

The Department of the Treasury

Report to Congress on International Economic and Exchange Rate Policies

For the period July 1, 2001, through December 31, 2001

THIS REPORT IS REQUIRED UNDER SECTION 3005 OF THE OMNIBUS TRADE AND COMPETITIVENESS ACT OF 1988 (THE "ACT"). THIS REPORT REVIEWS DEVELOPMENTS IN U.S. INTERNATIONAL ECONOMIC POLICY, INCLUDING EXCHANGE RATE POLICY.

Major Findings

- **U.S. economic growth over the period of July 1, 2001 through December 31, 2001¹ was disrupted by the September 11 terrorist attack.** Although the economic slowdown worsened, with real GDP declining in the third quarter of 2001, the U.S. economy bounced back in the fourth quarter, supported by favorable fiscal and monetary policies, and growth is continuing into 2002.
- **Global growth continued to slow overall during the period, leading to export and import contraction in all key economies.** U.S. imports contracted at a faster rate than exports and the current account deficit narrowed in the second half.
- **Trade-weighted indices of the dollar showed little change over the period.** Net capital flows into the United States remained robust, reflecting continued strong global investor confidence in the health, dynamism and attraction of U.S. markets.
- **No major trading partners of the United States manipulated exchange rates under the terms of Section 3004 of the Act during the period.** Treasury continues to monitor the exchange rate practices of major U.S. trading partners and to encourage moves to more flexible exchange rate regimes when appropriate.

The United States Economy

Overview of the U.S. Domestic Economy

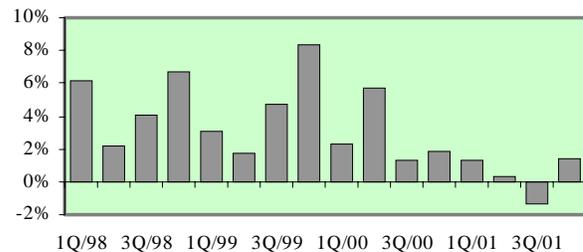
Although the U.S. economy was slowing through the second half of 2000 and the first half of 2001, there were signs of firming early in the third quarter of 2001 suggesting that growth might strengthen. The September 11 terrorist attack and its aftermath caused the economy to retrench. Consumers pulled back on spending and capital investment continued to decline. Real GDP in the third quarter fell at a 1.3% annual rate, the first decline in nearly a decade.

Fiscal and monetary policies were already in place to counteract the effects of the slowing economy and those policies contributed to a return to growth in the fourth quarter. Tax rebate checks and lower marginal rates reduced taxpayers' liability by about \$44 billion last year. The Federal Reserve lowered interest rates

six times in the first half of the year, and cut rates another five times during the period. After growing at a 1.0% annual rate in the third quarter, consumer spending surged at a 6.1% rate in the fourth, and real GDP rebounded at a 1.7% rate. GDP growth continued to strengthen going into 2002.

Productivity rose even as the economy contracted, an unusual development, and accelerated sharply from a 1.1% annual rate increase in the third quarter to an

U.S. Real Gross Domestic Product, 1997-2001
(% change over previous quarter, SAAR)



¹ "The period" means July 1, 2001 through December 31, 2001 in this report, unless otherwise indicated.

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outsized 5.2% pace in the fourth quarter. Solid productivity gains at about the 2.4% trend rate of growth since 1995 are expected to continue.

Overview of U.S. International Sector

Current Account

The current account deficit fell to \$417 billion, or 4.1% of GDP, in 2001 from a \$445 billion, or 4.5% of GDP, level in 2000. The narrowed deficit was the net result of significant reductions in imports and exports, both depressed by the slowdown in global activity. The contraction in trade was particularly severe for capital goods in both the United States and its trading partners.

