

Department of the Treasury

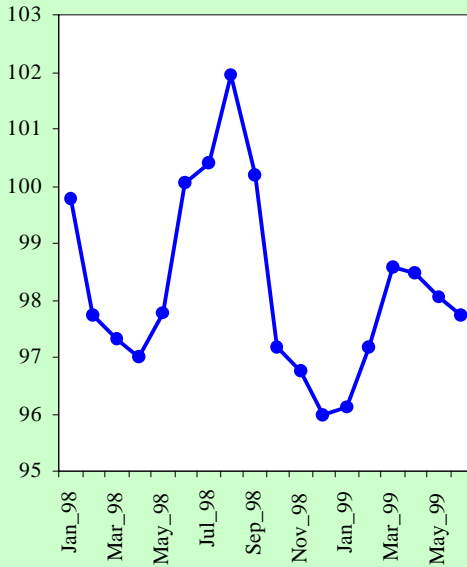
Annual Report to Congress on International Economic and Exchange Rate Policy

Period Covered: November 1, 1998 to June 30, 1999

Real Value of the Dollar

Federal Reserve Board Staff Real

Broad Dollar Index, 1973=100



This report reviews developments in U.S. international economic policy, including exchange rate policy, during the period from November 1, 1998 through June 30, 1999. This report is required under Section 3005 of the Omnibus Trade and Competitiveness Act of 1988 (the Act).

**EMBARGOED FOR RELEASE
UNTIL:**

4:30 p.m., September 3, 1999

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Summary

Major Findings

- **The U.S. economy performed strongly over the period November 1, 1998 to June 30, 1999, despite economic weakness in both emerging market economies and some of the industrial countries.** The U.S. economy over this period continued to experience a combination of strong output growth, low inflation, and employment expansion not seen in nearly three decades.
- **However, amid continuing economic contractions or declining growth rates across emerging markets, Japanese weakness, and a slowdown in European growth, U.S. export growth stagnated and the U.S. current account deficit increased significantly, and it is likely to continue to increase over the months ahead.**
- **During the period covered by this report, the relative strength of the U.S. economy fueled strong capital inflows into the United States.** The increased capital inflows helped sustain domestic investment despite low personal savings, but also implied a continued deterioration in the U.S. net international investment position.
- **Treasury determined that none of our major trading partners manipulated exchange rates under the terms of Section 3004 of the Act during the period under consideration.**

Policy Priorities

- **Maintain sound economic and financial policies in the United States, including our strong dollar policy, which is in the interest of the United States.**
- **Encourage sound fiscal and monetary policies by our major trading partners to help ensure an orderly return to more balanced global growth patterns, and over time contribute to reduced global imbalances.**
- **Encourage policies that promote strong domestic demand led growth and low inflation in the G-7 nations, with a particular focus on macroeconomic stimulus and implementation of banking reforms in Japan and appropriate macroeconomic policies and structural reforms in Europe.**
- **Remain prepared to support temporary financial assistance, led by the IMF and other IFIs, in support of strong programs to promote recovery and stability in emerging market economies.**
- **Put in place agreed measures and policies that will strengthen the international financial architecture and reduce the risk of future crises.**
- **Continue efforts to open foreign markets to U.S. exports while resisting protectionist sentiments everywhere, especially in G-7 nations.**
- **Continue to monitor the policies and practices of U.S. trading partners for evidence of currency manipulations.**

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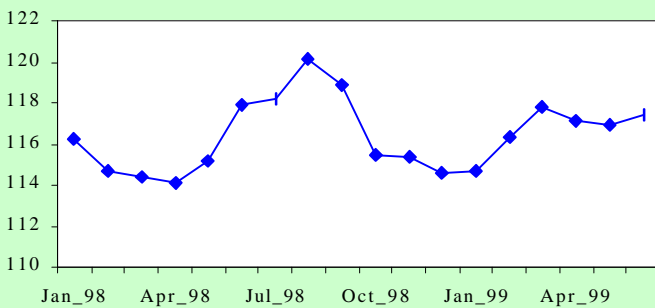
Economic Policy and Currency Market Developments in Key Economies

United States

Between November 1998 and June 1999, the Federal Reserve Board staff's nominal dollar index indicates that the nominal value of the dollar appreciated roughly 1.8% on a trade-weighted basis. This appreciation, which followed a 4% depreciation between August 1998 and November 1998, likely reflected the relative strength of the U.S. economy compared to key U.S. trading partners. Also, U.S. monetary policy was relaxed with a 75 bps. cut in interest rates in the fall in 1998, but then tightened in June 1999 with a 25 bps. increase. Although during the period of this report the dollar appreciated relative to the yen, the euro, and the pound, overall this was partially offset by a depreciation of the dollar against the Canadian dollar. A rebound in some emerging market currencies, notably those of Mexico and Korea, also helped to temper the overall appreciation of the dollar. Between November 1998 and June 1999, the Federal Reserve staff's real effective dollar exchange rate appreciated by roughly 1%.

Currency Movements: United States

Federal Reserve Board Nominal Broad Dollar Index, 1997=100



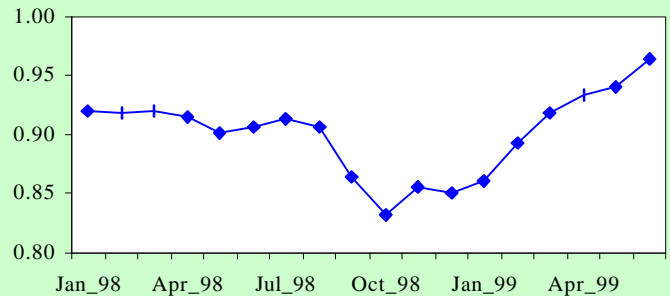
Euroland

On January 1, 1999, the currencies of the eleven countries that compose the European Monetary Union were irrevocably fixed based on the central parities of the European Monetary System and the value of the new common currency, the euro, was set equal to the value of the ECU on December 31, 1998. Euro notes and coins will begin to replace the separate national currencies on January 1, 2002. Between January 1999 and June 1999, the dollar appreciated 12.7% against the euro. The real effective value of the euro depreciated roughly 5% between January 1999 and May 1999. Market participants attribute the decline to weaker Euroland growth compared to the United States. In response to slowing growth in Euroland, the European Central Bank cut the benchmark interest rate, the repo rate, by 50 bps. to 2.5% in March 1999, following a coordinated interest

rate cut by member countries led by the Bundesbank's 30 bps. cut in December 1998. The June *Consensus* forecast anticipates 2.0% growth in the Euroland countries in 1999, compared to 2.7% growth in 1998. European countries need to pursue appropriate macroeconomic policies and structural reforms to promote strong domestic demand led growth.

