro declined from a high of near \$1.60 in late April to \$1.27 by the end of October – a 13 percent depreciation since the start of the year. In contrast, renewed risk aversion resulted in yen appreciation. At the end of October, the yen had appreciated by 12 percent against the dollar since the start of the year.

Change in U.S. Dollar's Value in 2008 through 10/31/08



Similarly, new concerns about the durability of emerging market growth and the ability of emerging markets to “decouple” from advanced economy growth coupled with tightening credit conditions and diminished capitals flows weighed on emerging market currencies. The dollar, often seen as a “safe haven” currency, appreciated against a broad range of currencies.

Country Analyses

Asia & Pacific

China

Gradual reform and heavy government intervention continue to characterize China’s managed float exchange rate regime. In the first half of 2008 Chinese authorities allowed greater flexibility in the dollar exchange rate. At the same time, China’s central bank engaged in record levels of foreign exchange market intervention. China’s exchange rate policy impedes the needed shift towards domestic private consumption – and away from net exports and investment – as the drivers of Chinese growth; is a major impediment to financial sector development; and, constrains the development of an autonomous monetary policy tailored to stabilizing inflation and domestic economic growth.

China’s exchange rate regime is officially described as a managed float with reference to a basket of the currencies of China’s major trading partners. The central bank, the People’s Bank of China (PBOC), buys foreign currencies in China’s foreign exchange market to limit the appreciation of the renminbi versus other currencies. The PBOC allowed a faster rate of appreciation against the dollar in the first half of 2008 than in any period since the end of the renminbi’s peg to dollar in July 2005. The renminbi gained a total of 6.2 percent against the dollar in the first half of 2008, just short of the 6.4 percent gain in the entire year in 2007. The pace of renminbi appreciation was more than 20 percent on an annualized basis both in January and March. Cumulatively, the renminbi appreciated 17.2 percent against the dollar from the end of the dollar peg through June 30, 2008. On a real trade-weighted basis (averaging exchange rate movements across China’s trading partners and adjusting for consumer price inflation

differentials), the renminbi gained 2.3 percent in the first half of 2008.⁹ Cumulative real trade-weighted appreciation since the end of the dollar peg was 12.8 percent at the end of June.

Since the end of June and in the context of slowing external growth and receding concerns about inflation, renminbi appreciation has stalled against the dollar. The renminbi was virtually unchanged (rising 0.2 percent) against the dollar from June 30, 2008, to end-October. However, given the dollar's rebound in this time period, the renminbi's trade-weighted appreciation accelerated. Between June and October, the renminbi gained 10.8 percent on a real effective basis.

Despite the accelerated appreciation of the renminbi in the first half of 2008, the negative impacts of China's gradualist approach to exchange rate reform became more apparent as non-trade, non-FDI capital inflows ballooned and the PBOC's foreign currency intervention activities reached an unprecedented scale. The undervalued renminbi, combined with positive interest rate differentials, prompted investors to find ways to circumvent China's capital controls to move money into China. These net portfolio inflows, combined with persistent surpluses in trade and direct investment, required large-scale intervention by the PBOC to manage the renminbi's value. China's foreign reserves rose by \$280.6 billion in the first half of 2008, up 18 percent from the end of 2007.¹⁰ However, this increase presents an incomplete picture of the extent of foreign exchange market intervention, as several important policy actions shifted accumulated foreign exchange out of the PBOC's official reserves. Accounting for these policy measures, the PBOC took in an estimated \$760 billion in foreign exchange in the 12 months up to June 2008, equal to 20.4 percent of current GDP, or on average \$3 billion per trading day.¹¹ This is almost double the increase in reserves in the twelve months leading up to June 2007.

When the PBOC intervenes, it buys foreign currency with renminbi, adding to the domestic money supply. In order to counter the inflationary effects of such large foreign exchange purchases from the corresponding creation of domestic liquidity, the PBOC "sterilizes" its foreign exchange purchases by taking counteracting measures to recapture the money it has created. One liquidity absorption measure is the issuance of central bank bonds. The PBOC issued RMB 2.94 trillion (\$417 billion) in the first half of 2008, and by the end of June 2008, had a total of RMB 4.24 trillion (\$657.3 billion or 37 percent of base money) in sterilization bills outstanding. The central bank also uses repurchase agreements and increases in banks' required reserve ratio (RRR) to manage liquidity. As of end-June the PBOC had RMB 175.6 billion (\$20.6 billion) of repurchase agreements outstanding. The PBOC raised the RRR by 3 percentage points to 17.5 percent in the first half of the year, but reduced the ratio by 50 basis points in October as economic growth slowed.

Faced with continued large capital inflows, the authorities chose to strengthen supervision of foreign exchange trading to try to limit unauthorized transactions. In August 2008, China announced revisions to foreign exchange control regulations for the first time since 1997. The

⁹ According to the effective exchange rate series compiled by the Bank for International Settlements.

¹⁰ This includes purchase of foreign exchange through intervention, valuation changes on non-dollar foreign exchange reserves, and possibly interest earnings on accumulated reserves.

¹¹ On top of the PBOC's \$476 billion in official reserve accumulation from June 2007 to June 2008, this estimate includes \$203.5 billion in foreign exchange deposited with the PBOC by commercial banks to meet increases in the required reserve ratio and an upward adjustment of \$80 billion for CIC's purchases of foreign exchange from the PBOC. CIC's foreign exchange purchases were reportedly executed between August 2007 and March 2008.

updated foreign exchange measures largely focus on heightened scrutiny and verification of foreign exchange transactions. These potentially burdensome administrative measures point to the complications caused by excessively slow exchange rate reform of a currency whose value is out of line with market supply and demand.

The gap between the real exchange rate and its equilibrium level remains wide and the renminbi remains substantially undervalued, according to a number of estimates. Despite a cyclical slowdown in China's major trading partners, China's large external surpluses continue to grow. In the first ten months of 2008, China's global trade balance grew to a record high of \$216 billion, with exports growing by 22 percent over the same period in 2007. Imports grew by 30.7 percent in the first half of 2008 from the first half of 2007, in part due to rising import prices, but import growth in the second half of 2008 has decelerated on a monthly basis, down to a sixteen-month low of 15.6 percent in October versus October 2007. China's global trade surplus in the first three quarters of 2008 declined slightly to \$181 billion (6.6 percent of GDP) from \$186.1 billion (9 percent of GDP) in the first three quarters of 2007. However, it remains large compared to global trade surpluses of \$109.7 billion in the first three quarters of 2006 and \$68.5 billion in the first three quarters of 2005.

Progress is slow on the structural reform agenda to rebalance growth away from investment and net exports and towards domestic consumption. The share of consumption in China's real GDP growth declined from a recent peak of 62.3 percent in 2000 to 49.0 percent in 2007. In the first half of 2008, growth in urban retail sales, a major component of household consumption, remained flat in real terms, up 12.9 percent year-over-year versus 12.7 percent year-over-year in the first half of 2007. Rising government consumption and declining corporate profit growth may lead to a smaller surplus of national saving over investment in 2008, and thus a smaller current account surplus, though data are not yet available. However, in the absence of further liberalization of both the exchange rate and domestic interest rates, the saving and investment gap, and therefore the external surplus, will expand again when global growth picks up.

China's real GDP expanded by 10.4 percent year-over-year in the first half of 2008, down from 11.9 percent year-over-year in 2007. Inflation was policymakers' primary concern, as CPI growth climbed to 8.5 percent year-over-year in April. By the fall, as food price increases slowed and other commodity prices declined inflationary pressures were rapidly fading. CPI inflation subsided to 4.0 percent year-over-year in October. Producer price inflation (PPI) rose from 6.1 percent year-over-year in January, to a record high of 10.1 percent in August, before declining to 6.6 percent in October.