U.S. Balance of Payments and Trade
(\$ billions, SA, unless otherwise indicated)

	2000	2001	2001			
			Q1	Q2	Q3	Q4
Balance on Current Account						
Billions of \$	-444.7	-417.4	-112.1	-107.9	-98.5	-98.8
Per Cent GDP	-4.5	-4.1	-4.4	-4.2	-3.9	-3.9
Select Financial Flows						
Net Direct Investment	135.2	1.9	11.7	24.3	-20.6	-13.5
Net Sales of US Securities						
to Non Official Foreigners	432.9	514.2	149.5	131.8	73.3	159.6
Net US Banking Flows	-50.5	-9.1	-102.9	44.2	-.2	49.8
Trade in Goods						
Balance	-452.2	-426.6	-112.6	-107.8	-105.5	-100.7
Total Exports	772.2	720.8	194.5	185.5	173.4	167.4
of which:						
Agricultural Products	52.8	55.0	13.6	13.5	13.7	14.1
Capital Goods Ex Autos	357.0	322.3	91.5	82.9	75.9	72.0
Automotive Products	80.2	74.6	17.9	19.1	19.3	18.3
Total Imports	1224.4	1147.4	307.2	293.2	279.0	268.1
of which:						
Petroleum Products	120.2	103.7	29.3	28.5	25.6	20.3
Capital Goods Ex Autos	346.7	297.8	86.2	74.7	69.1	67.8
Automotive Products	195.9	189.7	46.7	47.8	48.0	47.2
Advanced Technology (NSA)						
Balance	5.3	4.8	4.8	3.5	-1.1	-2.3
Exports	227.4	200.1	57.1	51.6	45.6	45.8
Imports	222.1	195.3	52.4	48.0	46.7	48.2

Financial Flows

Net financial flows into the United States remained strong throughout 2001, although the composition of the flows varied over the course of the year. These inflows easily financed the U.S. current account deficit and reflected international investors' continued strong interest in investment opportunities in the U.S. market.

International Investment Position

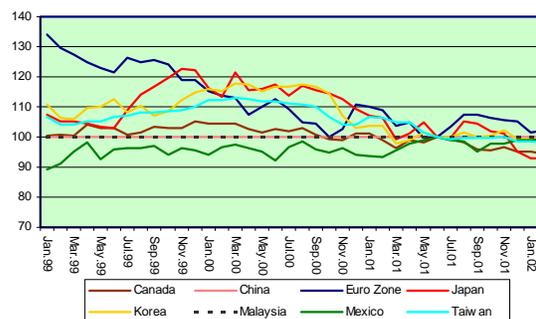
The net investment position of the United States at the end of 2000, the latest date for which data are available, was a negative \$2.2 trillion with direct investment evaluated at market value. Net investment income payments to foreigners, however, amounted to only \$13.7 billion in 2001, as net

receipts of \$95.2 billion from direct investment offset net payments on portfolio investment.

The Dollar in Foreign Exchange Markets

The dollar, on a trade-weighted basis, showed little change over the period notwithstanding a temporary increase in uncertainties about the U.S. economy and U.S. markets in the wake of the September 11 terrorist attacks. The Federal Reserve Board's broad nominal dollar index indicated that the dollar appreciated 0.3% on a trade-weighted basis, after appreciating 4.0% the first half of 2001. The real dollar index depreciated 0.6% during the period, after appreciating 4.4% during the first half of the year. The dollar moved from ¥125 per dollar to ¥131 per

Bilateral Exchange Rates
(Dollars per Foreign Currency Unit, June 2001 = 100)



dollar and from \$0.85 per euro to \$0.89 per euro over the period.

In the July-September quarter, the dollar depreciated on expectations of a protracted cyclical downturn in the United States. In an atmosphere of slowing global growth, market participants became more risk-averse and pulled back from higher risk assets generally. Some market participants, fearing greater economic dislocation after the September 11 terrorist attacks, sought to reduce their economic exposure to U.S. markets. Some investors shifted assets into war and conflict safe-havens, while others merely reduced their external exposure.

However, in the October-December quarter, market participants grew increasingly convinced that the United States would adapt its economic policies quickly to reduce the risks of a protracted downturn. Data releases during November reinforced an emerging sentiment that the US would lead the cycle and prompted upward revisions of market forecasts of U.S. growth. The rapid success of U.S. military efforts in Afghanistan was also a factor supporting the dollar. In contrast, economic data from Europe

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were not viewed as offering assurance about a prompt return to growth, while Japanese data pointed to continued depressed activity.

