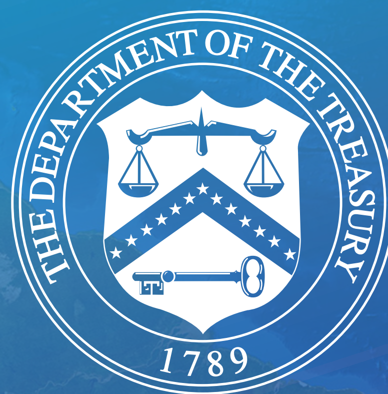

REPORT TO CONGRESS

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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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

This Administration places a very high priority on ensuring that American workers and companies face a level playing field when competing internationally. When our trading partners engage in currency manipulation, they impose significant, and often long-lasting, hardship on American workers and companies. Expanding trade in a way that is freer and fairer for all Americans requires that other economies avoid unfair currency practices and persistent exchange rate misalignments; that they refrain from competitive exchange rate devaluations; and that they not target exchange rates for competitive purposes. A stronger and fairer international trading system must also be supported by more robust and better balanced growth globally, with demand-led growth becoming the engine for expansion in key economies that have large external surpluses. This Report, by monitoring where unfair currency practices may be emerging and encouraging policies and reforms to address large external surpluses, represents an important component of this Administration's strategy for securing a stronger America and a more robust and fair global economy.

Treasury Assessments of Major Trading Partners

Treasury has established thresholds for the three criteria specified in the Trade Facilitation and Trade Enforcement Act of 2015 (the "2015 Act") that determine whether enhanced analysis is necessary: (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 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 12 month period.[3] In 2016, the $20 billion bilateral trade surplus threshold captures almost 80 percent of the value of all trade surpluses with the United States, while the 3 percent current account threshold captures more than three-fourths of the nominal value of global current account surpluses.

Pursuant to the 2015 Act, Treasury has found in this Report that no major trading partner met all three criteria for the current reporting period.

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 Omnibus Trade and Competitiveness Act of 1988 (the "1988 Act") for currency manipulation in the second half of 2016.

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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, and the UK. Taking into account services trade would reduce the bilateral trade surplus of these economies with the United States.

[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.

Regarding the 2015 Act, while no economy met all three of the criteria for the current reporting period, Treasury is determined to watch very closely for any unfair currency practice that creates a burden for U.S. workers and U.S. companies. Though there has been a trend in the last two years towards reduced currency intervention by key trading partners, it is critical that this not represent merely an opportunistic response to shifting global macroeconomic conditions – in particular changes in capital flows which have created depreciation pressures on many emerging market currencies – but a durable policy shift away from foreign exchange policies that facilitate unfair competitive advantage. Further, the current global configuration of external positions, in which there are pockets of extremely large trade and current account surpluses, is untenable. The United States cannot and will not bear the burden of an international trading system that unfairly disadvantages our exports and unfairly advantages the exports of our trading partners through artificially distorted exchange rates. Treasury is committed to aggressively and vigilantly monitoring and combatting unfair currency practices.

Treasury has established a "Monitoring List" of major trading partners that merit close attention to their currency practices. An economy meeting two of the three criteria in the 2015 Act will be 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 one-off factors. As an added 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, the Monitoring List comprises China, Japan, Korea, Taiwan, Germany, and Switzerland**.

With regard to these six economies:

- China has a long track record of engaging in persistent, large-scale, one-way foreign exchange intervention, doing so for roughly a decade to resist renminbi (RMB) appreciation even as its trade and current account surpluses soared. China allowed the RMB to strengthen only gradually, so that the RMB's initial deep undervaluation took an extended period to correct. The distortion in the global trading system resulting from China's currency policy over this period imposed significant and long-lasting hardship on American workers and companies. Moreover, China continues to pursue a wide array of policies that limit market access for imported goods and services, and maintains a restrictive investment regime which adversely affects foreign investors.