In response to inflationary pressures, the authorities enacted an officially-described "tight" monetary policy at the end of 2007, with quantitative restrictions on banks' credit growth paired with the PBOC's sterilization activities. As consumer price inflation receded and external growth weakened, policy attention shifted back to maintaining growth. In July 2008, a pre-Olympics Politburo meeting led to a shift in the Chinese government's top economic priority from fighting inflation and overheating to maintaining "stable and relatively fast growth." Since September, authorities cut benchmark bank lending rates by 189 basis points and lowered banks' required reserve ratios by 150 basis points for large banks and 350 basis points for small banks. In early November, the State Council announced a two-year \$590 billion economic stimulus package, although the amount of incremental new spending in this package is unclear.

A positive outcome of China's exchange rate reform agenda is the growing use of foreign exchange derivative instruments. Market participants are employing hedging tools in greater proportions. In the first half of the year, banks bought forward \$95 billion in foreign exchange, amounting to 14.3 percent of China's exports, and sold forward \$53 billion of foreign exchange, amounting to 9.3 percent of China's imports.

Faster and more decisive implementation of exchange rate reform is essential for maintaining sustained, stable growth in China. If the current macroeconomic imbalances continue, in a period in which growth has slowed materially in the rest of the world, then the vulnerability of China's economy and the ultimate costs of adjustment will become much larger. China needs to move more quickly towards a market-determined exchange rate and allow greater appreciation of the renminbi against the dollar in the near-term. The pace of appreciation against the dollar demonstrated in early 2008 is welcome and should be continued. Treasury continues to use every opportunity, both in bilateral and multilateral settings, to impress upon Chinese authorities the urgency and central importance of exchange rate reform.

India

India's official exchange rate arrangement is a managed float and the rupee has shown significant movement, including appreciating against the dollar for much of 2007 before depreciating for much of 2008. The stated aim of foreign exchange intervention is to smooth volatility, and in general this appears to have been the case. While the Reserve Bank of India (RBI) seeks to achieve its monetary objectives of price stability and well-anchored inflation expectations by adjusting market liquidity through the repo rate, reverse repo, and the cash reserve ratio, the RBI has at times used the exchange rate to help meet monetary objectives including in 2007 when greater appreciation was used to help dampen inflation.

India has seen an acceleration of economic growth since 2003, reaching 9.6 percent on a seasonally adjusted annualized basis in the first half of 2008. With rising domestic inflation, a growing current account deficit, and slowing external demand, Indian growth is expected to fall in the second half and into 2009. Wholesale prices increased 7.6 percent in the first half of 2008 from the same period in 2007, and have accelerated since, reaching 12.1 percent on a year-over-year basis in September. The RBI left its policy interest rate unchanged (7.75 percent) from January through May but raised the cash reserve ratio (CRR) by 75 basis points to 8.25 percent in May. In June and July, the RBI hiked its repurchase rate by 1.25 percentage points to 9 percent, and raised the cash reserve ratio by a further 75 basis points.

The current account deficit was 3.2 percent of GDP in the first half of 2008, compared to 0.7 percent of GDP in the second half of 2007. The U.S. bilateral trade deficit with India widened to \$4 billion in the first half of 2008, from \$1 billion in the second half of 2007. India's overall net capital inflows fell to \$38.6 billion in the first half of 2008, from \$65 billion in the second half of 2007, but were still adequate to finance the current account deficit.

During the review period India continued to receive large foreign direct investment inflows. But, after strong inflows during 2007, portfolio capital shifted to net outflows during 2008. India has varied controls on capital flows in response to shifts in the balance of payments. In the face of high capital inflows and rupee appreciation last year, India tightened restrictions on external

commercial borrowings in August 2007. As the current account deficit increased and portfolio capital shifted to net outflows, India partially relaxed capital controls in June 2008.

After appreciating 11 percent against the dollar in 2007, the rupee depreciated by almost 9 percent in the first half of 2008 (with most of the depreciation occurring in May). The pace of depreciation accelerated in the third quarter. Between the end of June and end-October the rupee fell by nearly 15 percent against the dollar. In real effective trade-weighted terms as calculated by JP Morgan, the rupee depreciated by 7.4 percent in the first half of 2008 and a further 3.4 percent through October. India's foreign exchange reserves increased by \$35.7 billion in the first half of 2008 to \$302.3 billion, but fell by \$20 billion in the third quarter.

Japan

Japan maintains a floating exchange rate regime. The yen trades in a deep market in which daily transactions average \$530 billion.¹² Over the past ten years, the yen-dollar exchange rate has fluctuated between ¥147 and ¥94 to the dollar; over the first 6 months of 2008, it fluctuated between ¥112 and ¥96 to the dollar.

The yen appreciated 4.3 percent against the dollar in the first half of the year after appreciating 9.5 percent against the dollar in the second half of 2007. In real effective terms, the yen appreciated 1.0 percent in the first half of the year after appreciating 4.3 percent in the second half of 2007. Since the end of June, the yen has strengthened further, moving from ¥106.2 to ¥98.5 at the end of October, bringing year-to-date appreciation against the dollar to 12 percent.

Japan's longest post-war economic recovery ended in the second quarter of 2008, as real GDP declined by 3 percent, year-over-year. The Japanese economy is expected to continue to contract in the third quarter. Industrial production declined in the first and second quarters of 2008 and the labor market remains weak. Consumer prices rose 0.1 percent year-over-year in 2007, but core prices (excluding food and energy) declined 0.3 percent. In July 2008, the CPI increased at its fastest rate in nearly ten years (2.3 percent year-over-year), driven by higher food and energy prices, but fell to 2.1 percent in September. Excluding food and energy the CPI increased by 0.2 percent year-over-year in September. The strengthening of the yen since mid-year 2007 has likely exerted downward pressure, other things being equal, on overall prices.

Japan's domestic saving exceeds domestic investment, which is reflected in a persistent Japanese current account surplus. Earnings on accumulated reserves and overseas investments now mean that net income flows exceed the trade surplus as a contributor to the current account surplus. Japan's current account surplus increased 23 percent in 2007, rising to \$212.3 billion from \$172.1 billion in 2006. However, the half-year surplus declined from \$108.7 in the second half of 2007 to \$99.6 billion in the first half of this year. Japan's merchandise trade surplus declined by 28 percent on a year-over-year basis in the first half of 2008 to \$45.2 billion. Japan's merchandise trade surplus with the U.S. narrowed one percent from the first half of 2007 to the first half of 2008 at \$39.7 billion.

¹² Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in April 2007, Bank for International Settlements, September 2007; <http://www.bis.org/publ/rpfx07.htm>.

Net outflows of private capital increased in the first half of 2008 compared to the second half of 2007, rising to \$111.6 billion from \$91.6 billion. The “yen carry trade,” in which investors borrow yen at a low interest rate to invest in higher return foreign currency assets, was prominent for much of 2007 but diminished during the latter part of the year and in the first half of 2008. The narrowing of interest rate differentials between Japan and the United States, increased aversion to risk following the financial market turbulence in the second half of 2007, and the fact that yen appreciation imposed losses on many outstanding carry trades all combined to reduce incentives for investing in overseas assets. The yen’s appreciation peaked at ¥96.88 to the dollar on March 17. Carry trade positions increased in the second quarter of the year, as investors’ appetite for high-yielding currencies returned, contributing to the yen’s nine percent depreciation from March 17 to June 30. However, as the global financial turmoil intensified in September and October, the yen appreciated as investors again unwound carry trade positions and fled to high quality assets. On October 27, the yen reached a ten year high of ¥93.58 to the dollar.