During the period G-7, Finance Ministers and Central Bank Governors referred to exchange rates among the major currencies in two communiqués (July 7, 2001, and October 6, 2001), each time stating: "We will continue to monitor developments closely and to cooperate as appropriate."

Major Industrial Economies

The growth of industrial economies fell sharply in 2001. G-7 countries, as a whole, experienced negative growth in all but the first quarter of 2001. Inflation in G-7 countries fell to a 1.2% y/y (year on year) rate in December 2001 compared with 2.5% in June 2001 and 2.4 % in December 2000.

Euro Zone Countries

Euro Zone growth slowed to 1.5% in 2001, down sharply from 3.4% in 2000. Growth dipped to a minus 0.7% (seasonally adjusted at an annual rate or saar) rate in Q4 from 0.8% in Q3. Of the eight largest Euro-12 countries, only Spain avoided at least one quarter of negative growth. Early confidence that the Euro Zone could escape the global slowing was unduly optimistic. The area-wide unemployment rate was 8.5% in December, up from a ten-year low of 8.3% reached early last year. During the second half of 2001, the ECB cut its key lending rates by 125 basis points in response to slower growth.

The rate of increase in the consumer price index spiked above a 3% y/y rate in the late spring of 2001 from a combination of food price increases and continued high oil prices; the core inflation rate remained over 2% through the end of 2001.

The euro appreciated 5% against the dollar during the period, having depreciated nearly 10% during the first half of 2001. The euro appreciated early in the period but was able to maintain levels consistently above \$0.90 from only mid-August to mid-October. The euro's failure to sustain an appreciation against the dollar during 2001 was, at least partially, attributable to Europe's vulnerability to the worldwide slowdown.

Japan

The Japanese economy fell back into recession in the second quarter of 2001 following a brief and shallow recovery from the 1997-98 downturn. Real GDP declined 1.7% in the second half of 2001, as both private and public domestic demand contracted and declining net exports also contributed to the downturn. For the year as a whole, real GDP shrank 0.5% as declines in net exports and public demand offset marginal growth in private demand. Deflation remained entrenched, with consumer prices down 0.7% in 2001, the third consecutive year of decline.

The Bank of Japan, in an effort to end persistent deflation, increased the liquidity it provided the money market by raising its bank reserves target in stages from ¥5 trillion to a ¥10-15 trillion range by the end of the year. Short-term interest rates remained virtually at zero throughout the period, and the monetary base grew at a 22% annualized rate. However, growth in broader monetary aggregates remained slow (M2+CDs grew 2.8% saar) and there was no sign of easing deflationary pressures. The weakness in the growth in broad money is a reflection of the weak balance sheets of Japan's financial and corporate sectors. Vigorous action is needed to tackle these twin problems.

Japan's current account surpluses have declined in recent years, from \$119 billion or 3.0% of GDP in 1998 to \$87 billion or 2.3% of GDP in 2001.

The yen depreciated 5.8% against the dollar over the period, ending the year at ¥131.8, while also depreciating 5.7% in real trade-weighted terms. Despite the weaker yen, Japan's trade surplus narrowed from \$36.0 billion (sa) in the first half of 2001 to \$35.5 billion in the second half, as declining exports more than offset a \$16.6 billion (8.3%) decline in imports. In contrast, the current account surplus widened to \$46.9 billion from \$41.6 billion, as a narrowing services deficit and a widening surplus on investment income more than offset the modest decline in the trade balance. In real terms there was a 7.9% fall in net exports from the first to the second half of 2001 contributing to the downturn in real GDP.

The U.S. bilateral trade deficit with Japan in 2001 fell sharply to \$70.6 billion (BOP basis) from the \$82.9 billion level posted in 2000.

Japanese foreign exchange intervention in 2001 was confined to September 17 – 28, in the aftermath of

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the September 11 attacks. Ministry of Finance data indicate sales of \$27 billion equivalent of yen were made.