  China currently has an extremely large and persistent bilateral trade surplus with the United States, which underscores the need for further opening of the Chinese economy to American goods and services, as well as faster reform to rebalance the Chinese economy toward greater household consumption. China's goods trade surplus with the United States, at $347 billion in 2016, is by far the largest among any of the United States' major trading partners. It has also declined by only 5 percent in 2016 from its peak in 2015. Further opening of the Chinese economy to U.S. goods and services as well as faster implementation of reforms to rebalance the Chinese economy toward

greater household consumption would aid in reducing the bilateral imbalance. In comparison to the extremely large and persistent bilateral trade imbalance, China's multilateral external position has undergone greater adjustment in recent years, with its current account surplus having decreased most recently from 2.8 percent of GDP in 2015 to 1.8 percent of GDP in 2016. Further, after engaging in one-way, large-scale intervention to resist appreciation of the RMB for a decade, China's recent intervention in foreign exchange markets has sought to prevent a rapid RMB *depreciation* that would have negative consequences for the United States, China, and the global economy. Treasury will be scrutinizing China's trade and currency practices very closely, especially in light of the extremely sizable bilateral trade surplus that China has with the United States. China will need to demonstrate that its lack of intervention to resist appreciation over the last three years represents a durable policy shift by letting the RMB rise with market forces once appreciation pressures resume. Treasury places significant importance on China adhering to its G-20 commitments to refrain from engaging in competitive devaluation and not to target China's exchange rate for competitive purposes. Treasury also places high importance on greater transparency of China's exchange rate and reserve management operations and goals.

- Japan continues to experience weak demand growth, which has contributed to Japan's trade imbalances, and needs to deploy all policy levers in order to revive domestic demand and combat low inflation while avoiding a return to export-led growth. Japan has a significant bilateral trade surplus with the United States, with a goods surplus of $69 billion. Japan's current account surplus for 2016 was 3.7 percent of GDP, a substantial increase from 3.1 percent in 2015, and the highest annual surplus since 2010. Japan has not intervened in the foreign exchange market, however, in over five 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. Given that the weakness of domestic activity and demand growth are contributing to Japan's trade imbalances, it is critical that the authorities complement accommodative monetary policy and flexible fiscal policy with continued implementation of structural reforms focused on enhancing the labor market, raising productivity, and improving the long-term economic outlook.

- Korea has a track record of asymmetric foreign exchange interventions, highlighting the urgency of the authorities durably limiting foreign exchange intervention only to circumstances of disorderly exchange market conditions and making foreign exchange operations more transparent. Korea has a significant bilateral trade surplus with the United States, with a goods surplus of $28 billion in 2016. Korea also has an elevated current account surplus which stood at 7.0 percent of GDP in 2016. Treasury estimates that during 2016 Korea was a net seller of foreign exchange of about $6.6 billion (0.5 percent of GDP). This is in notable contrast to several prior years of asymmetric intervention to resist won appreciation. In its last analysis of the won, the IMF maintained its assessment that the won is undervalued. This undervaluation supports the large current account surplus and reflects continued underperformance of Korean domestic demand. Treasury urges Korea to enhance the flexibility of the exchange rate and will be closely monitoring Korea's currency intervention practices.

- Taiwan has a track record of asymmetric foreign exchange interventions, highlighting the urgency of the authorities limiting foreign exchange intervention only to circumstances of disorderly exchange market conditions and making foreign exchange operations more transparent. Taiwan has an extremely large current account surplus which stood at over 13 percent of GDP in 2016. In nominal dollar terms, Taiwan has the fifth largest current account surplus in the world at $71 billion. Treasury estimates that in 2016 Taiwan made net purchases of $10 billion in foreign exchange, amounting to 1.8 percent of GDP, with the majority of those purchases in the first three quarters. This meant that 2016 was the first time in several years that Taiwan's net purchases of foreign exchange were below 2 percent of GDP. Treasury urges Taiwan's authorities to demonstrate a durable shift to a policy of limiting foreign exchange interventions to only exceptional circumstances of disorderly market conditions, and to increase the transparency of foreign exchange market intervention and reserve holdings.