Japanese authorities have not intervened in the foreign exchange market since March 2004.¹³ Although Japan has not intervened, Japan’s foreign exchange reserves continued to rise in the first half of 2008, reflecting interest earnings and valuation effects (as the value of other currencies have risen against the dollar and as bond prices have risen as interest rates have fallen). Foreign exchange reserves totaled \$973.8 billion at the end of June 2008, up from \$948.4 billion at the end of December 2007, a 2.7 percent increase.

Malaysia

In prior reports, we have cited Malaysia’s large current account surplus and rapid accumulation of foreign reserves as signs of imbalance in the Malaysian economy and as likely indicators of an undervalued ringgit. In the first half of 2008, Malaysia’s current account surplus and foreign reserves continued to grow rapidly. Although this is in part due to higher global prices for Malaysia’s exports, the continued large imbalance between domestic saving and investment and signs of an acceleration in domestic inflation suggest that the ringgit remains undervalued. This view is supported by various models of equilibrium exchange rates.¹⁴

In July 2005, Malaysia ended the ringgit’s fixed exchange rate to the dollar and revalued the currency. Since then, Malaysia’s central bank, Bank Negara Malaysia (BNM), has operated a managed floating exchange rate regime. Officially, the BNM has no explicit exchange rate target and intervenes in both directions to smooth out excessive volatility in the exchange rate.

During the first half of 2008, the ringgit depreciated 1.2 percent against the U.S. dollar and 2.7 percent on a real effective basis. The ringgit depreciated a further 2.4 percent against the dollar and 1.5 percent on a real effective basis between July and October. Since the end of the peg in 2005, the ringgit has appreciated 9.0 percent against the U.S. dollar, and by 4.0 percent on a real effective basis.

¹³ The Ministry of Finance determines the timing and magnitude of foreign exchange interventions, and the operations are carried out by the Bank of Japan.

¹⁴ Estimates of equilibrium exchange rates by William Cline and John Williamson (<http://www.petersoninstitute.org/publications/pb/pb08-7.pdf>) in July 2008 found that the ringgit was substantially undervalued.

Malaysia's official foreign exchange reserves grew rapidly over the first quarter of 2008, increasing by 20.2 percent – the most rapid official reserve growth in Asia during this period. The pace of growth was significantly faster than in the second half of 2007, when reserves increased by only 3.0 percent. Reserve growth slowed in the second quarter of 2008 to 5.0 percent and reserves decreased by 4.6 percent in July and August ending at \$117 billion – still well above their end of 2007 level (\$95 billion).¹⁵ Malaysia's reserves significantly exceed commonly accepted adequacy levels, equaling over eight months of imports and over four times the country's short term external debt.

Malaysia's current account surplus – which has been above 10 percent of GDP since 2002 – continued to grow in the first half of the year, reaching a high of 21.6 percent in the second quarter of 2008. The recent increase in the current account surplus has been driven by strong demand and higher prices for Malaysia's commodity exports, but the persistently large current account surplus reflects a continuing gap between Malaysian saving and investment.

Rapid growth in Malaysian exports in the first half of 2008 reflected a sharp improvement in Malaysia's terms of trade, which rose 5.9 percent due to higher prices for commodity exports such as petroleum, natural gas, palm oil, and rubber. Total Malaysian exports grew 15.5 percent and imports grew 8.4 percent in the first half of 2008 on a year-over-year basis. Malaysia's overall merchandise trade surplus in the first half of 2008 rose by 63.7 percent year-over-year to \$22.6 billion. In real terms, Malaysia's net exports grew by 20.0 percent on a year-over-year basis in the second quarter of 2008, accounting for 2.8 percentage points (41.7 percent) of the 6.7 percent growth rate of the economy. In contrast, Malaysia's bilateral trade surplus with the United States fell slightly from \$10 billion for the first half of 2007 to \$9.5 billion for the first half of 2008.

Saving in Malaysia remains high, and a significant amount of that saving is done by the public sector – 15 percent of GDP compared to 20 percent of GDP for private saving. At the same time, investment in Malaysia has yet to recover to its pre-Asian financial crisis peak. In the first half of 2008, real gross fixed capital formation increased 12.1 percent on a year-over-year basis. Investment as a share of GDP however, declined to 20.1 percent in the first half of 2008, well below the average of 41.6 percent from 1993 to 1997. (Even if one looks back well before the pre-Asian Financial Crisis investment boom, investment to GDP averaged 37.0 percent of GDP between 1991-93). Malaysia's large savings-investment imbalance provides the structural basis for the country's large and persistent current account surplus.

Price growth in Malaysia accelerated in the first half of 2008, based largely on rising food and energy prices. Following a 41 percent fuel price hike in early June, CPI inflation reached a peak of 8.5 percent in July, its highest level in 26 years. The rate of inflation remains elevated, ending at 8.2 percent in September.

While the Malaysian authorities have intervened in both directions to smooth exchange rate volatility, the tendency has been to intervene by selling ringgit and accumulating reserves. A more flexible exchange rate would help contribute to more balanced and stable economic growth.

¹⁵ The decrease in reserves over this period may have reflected BNM's policy response to foreign selling of government bonds and BNM bills.

in Malaysia by allowing domestic consumption and private investment to play a greater role in the economy and by enabling the economy to adjust more effectively to external shocks.

Singapore

Singapore's central bank, The Monetary Authority of Singapore (MAS) uses the exchange rate as the primary tool for maintaining price stability, effectively linking domestic prices to international traded goods prices.¹⁶ The MAS actively manages the exchange rate against an undisclosed basket of currencies of major trading partners and aims for "modest and gradual" nominal appreciation against the currency basket.¹⁷ In the first half of 2008, the Singapore dollar (SGD) appreciated by 5.2 percent against the U.S. dollar, but only 3.3 percent on a nominal effective basis. As a result of higher domestic inflation, the SGD appreciated by 7.5 percent on a real effective basis in the first half of 2008. In April, the MAS responded to inflationary pressure by reaffirming the country's exchange rate policy and resetting the midpoint of the band at the then prevailing market rate, leading to a one-time 2 percent exchange rate appreciation against the U.S. dollar. The MAS intervenes in the foreign exchange market to reduce pressure for faster appreciation, sterilizing these interventions through foreign exchange swaps, direct borrowing, and repos.

Since the middle of the year, the SGD has reversed course, depreciating 9.0 percent against the dollar between the end of June and end of October. The real effective exchange rate, however, fell by only 2.5 percent over this period.

Singapore's large current account surplus — fueled in recent years by high and growing national savings rates and falling domestic investment rates — narrowed considerably in the first half of 2008, falling to 15 percent of GDP from 24 percent of GDP in 2007, as weaker demand in the advanced economies resulted in a sharp drop in exports. Although declining, the current account surplus remains large, supporting estimates that the real effective exchange rate remains undervalued.¹⁸

Despite the decline in exports, Singapore maintained its global trade surplus in the first half of 2008 — \$25.8 billion (against \$48 billion in 2007). The country has a trade deficit with the United States, however, with the balance declining further from \$4.2 billion in the second half of 2007 to \$7.3 billion in the first half of 2008.

High corporate savings and a continuing fiscal surplus (2.6 percent of GDP in FY2007 although authorities have budgeted a small deficit for FY2008) contribute to one of the world's highest national savings rates (47 percent of GDP in 2007). Analysts note that the government historically understates the fiscal surplus, because it excludes items such as capital gains from past reserve investments, and an undisclosed portion of dividends and interest from the Government Investment Corporation (GIC) and the state-owned Temasek holding company.

¹⁶ Singapore is a highly open economy, with trade flows amounting to more than 350 percent of GDP.