Canada

Economic developments in Canada paralleled those in the United States in 2001. The Canadian economy slipped from a slow growth rate of 0.9% saar in the second quarter into negative growth of 0.6% saar during the third quarter, rebounding to a 2.0% saar growth rate in the fourth. Inflation remained low, dipping to 0.7% y/y in December 2001 from 2.6% at the end of the third, 3.3 % at the end of the second, and 2.6% at the end of the first quarter. The Bank of Canada (BoC) lowered interest rates in the second half of the year as the economy weakened and inflation remained subdued, although the spread of Canadian interest rates over U.S. rates widened.

During the period, the overall current account surplus fell to 1.3% of GDP from 4.0% of GDP in the first half of 2001.

The Government of Canada (GOC) has pursued sound reforms during the past decade, placing the Canadian economy on a much stronger footing than in previous years. In the early 1990s, interest rates were in double digits, employment declining, fiscal deficits were large and inflation high. The past decade has seen remarkable improvements in each of these areas. Productivity levels have improved in Canada, and some sectors have levels comparable to those in the United States. However, due importantly to developments in the information and technology (IT) sector, U.S. productivity remained much stronger, thus supporting continued investment flows from Canada to the United States.

The Canadian dollar fell 4.7% against the U.S. dollar and 9.3% against the euro, while rising 1.5% against the yen, during the period. Although the Canadian dollar fell sharply against the euro during the period, it has risen overall against the European currencies during the past decade.

The BoC identifies the long-term decline in inflation-adjusted (or real) non-energy commodity prices as a significant factor in explaining the long-term decline in the U.S.\$/C\$ exchange rate. A BoC price index tracking these commodities fell 16.4% during the period, reaching a level not seen since 1987. Although widening interest rate differentials vis a vis the United States might have provided some support to the Canadian dollar, the market did not regard

these increased spreads as sufficiently attractive to stimulate large scale inflows to Canada.

The Canadian dollar freely floats. A 1998 study by the BoC of its foreign exchange intervention concluded that its prior policy of regular intervention had very limited impact on foreign exchange rates. The BoC has not intervened in foreign exchange markets since 1998.

Other Industrial and Emerging Market Economies:

Overview of Emerging Market Finances

Risk aversion measures increased significantly after the terrorist attacks on September 11th. According to some measures, the risk premia paid on emerging market debt reached or were near record highs. These increases in measures of risk were driven more by a “flight-to-quality” and less by a “flight-to-liquidity”. However, following the September attacks, there was no widespread, panicked selling of all emerging market asset classes as occurred in the 1998 Russia-LTCM crisis. By November 2001, risk levels had declined to levels maintained over 2000 and the first part of 2001. The yield spread over U.S. Treasuries of JP Morgan’s Emerging Market Bond Index Plus (EMBI+) peaked at 1,005 basis points at the end of the third quarter, and declined in 4Q/2001 to a level lower than that recorded at end 2000.

In 4Q/2001, in spite of the turmoil created by developments in Argentina, bond markets performed strongly and equity markets, on average, outperformed their developed market counterparts. Contagion from Argentina was not widespread during the period, as investors discriminated among risks. Investors, in particular, took underweight positions in risky credits (Argentina and initially

Financial Developments in Emerging Markets						
	2000	2001	1Q/01	2Q/01	3Q/01	4Q/01
Issuance (US\$ bil.)	216.4	163.2	42.2	50.1	27.2	43.7
Bonds	80.5	88.6	26.8	28.7	11.6	21.5
Equities	41.7	11.2	2.3	5.3	1	2.6
Loans	94.2	63.4	13.1	16.1	14.6	19.6
Secondary Bond Markets (end period spread in bps)						
EMBI+	756	731	784	766	1005	731
Asia	489	356	450	397	494	356
Latin America	706	833	763	803	1103	833
Em. Europe	988	621	957	766	874	621
Stock Market Returns (%)						
MSCI EM Free	-31.8	-4.9	-6.2	3.1	-22.1	26.3
Asia	-42.5	4.2	-0.1	-1.6	-20.1	32.8
Latin America	-18.4	-4.3	-3.5	7.1	-24	21.8
Em. Eur./M. East	-23.4	-17.7	-22	4.5	-25.8	36.3

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Brazil) while going overweight in those that seemed more stable (primarily Asia and eastern Europe).