- Germany, the largest economy within the euro area, should take policy steps – particularly greater use of fiscal policy – to encourage stronger domestic demand growth, which would place upward pressure on the euro's nominal and real effective exchange rates and help reduce its large external imbalances. Germany has a very large bilateral goods trade surplus with the United States, at $65 billion, and an extremely large current account surplus at 8.3 percent of GDP in 2016. In nominal dollar terms, Germany has the world's largest current account surplus at close to $300 billion. This surplus represents a substantial excess of German income over German domestic absorption. Stronger demand growth in Germany will be a key factor going forward, as will be addressing Germany's low real effective exchange rate. The European Central Bank (ECB) has not intervened in foreign currency markets since 2011, and did so then as part of a G-7 concerted intervention to stabilize the yen following Japan's earthquake and tsunami.[4]

- Switzerland over the past few years has used foreign exchange purchases to help counter persistent pressures from safe haven inflows and deflationary forces. Switzerland has space to deploy fiscal policy more forcefully to support domestic economic activity, and could also rely more heavily on traditional monetary policy tools (e.g., interest rates) to combat deflationary pressures, which would help reduce the need for foreign exchange intervention. Switzerland has a large current account surplus at 10.7 percent of GDP, and the sixth largest surplus in the world in nominal dollar terms at $71 billion. Per Treasury estimates, Switzerland has engaged in sizable, one-sided foreign exchange purchases over the last year. The IMF has found the Swiss franc to be overvalued. Though Switzerland's economic policy situation is distinctive given its small stock of domestic assets, which limits monetary policy options to address persistent deflation and safe haven inflows, Switzerland could increase reliance on policy rates in order to limit the need for foreign exchange interventions, which should be made more transparent.

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[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 last six months of 2016 and, where data are available, developments through end-March 2017. The economies covered in this Report are the 12 largest trading partners of the United States. Their total goods trade with the United States amounted to nearly $2.6 trillion over the last 12 months, or around 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 fourth quarter of 2016).

U.S. Economic Trends

In the fourth quarter of 2016, private domestic demand provided strong support for the continued expansion of the U.S. economy. Consumer spending grew solidly, while business fixed investment, residential investment, and inventory accumulation all made positive, if smaller, contributions. On the public side, government expenditures made a slightly positive contribution to GDP; on the international side, a sharp drop in net exports between the third and fourth quarters introduced a major drag to GDP, although an unusually high level of agricultural exports in the third quarter contributed to the size of the decline.

Despite the slower growth that falling net exports caused in the fourth quarter, the U.S. economy closed 2016 with considerable underlying strength as evidenced by strong job creation, low unemployment, and rising wages and incomes. Over the last two quarters of the year, real GDP expanded at a 2.8 percent annual rate after rising at a much slower 1.1 percent annual rate in the first half. A resumption of inventory accumulation in the latter half of 2016 accounted for much of the acceleration – contributing 0.8 percentage point to growth during the second half of the year after pulling it down by 0.8 percentage point during the first half. Business fixed investment added 0.2 percentage point during the second half of 2016, after posing a drag of that size in the first half. Residential investment added 0.1 percentage point in the second half of 2016, after an essentially flat contribution during the first half. Consumer spending, which accounts for just over two-thirds of all economic activity in the United States, grew at a very solid 3.2 percent in the second half of 2016, after growing at 3.0 percent in the first half of the year.

Near-Term U.S. Growth Outlook

Solid fundamentals, including strong labor markets, buoyant consumer sentiment, steady gains in household wealth, and rising construction spending all point to healthy growth in private domestic demand over 2017. A consensus of private forecasters predicts that real GDP will expand at a solid 2.1 percent in the first half of 2017 and then accelerate to 2.4 percent in the second half of the year. Overall, they expect GDP growth of 2.2 percent for the whole of 2017, a step up from the 1.9 percent rate reached in 2016.