¹⁷ The MAS manages the exchange rate within an undisclosed band and can choose to 1) change the midpoint of the band to allow for a one-off adjustment, 2) change the band's gradient to signal a possible turning point in the monetary policy cycle, or 3) widen the band.

¹⁸ See for example, estimates by William Cline and John Williamson, <http://www.petersoninstitute.org/publications/pb/pb08-7.pdf>.

The GIC and Temasek manage funds from Singapore's large fiscal surpluses, much of which stems from its compulsory social security savings. GIC invests almost exclusively overseas, but does not disclose its asset size. Temasek invests significantly in overseas markets either directly through overseas acquisitions or indirectly through Singapore-based companies, and had a total portfolio valued at \$134 billion at the end of March 2008. Before transferring fiscal surpluses to GIC, MAS changes the funds into foreign exchange on behalf of the government.

The country's developed and open financial sector (Singapore has no capital controls) attracts large capital inflows, resulting in net private capital inflows. Substantial outflows from GIC and Temasek, however, result in a capital account deficit (2.1 percent of GDP in the first half of 2008). Meanwhile, Singapore continues to attract significant foreign direct investment, which totaled nearly \$17 billion in 2007. Net capital outflows of \$2.6 billion failed to offset Singapore's current account surplus, fueling significant foreign reserve accumulation. From January – June 2008, foreign reserves increased by \$14 billion, reaching \$177 billion and representing more than 100 percent of GDP and 116 percent of short term debt.

Inflation accelerated markedly over the first half of 2008 to 7.1 percent year-over-year (up from 3.4 percent over the second half of 2007), fueled by rising food and housing costs. In August, inflation declined to 6.4 percent year-over-year but rose again in September to 6.7 percent.

While economic growth has been strong, with GDP reaching 7 percent (on a year-over-year basis) in the first quarter of 2008 (following average 2007 GDP growth of nearly 8 percent), an export slump in the second quarter (on falling global demand) slowed growth to just over 2 percent. The slowdown has been broad-based, with the manufacturing, construction, and services sectors all falling.

South Korea

South Korea maintains a managed floating exchange rate policy which is determined by the Ministry of Strategy and Finance (MOSF) and administered by the Bank of Korea (BOK).¹⁹ While the Korean won fluctuated over the reporting period, monetary authorities periodically intervened to stem its sharp depreciation. The won has been hit particularly hard by the global financial market turmoil.

From 2002 to 2007, the South Korean won appreciated nearly 28 percent in nominal terms against the U.S. dollar. Since late last year, however, the won has reversed direction due to the sharp increase in investors' risk aversion, tightening of credit conditions as a result of the distressed global financial markets, and a slowing domestic economy. The won stood at KRW1029.3 at the end of June 2008 as compared to KRW930.2 at the end of 2007, a depreciation of more than 10 percent. Since the end of June, the currency has plummeted an additional 23 percent as foreign investors continued to sell South Korean assets and concerns about dollar liquidity in the Korean financial system escalated. The Korea Composite Stock Price Index (KOSPI) is down 49 percent since the beginning of the year. On October 30, the won hit a ten-year low of KRW1245. Through the first ten months of the year, Korea's real effective exchange rate has depreciated 19 percent.

¹⁹ The Foreign Exchange Transaction Act (FETA) and the Bank of Korea Act stipulate that the MOSF and BOK share in responsibility for foreign exchange policy, but gives overall authority to MOSF.

Foreign exchange reserves declined by over \$4 billion in the first half of 2008, the first negative half-year change since 2001. From end-June to end-September, reserves have fallen an additional \$18.4 billion, for a year-to-date decline of \$22.6 billion or 8.6 percent of total reserves. The change in reserves largely reflects more active intervention in the foreign exchange markets to support the won. At the end of September, South Korea's foreign exchange reserves stood at \$239.7 billion.

Korean authorities remain critical of speculation in the won and have pledged to intervene in the foreign exchange market if necessary.²⁰ On October 20, the BOK announced it would inject up to \$30 billion in its reserves to address foreign exchange liquidity tightness. In addition, the government provided a three-year guarantee on up to \$100 billion (10 percent of GDP) in external debt issued by domestic banks between mid-October and end-June 2009. This guarantee is large enough to cover new debts to be taken during this period, and should help alleviate dollar hoarding by banks.

In the first half of 2008, South Korea's trade balance shifted to a deficit of \$6.5 billion from a surplus of \$7.5 billion a year earlier, as dollar import growth outpaced export growth on the back of record high oil and commodity prices. The merchandise trade surplus with the United States, South Korea's second largest trading partner, fell to \$3.7 billion from \$4.6 over the same period in 2007. Korea's services account remains in deficit, reflecting still significant overseas travel for leisure and education, despite the weak won. In the first half of 2008, South Korea's current account recorded a seasonally adjusted deficit of \$1.7 billion or 0.7 percent of GDP. In the same period, foreign direct investment recorded a net outflow of \$886 million.

In the first half of 2008, the South Korean economy grew by 5.2 percent, driven largely by robust export growth, compared to 3.0 percent in the second half of 2007. Consumer price inflation reached a peak of 5.9 percent on a year-over-year basis in July, which prompted the Bank of Korea to raise its benchmark policy interest rate by 25 basis points to 5.25 percent on August 7. Inflation has since slowed to 5.1 percent in September as oil prices moderated. Though inflation still remains above the BOK's target range of 2.5 to 3.5 percent, on October 9, following the coordinated monetary easing by the major global central banks, the BOK also cut its policy rate by 25 basis points to 5.0 percent, as the policy focus shifted from controlling inflation to addressing the financial market turmoil and its potential impact on the real economy. On October 27, in a rare emergency session, the BOK cut interest rates by an additional 75 basis points.

Taiwan

According to the Taiwan central bank, Taiwan's exchange rate is market-determined except in instances when "the market is disrupted by seasonal or irregular factors" and the central bank intervenes. After fluctuating within a 31-35 NT\$/US\$ trading range for the last six years, the New Taiwan Dollar (NT\$) appreciated out of that range in early 2008, hitting a high in March of 29.95 NT\$/US\$. In the first half of 2008, the NT\$ appreciated by 6.8 percent against the dollar and by 2.5 percent on a real effective basis, largely on increased capital inflows. During July and August, the

²⁰ On September 25, 2008, Finance Minister Man-soo Kang stated that, "the government and the central bank will use all possible measures to stabilize the foreign exchange market."

NT\$ depreciated 4.2 percent against the dollar and 1.7 percent on a real effective basis, as slowing export orders weakened Taiwan's growth prospects.

After three years of net capital outflows, Taiwan recorded net inflows in the first half of 2008 as investors became increasingly optimistic about increased cross-Strait economic integration between Taiwan and the People's Republic of China. Following the election of Ma Ying-jeou in March, Taiwan and the mainland relaxed several cross-Strait investment restrictions, including raising the cap on Taiwan investment into the mainland, and allowing Taiwan banks to take a 20 percent stake in mainland banks. The reforms have made Taiwan a more attractive investment locale by making it easier for Taiwan-based firms to take advantage of opportunities on the mainland.

Taiwan's foreign exchange reserves increased by \$21 billion (7.7 percent) during the first half of 2008, reaching a high of \$290 billion. The Taiwan central bank attributed the increase to valuation adjustments resulting from the appreciation of the euro and other currencies against the U.S. dollar. Over July and August, reserves declined by 3.1 percent to \$282 billion as authorities partially offset private capital outflows. Taiwan does not disclose the currency composition of its foreign exchange reserves.