In 3Q/2001, unsettled financial conditions in Argentina and Turkey and the September terrorist attacks on the United States sharply reduced the gross volume of emerging market fundraising in international capital markets, which fell to levels last seen at the time of the Russia-LTCM crisis. While 4Q/2001 saw some issuance rebound, the total emerging market issuance ended the year at levels comparable to the abnormally low years of the Asian and Russian crises.

Latin America

Growth in Latin America weakened substantially during the period, as the global decline in demand and adverse country-specific factors intensified. Mexico's growth turned negative, weighed down by the U.S. recession. Argentina suffered a real GDP contraction and progressive deterioration of financial conditions, leading to a financial crisis in January 2002. A central feature of the events leading to this crisis was the government's continuing failure to achieve a degree of fiscal discipline that markets considered sufficient. In Brazil, overall growth turned negative, despite a strong improvement in net export performance. On a regional level, the IMF projects that real growth slipped to about 1% for 2001, much lower than the 4% rise experienced in 2000. Only Ecuador recorded more rapid growth in 2001 than in 2000.

However, Latin American access to external capital was surprisingly resilient. Bond issuance declined by only \$2 billion in 2001, to \$41 billion, and EMBI+ sovereign spreads widened just 30 basis points (bps) during the period to 833bps over comparable U.S. Treasuries. Nonetheless, there was increased pressure on floating exchange rates and depletion of international reserves in those countries with fixed exchange rates.

Argentina

Significant economic, financial, and political turmoil erupted in Argentina at the end of 2001, culminating in January 2002 in a default on external obligations, an end to foreign exchange convertibility (pegging the peso to the dollar at 1:1). Following the decision to float, the peso depreciated from an initial level of 1.40 pesos per dollar to as low as 3.25 pesos per dollar in late March 2002 (3.75 in mid-day trading).

The peso has been bolstered recently by additional foreign exchange restrictions imposed by the Central Bank. Events leading up to this crisis resulted largely from deteriorating monetary conditions during the period. Large-scale bank deposit outflows (\$18 billion in 2001) weakened Argentina's foreign reserve position, the credibility of its exchange rate regime, and the solvency of its banking system. The Government imposed comprehensive deposit controls in early December 2001. Financial indicators weakened significantly throughout the year -- the Merval stock index fell by 50% in 2001, EMBI+ spreads widened from 800 bps in the first quarter of the year to 4,500 bps by year end, while short-term interbank rates rose from an average of 11% in 2001 to 29% by year's end.

Underlying Argentina's financial crisis was its continued poor growth and weak fiscal performance. Output in 2001 contracted by 3.3%, with the decline increasing to nearly 5%, at an annualized rate, during the period. This was the third consecutive year of falling output. The unemployment rate rose to 18% in 2001 from 15% the year before; consumer price deflation (y/y -1.0%) continued; Argentina's fiscal deficit widened. Although Argentina's trade balance strengthened by \$6 billion through the first three quarters of the year, its current account balance declined by \$5 billion (to -2.9% of GDP) due largely to rising interest payments and service imports. The real, trade-weighted appreciation of the peso by roughly 6% in 2001 followed a 15% rise during the two previous years. Argentina's inability to meet program performance standards led the IMF to suspend funding in December. President de la Rúa resigned soon thereafter, and, following a succession of interim leaders, Eduardo Duhalde assumed the presidency on January 2.

Brazil

The short term political, external, and fiscal risks that plagued Brazil throughout much of 2001 subsided toward year-end and in early 2002. In late September, financial markets began to "decouple" Brazil from Argentina. This was due to Brazil's stronger economic fundamentals, anticipation of reduced debt payments in 2002, and a variety of technical factors that increased demand for liquid emerging market debt. The result was both a decline in new sovereign borrowing costs (from about 1,250 bps to a still-high 800 bps above U.S. Treasuries) and ongoing access to capital markets during the height of Argentine volatility.

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Real GDP growth slowed to 1.5% in 2001 from 4.5% in 2000. On a seasonally adjusted basis, q/q growth was -0.8% and -1.6% in the third and fourth quarters, respectively. This deterioration was due largely to a worsening global environment, high domestic interest rates, and a domestic energy crisis. In 2001, Brazil's trade surplus was \$2.6 billion (0.5% of GDP)—the first surplus since 1994. The current account deficit was \$23.2 billion in 2001 (4.6% of GDP), versus \$24.7 billion in 2000. Foreign Direct Investment (FDI) fell to \$22.6 billion in 2001 (97% of the current account balance), down from \$32.8 billion in 2000.