Currency Movements: Euroland

Euros per Dollar



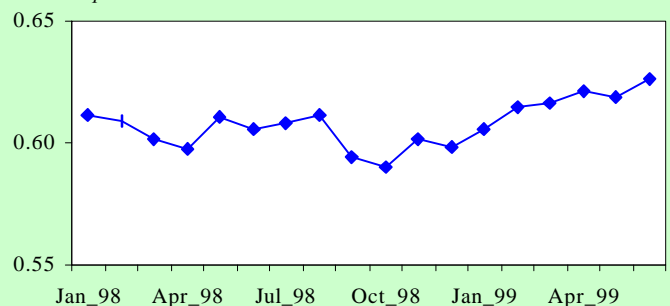
Note: European Currency Units prior to January 1, 1999

United Kingdom

During the period covered by this report, the dollar appreciated 4.1% against the pound in response to slowing growth and falling interest rates in the United Kingdom, although both currencies appreciated against the euro. First quarter 1999 real GDP in the United Kingdom was flat following a small 0.3% increase in the final quarter of 1998. In response to the slowing domestic economy, the Bank of England initiated a series of interest rate cuts on October 8, 1998 that has so far resulted in total cuts of 200 bps. Interest rates in the UK remain roughly 250 bps. higher than interest rates in Euroland.

Currency Movements: United Kingdom

Pounds per Dollar



Japan

After a sharp rise in the value of the yen against the dollar in the fall of 1998, between November 1998 and January 1999, the yen appreciated a further 5.8% from 120.3¥/\$ to 113.3¥/\$. In February 1999 the trend reversed and the dollar began to appreciate against the yen following additional monetary easing

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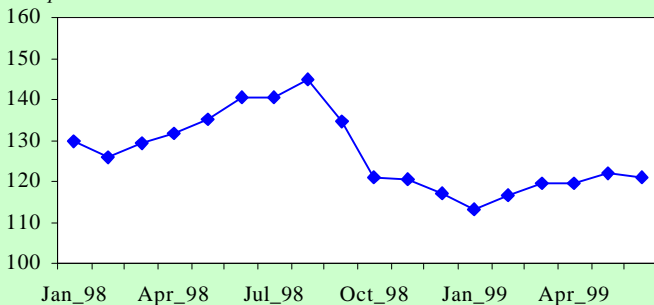
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by the Bank of Japan, which acted on February 12, 1999 to push overnight interest rates to near-zero levels. Upward pressure on the yen emerged in June 1999 when it was announced that Japan's economy recorded an annualized 7.9% growth rate in the 1st quarter of 1999, following five consecutive quarters of negative real GDP growth. This rise in output largely reflected the impact of fiscal stimulus measures enacted in 1998, although growth was recorded in all components of domestic demand. In the days following the release of the GDP data on June 10, 1999, the Japanese monetary authorities intervened in the currency markets – purchasing substantial amounts of dollars and euros – to prevent an appreciation of the yen. Neither U.S. nor European monetary authorities participated in the Japanese intervention, although the European Central Bank acted as the Bank of Japan's agent in the European markets. Despite the strong 1st quarter GDP numbers, private demand remains weak, making it critically important that Japan maintain macroeconomic stimulus until sustainable, domestic demand led growth is restored. Furthermore, although Japan has taken important steps in addressing its banking sector problems, more aggressive steps to accelerate the permanent disposal of bad assets are needed.

Currency Movements: Japan

Yen per Dollar

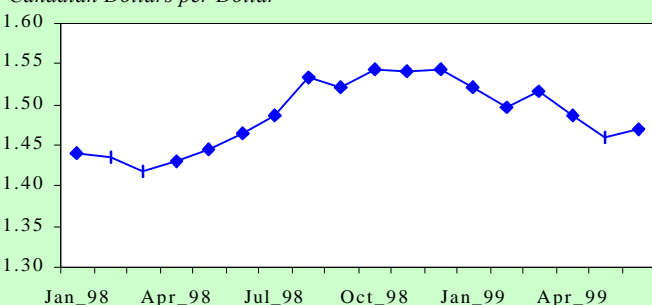


Canada

During the period covered by this report, the dollar depreciated by 4.6% against the Canadian dollar. Market participants attributed the rise in the Canadian dollar largely to two factors. First, growth prospects for Canada improved. Second, commodity prices stopped falling at the end of 1998, and with some such as oil prices, rising. Because Canada exports a significant amount of commodities, an improved outlook for commodity prices boosts the demand for Canadian dollars.

Currency Movements: Canada

Canadian Dollars per Dollar



Brazil

Brazil came under acute financial pressure in the second half of 1998 as markets focused on its fixed (sliding band) exchange rate and wide fiscal deficit. In November 1998, Brazil reached agreement with the IMF on an economic program with fiscal adjustment at its core, which the international community agreed to support with a \$41.5 billion package: \$18 billion from the IMF, \$9 billion from the IDB and World Bank, a \$13.28 billion from a BIS lending facility for Brazil, most of which was guaranteed by a number of countries, including the United States, and a parallel \$1.25 billion lending facility from the Bank of Japan.

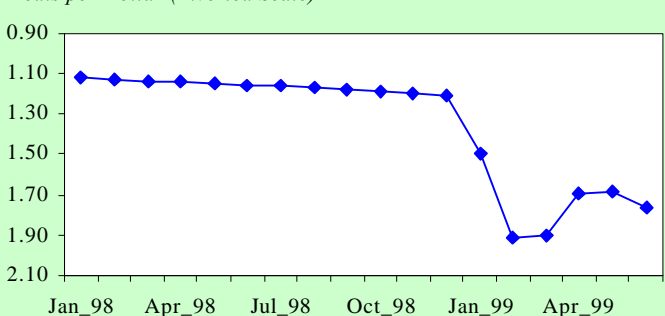
Following the agreement with the IMF and announcement of international support, Brazil's financial situation improved, and the pace of foreign reserve loss slowed significantly. However, investor confidence deteriorated in December, and reserve outflows accelerated again. Doubts about the capacity to implement fiscal adjustment intensified in January 1999, in part due to actions by some Brazilian states. By mid-January, net international reserves had fallen to \$30 billion, compared to \$70 billion only 6 months earlier, and the Brazilian authorities first decided to devalue the *real* and, later, they allowed it to float.

