REPORT TO CONGRESS

Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States

U.S. DEPARTMENT OF THE TREASURY
OFFICE OF INTERNATIONAL AFFAIRS

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Contents

This Report reviews developments in international economic and exchange rate policies and is submitted pursuant to the Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C. § 5305, and Section 701 of the Trade Facilitation and Trade Enforcement Act of 2015, 19 U.S.C. § 4421.[1]

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

Executive Summary

Global growth in 2018 has become less even and broad-based than it was amidst the synchronized upswing last year. The United States remains a bright spot in the global economy, with growth having accelerated in the second quarter, but there are signals that economic activity may be slowing in other key regions (the euro area; China) while many emerging markets have come under pressure from rebounding commodity prices, rising interest rates, and shifts in sentiment. The Administration's economic reform efforts – including tax reform, ongoing regulatory initiatives, and major new trade agreements – are bearing fruit, as business investment in the United States has accelerated and the outlook for median income growth is strong. Restoring broad-based growth across the global economy would be helped by economies putting in place reforms that enhance the efficiency of tax systems, upgrade regulatory frameworks to better support domestic investment, and support sound monetary policies.

Real exchange rate movements in 2018 have not generally been in a direction that would promote more balanced global growth. Most notably, the recent strengthening of the dollar and the decline in China's currency would, if sustained, exacerbate persistent trade and current account imbalances. In March, all G-20 members agreed that strong fundamentals, sound policies, and a resilient international monetary system are essential to the stability of exchange rates, contributing to strong and sustainable growth and investment. It is important that major economies pursue this vision more vigorously. Treasury will also be monitoring closely the extent to which intervention by our trading partners in foreign exchange markets is symmetrical, and whether economies that choose to "smooth" exchange rate movements resist depreciation pressure in the same manner as appreciation pressure.

The U.S. trade deficit has continued to widen in 2018, partly reflecting robust domestic demand growth in the United States compared to major trading partners, but also due to persistent trade and investment barriers in many economies, along with sustained undervaluation of many currencies per assessments by the International Monetary Fund (IMF). Bilateral trade deficits with several major trading partners are at very high levels, particularly with China. Moreover, current account surpluses among several major trading partners have remained excessive for many years.

The Administration remains deeply concerned by the significant trade imbalances in the global economy, and is working actively across a broad range of areas to help ensure that trade expands in a balanced way that protects U.S. firms and workers against unfair foreign trade practices. The United States is committed to working towards a fairer and more reciprocal trading relationship with China.

The United States is also committed to combatting unfair currency practices that facilitate competitive advantage, including unwarranted intervention in currency markets. Among major U.S. trading partners, Korea announced this year that it would begin reporting publicly on foreign exchange intervention in early 2019. We welcome this important development in Korea's foreign exchange practices. In addition, in the context of trade negotiations, Mexico, Canada, and the United States have agreed to incorporate commitments into the U.S.-Mexico-Canada trade agreement to avoid unfair currency practices and confirm ongoing transparency on related information. We will consider adding similar concepts to future U.S. trade agreements, as appropriate.

Treasury also continues to press major trading partners of the United States that have maintained large and persistent external surpluses to support stronger and more balanced global growth by facilitating domestic demand growth as the primary engine for economic expansion.

Treasury Analysis Under the 1988 and 2015 Legislation

Since 1988, the Treasury Department has been issuing reports to Congress that analyze international economic policies, including exchange rate policies, of the major trading partners of the United States. Two pieces of U.S. legislation govern the content of these reports.

The Omnibus Trade and Competitiveness Act of 1988 (the "1988 Act") requires the Secretary of the Treasury to provide semiannual reports to Congress on international economic and exchange rate policy. Under Section 3004 of the 1988 Act, the Secretary must:

> *"consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade."*

This determination is subject to a broad range of factors, including not only trade and current account imbalances and foreign exchange intervention (criteria under the second piece of legislation discussed below), but also currency developments, exchange rate practices, foreign exchange reserve coverage, capital controls, and monetary policy.

The Trade Facilitation and Trade Enforcement Act of 2015 (the "2015 Act") calls for the Secretary to monitor the macroeconomic and currency policies of major trading partners and engage in enhanced analysis of those partners if they trigger certain objective criteria that provide insight into possibly unfair currency practices.

Treasury has established thresholds for the three criteria as follows: (1) a significant bilateral trade surplus with the United States is one that is at least $20 billion;[2] (2) a material current account surplus is one that is at least 3 percent of gross domestic product (GDP); and (3) persistent, one-sided intervention occurs when net purchases of foreign currency are conducted repeatedly and total at least 2 percent of an economy's GDP over a

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[2] Given data limitations, Treasury focuses in this Report on trade in goods, not including services. The United States has a surplus in services trade with many economies in this report, including Canada, China, Japan, Korea, Mexico, Switzerland, and the United Kingdom. Taking into account services trade would reduce the bilateral trade surplus of these economies with the United States.

12-month period.[3] In 2017, the $20 billion bilateral trade surplus threshold captured almost 80 percent of the value of all trade surpluses with the United States, while the 3 percent current account threshold captured more than three-fourths of the nominal value of global current account surpluses.

China has a long history of pursuing a variety of economic and regulatory policies that lead to a competitive advantage in international trade, including through facilitating the undervaluation of the renminbi (RMB). The Treasury Department cited China for manipulating its currency regularly between 1992 and 1994, noting China's continued reliance on foreign exchange restrictions that limited Chinese imports. In January 1994, China devalued its currency by 33 percent, from 5.82 RMB to the dollar to 8.72. China then fixed its exchange rate at 8.28 for a decade until 2005, a level that was deeply undervalued. Notwithstanding its constructive decision not to *further* devalue its currency during the 1997-98 Asian Financial Crisis, China's insistence on maintaining the RMB exchange rate at a highly undervalued level for such an extended period of time created strong economic incentives to artificially increase the size of China's export sector, just as it negotiated its entry into the World Trade Organization in 2001.

Subsequently, even as its trade and current account surpluses soared, China undertook protracted, large-scale intervention in the foreign exchange market and allowed the RMB to strengthen only gradually. Chinese net purchases of foreign exchange averaged almost nine percent of GDP annually from 2002 to 2009, building excess reserves that eventually reached about $4 trillion. Importantly, China's current account surplus expanded from below 2 percent of GDP in 2001 to a peak of almost 10 percent of GDP in 2007. Since then, China's current account surplus has declined substantially, falling to 0.5 percent of GDP in the four quarters through June 2018. However, it remains unevenly spread among China's trading partners. In particular, China retains a very large and persistent trade surplus with the United States, at $390 billion over the four quarters through June 2018.

Thus, since the 1988 Act was passed, China's exchange rate and intervention practices promoted and sustained a significant undervaluation of the RMB for much of this period, imposing significant and long-lasting hardship on American workers and companies.

Over the last decade, the RMB has generally appreciated on a real, trade-weighted basis. This appreciation has led the IMF to shift its assessment of the RMB in recent years and conclude that the RMB is broadly in line with economic fundamentals. Notwithstanding this gradual real trade-weighted appreciation, on a bilateral basis RMB depreciation in the last few months has brought the RMB back to where it stood against the dollar in nominal terms almost a decade ago.

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[3] In assessing the persistence of intervention, Treasury will consider an economy that is judged to have purchased foreign exchange on net for 8 of the 12 months to have met the threshold. These quantitative thresholds for the scale and persistence of intervention are considered *sufficient* on their own to meet the criterion. Other patterns of intervention, with lesser amounts or less frequent interventions, might also meet the criterion depending on the circumstances of the intervention.

Moreover, in the last couple of years, China has shifted from a policy of gradual economic liberalization to one of reinforcing state control and increasing reliance on non-market mechanisms. The pervasive use of explicit and implicit subsidies and other unfair practices are increasingly distorting China's economic relationship with its trading partners. These actions tend to limit Chinese demand for and market access to imported goods, leading to a wider trade surplus. China's policies also inhibit foreign investment, contributing to weakness in the RMB.

Of concern, the RMB has fallen notably in recent months. Since mid-June, the RMB has depreciated to date against the dollar by more than 7 percent. The RMB has also fallen by nearly 6 percent over the same period versus a broad trade-weighted basket of currencies. The majority of depreciation against the dollar occurred between mid-June and mid-August; from mid-August through end-September, the RMB remained within a relatively narrow range of 6.8-6.9 RMB to the dollar. This depreciation of the RMB will likely exacerbate China's large bilateral trade surplus with the United States, as well as its overall trade surplus.

While China's exchange rate practices continue to lack transparency, including its intervention in foreign exchange markets and its management of daily central parity settings to influence the value of the RMB, Treasury estimates that direct intervention by the People's Bank of China (PBOC) this year has been limited. Since the summer, the Chinese authorities have reportedly employed limited tools to stem depreciation pressures, including implementing administrative measures and influencing daily central parity exchange rate levels. Broader proxies for intervention indicate there have been modest foreign exchange sales recently by state banks, helping stem depreciation pressures, though it is clear that China is not resisting depreciation through intervention as it had in the recent past.

Treasury Conclusions Related to China

Based on the analysis in this Report, Treasury determines, pursuant to the 2015 Act, that China continues to warrant placement on the Monitoring List of economies that merit close attention to their currency practices. Treasury determines that while China does not meet the standards identified in Section 3004 of the 1988 Act at this time, Treasury is concerned about the depreciation of the RMB and will carefully monitor and review this determination over the following 6-month period, including through ongoing discussions with the PBOC.

- China continues to run an extremely large and persistent bilateral trade surplus with the United States, by far the largest among any of the United States' major trading partners, with the goods trade surplus standing at $390 billion over the four quarters through June 2018. As discussed above, recent depreciation of the RMB will likely exacerbate China's large bilateral trade surplus with the United States, as well as its overall trade surplus. Treasury places significant importance on China adhering to its G-20 commitments to refrain from engaging in competitive devaluation and to not target China's exchange rate for competitive purposes. China could pursue more market-based economic reforms that would bolster confidence in the RMB. Treasury continues to urge China to enhance the transparency of China's exchange rate and reserve management operations and goals. Treasury is deeply disappointed that China continues to refrain from disclosing its foreign exchange intervention. Finally, to enhance the sustainability of both Chinese and global growth, China needs to aggressively advance reforms that support greater household consumption growth and rebalance the economy away from investment.

Treasury Conclusions Related to Other Major Trading Partners

Pursuant to the 2015 Act, Treasury has found in this Report that no major trading partner met all three criteria during the four quarters ending June 2018. Similarly, based on the analysis in this Report, Treasury also concludes that no major trading partner of the United States met the standards identified in Section 3004 of the 1988 Act.

Regarding the 2015 legislation, Treasury has established a Monitoring List of major trading partners that merit close attention to their currency practices and macroeconomic policies. An economy meeting two of the three criteria in the 2015 Act is placed on the Monitoring List. Once on the Monitoring List, an economy will remain there for at least two consecutive Reports to help ensure that any improvement in performance versus the criteria is durable and is not due to temporary factors. As a further measure, this Administration will add and retain on the Monitoring List any major trading partner that accounts for a large and disproportionate share of the overall U.S. trade deficit even if that economy has not met two of the three criteria from the 2015 Act. **In this Report, in addition to China, the Monitoring List comprises Japan, Korea, India, Germany, and Switzerland.**

With regard to the other five economies on the Monitoring List:

- Japan maintains the third-largest bilateral goods trade surplus with the United States, with a goods surplus of $70 billion over the four quarters through June 2018. Japan's current account surplus over the four quarters through June 2018 was 4.0 percent of GDP, close to its highest level in a decade. Japan has not intervened in the foreign exchange market in almost seven years. Treasury's expectation is that in large, freely-traded exchange markets, intervention should be reserved only for very exceptional circumstances with appropriate prior consultations. Japan should take advantage of the current window of steady growth to enact critical structural reforms that can support sustained faster expansion of domestic activity, create a more sustainable path for long-term growth, and help reduce Japan's public debt burden and trade imbalances.