Fiscal Policy and Public Finances

After weighing on U.S. economic activity in recent years, the rapid pace of fiscal consolidation has moderated in recent quarters. During the latter half of 2016, federal government spending made a slightly positive contribution to real GDP growth, after subtracting 0.1 percentage point during the first half of the year. State and local outlays added roughly 0.1 percentage point to growth in the first and second halves of 2016. Looking ahead, federal government fiscal spending is expected to make a negative contribution to growth in the first quarter of 2017 but to turn modestly positive over the rest of the year. Beyond 2017, the impacts of any fiscal easing will depend on the final tax and budgetary legislation. Overall, the Administration's current policy proposals are more focused on boosting private domestic demand through tax relief than on increasing government consumption directly.

In FY2016, the federal budget deficit was 3.2 percent of GDP, up from 2.5 percent of GDP in FY2015. Debt held by the public rose to $14.2 trillion in FY2016. As a share of the economy, publicly held debt rose from 73.7 percent at the end of FY2015 to about 77.1 percent of GDP in FY2016.

Labor Market and Inflation Trends

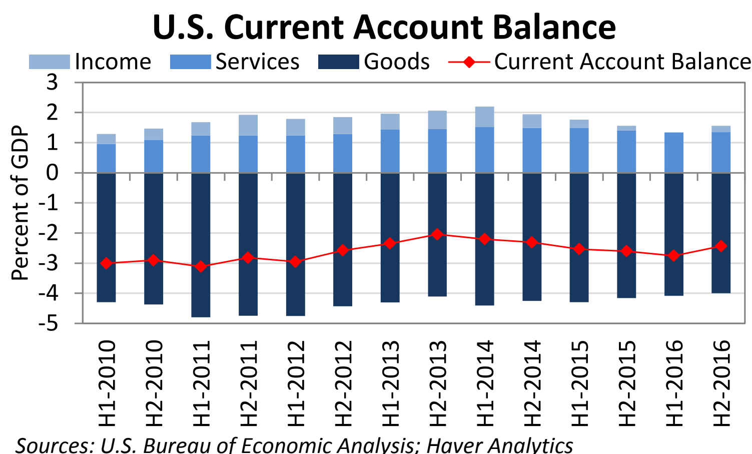
The pace of job creation has remained strong in recent months, and the unemployment rate has fallen further. Nonfarm payroll employment rose by 187,000 jobs per month, on average, during 2016, and for the six months ending in March 2017, monthly gains averaged 163,000. The unemployment rate currently stands at 4.5 percent, less than half its 2009 peak of 10 percent. Other indicators also point to declining slack in U.S. labor markets: involuntary part-time employment has fallen below its pre-recession average, and the labor force participation rate has been rising, although it has not fully recovered to its pre-recession level.

Headline inflation has turned up from mid-2016 with the recovery in energy prices but remains moderate, while core inflation (which excludes food and energy prices) remains relatively low and stable. The consumer price index rose 2.7 percent during the year ending February 2017, compared with a 1.0 percent rise over the year ending February 2016. Core consumer prices were up 2.2 percent over the year ending February 2017, a tick lower than the 2.3 percent increase during the same period a year earlier. By some measures, growth of compensation has strengthened over the past year, but remains below its pre-recession norms. Average hourly earnings rose 2.3 percent over the twelve months ending February 2017, stepping up from an average annual rate of 2.0 percent from 2011 through 2014. The Employment Cost Index for private industry workers showed total compensation rising 2.2 percent over the twelve months ending December 2016, up from a rate of 1.9 percent in the preceding year.