Within two months of the decision to float the *real*, it depreciated 44%, to a low of 2.15R/\$ on March 3, 1999. In March, Brazil named a new team at the central bank, reached agreement with the IMF on a revised program, passed key fiscal measures, and secured the commitment of major foreign creditor banks to maintain their short-term exposure to Brazil. Those developments, plus evidence that domestic inflation pressures remained relatively subdued, helped to restore confidence. Capital outflows began to reverse and the *real* appreciated significantly. At the end of June, the *real* was 1.75R/\$, 31% depreciated from its pre-devaluation level but up 23% from its low point of early March. The IMF projects that GDP will contract by about 1% this year, with about 8% consumer price inflation, a significantly more favorable outcome than anticipated earlier.

Unlike the crisis in some Asian countries, Brazil's economic crisis resulted primarily from public sector rather than private sector imbalances. Brazil's large fiscal deficits amounted to 7% and 8% of GDP in 1997 and 1998, respectively. Financial sector and corporate governance problems were not major contributors to the economic crisis, and therefore did not figure prominently in Brazil's IMF program.

Currency Movements: Brazil

Reals per Dollar (Inverted Scale)



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Other Latin American Countries

In the second half of 1998, global investors focused on potential policy vulnerabilities in Latin American countries, which, along with emerging market financial strains in general, led to tighter credit conditions. Political uncertainty also contributed to the economic slowdowns in some countries.

- **Mexico.** Last fall, economic growth in Mexico slowed in response to a sharp hike in domestic interest rates to contain inflation pressures stemming from peso depreciation. The situation was further aggravated by low oil prices, which led the government to make fiscal cuts in order to meet its fiscal deficit targets. But strong economic momentum from the first half of 1998 and the strong economy in the United States helped Mexico to achieve a 4.8% growth rate for 1998 despite the slowdown – a higher growth rate than any of the other major economies in Latin America. By June 1999, the value of the peso had appreciated by 6.1% from January 1999, supported by an improved economic outlook, thanks in part to calmer global markets and a rise in world oil prices.
- **Venezuela.** During the period of this report, Venezuela experienced widening fiscal deficits (due in part to low oil prices) and political uncertainties (associated with the election of President Hugo Chavez in December 1998), as well as the effects of global financial turbulence. It responded to the resulting financial pressures by sharply raising domestic interest rates last fall. The high interest rates and low oil prices – oil accounts for about 70% of Venezuelan exports – contributed to recession and a rise in unemployment this year. Although economic activity showed few signs of recovery in the first half of 1999, the easing of global financial pressures and the sharp rebound in oil prices in the past few months have helped interest rates to fall back to previous levels and improved the fiscal outlook.
- **Argentina.** Argentina was also affected by global financial turbulence, which restricted its access to international capital markets, by low commodity prices, and by a weakening of exports to Brazil, a key trading partner. Those factors contributed to a sharp economic slowdown, from 4.2% growth in 1998 to an anticipated 1.5% contraction expected by the IMF and the Argentine government for 1999, before recovery in 2000. During this period Argentina remained committed to its currency board arrangement. The Argentine government announced that it would consider full dollarization of its economy.
- **Ecuador.** Ecuador was the Latin American country in most dire economic circumstance in the first half of 1999, largely due to low oil prices, the El Niño weather

phenomenon, and reduced access to international capital markets. These conditions were aggravated by serious solvency problems in much of the banking sector, its high levels of foreign and domestic debt, chronic fiscal deficits, and questions about the ability of the government to deliver a strong policy response. In February, Ecuador allowed its currency, the sucre, to float. Following a sharp depreciation, the sucre temporarily rebounded, supported by a freeze on bank deposits. Ecuador is at present discussing a stand-by arrangement with the IMF.

- **Colombia.** The Pastrana administration (elected in May 1999) responded to oil price and global capital market shocks and to the widening fiscal deficits it inherited by raising interest rates and enacting fiscal cuts. As the economy slowed, the levels of nonperforming loans in the banking system rose. Slow progress in the peace talks with leftist guerillas added to the concerns of foreign investors, and pressure on the exchange rate led Colombia to devalue its currency in June 1999. Looking forward, Colombia's main economic challenges include resuming economic growth and restoring the health of the banking system. Colombia is currently discussing a program that could receive the IMF's financial support.

Real GDP Growth: Selected Latin American Countries

% change over a year ago

	<u>Mexico</u>	<u>Brazil</u>	<u>Venezuela</u>	<u>Argentina</u>
Q1_98	6.4	1.2	9.7	6.4
Q2_98	5.6	1.4	1.7	6.7
Q3_98	4.8	-0.2	-4.5	3.3
Q4_98	2.6	-1.9	-8.2	-0.6
Q1_99	1.9	-0.8	--	-3.0

Source: Haver Database

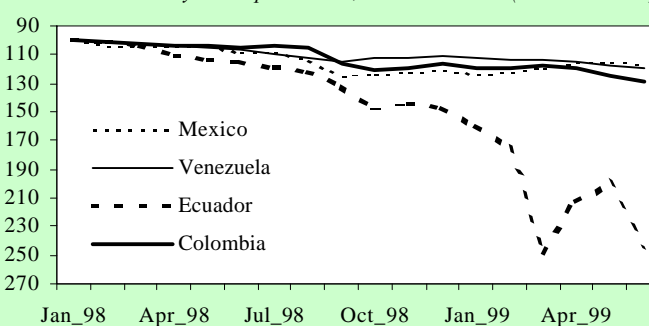
Currency Values: Selected Latin American Countries

Domestic currency units per Dollar

	<u>Nov98</u>	<u>Jun99</u>	<u>Change</u>
Mexico (Pesos/\$)	9.97	9.51	-4.6%
Venezuela (Bolivares/\$)	569.1	602.6	5.9%
Ecuador (Sucres/\$)	6449.4	10854.1	68.3%
Colombia (Pesos/\$)	1562.2	1695.4	8.5%

Currency Movements: Selected Latin American Countries

Domestic Currency Units per Dollar, Jan. 1998=100 (Inverted Scale)



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Emerging Asia

The economic and financial situation in Asia improved markedly during the period covered by this report. Continued progress in implementing economic reforms aided in bolstering investor confidence while stimulative macroeconomic policies made possible by recovering confidence throughout the region also helped to restore growth in the countries most affected by the crisis.