- Korea has for many years maintained an excessively strong external position, though there has been some moderation in its external imbalances recently. Korea's goods trade surplus with the United States continued to narrow to $21 billion over four quarters through June 2018, contracting over $7 billion from its peak level in 2015. Korea's current account surplus also narrowed slightly over the four quarters through

June 2018 to 4.6 percent of GDP. The won appreciated 7 percent against the dollar over the second half of 2017, but much of this move has reversed in 2018. There was a notable and concerning pick-up in foreign exchange intervention in November 2017 and January 2018 that appears to have been for the purpose of slowing won appreciation against the dollar. These purchases were partially reversed through net foreign exchange sales in the first half of 2018 as the won depreciated against the dollar. The IMF continues to describe Korea's current account surplus as larger, and its exchange rate as weaker, than justified by medium-term economic fundamentals. Further, despite real effective appreciation over four quarters through June 2018 of 2 percent, the won is not notably strong compared to levels it has been over the last couple decades. It is important that the Korean authorities act to strengthen domestic demand; recent fiscal policy proposals would be a step in the right direction, but Korea maintains ample policy space to more forcefully support demand growth. Treasury will continue to monitor closely Korea's currency practices, including the authorities' recently announced plans to increase the transparency of exchange rate intervention.

- India's circumstances have shifted markedly, as the central bank's net sales of foreign exchange over the first six months of 2018 led net purchases over the four quarters through June 2018 to fall to $4 billion, or 0.2 percent of GDP. This represented a notable change from 2017, when purchases over the first three quarters of the year pushed net purchases of foreign exchange above 2 percent of GDP. Recent sales have come amidst a turnaround in foreign portfolio flows, as foreign investors pulled portfolio capital out of India (and many other emerging markets) over the first half of the year. The rupee depreciated by around 7 percent against the dollar and by more than 4 percent on a real effective basis in the first half of 2018. India has a significant bilateral goods trade surplus with the United States, totaling $23 billion over the four quarters through June 2018, but India's current account is in deficit at 1.9 percent of GDP. As a result, India now only meets one of the three criteria from the 2015 Act. If this remains the case at the time of its next Report, Treasury would remove India from the Monitoring List.

- Germany has the world's largest current account surplus in nominal dollar terms, $329 billion over the four quarters through June 2018, which represented its highest nominal level on record. Germany also maintains a sizable bilateral goods trade surplus with the United States, at $67 billion over the four quarters through June 2018. There has been essentially no progress in reducing either the massive current account surplus or the large bilateral trade imbalance with the United States in recent years, in part because domestic demand in Germany has not been sufficiently strong to facilitate external rebalancing and because Germany's low inflation rate has contributed to a weak real effective exchange rate. As it now stands, these surpluses represent a substantial excess of income over spending, which translates into weaker imports by Germany than could be, and thus very large capital outflows. Germany should take policy steps to unleash domestic investment and consumption – including meaningful fiscal reforms to minimize burdens from elevated labor and value-added taxes – which would narrow the gap between domestic income and spending and help reduce large external imbalances. The European Central Bank (ECB) has not intervened unilaterally in foreign currency markets in over 15 years.[4]

- Switzerland's foreign exchange purchases have declined markedly in both scale and persistence since mid-2017. This has come as economic conditions have also shifted: inflation in Switzerland has turned positive, domestic economic activity has picked up, and pressures from safe haven inflows have been less persistent. Treasury estimates that net purchases of foreign exchange over the four quarters through June 2018 totaled $17 billion, equivalent to 2.4 percent of GDP, with purchases occurring less frequently than in prior years. The Swiss franc appreciated modestly in both nominal and real effective terms over the first half of 2018; however, the real effective exchange rate remains less than 6 percent above its 20-year average level. Switzerland had a very large current account surplus at 10.2 percent of GDP over the four quarters through June 2018. To help narrow the large and persistent trade and current account surpluses, Switzerland should adjust macroeconomic policies to more forcefully support domestic economic activity. Treasury also urges the Swiss authorities to enhance the transparency of exchange rate intervention.

Treasury continues to track carefully the foreign exchange and macroeconomic policies of our trading partners under the requirements of both the 1988 and 2015 Acts, and to review the number of economies covered in this Report.

[4] For the purposes of Section 701 of the 2015 Act, policies of the ECB, which holds responsibility for monetary policy for the euro area, will be assessed as the monetary authority of individual euro area countries.

Section 1: Global Economic and External Developments

This Report covers economic, trade, and exchange rate developments for the first six months of 2018 and, where data are available, developments through end-September 2018. This Report covers developments in the 12 largest trading partners of the United States, as well as Switzerland, which is currently the United States' 15th largest trading partner.[5] These economies' total goods trade with the United States amounted to $2.9 trillion over the four quarters through June 2018, over 70 percent of all U.S. goods trade during that period. For some parts of the analysis, especially those parts having to do with Section 701 of the 2015 Act, data over the most recent four quarters for which data are available are considered (typically up through the second quarter of 2018).

U.S. Economic Trends

The U.S. economic expansion accelerated markedly in the first half of 2018, growing at an annual rate of 3.2 percent, compared with 2.6 percent in the second half of last year. Growth of private domestic final demand remained strong in the first half of this year, rising by 3.1 percent, compared with a rate of 3.3 percent in the latter half of 2017, while net exports picked up, contributing positively to growth.

The underpinnings of growth have improved thus far in 2018, and include a faster pace of job creation, strong labor markets with rising labor force participation, multi-year highs in measures of consumer and small business confidence, solid household finances, and the strongest outlook for business activity and private investment in many years. Further, the effects of tax reform appear to be feeding through into the economy, with business fixed investment growing strongly over the first half of the year. These factors boosted private domestic demand to a 4.3 percent pace in the second quarter of 2018. Inflation (headline as well as core, which excludes food and energy) continued to tick up but remained moderate, and interest rates, including mortgage rates, also moved up. As of early October 2018, a consensus of private forecasters predicted that real GDP would expand at a rate of 3.1 percent in 2018.

Recent U.S. Growth Performance

Real GDP expanded at an average annual rate of 3.2 percent over the first half of 2018 2017, accelerating noticeably from the 2.6 percent rate in the second half of the year. Domestic final demand remained firm, and after reaching its fastest pace in three years in the final quarter of 2017 (4.4 percent), rebounded to 4.3 percent at an annual rate in the second quarter of 2018. Consumer spending contributed 1.5 percentage points to GDP growth in the first half of 2018, less than the 2.1 percentage points added in the latter half of 2017. Business fixed investment added 1.3 percentage points to growth in the first half of this year, nearly triple the 0.5 percentage point contribution made in the latter half of

[5] Switzerland is included in this Report as it has previously appeared on Treasury's Monitoring List since the October 2016 Report.

last year. After making a modest, 0.2 percentage point contribution to growth in the second half of 2017, residential investment subtracted 0.1 percentage point over the first half of this year. Net exports added 0.6 percentage point to growth in the first half of 2018, after posing a drag on growth of 0.4 percentage point in the latter half of 2017. Inventory accumulation added 0.1 percentage point to growth during last year's second half, but subtracted 0.4 percentage point from growth in the first two quarters of this year. Government spending boosted growth by 0.1 percentage point in the second half of 2017, and by 0.3 percentage point in the first half of 2018.

Sound Fundamentals

Payroll employment growth accelerated in 2018, after growing at an already-firm pace throughout 2017, and as of September 2018 the unemployment rate had declined to a 49-year low. Nonfarm payroll employment added 208,000 jobs per month, on average, over the first nine months of 2018, stepping up from the 182,000 average monthly pace in 2017. In September the unemployment rate declined to 3.7 percent, the lowest rate since 1969. Other measures of labor market conditions continue to improve: there are signs of faster growth in wages, and broader measures of unemployment continue to trend lower.

Measures of consumer mood are at, or very near, multi-year highs according to recent surveys, with households continuing to express positive views about current and future economic conditions. Compensation growth continues to firm on a gradual basis: average hourly earnings for production and nonsupervisory workers rose 2.7 percent over the twelve months through September 2018, faster than the 2.6 percent, year-earlier pace, and also stepping up from the rates that prevailed from 2011 through 2015. Total compensation costs for civilian workers advanced 2.8 percent over the four quarters ending in June 2018, 0.5 percentage point higher than the year-earlier pace. Moreover, the debt-service ratio facing households is near historical lows, and household net worth stands at a record high.

Business activity and investment have continued to accelerate this year, building on last year's solid gains. According to the most recent survey of the Institute for Supply Management (ISM) in September, the composite index for the manufacturing sector signaled brisk growth, standing just below the 14-year high reached in August. Fifteen of 18 industries reported expansion, while only three industries reported contraction. The ISM's non-manufacturing index also pointed to faster expansion in the services sector in September, climbing to its highest level in over 20 years. After several weak quarters in 2015 and early 2016, business fixed investment has firmed noticeably over the past eighteen months, rising by 10.1 percent during the first half of 2018, after growing by 4.1 percent in the latter half of 2017 and by 8.4 percent during last year's first half.

Although headline inflation continues to accelerate, it remains moderate by historical standards. The consumer price index (CPI) for all items rose 2.3 percent over the twelve months through September 2018, faster than the 2.2 percent rate seen over the year through September 2017. Growth in the core CPI (which excludes food and energy prices) moved up to 2.2 percent over the year through September 2018, above the 1.7 percent rate seen over the year through September 2017.

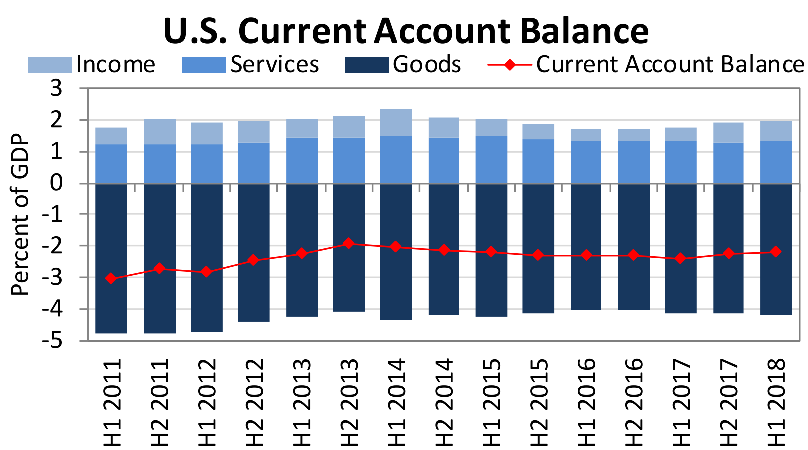
Fiscal Policy and Public Finances

In December 2017, the United States enacted the first major re-write of the U.S. tax code in three decades. The new tax code is designed to markedly strengthen incentives for business investment and to deliver tax relief to middle income households. The new tax law lowered the U.S. corporate tax rate from one of the highest in the developed world to near the average of other advanced economies; it allows businesses to immediately deduct 100 percent of the cost of most of their new capital investments for the next five years; and it delivers relief to working families through lower income tax rates, a larger standard deduction, and an expanded child tax credit. Combined with regulatory reforms and infrastructure initiatives, tax reform is expected to encourage people to start new businesses, draw more workers into the labor market, and support a sustained increase in productivity.