Taiwan's current account surplus shrank from 8.3 percent of GDP in 2007 to 7.3 percent in the first half of 2008, reflecting sluggish global demand growth and high commodity prices. Although Taiwan has historically been vulnerable to swings in the global manufacturing cycle, it fared relatively well during the first half of 2008 as strong demand growth in Asia balanced reduced demand from developed economies. However, Taiwan's merchandise trade balance weakened as the year progressed, falling from a high of \$1.9 billion in surplus in February to deficits of \$1.2 billion in both July and August. Taiwan's merchandise exports to the United States – which are heavily concentrated in electronics and machinery – decreased 1.7 percent year-over-year in the first half of 2008 to \$18.0 billion. At the same time, Taiwan's merchandise imports from the United States increased 15 percent to \$14.8 billion.

Taiwan's real GDP growth decelerated from an annualized pace of 2.4 percent in the second half of 2007 to 1.0 percent in the first half of 2008. Reflecting concern over moderating growth and global financial stability, Taiwan's central bank ended a four year monetary tightening cycle with a surprise cut in its policy rate by 12.5 basis points on September 25 and a larger cut of 25 basis points on October 9, resulting in a benchmark rate of 3.25 percent.

Australia

The Australian dollar was floated in 1983, and the Reserve Bank of Australia (RBA) does not consider the exchange rate to be either a target or an instrument of monetary policy. However, the RBA does consider the exchange rate as part of the transmission mechanism of monetary policy, and intervenes when it believes the exchange rate has overshot or when market conditions threaten to become disorderly. The RBA regards overshooting as occurring when the exchange rate has appreciated or depreciated significantly and when the move does not appear to be supported by economic and financial factors. This approach effectively means that the bulk of the RBA's intervention takes place around the cyclical highs and lows in the exchange rate.

Since hitting its weakest point this decade of over two Australian dollars per U.S. dollar in March 2001, the Australian dollar strengthened by more than 85 percent over the past seven years, due to higher terms of trade and positive interest rate differentials. In the first half of 2008, the Australian

dollar appreciated to a high of 1.02 per U.S. dollar and the real effective exchange rate rose by 9.1 percent, reaching its highest level in over 23 years.

In late July, however, the Australian dollar abruptly reversed its upward trend due to a sharp decline in commodity prices, rising expectations of an economic slowdown, and decreasing demand for high-yielding currencies as global risk aversion increased. The Australian dollar depreciated to 1.27 per U.S. dollar by the end of September, 10 percent below its level at the end of 2007.

The RBA intervened in the foreign exchange markets in late October 2008, for the first since August 2007. The October intervention halted a sudden steep depreciation of the Australian dollar (23 percent since the end of September) as investors sold Australian assets and unwound yen carry trade positions. The central bank continued to intervene to stabilize the exchange rate into November. As of the end of October, the Australian dollar had declined by 25.1 percent against the U.S. dollar since the end of 2007, and declined 20.4 percent on a real effective basis. Foreign currency reserves increased to \$31.5 billion at the end of June 2008 from US\$24.2 billion at the end of 2007, but fell to \$26.4 billion at the end of September.

Australia has run a sustained current account deficit, drawing on foreign investment to supplement domestic saving. Australia's current account deficit decreased from 6.8 percent of GDP at the end of 2007 to 4.35 percent at the end of the June 2008, due in part to slowing economic growth and investment. Meanwhile, Australia's bilateral merchandise trade deficit with the U.S. increased by 26 percent from US\$5.0 billion in the first half of 2007 to US\$6.3 billion in the first half of 2008. Net capital inflows increased strongly during 2007 and the first quarter of 2008. But in the second quarter of 2008 net portfolio capital flows reversed direction, and the financial account balance declined 42 percent quarter-over-quarter, as international investors unwound carry trade positions and withdrew from risk.

Real GDP grew at an annualized rate of 1.4 percent in the second quarter of 2008, down from 2.7 percent in the first quarter. The CPI increased 4.5 percent year-over-year in the second quarter, compared to 3.0 percent at the end of 2007. Inflation continued to rise in the summer, reaching 5.0 percent in the third quarter.²¹ The RBA raised its policy interest rate target by 50 basis points to 7.25 percent during the first quarter to reduce inflationary pressures. In September, the RBA reversed course, lowering the policy target by 25 basis points due to increasing downside risks to economic growth. In October and early November, the RBA reduced the target rate by 100 and 75 basis points, respectively, to 5.25 percent, as the economic outlook continued to deteriorate.

New Zealand

New Zealand officially maintains a floating exchange rate. The Reserve Bank of New Zealand (RBNZ) is empowered to intervene in the foreign exchange market in order to help the Bank achieve its policy objective of price stability, but rarely does so. New Zealand is a relatively open economy — exports plus imports equal approximately 55 percent of GDP — implying that exchange rate movements can have a significant effect on inflation. The RBNZ states that it may intervene during periods of “extreme market disorder” and to help trim the peaks and troughs of the exchange rate cycle. In June 2007, the Reserve Bank, citing an “exceptionally high and unjustified” level of the New Zealand Dollar (NZD), intervened for the first time since the NZD was floated in 1985. The RBNZ has not intervened since.

²¹ Inflation data in Australia are published on a quarterly basis.

The NZD appreciated 10.4 percent against the U.S. dollar during 2007 with most of the appreciation occurring during the first half of the year. The NZD remained largely stable against the U.S. dollar in the first half of 2008, appreciating 2.4 percent in the first quarter before returning to its year-end 2007 level (of around 1.31 NZD/USD) by the end of the second quarter. In the third quarter the NZD depreciated sharply to 1.50 per U.S. dollar, a 13 percent drop, its weakest value since November 2006. This was largely a result of falling commodity prices and interest rate cuts by the RBNZ aimed at boosting economic growth. The real effective exchange rate for New Zealand remained stable in the first quarter of 2008 before falling by over 11.2 percent through the second and third quarters.

Foreign currency reserves rose to US\$19.4 billion as of end-June 2008, representing an increase of 13.2 percent year-over-year. New Zealand's current account deficit was equivalent to 8.2 percent of GDP in 2007 and rose to 9.1 percent in the first half of 2008. The increase reflected the widening of deficits in both income and transfers, and goods and services balances. The deficit in income and transfers increased from US\$4.8 billion in the second half of 2007 to US\$5.3 billion in the first half of 2008, while the deficit in goods and services grew from US\$508 million in the second half of 2007 to US\$1.1 billion in the first half of 2008, due in part to the negative effect of drought conditions on agricultural exports. However, New Zealand's bilateral merchandise balance with the United States increased from a surplus of US\$161 million in the first half of 2007, to a surplus of US\$408 million in the first half of 2008. In 2007 the financial account grew by 14 percent year-over-year, as net capital inflows increased. In the first quarter of 2008, the financial account balance declined sharply, by 45 percent quarter-over-quarter, but grew substantially in the second quarter, by 107 percent quarter-over-quarter, resulting in a net increase of 13 percent versus fourth quarter 2007. This shift in flows was in part due to a sudden decrease and subsequent increase in carry trade positions of international investors seeking yield.

Europe

Euro area

The value of the euro is market-determined, and the average daily trading volume in the euro is equivalent to \$1.2 trillion.²² The European Central Bank (ECB) has not intervened in the foreign exchange market since November 2000 when it defended the euro against further depreciation. The objective of ECB monetary policy is to maintain price stability defined as an inflation rate close to but less than 2.0 percent over the medium term. Official foreign reserves of the Eurosystem increased approximately \$5.5 billion to \$354 billion between January and June of 2008, an increase of 2 percent.