- The stabilization of exchange rates and falling inflation in the region enabled central banks to continue to lower interest rates during the reporting period. Interest rates fell most dramatically in Indonesia, declining from 56% in October 1998 to 19% in June 1999.
- Growth bounced back most strongly in Korea, and the *Consensus* forecast now predicts a 5.1% rise in real GDP in 1999 after a 5.8% contraction last year. Malaysia, the Philippines, and Thailand are also expected to return to positive growth this year, while growth in Singapore is forecast to strengthen significantly. Growth in China is forecast by the government to slow from 7.8% in 1998 to 7.0% in 1999, while growth in Taiwan is expected to hold steady at 4.8% in 1999. Based on June 1999 *Consensus* forecasts, only Hong Kong and Indonesia are expected to remain in recession during 1999, although the contraction in both economies is predicted to be far smaller than in 1998.
- Most countries in Asia are expected to record smaller current account surpluses in 1999, compared to 1998, as imports have begun to rebound from their extraordinarily weak levels of last year. Stronger regional growth, continued robust growth in the United States, and an upturn in electronics demand are also contributing to an improved outlook for exports.

Exchange rates in the region have stabilized, and both the Korean won and Indonesian rupiah have strengthened substantially. Equity markets in Asia rose sharply as a result of the improved economic and financial outlook. Nevertheless, there is little room for complacency in the region given the extent of bank and corporate restructuring and other challenges that remain to be tackled.

- Although there has been significant progress in bank recapitalization and restructuring, this is a complex and difficult challenge that will take considerable time to resolve. The process of corporate restructuring and restoring health to corporate balance sheets is only now beginning in these countries.
- The external environment also presents some potential risks to recovery. Stronger domestic growth in Japan

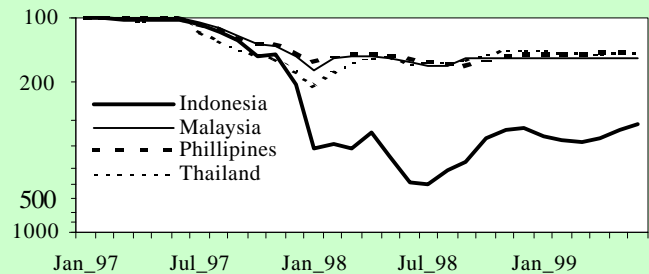
and Europe would help provide support for exports for the region, as well as further strengthen commodity prices.

China faces significant challenges in maintaining economic growth and pushing forward key structural reforms. The government has substantially increased public investment and has relaxed monetary policy, but growth is slowing and deflationary pressures seem to be spreading. The Government of China has made reform of its troubled financial sector a priority, but efforts are still at an early stage. Concerns about contributing to rising unemployment has kept reform of China's state owned enterprises on a cautious path.

Currency Movements: Selected ASEAN Countries

Domestic currency units per dollar, Jan. 1997 = 100

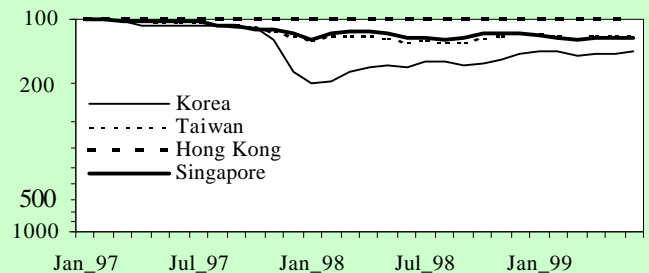
Logarithmic scale, inverted scale



Currency Movements: NIEs

Domestic currency units per dollar, Jan. 1997 = 100

Logarithmic scale, inverted scale



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U.S. Economy

Overview of the U.S. Economy

With a combination of strong growth and low inflation, the U.S. economic expansion continued during the period covered by this report (November 1, 1998 to June 30, 1999). U.S. GDP expanded 6.0%, 4.3%, and 2.3% in the 4th quarter of 1998 and the 1st and 2nd quarters of 1999, respectively, compared to 3.9% growth for 1998 as a whole. The consistent growth in real U.S. output contributed to a fall in the unemployment rate from 4.5% in October 1998 to 4.3% in June 1999. CPI inflation (year over year) remained low but increased slightly, edging up from 1.5% in October 1998 to 2.1% in May 1999. The strength of consumer spending as a driving force in the economy was illustrated by the steady decline of the recorded personal savings rate from -0.2% in October 1998 to -1.0% in June 1999, although national savings has risen as a result of the government budget surplus (see chart on page 8).

External events continued to have a significant impact on the U.S. economy. Strong domestic growth and economic weakness abroad contributed to a widening goods and services deficit, which in turn eased some domestic demand pressures.

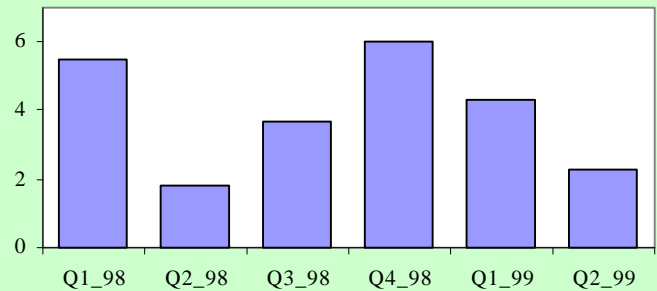
IMF Article IV Consultation

The conduct of economic policy by the U.S. Administration and the Federal Reserve was praised by the IMF staff in the conclusion of the IMF staff's 1999 consultation with the United States on June 17, 1999 (in accordance with Article IV of the IMF's Articles of Agreement). The IMF staff said that "[t]he U.S. authorities are to be highly commended for their sound fiscal and monetary policies, which have contributed significantly to what is now approaching the longest economic expansion in U.S. history."

The IMF staff noted that the United States is the principal engine of global growth during the recent period of global financial turbulence and that "U.S. monetary policy played a key role in stabilizing international financial markets." The staff also noted that "[o]ver the past year and a half, the appreciation of the U.S. dollar has shifted demand abroad, helping to avert overheating in the United States and mitigating the adverse effects of the global economic turbulence." The IMF staff, however, cautioned that the orderly return of more balanced global demand growth patterns would be a policy challenge for both the United States and its trading partners. Consistent with a broad effort by the United States to enhance the transparency of the IMF, the United States is part of a pilot program recently established by the IMF's Executive Board to allow countries to release the staff reports on their Article IV reviews. The staff report is expected to be publicly released in August 1999.