The CPI increased about 7.7% in 2001 and exceeded the upper band of the official target (2%-6% band), owing both to substantial increases in public enterprise charges and the 45% depreciation in the exchange rate in the year to end-September. The *real* reversed its course and appreciated 18% from mid-September to close the year at 2.3 real/US\$--the same level as end-June. The Central Bank of Brazil (BCB) sought to limit inflation by minimizing exchange rate depreciation through the sale of dollar-linked debt (\$9.4bn net in the period) and spot foreign exchange reserves (\$6b in the period). During 2001, the inflation adjusted trade-weighted exchange rate depreciated 5.1%.

Net international reserves (excluding dollar-linked liabilities of the BCB) increased during the period by \$2.1 billion to \$36.2 billion. Short-term external debt (residual maturity) was 119% of reserves. As a percent of M2, net reserves decreased from 27.6% to 21.1%.

Mexico

Negative growth in Mexico was primarily driven by the slowdown in the U.S. economy, which lowered the demand for its exports during the period. Real growth slowed to -1.6% y/y in 4Q/2001 (compared with 4.7% y/y in 4Q/2000), bringing real annual growth for the year down to -0.3%. A low annual inflation rate of 4.4% for the year allowed the Bank of Mexico to ease monetary policy to help stimulate growth.

During 2001, the current account deficit reached US\$17.5 billion or 2.8% of GDP, down from 3.1% of GDP in 2000. The capital account surplus of \$22.7 billion was dominated by a historically high \$24.7 billion FDI inflow, of which \$12.5 billion was associated with Citigroup's acquisition of Banco Nacional de Mexico.

The authorities let the exchange rate float freely in the period and the peso depreciated a modest 1.3% against the U.S. dollar to 9.16 pesos/\$. Net international reserves rose \$2 billion during the period to \$42 billion (14.2% of M2 and three months of import cover).

Central and Eastern Europe

The region of Central and Eastern Europe continued to experience solid growth in 2001, even if at a slightly slower pace than in 2000. Growth in Southeastern Europe is expected to show the greatest acceleration in the area, led by a strong expansion in Romania. Of the largest or more advanced economies, only Poland came close to slipping into a recession. Ukraine was one of the best performers, with the economy growing by 9% in real terms, while in Russia growth slowed from 8.5% to 5% in 2001. Polish GDP growth dropped from 4.2% in 2000 to 1.1% in 2001 due to a cyclical downturn and tight monetary policy. The other advanced transition economies, Hungary and the Czech Republic, grew by 3.8% and 3.5%, respectively (compared to 5.2% and 2.9% in 2000).

Countries in this region experienced very different exchange rate pressures in 2001. A sharp decline in oil prices after September reduced upward pressure on Russia's exchange rate during the period, and the ruble depreciated from 28.2 R/\$ at the end of 2000 and 29.2 R/\$ at the end of June 2001 to 30.5 R/\$ at the end of 2001. Overall, the ruble's real appreciation was an estimated 7% in 2001, compared to 22% in 2000. The CBR's intervention in the foreign exchange market helped boost reserves \$8.5 billion to \$36.5 billion in 2001, although reserve growth stagnated after September due to early debt payments to the IMF and a worsening external balance. In Ukraine, the hryvnia remained stable during the period, strengthening slightly from 5.4/\$ to 5.32/\$. There were no significant interventions by the central bank.

In the key Central European economies, the prospect of future EU membership and inflows of capital in the form of privatization payments and FDI have resulted in a strengthening of the currencies in nominal and real terms. Both Poland and Hungary saw a brief, sharp drop in their currencies in July but by year-end both the zloty and the forint had strengthened. In the Czech Republic, the main policy preoccupation during the period was a concern with excessive crown appreciation in the face of the

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inflow of privatization receipts and EU accession-related funds, but the government did not undertake any significant steps to limit the strength of the crown. The strengthening of these three currencies helped to bring inflation down in the region, with the average inflation rate in 2001 in these three countries only 4.8%, compared to 7.5% in 2000.