In the first half of 2008, the European Central Bank (ECB) held its policy rate steady at 4.25 percent in an effort to keep a lid on inflation whereas the Federal Reserve cut its policy rate by 100 basis points during this period. The perceived differences in relative economic outlooks supported the 7.3 percent appreciation of the euro against the U.S. dollar during this period. In nominal effective terms, the euro appreciated by 4.1 percent in the first half of 2008. Between the end of June and the end of October, the euro depreciated by 23.5 percent against the dollar as the euro area's growth outlook deteriorated sharply and global economic and financial conditions worsened. As part of a coordinated effort by global central banks, the ECB cut its

²² Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in April 2007, Bank for International Settlements, September 2007; <http://www.bis.org/publ/rpfx07.htm>.

policy rate by 50 basis points to 3.75 percent on October 9 as the financial turmoil worsened. In November, the European Commission cut its 2009 economic growth forecast to 0.1 percent. The November IMF forecast expects output to decline by 0.5 percent next year.

The euro area's over-all current account balance deteriorated to a deficit of 0.5 percent of GDP in the first half of 2008, from a surplus of 0.1 percent of GDP during the second half of 2007. Bilaterally, the euro area's trade surplus with the U.S. decreased 20 percent in the first half of 2008 over the second half of 2007 from \$46.1 billion to \$38.5 billion. The euro area is the United States' second largest trading partner after Canada.

Norway

Norway maintains a freely floating exchange rate. Norway's central bank has said it will intervene in foreign exchange markets to influence the value of the kroner if the exchange rate is deemed to be out of line with fundamentals or if foreign exchange rate markets become thinly traded. However, it has not intervened since January 1999. The freely floating exchange rate regime allows the central bank to pursue an independent inflation-targeting monetary policy regime. Foreign exchange reserves decreased \$10.4 billion to \$49.9 billion during the first half of 2008.

The Norwegian kroner appreciated 6.2 percent against the dollar during the first half of 2008 while the kroner's real effective exchange rate index appreciated 4.4 percent during the same period. Between the end of June 2008 and the end of October 2008, the kroner depreciated by 32 percent against the dollar, and 12 percent on a real effective basis, as oil prices declined.

Management of the Pension Fund – Global (PF-G) — the custodian of Norway's oil and gas savings — influences currency developments. By investing the PF-G's resources overseas, Norway reduces the upward pressure that oil and gas-related earnings inflows might have on the exchange rate. At the end of June 2008 the PF-G's market value was \$391 billion (87 percent of total 2007 GDP, or 116 percent of non-oil and gas GDP).

By law, the real return on the PF-G's investments abroad (estimated at 4 percent) can be used for current government consumption while the principal remains as a retirement fund for future generations. Some of the PF-G's return is already being used to service retirement benefits through the budget. Oil production is expected to peak in 2008 and halve by 2030.

Norway is a major oil and gas exporter and a key player in the oil services industry. Its current account surplus during the first half of 2008 was \$43.3 billion (17.8 percent of GDP), compared to \$25.3 billion (14.1 percent of GDP) in the first half of 2007 and \$34.9 billion (16.7 percent of GDP) in the second half of 2007. Excluding the oil and gas sectors, Norway had a current account deficit of 9.5 percent of GDP during the first half of 2007 and the corresponding period in 2008. Merchandise exports in the first half of 2008 were up 21.2 percent over the same period in 2007, largely due to rising oil and gas prices, while imports increased 7.1 percent. Norway had a bilateral merchandise trade surplus of \$2.3 billion with the United States in the first half of 2008, up \$64.5 million from the corresponding period of 2007.

Russia

The exchange value of the Russian ruble is managed by the Central Bank of Russia (CBR) against a reference basket of the U.S. dollar and euro. The U.S. dollar's and euro's shares in the basket are 55 percent and 45 percent, respectively. The central bank continues to closely manage the exchange rate in an effort to simultaneously meet inflation targets and limit real exchange rate appreciation. The ruble appreciated 4.6 percent against the dollar and 0.5 percent against the basket during the first half of 2008. However, from August 7 through October 13, capital outflows surged, pushing the ruble down 3.5 percent against the basket and 10.5 percent against the U.S. dollar despite large scale sales of foreign currency by the CBR. The Central Bank's nominal trade-weighted index of the ruble depreciated by 1.5 percent in the first half of 2008; while Russia's relatively higher inflation caused its real trade-weighted index to appreciate by 3.2 percent. In the Russian Article IV report published in September 2008, the IMF estimated that the undervaluation of Russia's real exchange rate is narrowing and that the ruble was broadly in line with fundamentals; however, at least one of the methodologies presented suggests that the ruble may still be undervalued by as much as 20 percent.²³

The CBR's interventions to limit nominal exchange rate appreciation continued during the first half of 2008. Total international reserves climbed from \$478 billion at end-2007 to \$568 billion as of end-June 2008. Reserves reached nearly \$600 billion by the beginning of August but have subsequently fallen to \$546 billion due to capital outflows and the depreciation of the euro and other currencies against the dollar.

Russia's current account surplus reversed its downward trend in the first half of 2008, increasing to 6.8 percent of GDP as oil and other commodity prices reached record levels. Similarly, Russia's bilateral trade surplus with the United States increased from \$5.8 billion in the first half of 2007 to \$8.7 billion in the first half of 2008. However, imports from the United States in the first half of 2008 were 49 percent higher than in the first half of 2007, and export growth is expected to be much weaker in the second half given the fall in commodity prices. Net inflows of private sector capital were \$16.9 billion in the first half of 2008, substantially lower than in the first half of 2007.

Switzerland

Switzerland has a freely floating exchange rate. Its market-determined exchange rate allows the central bank to pursue an independent inflation-targeting monetary policy.

The Swiss franc rose by 9.8 percent against the U.S. dollar in the first half of 2008. The Swiss currency's real effective value increased by only 2.3 percent during this period. The smaller movement in the real effective value of the franc occurred because the franc was flat against the euro in the first half of 2008 and CPI inflation remained comparatively low at 2.9 percent year-over-year to June 2008. Between the end of June and the end of October, however, the dollar rose 13.5 percent against the Swiss franc, in line with the dollar's recent global appreciation.

²³ See, Russian Federation: 2008 Article IV Consultation—Staff Report, <http://www.imf.org/external/pubs/ft/scr/2008/cr08309.pdf>

Switzerland is a small open economy that is heavily influenced by conditions in the European Union, with about 60 percent of its exports destined for the euro area. Swiss interest rates have been about 1.5 percent lower than those in the euro area since 2006, with the center of its policy band at 2.75 percent in the first half of 2008 versus 4.25 percent in the euro area. This differential tended to depreciate the Swiss franc against the euro and helped make the Swiss franc a popular funding currency in Europe for “carry trades.” The fact that the real effective value of the Swiss franc has been almost flat recently, however, suggests that market volatility is making the carry trade less attractive. Switzerland’s foreign exchange reserves rose by \$2.6 billion to \$46.5 billion in the first half of 2008.

Switzerland has had a large and persistent current account surplus — equal to 13.3 percent of GDP in 2007. The surplus is driven by robust financial services income (mostly banking fees and services derived from its role as an international financial center) and investment income from large foreign direct investments. However, the current account surplus in the first half of 2008 (\$20 billion) was over 40 percent lower than in the same period in 2007. This was largely due to investment income plunging by 94 percent (because of losses at the banks’ foreign subsidiaries in the financial turmoil). The counterpart to the current account surplus is largely net direct and portfolio investment abroad, which amounted to about \$45 billion in the first half of 2008. The U.S. merchandise trade surplus with Switzerland was \$3.6 billion in the first half of 2008 compared with \$1.7 billion in the corresponding period in 2007. U.S. exports to Switzerland leapt by 38.5 percent in the first half of 2008 over the corresponding period in 2007, and imports from Switzerland grew by 20.4 percent.