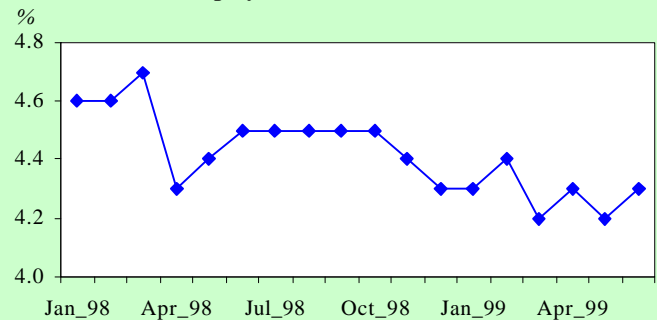
U.S. Real Gross Domestic Product

% change over previous quarter, annual rate



Source: Bureau of Economic Analysis

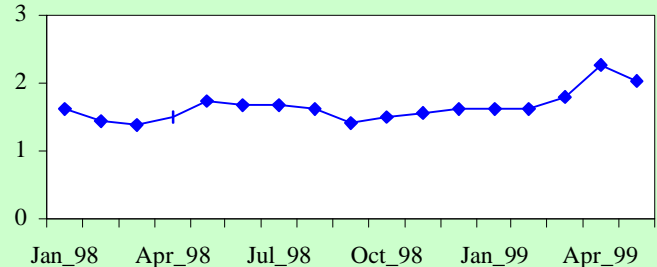
U.S. Civilian Unemployment Rate



Source: Bureau of Labor Statistics

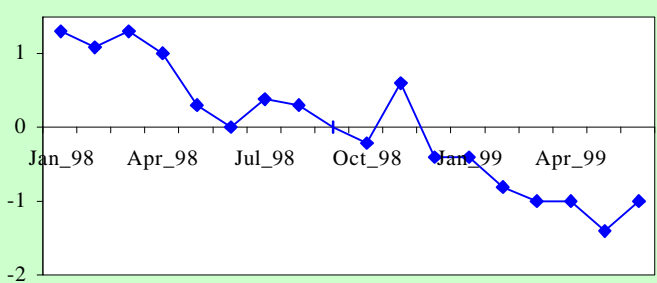
U.S. Consumer Price Inflation

% change over a year ago



U.S. Personal Savings Rate

% of disposable personal income (SAAR)



Source: Bureau of Economic Analysis

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Trade Flows

The strength of the U.S. economy, combined with weakness abroad, generated significant expansions of both the trade and current account deficits during the period covered by this report, despite a surge of exports in the 4th quarter of 1999. The current account deficit rose from \$254 billion SAAR (seasonally adjusted annual rate) in the 3rd quarter of 1998 to \$274 billion SAAR in the 1st quarter of 1999. During this same period, the goods and services trade deficit increased from \$183 billion SAAR to \$215 billion SAAR, while the April-May 1999 deficit was \$239 billion SAAR. The current account deficit reached \$221 billion, 2.6% of GDP, in 1998, a record in absolute terms but, as a percentage of GDP, significantly less than the 3.5% of GDP deficit recorded in 1987.

- The primary factor underlying the sharp rise in the current account deficit in 1998 was the overall fall in U.S. exports. Goods exports to emerging Asia fell \$20.6 billion, while exports to Japan fell \$7.6 billion.

Nominal U.S. exports actually fell 0.5% in 1998, the first year-over-year drop in exports since 1985, compared to the 10.4% growth experienced in 1998. This was attributable to severe economic weakness abroad, particularly in Asia, that decreased the foreign demand for U.S. goods and services. In contrast, strong economic growth in the United States generated sustained growth in nominal imports, although the 5.3% growth in

U.S. Trade in Goods and Services

\$ Billion (Balance of Payments Basis)

	Exports		Imports	
	Level	Change	Level	Change
1993	641.8	4.2%	711.7	9.0%
1994	702.1	9.4%	800.5	12.5%
1995	793.5	13.0%	891.0	11.3%
1996	849.8	7.1%	954.1	7.1%
1997	938.5	10.4%	1,043.3	9.3%
1998	933.9	-0.5%	1,098.2	5.3%

Source: Bureau of Economic Analysis, Bureau of the Census

U.S. Bilateral Merchandise Trade Balances

\$ Billion, nsa

	Mexico	Canada	Japan	China	EU
Q4_97	-2.9	-3.9	-15.4	-13.1	-5.6
Q1_98	-2.7	-3.0	-15.3	-11.5	-2.1
Q2_98	-4.5	-3.3	-15.6	-13.6	-7.0
Q3_98	-4.4	-5.3	-15.5	-17.3	-8.6
Q4_98	-4.2	-5.1	-17.6	-14.5	-9.7
Q1_99	-6.0	-6.9	-16.4	-13.6	-5.8

Note: Non-seasonally adjusted (nsa) bilateral trade data can be volatile from quarter to quarter.

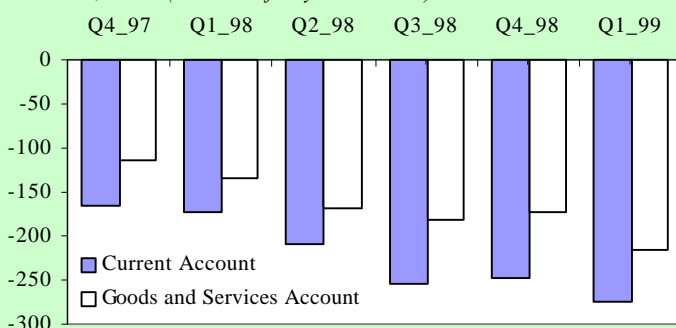
Source: Bureau of Economic Analysis, Bureau of the Census

nominal imports in 1998 was well below the 1997 growth rate of 9.3%. While the growth in nominal imports was muted by falling import prices and an appreciating dollar, the 1998 growth in real imports of 10.6% (national income product accounts (NIPA) basis) was also less than the 1997 rate of 13.9% (NIPA basis).