The Administration estimates that in FY 2018 the federal government budget deficit was $779 billion (3.9 percent of GDP), up from $666 billion (3.5 percent of GDP) in FY 2017. Under the Administration's budget proposals, the federal deficit over the next five years (FYs 2019 to 2023) would total $5.1 trillion (4.4 percent of GDP on average). However, the Administration expects that implementation of its budget proposals – including cuts to non-defense discretionary spending, elimination of the Affordable Care Act, and reform of multiple welfare programs – would gradually decrease the deficit to $539 billion (1.6 percent of GDP) by FY 2028. The Administration expects debt held by the public to rise from an estimated 78 percent of GDP ($15.8 trillion) in FY 2018 to a peak near 83 percent of GDP in FY 2022, before gradually declining to 75 percent of GDP by FY 2028.

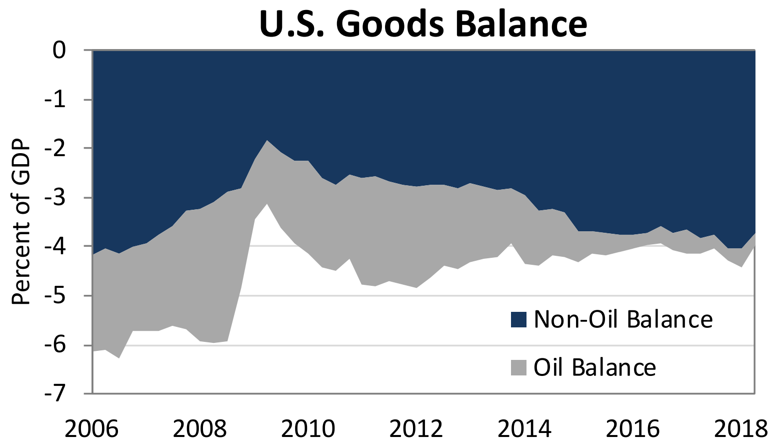
U.S. Current Account and Trade Balances

The U.S. current account was in deficit by 2.2 percent of GDP in the first half of 2018, broadly similar to its level in the second half of 2017 and slightly narrower than the 2.4 percent of GDP current account deficit over the same period a year earlier. While the goods trade deficit has expanded slightly in nominal terms (increasing $26 billion in the first half of 2018 compared to the same period a year earlier), it has been relatively steady as a share of GDP. The wider goods deficit has also been partly offset by a small rise in the services trade surplus (up $10 billion year-over-year in the first half of 2018).



Sources: Bureau of Economic Analysis, Haver

After narrowing in the post-crisis era to just below 2 percent of GDP in the second half of 2013, the headline U.S. current account deficit has been quite stable since 2015 in the ballpark of 2–2½ percent of GDP. Similarly, the goods trade balance has been relatively stable in recent years, in the range of 4–4½ percent of GDP. But significant shifts have occurred within the goods balance. The U.S. petroleum deficit has fallen to its lowest level in decades and has been steadily below 0.5 percent of GDP since the second half of 2015 as domestic production has expanded, compressing net petroleum imports. The non-oil goods deficit, by comparison, has been widening and now stands close to 4 percent of GDP. In general over the last few years, the widening non-oil goods deficit reflected strong import growth and relatively stagnant export growth, likely an effect of the broad strengthening of the dollar from mid-2014 to early 2017 alongside relatively stronger domestic demand growth in the United States compared to major trading partners in recent years. This picture has shifted slightly in 2018, however: while goods imports have continued to expand, U.S. goods exports have picked up in recent quarters, with non-oil goods exports more than 7 percent higher year-over-year in the first half of 2018.

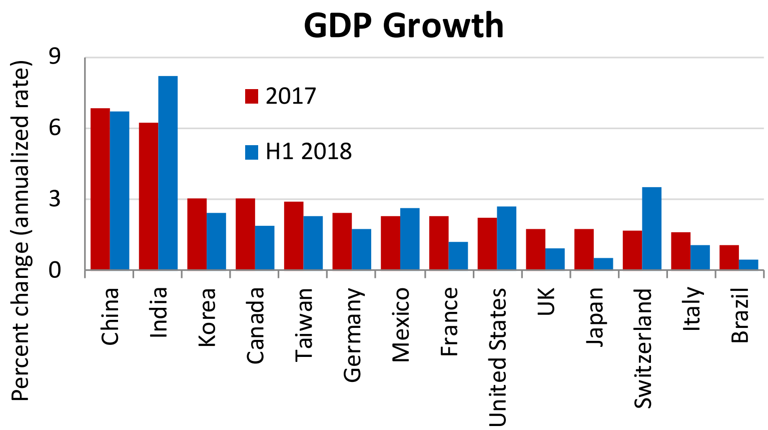


Source: Bureau of Economic Analysis

At the end of the second quarter of 2018, the U.S. net international investment position stood at a deficit of $8.6 trillion (42.3 percent of GDP), a deterioration of more than $900 billion compared to end-2017. The value of U.S.-owned foreign assets was $27.1 trillion, while the value of foreign-owned U.S. assets stood at $35.7 trillion. Recent deterioration in the net position has been due in part to valuation effects from an appreciating dollar that lowered the dollar value of U.S. assets held abroad, as well as the relative underperformance of foreign equity markets compared to U.S. stock markets in 2018.

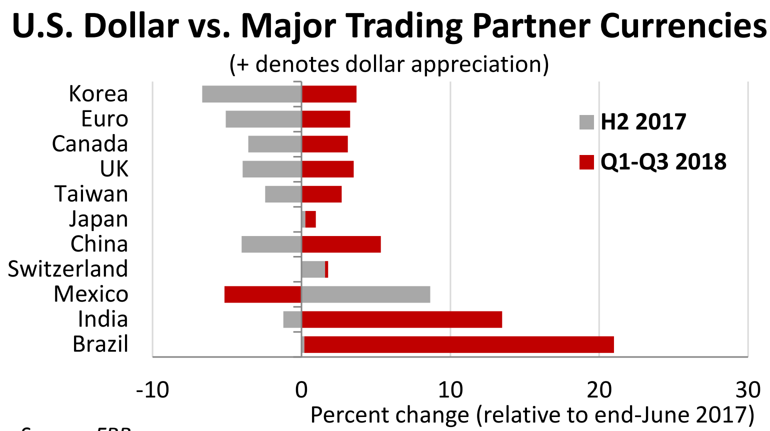
International Economic Trends

After a synchronized upswing across the global economy in 2017, global growth has become more uneven and less broad-based over the first half of 2018. Growth in advanced economies outside the United States has generally disappointed, with output growth across the euro area, Japan, and the United Kingdom stepping down from its 2017 level. Among emerging markets, both China and India continue to expand robustly, though in China there are signals that real activity may be slowing. Many other emerging markets, meanwhile, have come under pressure as rebounding commodity prices, rising U.S. interest rates, and shifts in investor sentiment have interacted with preexisting weaknesses and led to bouts of financial volatility, weighing on growth prospects. According to the IMF's October 2018 WEO, global growth is expected to be broadly stable at 3.7 percent over 2018 and 2019, similar its 2017 level. However, the outlook for several key advanced and emerging market economies has been marked down, and risks are tilted to the downside as uncertainty and recent lackluster growth among several large economies suppress medium-term prospects.



Note: H1 2018 for China and India based off Q2/Q2 NSA data.
Sources: National Authorities, Haver

Foreign Exchange Markets

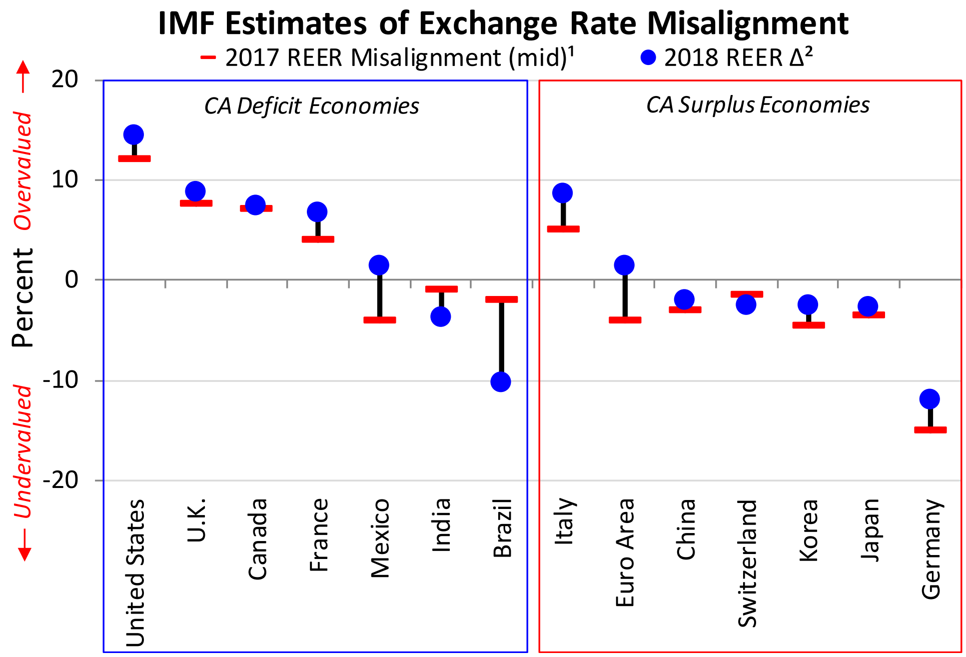


Source: FRB

The U.S. dollar appreciated 5.6 percent on a nominal effective basis over the first three quarters of 2018, retracing most of its decline over 2017 and approaching its peak levels in the post-crisis period. The dollar has strengthened broadly against a variety of advanced economy and emerging market currencies. Notably, the Brazilian real, pound sterling, renminbi, and euro faced sizable depreciation vis-à-vis the dollar amidst uncertainty surrounding the Brazilian economic outlook, Brexit, U.S.-China trade-related risks, and flagging European growth signals. Strong U.S. growth and the divergence in monetary policy of major economies also has played a role in currency movements, as relatively higher interest rates in the United States have attracted capital flows and put upward pressure on the dollar.

Of concern, the dollar is strengthening at a time when the IMF judges that the dollar is moderately overvalued on a real effective basis. Over the first three quarters of 2018, the dollar appreciated by 4.7 percent in real effective terms and now stands around 6 percent above its 20-year average. Continued dollar strength would likely exacerbate persistent trade and current account imbalances.

Notwithstanding recent broad dollar strength, a few key currencies have strengthened in nominal effective and real effective terms due to appreciation relative to their non-U.S. trading partners. Most notably, the euro has risen on a real effective basis in 2018 in a manner that helps correct for the undervaluation the IMF assessed for 2017. However, aside from the euro, real effective exchange rates across the United States' major trading partners have generally not moved in a direction that corrects for pre-existing misalignments.