United Kingdom

The value of the pound is market determined, as the UK’s current macroeconomic framework does not entail management of the exchange rate. The United Kingdom has not intervened since 1992. At the end of June 2008, the United Kingdom held \$60.6 billion in foreign exchange reserves, up from \$57.2 billion at the end of December 2007. Foreign exchange reserves are largely held on a precautionary basis to meet any change in exchange rate policy in the future, if required, or in the event of unexpected shocks.

The pound appreciated 0.3 percent against the dollar in the first half of 2008. However, the nominal effective exchange rate of the pound depreciated 7.0 percent in the first half of 2008, on the weakening UK growth outlook. Global instability and UK economic weakness has led to depreciation of the pound by 23.8 percent against the dollar between the end of June and October and 4.2 percent on a nominal effective basis.

The Bank of England (BoE) is responsible for the conduct of monetary policy and maintains an inflation target of 2.0 percent. In the first half of 2008, the BoE reduced its bank interest rate by 25 basis points twice, once in February and again in April, to 5.0 percent, citing deteriorating output growth and the ongoing global financial market turmoil. The BoE joined other central banks and cut its policy rate another 50 basis points in October to 4.5 percent in an effort to reduce market turbulence. The central bank slashed its policy rate by 150 basis points in November to 3 percent, as economic conditions worsened and the inflation outlook improved.

Inflation increased from 2.1 percent on a year-over-year basis in December 2007 to 3.8 percent in June 2008, well above the 2.0 percent target set by the BoE. Inflation rose throughout the

summer, peaking at 5.3 percent in September. The rate of inflation fell sharply in October to 4.5 percent. Economic growth rose by less than 1 percent on an annualized basis in the first half of 2008. Preliminary data for the third quarter indicates that the economy shrank by 2.1 percent, the first quarterly decline since 1992.

The United Kingdom's current account deficit narrowed from \$61.6 billion (4.3 percent of GDP) at the close of 2007 to \$38.8 billion (2.3 percent of GDP) in the first half of 2008, driven by a sharp fall in the first quarter. The U.S. bilateral trade balance turned positive swinging from a \$5.7 billion deficit in the second half of 2007 to \$20.8 million surplus, driven by stronger U.S. exports to the United Kingdom.

Middle East

The Gulf Cooperation Council Countries

Six countries make up the Gulf Cooperation Council (GCC): Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Finance ministers from the GCC countries took a further step toward monetary union (officially scheduled to start in 2010) at a meeting in September 2008. The ministers approved proposals to set up a monetary council and a draft charter for a monetary union. No decision was taken on the launch date for a common currency or the exchange rate regime. GCC officials have continued to state publicly their commitment to maintaining their current exchange rate regimes until the creation of a common currency.

Saudi Arabia

The Saudi riyal has been unofficially pegged to the U.S. dollar since 1986 (officially since 2003), and the country's central bank, the Saudi Arabian Monetary Agency (SAMA), has publicly stated that the peg to the U.S. dollar provides both external and internal stability. High and rising oil prices and the inability to fully sterilize the large increase in oil export revenues, however, combined with global food price pressures, have dramatically increased inflationary pressure in the last two years. This led to some market speculation that Saudi Arabia might change its exchange rate regime or re-peg its currency at a different rate. Despite this speculation, Saudi officials continued to publicly reiterate their commitment of the peg to the U.S. dollar and to achieving GCC monetary union.

Because of the peg, the value of the riyal fell in early 2008 in line with the decline in the value of the U.S. dollar against other currencies. In the first six months of 2008, Saudi Arabia's real effective exchange rate depreciated 2.3 percent compared to 0.7 percent depreciation in the last six months of 2007. Consistent with movement in the dollar, the riyal has appreciated 8.2 percent between June and October on a nominal effective basis and 10.4 percent on a real effective basis.

Saudi Arabia is among the most oil-dependent economies in the world, with more than 90 percent of its export earnings from oil, priced in dollars. Many of these dollar earnings from oil exports go into off-shore accounts and thus never enter into the domestic financial system, although the amounts are unknown. However, some of the dollars are absorbed into the Saudi economy where, given the peg and the inability to sterilize foreign exchange inflows fully, they result in an expanding domestic money supply. That has been the case since the prolonged rise in oil prices starting in 2002. Given an increase in the money supply, a rise in global food prices, and other factors, inflation has risen sharply. In 2007, Saudi consumer price inflation was 4.1 percent compared to 2.3 percent in 2006. By June 2008, it had reached 10.5 percent year-over-year.

From January to June 2008, net foreign assets held by SAMA increased almost \$82 billion, to \$400.5 billion from \$318.7 billion. (The government sells dollars from its oil revenues to SAMA in return for domestic currency deposits.) SAMA's official reserves (less gold) grew to \$34.8 billion in June 2008 from \$32.1 billion in January 2008.

Saudi Arabia's current account surplus fell to \$95 billion in 2007 from \$98.9 billion in 2006 – 24.9 percent and 27.8 percent of GDP, respectively. Saudi Arabia's merchandise trade surplus with the U.S. rose to \$21.5 billion in the first six months of 2008 from \$14.5 billion in the last six months of 2007. These changes largely reflected high and rising world oil prices rather than the real depreciation of the riyal.

Western Hemisphere

Argentina

Argentina intervenes frequently in the foreign exchange market to achieve exchange rate stability. Intervention has been on both sides of the market. Capital controls remain in effect on both local and foreign currency inflows. Argentina maintains these controls to limit potential volatility in the foreign exchange market and the amount of potential foreign exchange market intervention the central bank must engage in to maintain dollar/peso stability.

The Argentine peso appreciated 4.0 percent against the U.S. dollar in the first half of 2008. The average daily percentage change against the dollar was 0.13 percent in either direction, suggesting that the exchange rate is tightly managed in both directions. The nominal effective exchange rate depreciated by 1.8 percent in the first six months of 2008. Given higher inflation in Argentina vis-à-vis its trading partners, the real effective exchange rate (REER) appreciated by 0.5 percent in the first six months of 2008. Administrative measures that have limited price increases may be keeping the REER from appreciating even more.

The central bank's average weekly dollar purchases from end-June 2007 to end-June 2008 were \$85 million. There have been two periods over the last year in which the Argentine peso came under depreciation pressure. The first was from end-July to mid-October 2007 at the beginning of the global credit contraction. During this period the central bank sold an average of \$82 million per week to support the peso. The second period was from late-March to late-June 2008 when a farmers' strike hurt growth prospects and investor confidence. During this period, the central bank sold an average of \$156 million per week. Foreign currency reserves totaled \$45.3 billion at the end of June 2008, an increase of \$1.2 billion in the first half of 2008.

Since June 30, the peso has retraced its gains and depreciated further against the dollar. Continuing uncertainty over the government's policy direction and heightened investor concerns over the government's proposal to nationalize Argentina's private pension system has recently placed pressure on the peso. The government spent \$1 billion purchasing dollars to support the peso the week ending October 10.

The current account was in deficit in the second quarter of 2008, Argentina's first current account deficit since 2001. The U.S. bilateral trade surplus with Argentina increased to \$1.1 billion by end-June 2008, up from a surplus of \$540 million in the same period last year.

Argentina's economy continued to grow briskly in the first half of 2008, with real GDP growth at 7.9 percent, down slightly from 8.7 percent in 2007. Although official inflation rose only slightly to 8.8 percent year-on-year in June 2008, independent estimates of current inflation range from 20-25 percent. Administrative price controls on 70 percent of the items in the CPI basket might be contributing to lower official inflation, but systematic underreporting of CPI inflation is widely suspected by market analysts.

Brazil

Brazil has a flexible exchange rate regime and relies on inflation targeting to guide monetary policy. Concerned about excessive appreciation of the *real*, the authorities announced in March 2008 that exporters would be allowed to keep all proceeds from exports offshore, that taxes on foreign exchange transactions for exporters would be lifted, and that a 1.5 percent tax on foreign portfolio investments would be imposed.