The rise in the overall U.S. goods and services deficit was reflected in rising bilateral merchandise trade deficits with U.S. trading partners, particularly those in Asia and Europe. The trade deficit with Japan of \$64 billion in 1998, compared to \$56.1 billion in 1997, was the largest U.S. bilateral trade deficit. The second largest bilateral deficit was the \$56.9 billion 1998 deficit with China, up from \$49.7 billion in 1997. Other sizeable bilateral deficits were recorded with the European Union (\$27.3 billion in 1998, up from \$16.8 billion in 1997), Canada (\$16.7 billion in 1998, up from \$16.4 billion in 1997), and Mexico (\$15.9 billion in 1998, up from \$14.5 billion in 1997).

U.S. External Balances

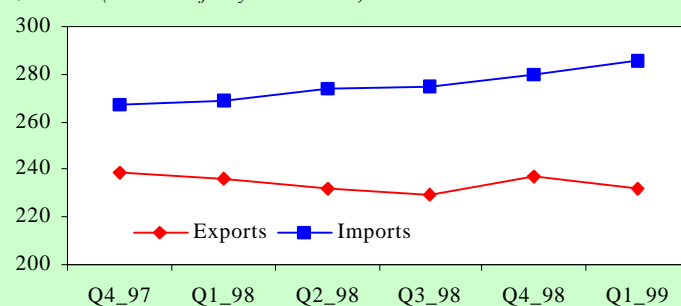
\$ Billion, SAAR (Balance of Payments Basis)



Source: Bureau of Economic Analysis, Bureau of the Census

U.S. Trade in Goods and Services

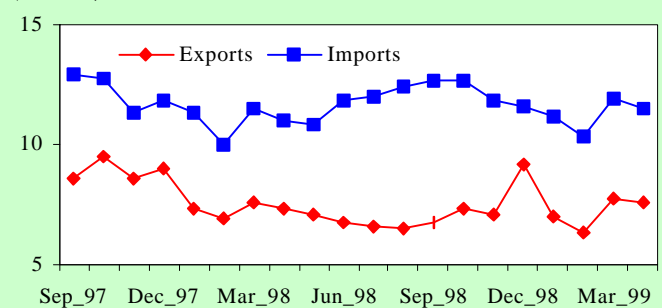
\$ Billion (Balance of Payments Basis)



Source: Bureau of Economic Analysis, Bureau of the Census

U.S. Merchandise Trade with Emerging Asia

\$ Billion, nsa



Source: Bureau of Economic Analysis, Bureau of the Census

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Capital Flows

Capital inflows remained strong during the period covered by this report, supporting high levels of business investment in the United States. Capital inflows help maintain lower interest rates than would likely be possible otherwise. Increased capital flows and trade deficits, however, increase the potential vulnerability to changes in global financial markets' perceptions of investment opportunities in the United States.

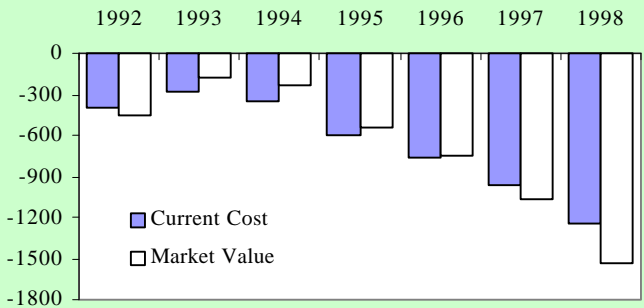
As global demand patterns revert towards historical trends, the United States will likely experience a moderation in the pace of capital inflows and a related adjustment in the current account. It is important that sound domestic policies be in place in both the United States and our major trading partners to help prevent a disruptive adjustment. In this light, policies in our major trading partners that encourage domestic growth and investment and policies in the United States that support national savings are important to contain the rise in imbalances and facilitate their eventual reduction.

The stock of U.S. assets owned by foreigners is increasing. The value of foreign investment in the United States already exceeds the value of U.S. investments in other countries. The U.S. net international investment position (NIIP) at year end 1998 was negative \$1,239 billion with direct investment valued at the current cost of replacing plant, equipment and other tangible assets, compared to negative \$968 billion at year end 1997. With direct investment valued at the current stock market value of owner's equity, the U.S. NIIP at year end 1998 and 1997 was negative \$1,538 billion and negative \$1,066 billion, respectively. The larger increase on this basis primarily reflects the continued large increases in U.S. equity prices. A growing negative U.S. NIIP implies that a larger amount of the return generated by assets in the United States will be payable to

foreigners in the future. It is vital that current high level of business investment is employed productively to support both future repayments to foreigner investors and increased standards of living in the United States.

U.S. Net International Investment Position

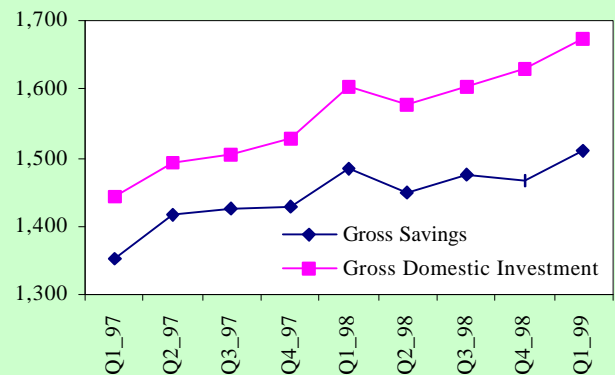
\$ Billion



Source: Bureau of Economic Analysis

U.S. National Savings and Investment

\$ Billion, SAAR



Source: Bureau of Economic Analysis

Capital Flows into the United States

\$ Billion, sa, details might not equal totals due to rounding

	Q4_97	Q1_98	Q2_98	Q3_98	Q4_98	Q1_99
Net Capital Flows	113	38	44	33	102	80
Net Portfolio Flows	44	98	60	-14	-31	78
U.S. acquisition of foreign assets*.....	-57	-21	-47	-5	-55	8
Foreign acquisition of U.S. assets.....	101	119	107	-9	50	70
Foreign Official.....	-26	11	-11	-46	24	9
Private**.....	127	108	118	38	27	62
Net Banking Flows	66	-50	6	44	15	21
Assets.....	-25	-1	-28	-33	37	35
Liabilities.....	91	-49	34	77	-22	-15
Net Direct Investment	3	-10	-22	3	90	-19
U.S. Direct Investment Abroad.....	-30	-37	-43	-22	-31	-38
Foreign Direct Investment in the United States.....	34	27	21	25	121	19

Source: Bureau of Economic Analysis

* Net private claims on foreigners by nonbanks plus net private U.S. purchases of foreign securities.