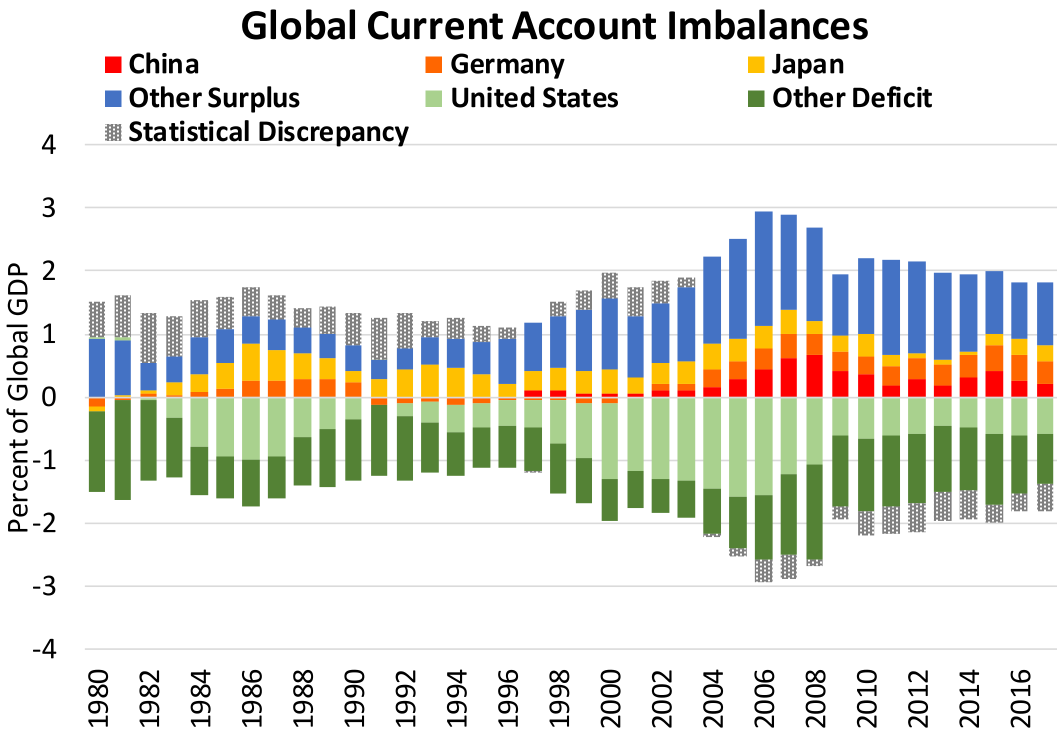
Sources: IMF 2018 External Sector Report, BIS REER Indices, and FRB
1/The IMF's estimate of real effective exchange rate (REER) misalignment (expressed as a range) compares the country's average REER in 2017 to the level consistent with the country's medium-term economic fundamentals and desired policies. The midpoint of the misalignment range is depicted above.
2/Change through August 2018 versus 2017 average.
Note: The IMF does not provide an estimate of Taiwan's REER misalignment.

Treasury judges that foreign exchange markets have continued to function smoothly in recent months, including as the Federal Reserve raised its interest rate corridor (in March, June, and September this year) and continued reducing the size of its balance sheet. The dollar continues to be the world's principal currency in international foreign exchange markets, reflecting its dominant global position both in terms of market turnover (being bought or sold in 88 percent of all currency trades) and trade settlement.[6]

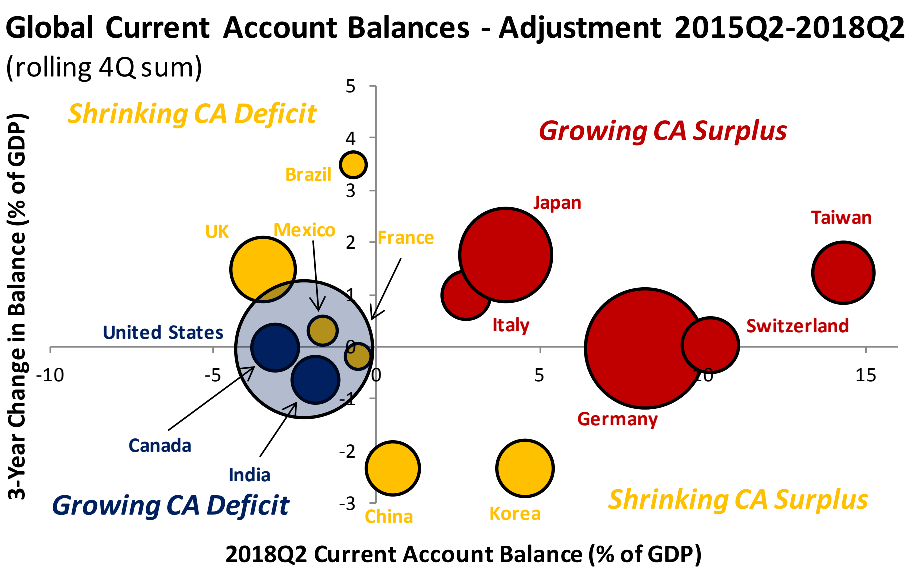
Global Imbalances

Global current account imbalances remain large. Imbalances narrowed slightly to 1.8 percent of global GDP in 2017, but from a historical perspective, imbalances had not reached 2 percent of global GDP prior to 2000. Persistent and concentrated imbalances have characterized the post-crisis landscape, particularly in the surplus economies of Asia and northern Europe. In part, this has reflected a rotation of surpluses from oil exporting economies (as global energy prices fell) into oil-importing industrial economies. The persistence of imbalances has also reflected relative real exchange rates – as noted in the previous section – with the dollar being relatively strong in historical terms since mid-2014.

[6] Currency market turnover according to the 2016 Bank for International Settlement *Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives*.



Sources: IMF WEO, Haver



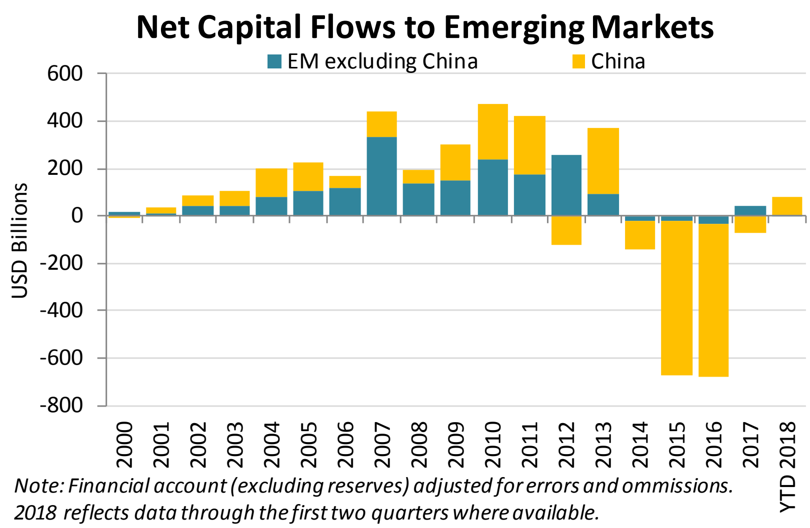
Sources: Haver, IMF WEO, National Authorities
Note: Size of bubble is relative to share of global imbalances

Over the last three years, the majority of the United States' major trading partners have seen current account imbalances widen – as has the United States – though there are some exceptions. China's current account surplus has narrowed markedly, though its merchandise trade surplus remains large and researchers have raised questions about measurement issues that could cause the reported current account balance to be understated. Korea's surplus has also narrowed somewhat from recent peak levels. But several European economies, as well as Japan and Taiwan, have seen external surpluses grow.

Imbalances have been sustained by the asymmetric composition of growth across key economies: Asian and European economies, where persistent surpluses are concentrated, relied heavily on positive contributions from net exports to drive growth between 2010 and 2015. More recently, gross capital formation in several of these economies has been stagnant with no downward adjustment to national saving, particularly in Germany, Japan, and Switzerland. Growth in North and Latin America since the crisis, by comparison, has been led by domestic demand, with the strengthening of U.S. demand being central to the recent global growth uptick. In order to reduce the risk of a future adjustment in external balances that weighs on global growth, major economies must put in place a more symmetric rebalancing process that entails all economies carrying a share of the adjustment.

Capital Flows

Financial turbulence in key emerging market economies in 2018 had broader spillovers and – coupled with rising U.S. interest rates that attracted capital flows into the United States – led foreign portfolio flows to emerging markets (excluding China) to fall off over the first half of 2018, with flows turning negative in the second quarter. Higher frequency data (from sources beyond quarterly balance of payments data) suggest that economies with relatively weak domestic fundamentals have experienced the largest and most sustained foreign portfolio outflows, particularly of portfolio debt. During the first two quarters of 2018, net portfolio flows in emerging markets (ex-China) totaled -$114 billion (based on data available through mid-October), declining by about $176 billion relative to the same period in 2017, with several emerging markets experiencing sustained portfolio outflows. Foreign direct investment to emerging markets, on the other hand, remained stable and positive in 2018, effectively counterbalancing net portfolio outflows. Overall, net capital flows to emerging markets (ex-China) were slightly positive, as in 2017, well below the levels typically witnessed a few years ago.



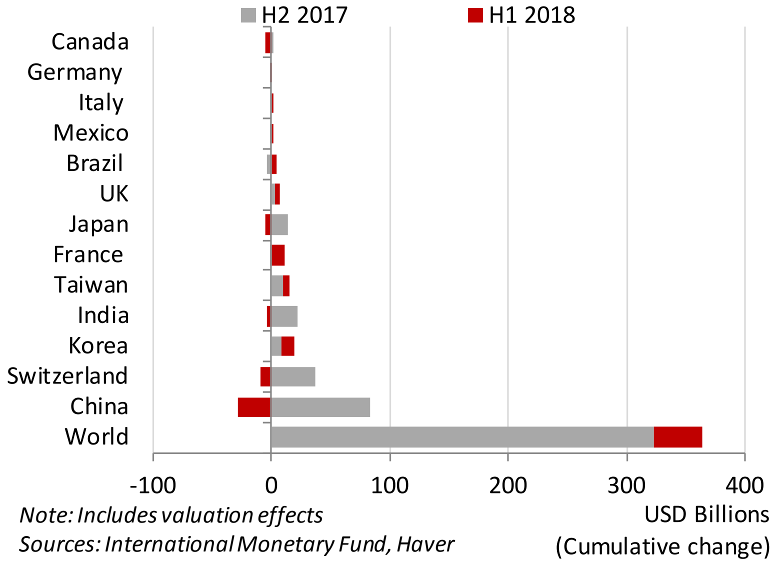
Note: Financial account (excluding reserves) adjusted for errors and ommissions. 2018 reflects data through the first two quarters where available.
Source: National Authorities, U.S. Department of the Treasury Staff Calculations

In China, stronger-than-expected domestic growth, tighter capital controls, and a more balanced renminbi outlook helped stem resident outflows while boosting foreign inflows during 2017, reversing a two-year trend of sizable net capital outflows. Since end-2017, domestic outflows have remained relatively modest while foreign direct and nonresident portfolio investment flows continue to pick up. Relative to the same period last year, net portfolio flows for the first two quarters increased by $91 billion, while net direct investment increased by $66 billion.

Foreign Exchange Reserves

Global foreign currency reserves have been broadly stable this year, with headline reserves now close to $11.5 trillion, up $41 billion over the first half of the year. After valuation changes pushed up headline reserve levels in the second half of 2017, the rise in the dollar in 2018 has weighed on the dollar value of global reserve stocks, with some net reserve accumulation over the first half of 2018 acting to keep headline reserves rising slightly. The increase in global reserves over the last year continues to reverse the $1.3 trillion decline in reserves witnessed between mid-2014 and the end of 2016 that was associated with many economies' reserve asset sales to stem or slow local currency depreciation.