The *real* strengthened through the first half of 2008, appreciating by 10.4 percent against the U.S. dollar, by 7.2 percent in nominal effective terms and 11.8 percent in real effective terms. The pace of reserve accumulation by the central bank slowed during the first half of 2008. Gross reserves increased to \$199.8 billion in June 2008, an increase of \$20 billion, compared to a \$33 billion increase during the previous six months.

While Brazil's current account had remained remarkably robust in light of the strong recovery of the *real*, it has moved decisively into deficit during the past year. Brazil's current account deficit widened to \$14.6 billion and the U.S. bilateral trade balance with Brazil recorded a small deficit of \$21 million in the first half of 2008. Meanwhile, the financial account surplus swelled to \$40.8 billion in the first half of 2008, reflecting a rise in trade credit lines and short-term loans during the period.

The strong *real* served as a valuable disinflation tool, especially as the inflation outlook deteriorated in the first half of 2008. Year-over-year inflation rose from just below the central bank's 4.5 percent midpoint target in December 2007 to 6.0 percent by June 2008. Inflation has continued to rise, reaching 6.4 percent for the year ending in October.

A sharp fall in commodity prices and a subsequent unwinding of leveraged positions of foreign investors beginning in August 2008 caused a sharp depreciation of the Brazilian *real*. By end-October the real had fallen 22 percent against the dollar since the beginning of the year. Most of the capital outflow was concentrated in foreign holdings of equities, which posted a net outflow of \$1.9 billion in September and \$4.4 billion in the first three weeks of October. However, the increased volatility of the Brazilian *real* spilled over to Brazilian companies exposed to exchange rate fluctuations and to smaller banks dependent on foreign credit lines, putting further downward pressure on the currency. As a result, credit conditions had deteriorated significantly by the end of October. The central bank had taken several measures to respond to the crisis, including: injections of dollars into the currency market via \$28 billion of swaps and sales of its foreign reserves and a commitment to swap up to \$50 billion; targeted measures to ease liquidity for small banks and exporters, including a one-for-one reduction in reserve requirements for large banks extending credit lines to small banks and dollar auctions specifically targeted for export finance; authority for two majority-state-owned banks to take equity positions in other banks. In order to facilitate capital inflows, the Brazilian authorities also repealed a 1.5 percent

tax on currency exchange for inflows of foreign capital and a 0.38 percent tax on the liquidation of foreign currency loans.

Canada

Canada has a freely floating, market-determined exchange rate and relies on inflation targeting to guide monetary policy. Canada's monetary authorities have not intervened in the foreign exchange market since September 2000, when they did so in coordination with other G-7 members to support the euro. The Canadian dollar depreciated 2.6 percent against the U.S. dollar in the first half of 2008. The pace of depreciation has accelerated since mid-July, with the Canadian dollar falling 16.5 percent against the U.S. dollar from the end of June to mid-October, as commodity prices fell sharply. The Canadian dollar depreciated by 2.8 percent on a nominal effective basis in the first half of 2008 and, 8.3 percent on a real effective basis.

In the first half of 2008, Canada's current account surplus expanded to \$11.1 billion or 1.4 percent of GDP, driven by sharply higher energy prices. The U.S. bilateral trade deficit with Canada was \$39.0 billion in the first half of 2008, compared to a deficit of \$34.9 billion in the first half of 2007.

The Bank of Canada's current target range for inflation is 1 to 3 percent. Inflation increased 2.0 percent in the first half of 2008, with year on year inflation in June at 3.0 percent. Inflation peaked at 3.5 percent in August, falling to 3.4 percent in September. The Bank of Canada lowered its target for the overnight rate by 50 basis points in March and again in April as signs of a slowdown in economic growth mounted. In October, the Bank of Canada lowered its target rate an additional 50 basis points as part of coordinated action by central banks to ease the financial crisis.

Nevertheless, Canada is weathering the financial turmoil better than other G-7 countries, given that its regulatory regime for banks is relatively conservative and that the Canadian housing market is weakening at only a moderate pace.

Mexico

Mexico has a flexible exchange rate and employs an inflation-targeting monetary policy regime. Pemex, the state-controlled Mexican oil company, is obligated by law to sell its foreign currency earnings to the Bank of Mexico to service the country's foreign debt. Reserves accumulate, therefore, when the foreign currency obtained by the Bank of Mexico is greater than foreign debt payments.

In late July, Mexico's foreign exchange commission announced the suspension of the dollar sales mechanism through which the central bank had sold a constant daily amount of reserves to the market since May 2003. The action was taken to rebuild the central bank's reserve position following the government's purchase of \$8 billion to cover future foreign exchange requirements.

During the first half of 2008, the Mexican peso appreciated by 5.6 percent against the U.S. dollar. On an effective basis, the peso appreciated 3.9 percent in nominal terms and by 5.8

percent in real effective terms in the first half of the year. Reserves posted strong gains in the year to June, increasing \$6.7 billion to \$93.0 billion, on the back of record-high oil prices.

The peso fell sharply against the dollar in September and October and the central bank intervened aggressively to stem the currency's fall. At the end of October the peso was down 18 percent against the dollar since the start of the year. The central bank also reinstated the daily dollar sales mechanism that was suspended in July. Rather than managing foreign exchange reserves accumulation as before, however, the central bank now will auction up to \$400 million when the peso depreciates more than 2 percent in a day. To ensure sufficient liquidity for banks and corporations, the central bank has also announced that it will pay interest on commercial bank deposits and has inaugurated a guarantee for commercial paper.

The current account deficit increased to 0.8 percent of GDP in the first half of 2008. Remittances were down 2.2 percent year on year in the first half of 2008, reflecting exposure to U.S. housing markets. The U.S. bilateral trade deficit with Mexico was \$35.7 billion in the first half of 2008, compared to a deficit of \$34.3 billion in the first half of 2007.

As the U.S. economy continued to weaken in 2008, economic growth in Mexico similarly decelerated. Real GDP growth slowed to 2.8 percent year on year in June. At the same time, headline inflation of 5.3 percent year on year in June 2008 remained well above the Bank of Mexico's 3.0 percent target due to the effect of global commodity price increases.

Venezuela

Venezuela maintains a fixed exchange rate that is supported by comprehensive foreign exchange restrictions. The government pegged the currency to the U.S. dollar in 2003, following a period of rapid exchange rate depreciation, capital outflows, and falling international reserves. On January 1, 2008, the currency was redenominated and renamed the "strong bolivar," although the exchange rate vis-à-vis the U.S. dollar was virtually unchanged. The official nominal exchange rate was 2.15 strong bolivars to the U.S. dollar at end-June 2008, effectively constant since April 2005.

The government maintains the currency peg through tight controls on capital movements and the supply of available foreign exchange. Purchases of foreign exchange in Venezuela are subject to approval by CADIVI, the government's foreign exchange authority. However, demand from importers continues to exceed the foreign exchange supplied, which has led to the development of a parallel market. In the first half of 2008, the foreign exchange provided by CADIVI covered only about 57 percent of recorded private imports, with the remainder being financed in the parallel market.

Since November 2007, the government's main tool for influencing the parallel rate has been bond sales where the authorities issue U.S. dollar-denominated debt to satisfy demand for U.S. dollars and mop up excess liquidity. Importers and selected individuals can access dollars at the official rate, while all others must buy either on the parallel market or via bond sales. At the latest issue in May 2008, these bonds were sold at an implicit rate of 2.9 strong bolivars to the dollar. This strategy effected a 39.5 percent appreciation of the parallel rate between December 2007 and June 2008 to 3.45 strong bolivars per U.S. dollar. The strong bolivar continued to