Asia

Growth in Asia remained subdued during 2001, with several emerging Asian economies experiencing recessions due to the weakening in global demand, though it picked up considerably by year-end. Exports experienced double-digit declines (from the second half of 2000), particularly in economies dependent on IT exports (Korea, Singapore, Taiwan, and Malaysia). However, imports in many economies fell even more sharply due to the high import content of manufactured exports and weak investment owing to excess capacity and an overhang of corporate debt. As a result, current account surpluses in these economies either remained relatively unchanged or increased as a percent of GDP.

Given weak growth and low inflation, Asian countries eased monetary policies in line with the Federal Reserve. However, monetary stimulus did not translate into stronger credit growth in most countries, given that many financial institutions remained capital constrained and many corporations remained overly indebted. Monetary easing did lead to nominal exchange rate depreciation against the U.S. dollar in some countries. Movements in real effective exchange rates for most economies with floating exchange rate regimes were mixed, while real effective rates in economies with fixed exchange rate regimes tended to appreciate. Given weak growth and the threat of deflation, central banks accumulated reserves to limit the appreciation of their currencies.

Monetary authorities in most countries continued their move toward inflation-targeting regimes. In the Philippines, the authorities made final preparations toward formally adopting an inflation targeting framework. In Korea, the central bank adhered to an inflation-targeting framework, with limited exchange rate intervention. However, in Thailand, central bank authorities, while nominally maintaining an inflation-targeting regime, appear to have returned to a greater focus on exchange rate stability and capital flows, raising interest rates early in the period despite core

inflation in the lower half of the target range. In general, inflation targeting should lead monetary authorities to focus less on short-term exchange rate movements and more on the medium-term inflation outlook. However, given the large effect exchange rate changes have on inflation in most Asian economies, monetary authorities will continue to adjust monetary policy in response to exchange rate changes.

China

According to officially reported data, China's GDP growth slowed to 6.8% y/y from 7.9% in the period. The deceleration was mainly due to a decline in the growth of consumption and merchandise exports. Exports were adversely affected by the global downturn, with export growth falling to 5.0% year/year compared to 8.8% during the first half of 2001. However, the slowdown in domestic demand caused import growth during the period to decline faster than exports. The trade surplus for the second half of the year (FOB-CIF) was 2.4% of GDP, compared to 2.0% a year earlier. China's current account surplus for 2001 is expected to have declined slightly from 2.0% of GDP a year earlier. Using U.S. data, China's bilateral trade surplus with the U.S. was a non-seasonally adjusted \$46 billion during the period, compared to \$37 billion during the first half of 2001 and \$84 billion in 2000.

China implements a de facto currency peg to the dollar, which it has maintained within a tight band since 1995. In real effective terms, the Renminbi depreciated 2% during the period. Gross foreign reserves grew \$32 billion to \$212 billion in the reporting period as FDI inflows increased 15% to \$46.8 billion, reflecting China's accession to the WTO. Gross reserves at the end of the period were relatively low, equivalent to 12% of M2, compared to 10% at the end of June 2001. According to BIS figures, reserves measured 650% of short-term external debt (residual maturity) at end-June 2001; similar data for end-December 2001 are not yet available. China continues to maintain wide-ranging controls on both capital outflows and inflows.

Korea

Real GDP recovered in the period, growing at 5.1% and 5.9% (estimated) in the third and fourth quarters, respectively (*q/q, saar*), following 1.2% and 1.8% growth in the first and second quarters. This rebound in growth was driven by domestic demand, primarily private consumption supported by stimulative

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monetary and fiscal policies. Merchandise exports fell 19.4% during the period, compared to a year earlier, due to weak global demand, while imports fell 16.2% largely as a result of sluggish import-intensive exports and weak investment. Accordingly, Korea's current account surplus as a percent of GDP declined from 2.4% in 2000 and 2.6% in the first half of 2001 to 0.7% in the period.