** Net purchases of U.S. Treasury securities, net nonbank liabilities to foreigners, net purchases of gov. non-Treasury securities, and net U.S. currency flows.

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U.S. Exchange Rate Policies

G-7 Statements on Exchange Rate Policies

During the reporting period, November 1, 1998 to June 30, 1999, G-7 Finance Ministers and Central Bank Governors reaffirmed their standing commitment to reduce imbalances and cooperate closely in the exchange rate markets.

- **February 20, 1999.** "In view of the increasing integration of the world economy and financial system we have a special responsibility with regard to improving the conditions for a proper functioning of the international financial and monetary system and, in particular, enhancing sound fundamentals necessary for exchange rate stability. To this end, we will maintain strong cooperation to promote stability of the international monetary system and to promote exchange rates among major currencies that are in line with fundamentals. We discussed developments in our exchange and financial markets since our last meeting. We reaffirmed our view on the importance of pursuing policies to help avoid excess volatility and significant misalignments of exchange rates of major currencies. We will continue to monitor developments in exchange markets and cooperate as appropriate."

- **April 26, 1999.** "We reaffirmed our view on the importance of pursuing policies to promote sound economic fundamentals and more balanced growth among key economies and thereby help avoid excess volatility and significant misalignments of exchange rates of major economies. We will continue to monitor developments in exchange markets and cooperate as appropriate."

Statement by Secretary Summers

Secretary Summers reaffirmed the principles of U.S. exchange rate policies:

- **July 26, 1999.** "As I have said many times, a strong dollar is very much in the interest of the U.S. That has been our policy, it will continue to be our policy. It is a policy that has served the U.S. well in promoting confidence, in reducing inflation, in reducing capital costs for American firms, in promoting capacity-creating investment."

Currency Intervention

U.S. monetary authorities did not engage in any intervention for their own account during the period covered by this report.

Emerging Market Exchange Rate Regimes

Elements of Manipulation

Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 requires the Treasury to analyze annually the exchange rate policies of foreign countries, in consultation with the IMF, and to consider whether countries manipulate the rate of exchange between their currency and the dollar for purposes of preventing effective balance of payments adjustments or gaining unfair comparative advantage in international trade. The Secretary of the Treasury is required to undertake negotiations with those manipulating countries that have material global current account surpluses and significant bilateral trade surpluses with the United States, unless there would be a serious detrimental impact on vital national economic and security interests.

- **Treasury undertook a broad review of the performance of major trading partners of the United States and concluded that none of them has manipulated their exchange rate under the terms of Section 3004 during the period examined.** While several countries in Asia developed large external surpluses in the wake of the regional financial crisis, these surpluses were a consequence of the collapse of domestic demand and investor confidence, not the result of currency manipulation.

In evaluating evidence of currency manipulation, Treasury looks at the following five factors:

- **External Balances.** Persistent global current account surpluses are fundamentally a reflection of an excess of national savings over national investment, but in some cases may also reflect efforts to maintain an exchange rate level that would prevent external adjustment.
- **Exchange Restrictions and Capital Controls.** Restrictive exchange regimes and capital controls can be a concern, particularly where the restrictions are designed to maintain an consistently undervalued exchange rate.
- **Exchange Rate Movements.** Large depreciations of exchange rates, if induced artificially rather than by market forces responding to fundamentals, could suggest an attempt to gain a comparative advantage in trade. Manipulation could also be reflected in the absence of a significant appreciation of the exchange rate when justified by fundamentals. Equilibrium real exchange rates, however, are determined by a number of factors and are therefore difficult to define.

- **Movements in Reserves.** Significant and persistent accumulation of foreign exchange reserves could be a source of concern if it reflects efforts to maintain an excessively competitive exchange rate.
- **Macroeconomic Trends.** When analyzing these economies, Treasury looks at the macroeconomic policy stance and other conditions that are important determinants of exchange rates.

Country Assessments

As the law requires, economies were closely examined as potential exchange rate manipulators if they had significant global current account surpluses and bilateral surpluses with the United States and maintained a fixed or actively managed exchange rate system during the period of this report. The following countries met these criteria.

- **Singapore.** Singapore's current account surplus is estimated to have increased to 19.6% of GDP in 1998 from 15.4% in 1997, due largely to a drop in imports as GDP growth slowed to 1.5% in 1998, the lowest growth rate in more than a decade. The June *Consensus* forecast predicts a recovery in growth to 2.5% this year and, consequently, the current account surplus is projected to decrease to 18% of GDP in 1999 as domestic imports recover. Since November 1998, the Singaporean dollar has depreciated 5% against the U.S. dollar and 1% in real-effective terms. The relatively small decline in the Singaporean dollar appears to reflect the relaxation of monetary policy and the relative weakness of the economy. Singapore's reserves have increased by less than 2% during the period covered by this report.
- **China.** During the reporting period, China continued to fix the renminbi to the dollar at 8.28 RMB/\$. The real effective exchange rate was stable but has depreciated roughly 9% since December 1997 as regional exchange rates appreciated since the peak of the crisis. In 1998, China's current account surplus fell slightly to \$29 billion (3% of GDP, compared to 3.2% in 1997) and is expected to be significantly smaller in 1999 as China's trade surplus declines. For the first five months of 1999 the trade surplus fell 62 percent to \$7.1 billion compared to the same period in 1998, as exports dropped 5 percent due to weak demand in Asia. Also, official imports surged 15 percent, partially in response to a crackdown on smuggling which reportedly resulted in greater accuracy in the recording of imports. The government tightened foreign exchange controls in September 1998 in an effort to reduce smuggling and capital flight. In June 1999, the PRC restricted RMB transactions outside of China's borders in a further effort to maintain strict control of the exchange rate. Despite these restrictions

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reserves grew only \$6 billion in 1998 and grew less than \$2 billion during the first five months of 1999.