Change in Foreign Currency Reserves



Note: Includes valuation effects
Sources: International Monetary Fund, Haver

Table 1: Foreign Exchange Reserves

	FX Reserves (% of GDP)	FX Reserves (% of ST debt)	FX Reserves (months of imports)
Switzerland	107%	68%	24.3
Taiwan	78%	257%	16.9
Korea	24%	324%	7.9
Japan	24%	42%	16.7
China	23%	279%	16.1
Brazil	18%	606%	19.4
India	14%	373%	7.9
Mexico	14%	331%	4.3
UK	4%	2%	1.8
Canada	4%	11%	1.5
Italy	2%	4%	0.8
France	2%	2%	0.7
Germany	1%	2%	0.3

Foreign exchange reserves as of Jun 2018.
Sum of rolling 4Q GDP through Q2-2018.
Short-term debt consists of gross external debt with original maturity of one year or less, as of the end of Q1-2018.
Sum of rolling 4Q imports of goods and services through Q1-2018.
Sources: National Authorities, World Bank, IMF

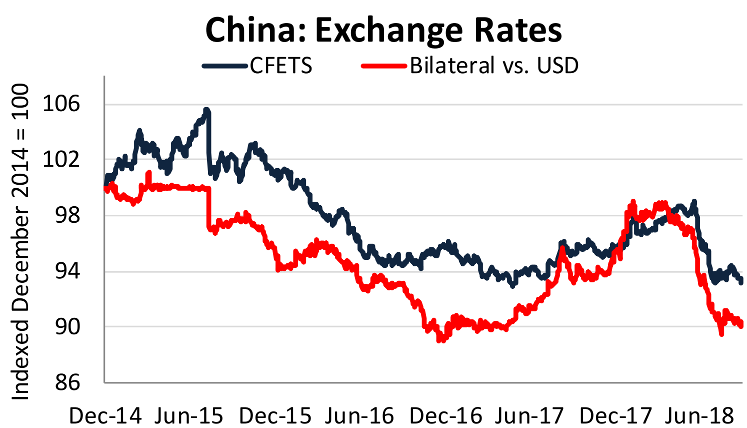
The economies covered in this Report continue to maintain ample – or more than ample – foreign currency reserves compared to standard adequacy benchmarks. Reserves in most economies are more than sufficient to cover short-term external liabilities and anticipated import costs. Excessive reserve accumulation imposes costs both on the local economy (in terms of sterilization costs and foregone domestic investment) and the world. Economies should focus on enhancing resilience through stronger policy frameworks, as recommended by the IMF, rather than through continued reserve accumulation.[7]

Economic Developments in Selected Major Trading Partners

China

China's trade surplus with the United States continues to be the largest trade imbalance across the United States' major trading partners, with the goods trade surplus growing to a record level of $390 billion over the four quarters through June 2018. While U.S. goods exports to China have risen (to $135 billion over the four quarters through June 2018, up $12 billion from the same period 12 months prior), goods imports have increased more (up $45 billion year-over-year to $525 billion over the four quarters through June 2018). The U.S. services trade surplus with China held steady near $20 billion over the first half of 2018, after totaling $40 billion in 2017.

Treasury remains deeply concerned by this excessive trade imbalance which is exacerbated by persistent non-tariff barriers, widespread non-market mechanisms, the pervasive use of subsidies, and other unfair practices which increasingly distort China's economic relationship with its trading partners. Treasury urges China to create a more level and reciprocal playing field for American workers and firms, implement macroeconomic reforms that support greater consumption growth, reduce the role of state intervention, and allow a greater role for market forces. It is in China's interest to implement measures that would reduce the bilateral trade imbalance.

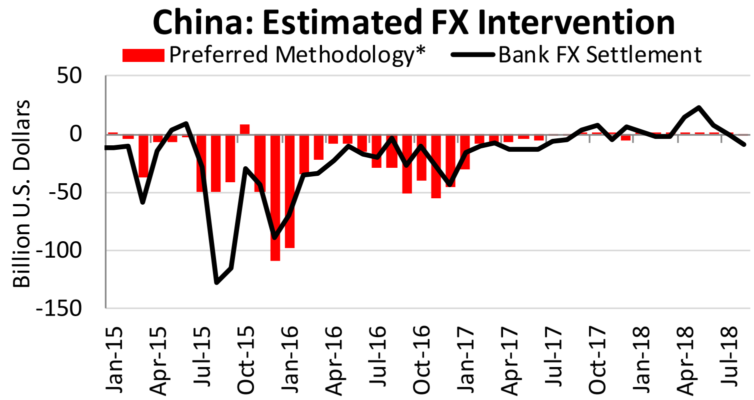


Sources: CFETS, Bloomberg

Recent movements in China's currency have not been in a direction that will help reduce China's large trade surplus. Since mid-June, the RMB has weakened more than 7 percent versus the dollar and close to 6 percent against the CFETS nominal basket. Treasury staff estimate China's direct intervention in the foreign exchange market to have been limited this year, including in recent months when the RMB was depreciating. After accounting for valuation effects, Treasury staff estimate net foreign exchange intervention by the People's Bank of China (PBOC) to be effectively neutral year-to-date. Broader measures that proxy for intervention suggest that foreign exchange purchases by financial entities beyond PBOC –

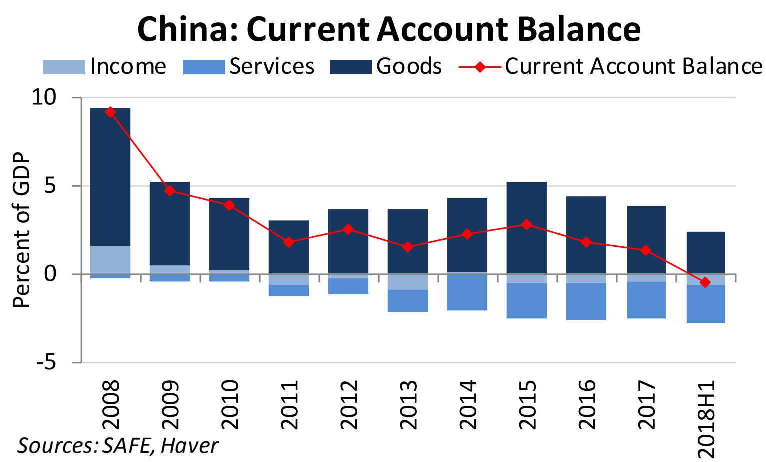
[7] International Monetary Fund, 2011, "Assessing Reserve Adequacy," IMF Policy Paper, February (Washington: International Monetary Fund).

notably state banks – increased in April and May, totaling close to $45 billion in the second quarter. Since the summer, authorities have reportedly used a few different tools to stem depreciation pressures including implementing administrative measures and influencing daily central parity exchange rate levels, including through reintroduction of a countercyclical adjustment factor. Alternatively, Treasury staff estimate that the PBOC has refrained from intervention to counter depreciation pressures. The same broader measure that indicated foreign exchange was purchased by entities beyond PBOC in the second quarter showed that there were foreign exchange sales of around $10 billion by the same set of entities in August.



Sources: PBOC, SAFE, U.S. Treasury Estimates
**Based on change in FX-denominated assets on PBOC balance sheet*

Treasury continues to place considerable importance on China adhering to its G-20 commitments to refrain from engaging in competitive devaluation and to not target China's exchange rate for competitive purposes. Treasury also strongly urges China to provide greater transparency of its exchange rate and reserve management operations and goals.



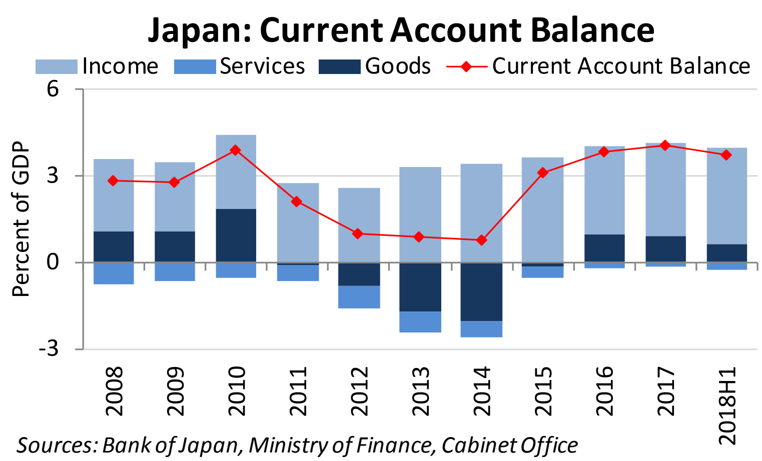
Sources: SAFE, Haver

China's overall balance of payments situation has generally stabilized since the second half of last year, with foreign exchange reserves steadying (at around $3.1 trillion), and financial and capital outflows slowing. Recent RMB depreciation has not been accompanied by capital outflow pressures, which have fallen substantially this year compared to the period from late 2015 to early 2017. Treasury estimates that, in the first half of this year, net outflows (excluding flows accounted for by trade and direct investment) totaled around $10 billion, markedly lower than $160 billion in the first half of 2017 or the $290 billion in the year prior. This moderation in net Chinese resident capital outflows was aided by relatively tighter capital control measures, in addition to an uptick of inflows into Chinese financial assets. Nonetheless, the persistent presence of sizeable net errors and omissions, which have been negative for seventeen consecutive quarters, could suggest continued undocumented capital outflows. Meanwhile, China's current account surplus over the four quarters through June 2018 totaled $68 billion, with a large goods surplus continuing to offset deficits in the services trade and the income balance.[8]

High-frequency indicators suggest economic activity has decelerated in 2018 as authorities have pursued the needed deleveraging campaign to address financial stability risks. Officially reported real GDP growth fell slightly to 6.7 percent in the second quarter compared to 6.8 percent in the first quarter on a year-over-year basis, with overall consumption as the largest contributor. Going forward, structural reforms that durably open China's economy to U.S. goods and services, alongside efforts to reduce state intervention, allow a greater role for market forces, and strengthen household consumption growth would provide more opportunities for American firms and workers to compete in Chinese markets and facilitate a more balanced economic relationship between the United States and China.

Japan

Japan's current account surplus remained elevated over the four quarters through June 2018 at 4.0 percent of GDP, up from a surplus of 3.8 percent of GDP for the same period 12 months prior. The large current account surplus continues to be driven primarily by high net foreign income, which accounted for over 90 percent of the overall surplus in the first half of 2018. Many past years of surpluses have produced sizable net foreign assets: Japan's net international investment position stood at 64 percent of GDP in 2017, the highest in the G-7, and the IMF projects it will rise to 77 percent of GDP in the medium term, suggesting sizable net foreign income flows for years to come. These foreign income flows are potential spendable income that could be used to bolster demand growth and help reduce Japan's sizeable current account surplus.

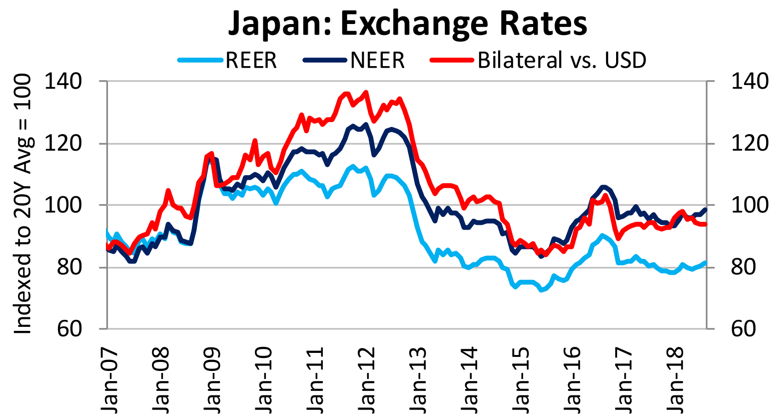


Sources: Bank of Japan, Ministry of Finance, Cabinet Office

Japan's goods trade surplus with the United States over the four quarters through June 2018 was $70 billion, broadly stable relative to the same period 12 months prior. The United States has a small surplus in services trade with Japan ($12 billion over the four quarters though June 2018), offsetting a small portion of the large goods trade imbalance.