Korea maintains a floating exchange rate and uses inflation targeting to set monetary policy, generally intervening in the foreign exchange market only to smooth what it considers excessive volatility. During the period, the won depreciated 1% against the U.S. dollar; however the real effective exchange rate appreciated by 1.1%. The Bank of Korea reduced policy interest rates by 100 basis points in the third quarter to respond to weak economic conditions and low inflation. Consumer prices rose 4.3% and 3.7% (projected) in the third and fourth quarters (*q/q, saar*). Despite Korea's early repayment in August of the outstanding balance of its IMF loans, gross reserves increased by \$8.6 billion during the reporting period to \$102.8 billion at year-end. This increase was due mostly to interest earnings and repayment of exceptional loans to Korean banks extended during the Asian crisis rather than direct central bank intervention in the foreign exchange market. As of December 2001, reserves were 284% of short-term external debt (residual maturity basis) compared to 229% in June 2001. The ratio of reserves to broad money (M3) was 13% in December, and was relatively constant over 2001. Korea has relatively few restrictions on capital flows.

Malaysia

After entering a technical recession in the first half of 2001, Malaysia's economy contracted 0.5% in the third quarter and grew 5.3% in the fourth quarter (*q/q, sa*) – a relatively favorable result compared to other export-dependent economies in the region that were negatively affected by the global IT slump. An expansionary fiscal policy helped to strengthen domestic demand and cushion the downturn. Despite negative merchandise export growth (down 16% *y/y* in the period), the current account surplus remained relatively unchanged at 9% of GDP in 3Q01 (latest data available), as slowing exports were matched by decelerating imports.

Malaysia has maintained a fixed peg to the dollar since September 1998, when it also imposed capital controls. Controls have since been relaxed, but offshore trading of the ringgit remains prohibited and

foreign portfolio investment by residents continues to be restricted. To limit short-selling, ringgit borrowing by non-residents is also restricted. The Malaysian authorities maintained the peg throughout 2001 despite occasional periods of downward pressure on the ringgit. Such pressure intensified in the first half of the year, as regional currencies weakened and substantial capital outflows led to a sharp decline in reserves. Pressure on the ringgit subsided during the period following successive cuts in U.S. interest rates, stabilization of regional currencies, and capital inflows attracted by progress toward corporate restructuring in Malaysia. At the end of the period, reserves stood at \$31 billion, equal to 352% of short-term external debt (residual maturity) and 32% of M2, up from \$26 billion, or 299% of short-term external debt and 28% of M2, at the end of June 2001. Due to the strengthening of the U.S. dollar during the period, the ringgit appreciated 1.4% on a real trade-weighted basis.

Taiwan

Real GDP declined 1.9% during 2001, the result of the global downturn, particularly in the market for IT products. Declining investment severely dampened domestic demand as well. This was the sharpest drop in GDP since the 1970s. The economy declined 4% (*saar*) in the third quarter but picked up during the final quarter of 2001, growing an estimated 6% (*saar*) as exports of computer and electronics goods rose. Merchandise exports in the second half were still 23% below the same period in 2000. With domestic demand still weak, the current account surplus rose to 8% of GDP during the second half of 2001 compared to 6% of GDP during the same period of 2000.

During the reporting period, given weak growth and limited inflation (with consumer prices rising at less than a 2% annual rate) Taiwan significantly eased policy interest rates. A weak banking system and overly indebted corporations in non-IT sectors hampered the stimulatory effect of monetary easing on credit growth. However, monetary easing and associated foreign exchange market intervention led to a depreciation of the Taiwan dollar by 1.6% against the U.S. dollar and by 4% on a trade weighted basis. Gross foreign reserves rose \$13 billion during the period to \$126.6 billion. As a percentage of M2, reserves rose from 20.2% to 22.5%, while as a percentage of short-term external debt (residual maturity) they declined from 474% to an estimated 457% during the period. Taiwan maintains a series of capital and administrative controls including limits

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on capital transactions by a citizen, select controls on FDI inflows and outflows, restrictions on offshore borrowing of the Taiwan dollar and at times limits on large single foreign exchange transactions.

Elements of Manipulation

Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 (the Act) 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 competitive

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 no major trading partners of the United States manipulated exchange rates under the terms of Section 3004 of the Act during the period.