- **Malaysia.** The Malaysian economy suffered its worst recession in more than a decade last year, with GDP contracting by 7.5%. The government is currently projecting 1% growth for this year. The current account swung from a deficit of 5% of GDP in 1997 to a surplus of 13% of GDP in 1998 as import demand contracted sharply, but is forecast to decrease to a surplus of 11% of GDP in 1999 as the economy begins to recover. Malaysia's exports have benefited recently from the depreciated value of the ringgit, which was pegged at RM3.8/\$1 in September 1998. Although this rate was 10% higher than the market rate at the time the exchange rate was pegged, most other regional currencies have appreciated since then. The real effective value of the ringgit remains 26% weaker than its pre-crisis level. Between October 31, 1998 and May 31, 1999, Malaysia's reserves increased by \$6.3 billion, or 27%, to \$30 billion. The government has relaxed the scope of the capital controls imposed last fall, but has not provided any indication as to when they will be abolished.
- **Taiwan.** During the period covered by this report, the New Taiwan Dollar (NTD) has moved little against the U.S. dollar, but has appreciated by roughly 9% on a real effective basis (due to deflation in China and Hong Kong). Since January 1998, Taiwan's central bank has intervened at times in an effort to maintain the currency in a narrow range around 32.5NTD/\$. Taiwan weathered the Asian crisis fairly well, with 4.8% growth in real GDP in 1998, and the government projects growth of 5.1% this year. Taiwan's current account balance in 1998 declined to a surplus of \$3.7 billion (1.4% of GDP), compared to \$7.7 billion in 1997. Foreign exchange reserves increased by \$11.1 billion, or 13%, over the reporting period, reaching \$97.7 billion in June 1999.
- **Korea.** The won appreciated by 14% against the dollar between November 1998 and June 1999. The contraction in domestic demand in 1998, combined with a substantially depreciated won (compared to pre-crisis levels) led to a sharp increase in the current account surplus in 1998 (\$40.5 billion, or more than 13% of GDP). After declining by 5.8% in 1998, the Korean economy is recovering with GDP expected to grow by 4-5% this year. The strengthening of the won and recovering import demand are resulting in a considerably smaller current account surplus this year. During the first four months of 1999 the current account surplus has fallen nearly 40% compared to the same period in 1998; over the same time period Korea's bilateral trade surplus with the U.S. has fallen by about 31%. Korea's useable

reserve position improved substantially during 1998, reaching approximately \$55 billion at the end of the year compared to \$9.1 billion at the end of 1997. Korea has continued to accumulate foreign exchange reserves, as a result of its current account surplus and capital inflows, with reserves totaling about \$60 billion at the end of June 1999.

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Policy Priorities

The most important policies in responding to the present challenges include the following objectives:

- **Maintain sound economic and financial policies in the United States, including our strong dollar policy, which is in the interest of the United States.**
- **Maintain sound domestic policies to offset the impact of the rising current account deficit.** An adjustment of the U.S. external imbalance would be eased by policies designed to raise the level of national savings. Maintaining a budget surplus is essential to this goal.
- **Policies that promote sustained, domestic demand led growth in our major industrial trading partners.** It is important that the Japanese authorities follow through on their recent efforts to restore economic growth in Japan and that European countries pursue strong growth policies, including structural reforms.
- **Providing financial assistance for strong economic programs, anchored with IMF support, designed to promote recovery and stability in emerging market economies.**
- **Put in place agreed measures and policies to strengthen the international financial architecture and reduce the risk of future crises.** G-7 leaders have endorsed steps to help prevent financial crises and better respond to them when they occur. These measures are designed to strengthen the international financial institutions, enhance transparency, strengthen regulation in lending countries, equip emerging market economies to deal better with risk, share responsibility for resolving crises with the private sector, and protect the vulnerable in society, particularly in the face of crises.
- **Continue efforts to open foreign markets to U.S. exports while resisting protectionist sentiment.**
- **Treasury will continue monitoring the markets for evidence of currency manipulation.**

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Appendix

OMNIBUS TRADE AND COMPETITIVENESS ACT OF 1988 (H.R. 3)

SEC. 3004. INTERNATIONAL NEGOTIATIONS ON EXCHANGE RATE AND ECONOMIC POLICIES.

(a) Multilateral Negotiations.-The President shall seek to confer and negotiate with other countries-

(1) to achieve-

(A) better coordination of macroeconomic policies of the major industrialized nations; and

(B) more appropriate and sustainable levels of trade and current account balances, and exchange rates of the dollar and other currencies consistent with such balances; and

(2) to develop a program for improving existing mechanisms for coordination and improving the functioning of the exchange rate system to provide for long-term exchange rate stability consistent with more appropriate and sustainable current account balances.

(b) Bilateral Negotiations.-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. If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses; and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payments adjustments and to eliminate the unfair advantage. The Secretary shall not be required to initiate negotiations in cases where such negotiations would have a serious detrimental impact on vital national economic and security interests; in such cases, the Secretary shall inform the chairman and the ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and of the Committee on Banking, Finance and Urban Affairs of Representatives of his determination.

SEC.3005. REPORTING REQUIREMENTS.

(a) Reports Required.-In furtherance of the purpose of this title, the Secretary, after consultation with the Chairman of the Board, shall submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, on or before October 15 each year, a written report on international economic policy, including exchange rate policy. The Secretary shall provide a written update of developments six months after the initial report. In addition, the Secretary shall appear, if requested, before both committees to provide testimony on these reports.

(b) Contents of Report.-Each report submitted under subsection (a) shall contain-

(1) an analysis of currency market developments and the relationship between the United States dollar and the currencies of our major trade competitors;

(2) an evaluation of the factors in the United States and other economies that underline conditions in the currency markets, including developments in bilateral trade and capital flows;

(3) a description of currency intervention or other actions undertaken to adjust the actual exchange rate of the dollar;

(4) an assessment of the impact of the exchange rate of the United States dollar on

(A) the ability of the United States to maintain a more appropriate and sustainable balance in its current account and merchandise trade account;

(B) production, employment, and noninflationary growth in the United States;

(C) the international competitive performance of United States industries and the external indebtedness of the United States;

(5) recommendations for any changes necessary in United States economic policy to attain a more appropriate and sustainable balance in the current account;

(6) the results of negotiations conducted pursuant to section 3004;

(7) key issues in United States policies arising from the most recent consultation requested by the International Monetary Fund under article IV of the Fund's Articles of Agreement; and

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(8) a report on the size and composition of international capital flows, and the factors contributing to such flows, including, where possible, an assessment of the impact of such flows on exchange rates and trade flows.

(c) Report by Board of Governors.-Section 2A(1) of the Federal Reserve Act (12 U.S.C. 225a(1)) is amended by inserting after “the Nation” the following:”, including an analysis of the impact of the exchange rate of the dollar on those trends”.

SEC. 3006. DEFINITIONS.

As used in this subtitle:

(1) Secretary.-The term “Secretary” means the Secretary of the Treasury.

(2) Board.-The term “Board” means the Board of Governors of the Federal Reserve System.