[8] There is evidence that China's deficit in services trade has been overstated by as much as 1 percent of GDP, with the actual current account balance being higher by a corresponding amount. See Wong, Anna (2017). "China's Current Account: External Rebalancing or Capital Flight?" International Finance Discussion Papers 1208. Board of Governors of the Federal Reserve System (U.S.).

Treasury remains concerned by the persistence of the large bilateral trade imbalance between the United States and Japan.



Sources: Bank of Japan, Bank for International Settlements

Safe-haven inflows amid heightened geopolitical tensions likely played a role in the 6.1 percent appreciation of the yen versus the dollar from January through end-March. From end-March through mid-July the yen depreciated around 6 percent against the dollar, predominantly reflecting broad dollar appreciation over the period. As of end-September, it stood 0.7 weaker against the dollar year-to date. On a real effective basis, the yen has been relatively stable and remains near the historically weak levels it has hovered around since the first half of 2013.

Japan publishes its foreign exchange intervention. Japan has not intervened in foreign exchange markets since 2011.

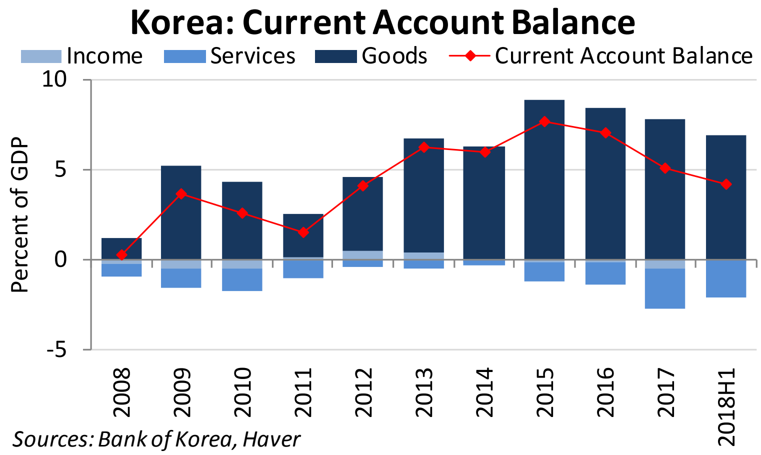
After weak growth in Q4 2017 and Q1 2018, growth rebounded in Q2 2018 to 3.0 percent annualized. Private final consumption and domestic fixed capital formation remain volatile, while the growth impulse from net exports has declined relative to 2016 and 2017.

After peaking at 1.5 percent year-on-year in February, CPI inflation has moderated somewhat, and stood at 1.3 percent year-on-year as of August. The Bank of Japan (BOJ) has maintained a policy of "Quantitative and Qualitative Easing with Yield Curve Control" since September 2016. The BOJ maintains the overnight policy rate at negative 10 basis points and purchases Japanese Government Bonds so that the 10-year yield remains "around" zero percent. In its July Monetary Policy meeting, the BOJ announced that it would increase the flexibility of its asset purchase program, reduce the size of account balances subject to negative interest rates, and allow more movement in the 10-year yield around its zero percent target. It also provided forward guidance that "the Bank intends to maintain the current extremely low levels of short- and long-term rates for an extended period of time" citing the need to monitor economic developments, including the impact of the increase in the consumption tax slated for 2019. Following this announcement, the BOJ purchased $3.6 billion in 5- to 10-year Japanese government bonds to stem a selloff that saw the 10-year yield touch an 18-month high of 0.15 percent.

Looking forward it will be important that the Japanese authorities continue with their structural reform agenda to entrench stronger growth, while ensuring the sustainability of public finances. In the context of the proposed consumption tax hike slated for fall of 2019, the authorities should ensure the contemplated offsets will be sufficient in both magnitude and design to sustain economic growth.

Korea

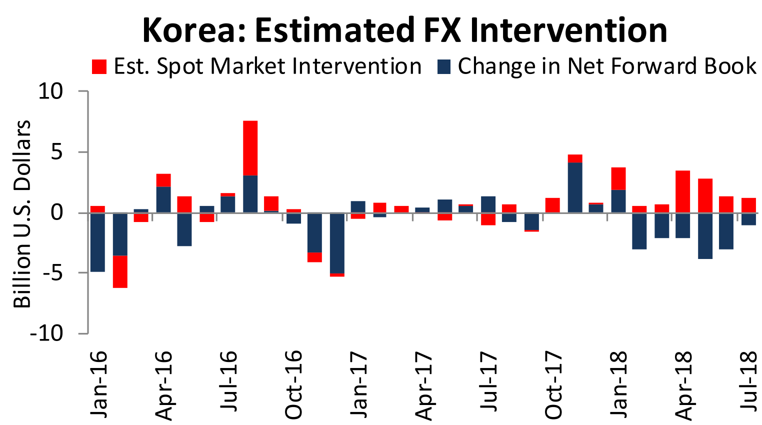
After peaking at close to 8 percent of GDP in 2015, Korea's current account surplus has been gradually narrowing, reaching 4.2 percent of GDP in the first half of 2018. The decline in the current account has been largely due to a widening of Korea's services trade deficit. Korea's overall goods trade surplus has also moderated somewhat, though it remains high at around 7 percent of GDP. The IMF in its most recent analysis continued to describe Korea's current account surplus as moderately stronger than justified by economic fundamentals.



Sources: Bank of Korea, Haver

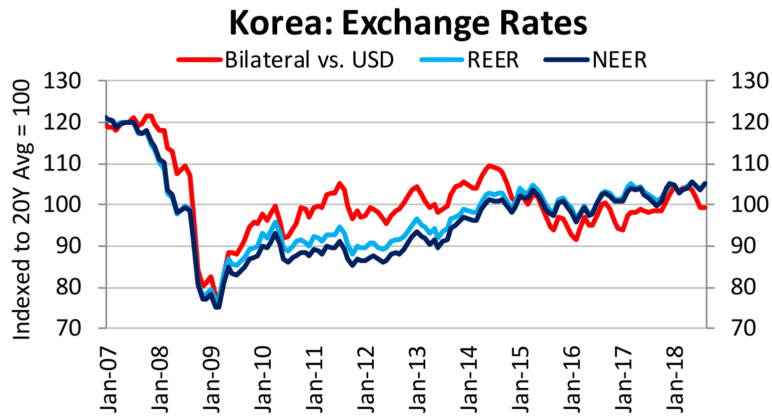
Korea's goods trade surplus with the United States stood at $21 billion over the four quarters through June 2018, down from a peak of $28 billion in 2015. The United States has a surplus in services trade with Korea, at $14 billion over the four quarters through June 2018.

Korea does not yet publish its foreign exchange market intervention. Korean authorities announced earlier this year that they would begin disclosing intervention data in early 2019. Treasury estimates that between July 2017 and June 2018 Korean authorities made net purchases of foreign exchange of $4.1 billion (0.3 percent of GDP), including activity in the forward market. Net purchases were concentrated in November 2017 and January 2018 (around $9 billion), a period when the won was appreciating both against the dollar and on a real effective basis. Appreciation against the dollar reversed in January, and the won has depreciated roughly 6 percent to date in 2018 against the dollar, while appreciating by 0.2 percent on a real effective basis as of August. Net intervention since January, meanwhile, has been relatively modest, with a decline in the Bank of Korea's net forward position largely offset by estimated spot market purchases.



Sources: Bank of Korea, U.S. Treasury estimates

The IMF has considered the Korean won to be undervalued every year since 2010, and in its most recent evaluation considered the won to be undervalued by 2-7 percent. Korea has well-developed institutions and markets and should limit currency intervention to only truly exceptional circumstances of disorderly market conditions. Korea maintains ample reserves at $390 billion as of June 2018, equal to more than three times gross short-term external debt and 24 percent of GDP. Treasury will be closely monitoring authorities' plans to begin reporting foreign exchange intervention in a more transparent and timely manner.



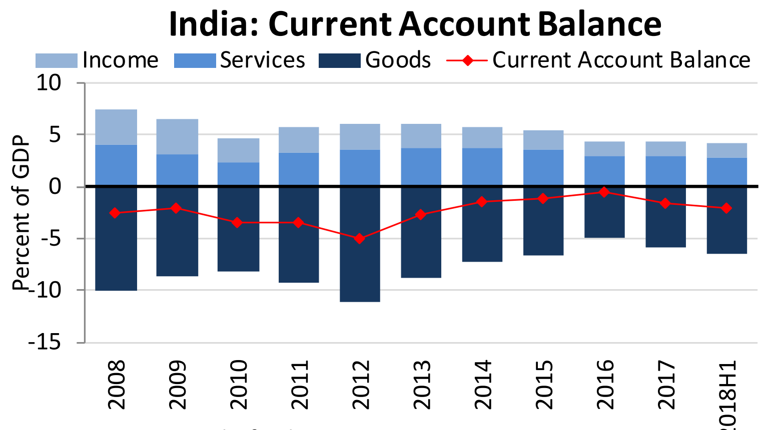
Sources: Bank of Korea, Bank for International Settlements

Though Korea's external position has adjusted somewhat since the peak of the current account surplus in 2015, there remains scope for policy reforms that would support a more durable strengthening of domestic demand. Korea was strongly reliant on external demand in the first few years after the global financial crisis, with net exports accounting for more than one-third of cumulative growth over 2011-2014. Domestic demand growth has generally been stronger since 2015, averaging above 4 percent annually, though it stepped down in the first half of 2018 and the outlook for domestic demand growth going forward is also clouded by elevated household debt.

In order to decisively rebalance the economy and further reduce the still-large trade and current account surpluses, Korea will need to have a sustained period in which domestic growth exceeds overall GDP growth. Korea maintains sufficient policy space to support domestic demand, particularly as public sector debt remains relatively low at around 40 percent of GDP. Recent policy proposals appear to be a step in the right direction: the Korean authorities' 2019 budget calls for a 9.7 percent increase in fiscal spending next year, which would be the highest increase in a decade. Proposed expenditures would enhance the social safety net through subsidies for hiring young and elderly workers and initiatives to increase female employment and childcare. The impact of these measures could be enhanced by extending their duration and better targeting them at those living below the poverty line, while pairing them with more comprehensive labor market reforms that reduce restrictions on laying off regular workers and incentivize hiring non-regular workers. Structural fiscal reforms to support household consumption could also be particularly helpful to raise domestic demand and avoid reliance on net exports to drive growth going forward.

India

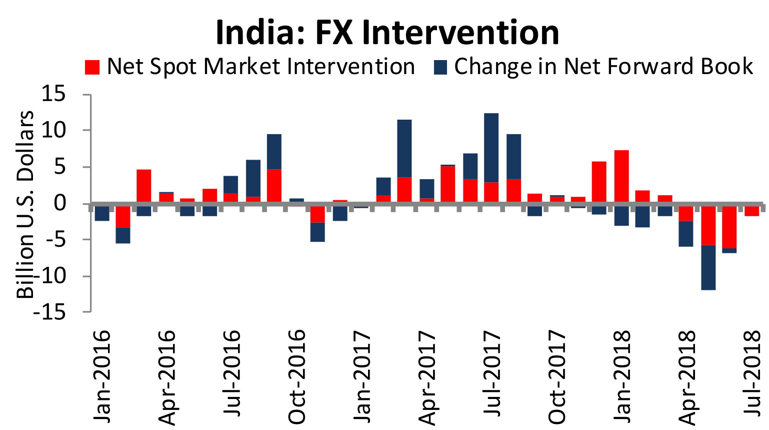
India's current account deficit widened in the four quarters through June 2018 to 1.9 percent of GDP, following several years of narrowing from its 2012 peak. The current account deficit has been driven by a large and persistent goods trade deficit, which has in turn resulted from substantial gold and petroleum imports. The goods trade deficit has widened out in the first half to 6.4 percent of GDP as oil prices have risen. The IMF projects the current account deficit to be around 2.5 percent of GDP over the medium term as domestic demand strengthens further and favorable growth prospects support investment.



Sources: Reserve Bank of India

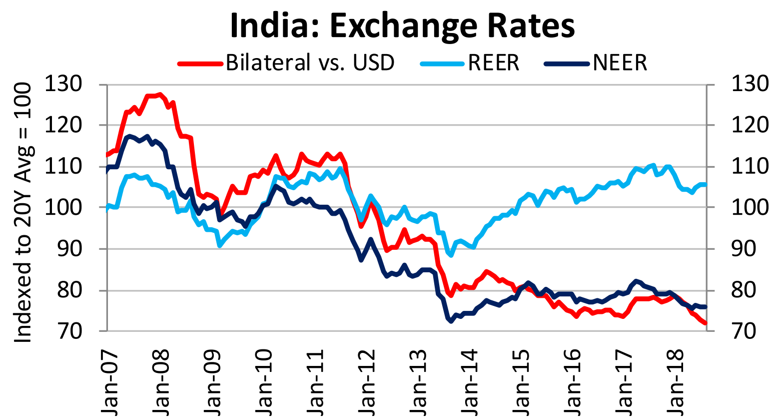
India's goods trade surplus with the United States was $23 billion for the four quarters through June 2018. India also had a small surplus in services trade with the United States of $4 billion over the same period. India's exports to the United States are concentrated in sectors that reflect India's global specialization (notably pharmaceuticals and IT services), while U.S. exports to India are dominated by key service trade categories, particularly travel and higher education.

India has been exemplary in publishing its foreign exchange market intervention. The Reserve Bank of India (RBI) has noted that the value of the rupee is broadly market-determined, with intervention used only during "episodes of undue volatility." According to the authorities' data, India was generally a net purchaser of foreign exchange from late 2013 to the middle of 2017, as the RBI sought to gradually build a stronger external buffer in the aftermath of the May 2013 "taper tantrum." Purchases accelerated in the first half of 2017 amidst strong portfolio inflows to India (and many other emerging markets); as a result, cumulative net purchases of foreign exchange exceeded 2 percent of GDP over 2017.



Source: Reserve Bank of India

Foreign exchange purchases generally declined in the second half of 2017, and the RBI shifted to selling foreign exchange in the first half of 2018. Net purchases of foreign exchange over the past four quarters through June totaled $4 billion (0.2 percent of GDP), including activity in the forward market. Sales of foreign exchange in the first half of this year came in the context of foreign portfolio outflows of $7 billion, as India experienced outflows (particularly of foreign portfolio debt) that were witnessed across many emerging markets in the second quarter. This mirrored the pattern of the last few years, in which intervention has typically tracked institutional portfolio flows. India maintains ample reserves according to IMF metrics for reserve adequacy, particularly given that India maintains some controls on both inbound and outbound flows of private capital. As of June 2018, foreign currency reserves stood at $380 billion, equal to 3.7 times gross short-term external debt, 8 months of import cover, and 14 percent of GDP.[9]



Sources: Reserve Bank of India, Bank for International Settlements

The rupee depreciated 7 percent against the dollar in the first half of the year, while the real effective exchange rate also reversed its general uptrend from the last few years, depreciating by 4 percent. In its most recent analysis, the IMF assessed the real effective exchange rate to be in line with economic fundamentals. The RBI's most recent annual report assessed the rupee to be "closely aligned to its fair value over the long term."

The Euro Area and Germany

Euro area GDP growth moderated this year after posting its strongest overall performance in a decade in 2017, but the economy continues to exhibit broad-based output growth across both countries and sectors. While the aggregate euro area output gap has been narrowing, the cyclical positions of individual member economies within the currency union remain divergent due to the legacies of the euro area crisis. Further, trend growth also varies widely across member countries, due in part to structural differences that affect competitiveness. These dynamics have weighed on the value of the euro, making the euro's exchange rate appear undervalued for some of the strongest-performing individual member countries in the currency union (e.g., Germany).

The euro depreciated by 3.5 percent against the dollar year-to-date through the end of August, but it has strengthened in 2018 on both a nominal effective and real effective basis, by 3.5 percent and 2.6 percent, respectively. Recent movements leave the euro still on the weaker side of longer-term trends: The euro is about 1 percent below its 20-year average in real effective terms and around 4 percent weaker on a nominal bilateral basis against the dollar versus its 20-year average. The weakness of the euro is a multi-year phenomenon, spurred initially by concerns about the resilience of the monetary union in the midst of the regional crisis and sustained more recently by monetary policy. The ECB's quantitative easing and negative interest rate policy opened a sizable gap in bond market yields between the euro area and other advanced economies, which has contributed to the euro's weakness versus its historical level in recent years. The euro area's improved economic performance helped support the common currency in 2017, but downside growth surprises and political uncertainty have weighed on the currency in recent months.

[9] Gross short-term external debt reflects external debt with remaining maturity of one year or less, as reported by the Joint External Debt Hub.

The ECB publishes its foreign exchange intervention, and has not intervened unilaterally in over 15 years.

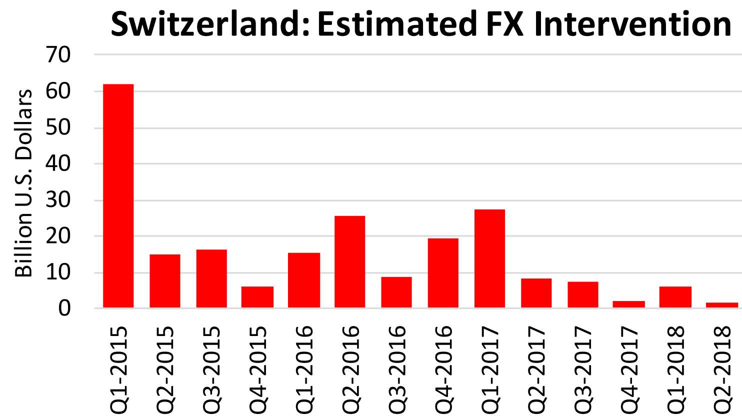
Germany's current account surplus has been the largest in the world in nominal terms since 2016, standing at $329 billion over the four quarters through June 2018 (equivalent to 8.2 percent of GDP). German economic policies supporting high domestic saving and low consumption and investment have pushed up Germany's current account surplus, with lower oil prices also supporting the external position since 2014. Over the long run, there has been a meaningful divergence between German domestic inflation and wage growth and (faster) average euro area inflation and wage growth. This has contributed to a general rise in Germany's competitiveness vis-à-vis its euro area neighbors. However, given the wide dispersion of economic performance across the euro area, the euro's nominal exchange rate has not tracked this rise in German competitiveness. Consistent with this, the IMF estimates that Germany's external position remains substantially stronger than implied by economic fundamentals, and Germany's real effective exchange rate undervalued by 10-20 percent. Further, with other euro area member countries implementing reforms to rebalance their economies and reduce external deficits, the strength of Germany's external position is impacting the external balance of the euro area overall: The IMF for the first time this year assessed the euro area as a whole to have an external position moderately stronger than the level implied by economic fundamentals.

A number of German economic policies have restrained domestic consumption and investment, including elevated labor and value-added taxes and strict fiscal rules. Growth was strongly supported by net exports for several years following the crisis, which led to a substantial widening of the current account surplus. Since 2015, growth has been more balanced, with German domestic demand largely accounting for growth over the last three years. This has helped stall the growth in the current account surplus, but it has not been sufficient to appreciably reduce external imbalances. Demand growth needs to accelerate substantially for a sustained period for external rebalancing to proceed at a reasonable pace, which would be supported by growth-friendly tax and other policy reforms.

Germany's bilateral trade surplus with the United States is excessive and a matter of significant concern. Treasury recognizes that Germany does not exercise its own monetary policy and that the German economy continues to experience strong gains in employment. Nevertheless, Germany has a responsibility as the fourth-largest economy globally and as an economy with a very large external surplus to contribute to more balanced demand growth and to more balanced trade flows. Allowing an increase in domestic demand against relatively inelastic supply should help push up wages, domestic consumption, relative prices against many other euro area members, and demand for imports; and higher relative prices would help appreciate Germany's undervalued real effective exchange rate. This would contribute to both global and euro area rebalancing.

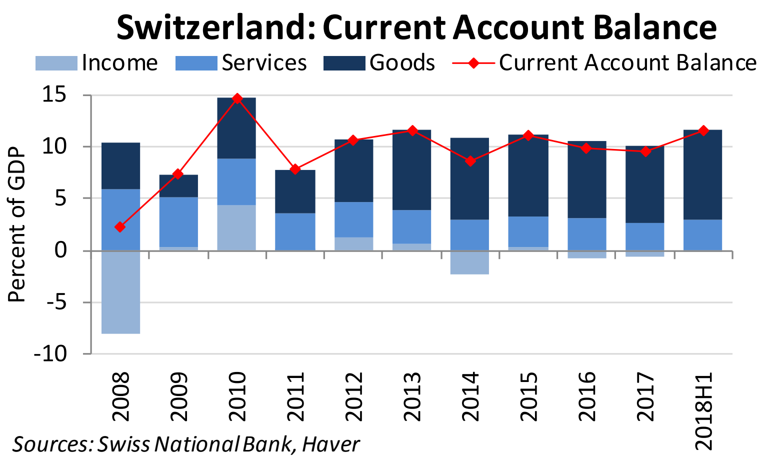
Switzerland

Prior to 2017, Switzerland had for several years received safe haven capital inflows amidst deflationary price pressures and muted domestic economic activity. In this context, foreign exchange intervention had been used – alongside negative interest rates – to contain appreciation pressures and combat deflation. Since mid-2017, the picture has shifted markedly: inflation in Switzerland has turned positive, domestic economic activity has accelerated, and pressures from safe haven inflows have been less persistent. In line with these developments, foreign exchange intervention has declined notably, in both scale and frequency. The Swiss National Bank (SNB) does not report foreign exchange intervention outside of a yearly total in its annual report. Based on sight deposit data, Treasury estimates that net purchases of foreign exchange over the four quarters through June 2018 were relatively limited, though possibly slightly in excess of 2 percent of GDP. Moreover, foreign exchange purchases are estimated to have been less frequent, particularly in 2018, compared to previous years.



Sources: SNB, Haver, U.S. Treasury estimates based on sight deposits

Switzerland's current account surplus remains elevated. The current account surplus in the first half of 2018 was 11.5 percent of GDP, up from 10.0 percent of GDP in the first half of 2017. The United States' goods trade deficit with Switzerland was $17 billion over the four quarters through June 2018, up from $13 billion compared to the same period a year earlier.



Sources: Swiss National Bank, Haver

The Swiss franc has appreciated year-to-date through the end of August, by 0.4 percent against the dollar and 3.1 percent against the euro. Reflecting the euro's greater importance for Switzerland's trade-weighted exchange rate, both the nominal and real effective exchange rate (NEER and REER) appreciated over the same time period, by 3.9 percent and 3.4 percent, respectively, unwinding a portion of the decline over the latter half of 2017. The depreciation of the franc over the second half of 2017 had led the SNB to shift its assessment of the franc to "highly valued" – a characterization that maintained through the first half of 2018. As of August 2018, the REER stood 5.5 percent above its 20-year average.

As a result of interventions and valuation changes, foreign reserves had grown to $772 billion by the end of the first quarter 2018 (from $762 billion at end-2017) but declined during the second quarter to $753 billion. This can be partly explained by a 4.1 percent appreciation of the dollar against the Swiss franc during the second quarter. With inflation now positive and safe haven pressures less persistent, the current window offers an opportunity to consider how to unwind this large stock of foreign assets on the central bank's balance sheet. Further, given that external surpluses remain very large and the acceleration in activity relatively nascent, Switzerland should adjust macroeconomic policies to more forcefully support domestic economic activity. For example, Switzerland appears to have ample fiscal space – with the budget broadly balanced and public debt around 40 percent of GDP – and could pursue tax or other structural reforms aimed at durably raising investment and productivity. Treasury continues to encourage the Swiss authorities to transparently publish all intervention data on a higher frequency basis.

Section 2: Intensified Evaluation of Major Trading Partners

The Trade Facilitation and Trade Enforcement Act of 2015 (the "2015 Act") requires the Secretary of the Treasury to provide semiannual reports on the macroeconomic and foreign exchange rate policies of the major trading partners of the United States. Section 701 of the 2015 Act requires that Treasury undertake an enhanced analysis of exchange rates and externally-oriented policies for each major trading partner "that has— (1) a significant bilateral trade surplus with the United States; (2) a material current account surplus; and (3) engaged in persistent one-sided intervention in the foreign exchange market." Additionally, the 2015 Act establishes a process to engage economies that may be pursuing unfair practices and impose penalties on economies that fail to adopt appropriate policies.

Key Criteria

Pursuant to Section 701 of the Trade Facilitation and Trade Enforcement Act of 2015, this section of the Report seeks to identify any major trading partner of the United States that has: (1) a significant bilateral trade surplus with the United States, (2) a material current account surplus, and (3) engaged in persistent one-sided intervention in the foreign exchange market. Section 701 requires data on each major trading partner's bilateral trade balance with the United States, its current account balance as a percentage of GDP, the three-year change in the current account balance as a percentage of GDP, foreign exchange reserves as a percentage of short-term debt, and foreign exchange reserves as a percentage of GDP. Data for the most recent four-quarter period (July 2017 to June 2018, unless otherwise noted) are provided in Table 1 (on p. 16) and Table 2 (below).

As noted earlier, Treasury's focus is on the 12 largest trading partners of the United States; these economies account for more than 70 percent of U.S. trade in goods. Additionally, this Report covers Switzerland, which is currently the United States' 15th largest trading partner, but has previously been among the 12 largest trading partners and has appeared on Treasury's Monitoring List. Treasury's goal is to focus attention on those economies whose bilateral trade is most significant to the U.S. economy and whose policies are the most material for the global economy.

The results of Treasury's latest assessment pursuant to Section 701 of the 2015 Act are discussed below.

Table 2. Major Foreign Trading Partners Evaluation Criteria

	Bilateral Trade	Current Account			Foreign Exchange Intervention			
	Goods Surplus with United States (USD Bil., Trailing 4Q) (1)	Balance (% of GDP, Trailing 4Q) (2a)	3 Year Change in Balance (% of GDP) (2b)	Balance (USD Bil., Trailing 4Q) (2c)	Net Purchases (% of GDP, Trailing 4Q) (3a)	Net Purchases (USD Bil., Trailing 4Q) (3b)	Net Purchases (USD Bil., Trailing 2Q) (3c)	Net Purchases 8 of 12 Months† (3d)
China	390	0.5	-2.3	68	0.0	1	6	Yes
Mexico	73	-1.6	0.3	-20	0.0	0	0	No
Japan	70	4.0	1.8	198	0.0	0	0	No
Germany	67	8.2	0.0	329	..	..	..	..
Italy	32	2.8	1.0	57	..	..	..	..
India	23	-1.9	-0.6	-50	0.2	4	-23	No
Korea	21	4.6	-2.3	73	0.3	4	-1	No
Taiwan	17	14.3	1.4	85	1.2	7	2	Yes
Switzerland	17	10.2	0.0	72	2.4	17	8	No
France	16	-0.6	-0.2	-16	..	..	..	..
Canada	15	-3.1	0.0	-53	..	..	..	..
United Kingdom	-7	-3.5	1.5	-98	..	..	..	..
Brazil	-9	-0.7	3.5	-14	-2.0	-41	-39	No
Memo : Euro Area	143	3.6	0.7	486	0.0	0	0	No

Sources: U.S. Census Bureau; Haver Analytics; National Authorities; U.S. Department of the Treasury Staff Estimates

†In assessing the persistence of intervention, Treasury will consider an economy that is judged to have purchased foreign exchange on net for 8 of the 12 months to have met the threshold.

Criterion (1) – Significant bilateral trade surplus with the United States:

Column 1 in Table 2 provides the bilateral goods trade balances for the United States' 12 largest trading partners and Switzerland for the four quarters ending June 2018.[10] China has the largest trade surplus with the United States by far, after which the sizes of the bilateral trade surpluses decline notably. Treasury assesses that economies with a bilateral goods surplus of at least $20 billion (roughly 0.1 percent of U.S. GDP) have a "significant" surplus. Highlighted in red in column 1 are the seven major trading partners that have a bilateral surplus that meets this threshold over the most recent four quarters. Table 3 provides additional contextual information where available on bilateral services trade with these trading partners.

Table 3. Major Foreign Trading Partners - Expanded Trade Data

	Bilateral Trade			
	Goods Surplus with United States (USD Bil., Trailing 4Q) (1a)	Goods Trade (USD Bil., Trailing 4Q) (1b)	Services Surplus with United States (USD Bil., Trailing 4Q)* (1c)	Services Trade (USD Bil., Trailing 4Q)* (1d)
China	390	660	-41	78
Mexico	73	584	-8	60
Japan	70	211	-12	80
Germany	67	180	1	69
Italy	32	74	3	23
India	23	81	4	54
Korea	21	122	-14	36
Taiwan	17	70	-1	18
Switzerland	17	61	n.a.	n.a.
France	16	87	-2	38
Canada	15	604	-27	95
United Kingdom	-7	119	-13	131
Brazil	-9	69	-21	35
Memo : Euro Area	143	589	n.a.	n.a.

Source: U.S. Census Bureau, Bureau of Economic Analysis

*Services data is through Q2 2018. Services data is reported on a balance of payments basis (not seasonally adjusted), while goods data is reported on a census basis (not seasonablly adjusted). Bilateral services trade data through Q2 2018 is not yet available for some trading partners.

[10] Although this Report does not treat the euro area itself as a major trading partner for the purposes of the 2015 Act – this Report assesses euro area countries individually – data for the euro area are presented in Table 2 and elsewhere in this Report both for comparative and contextual purposes, and because policies of the ECB, which holds responsibility for monetary policy for the euro area, will be assessed as the monetary authority of individual euro area countries.

Criterion (2) – Material current account surplus:

Treasury assesses current account surpluses in excess of 3 percent of GDP to be "material" for the purposes of enhanced analysis. Highlighted in red in column 2a of Table 2 are the five economies that had a current account surplus in excess of 3 percent of GDP for the four quarters ending June 2018. In the aggregate, these five economies accounted for more than half of the value of global current account surpluses as of the end of 2017. Column 2b shows the change in the current account surplus as a share of GDP over the last three years, although this is not a criterion for enhanced analysis.

Criterion (3) – Persistent, one-sided intervention:

Treasury assesses net purchases of foreign currency, conducted repeatedly, totaling in excess of 2 percent of an economy's GDP over a period of 12 months to be persistent, one-sided intervention.[11] Columns 3a and 3d in Table 2 provide Treasury's assessment of this criterion.[12] In economies where foreign exchange interventions are not published, Treasury uses estimates of net purchases of foreign currency to proxy for intervention. No economy meets this criterion for the four quarters ending June 2018, per Treasury estimates.[13]

Summary of Findings

Pursuant to the 2015 Act,[14] Treasury finds that no major trading partner of the United States met all three criteria in the current reporting period. Five major trading partners of the United States, however, met two of the three criteria for enhanced analysis in this Report or in the April 2018 Report. Additionally, one major trading partner, China, constitutes a disproportionate share of the overall U.S. trade deficit. **These six economies – China, Japan, Korea, India, Germany, and Switzerland – constitute Treasury's Monitoring List.** Japan, Germany, and Korea have met two of the three criteria in every Report since the April 2016 Report (the initial Report based on the 2015 Act), having

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[11] Notably, this quantitative threshold is sufficient to meet the criterion. Other patterns of intervention, with lesser amounts or less frequent interventions, might also meet the criterion depending on the circumstances of the intervention.

[12] Treasury uses publicly available data for intervention on foreign asset purchases by authorities, or estimated intervention based on valuation-adjusted foreign exchange reserves. This methodology requires assumptions about both the currency and asset composition of reserves in order to isolate returns on assets held in reserves and currency valuation moves from actual purchases and sales, including estimations of transactions in foreign exchange derivatives markets. Treasury also uses alternative data series when they provide a more accurate picture of foreign exchange balances, such as China's monthly reporting of net foreign assets on the PBOC's balance sheet and Taiwan's reporting of net foreign assets at its central bank. To the extent the assumptions made do not reflect the true composition of reserves, estimates may overstate or understate intervention. Treasury strongly encourages those economies in this Report that do not currently release data on foreign exchange intervention to do so.

[13] While Switzerland's net purchases of foreign exchange are estimated at above 2 percent of GDP, there has been a notable decline in the frequency and persistence of intervention.

[14] Section 701 of the Trade Facilitation and Trade Enforcement Act of 2015, 19 U.S.C. § 4421.

material current account surpluses combined with significant bilateral trade surpluses with the United States. Switzerland met two of the three criteria in every Report between October 2016 and April 2018 – having a material current account surplus and having engaged in persistent, one-sided intervention in foreign exchange markets – and it met one of the three criteria in this Report, a material current account surplus. India met two of the three criteria in the April 2018 Report – having a significant bilateral surplus with the United States and having engaged in persistent, one-sided intervention in foreign exchange markets – and it met one of the three criteria in this Report, a significant bilateral surplus with the United States. In both Switzerland and India, there has been a notable decline recently in the scale and frequency of foreign exchange purchases. Both Switzerland and India must demonstrate that this improvement against the intervention criteria is durable before they will be removed from the Monitoring List. China has met one of the three criteria in every Report since the October 2016 Report, having a significant bilateral trade surplus with the United States, with this surplus accounting for a disproportionate share of the overall U.S. trade deficit. **Treasury will closely monitor and assess the economic trends and foreign exchange policies of each of these economies.**

Further, based on the analysis in this Report, Treasury has also concluded that no major trading partner of the United States met the standard in the 1988 Act of manipulating the rate of exchange between its currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade during the period covered in the Report.

Notwithstanding these findings, Treasury remains deeply concerned by the significant trade imbalances in the global economy. Real exchange rate movements in 2018 – particularly the strengthening of the dollar and the decline in China's currency – would, if sustained, exacerbate persistent trade and current account imbalances. China's economic model, which continues to rely significantly on non-market mechanisms, is posing growing risks to the long-term global growth outlook. The United States is committed to working towards a fairer and more reciprocal trading relationship with China. To this end, we are engaging China to address its market-distorting policies and practices. Treasury also continues to press major trading partners of the United States that have maintained large and persistent external surpluses to support stronger and more balanced global growth by facilitating domestic demand growth as the primary engine for economic expansion.

Glossary of Key Terms in the Report

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

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

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

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

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

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

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

Real Effective Exchange Rate (REER) – A weighted average of bilateral exchange rates, expressed in price-adjusted terms. Unlike the nominal effective exchange rate, it is further adjusted for the effects of inflation in the countries concerned.

Trade Weighted Exchange Rate – see Nominal Effective Exchange Rate.