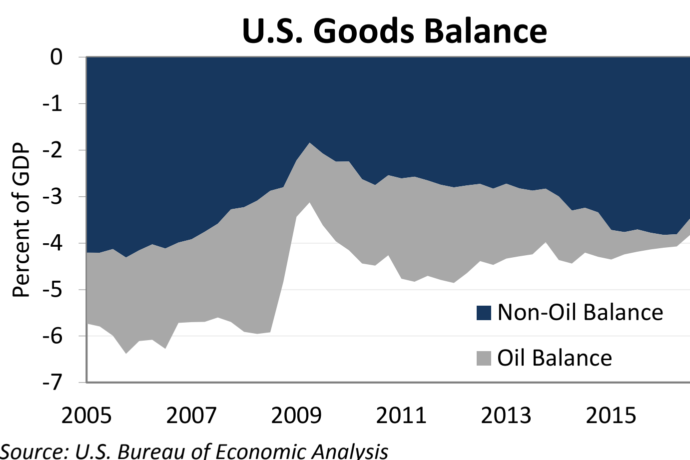
U.S. Current Account and Trade Balances

The U.S. current account was in deficit by 2.4 percent of GDP in the second half of 2016, narrowing from the 2.8 percent deficit in the first half of the year. This decline in the current account deficit was supported by a pick-up in net investment income, which rose by $25 billion in the second half of 2016 compared to the first half of the year, as earnings on U.S. assets abroad rose despite an appreciation of the dollar. On a year-over-year basis the U.S. current account balance remained unchanged in 2016 relative to 2015 at 2.6 percent of GDP.

After narrowing substantially in the aftermath of the global financial crisis, the non-oil goods balance – which consists predominantly of manufactured goods – has gradually widened and is approaching its pre-crisis level, at 3.6 percent of GDP in the second half of 2016 (compared to an average level a bit above 4 percent of GDP from 2004-2006). The adjustment in the goods balance relative to its pre-crisis level has come almost entirely through the fall in the U.S. petroleum deficit, which has reached its lowest level since 1998 and stood at just 0.4 percent of GDP in the second half of 2016 due to increased domestic oil production and lower world oil prices.



Sources: U.S. Bureau of Economic Analysis; Haver Analytics



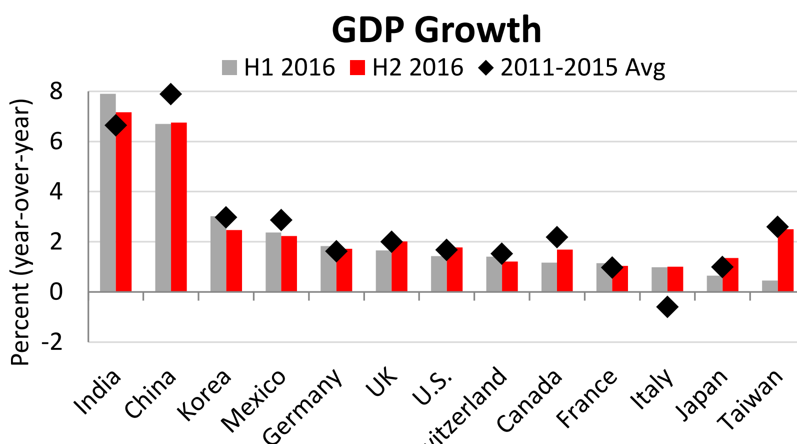
Source: U.S. Bureau of Economic Analysis

At the end of 2016, the U.S. net international investment position stood at a deficit of $8.1 trillion (43.7 percent of GDP), a deterioration of $829 billion compared to end-2015. The value of U.S.-owned foreign assets was $23.9 trillion, while the value of foreign-owned U.S. assets stood at $32.0 trillion. Recent deterioration has been due in part to valuation effects from an appreciating dollar that lowered the dollar value of U.S. assets held abroad denominated in foreign currencies, as well as the relative underperformance of foreign equity markets compared to U.S. stock markets in 2016.

International Economic Trends

The global economy grew by 3.1 percent in 2016, the lowest rate since the end of the global financial crisis. Global activity was tepid in the first half of 2016, but firmed somewhat over

the second half of the year as growth accelerated in several large economies (including the United States, Japan, and UK). Growth in emerging market economies was generally lackluster over 2016. Despite the firming of oil prices in the latter part of the year, conditions remain challenging for many commodity-dependent economies. Growth in China was solid through the end of 2016, but the necessary efforts to rebalance China's economy continue to generate spillovers for other economies given the reduction in commodity demand and still-significant excess capacity in key sectors.



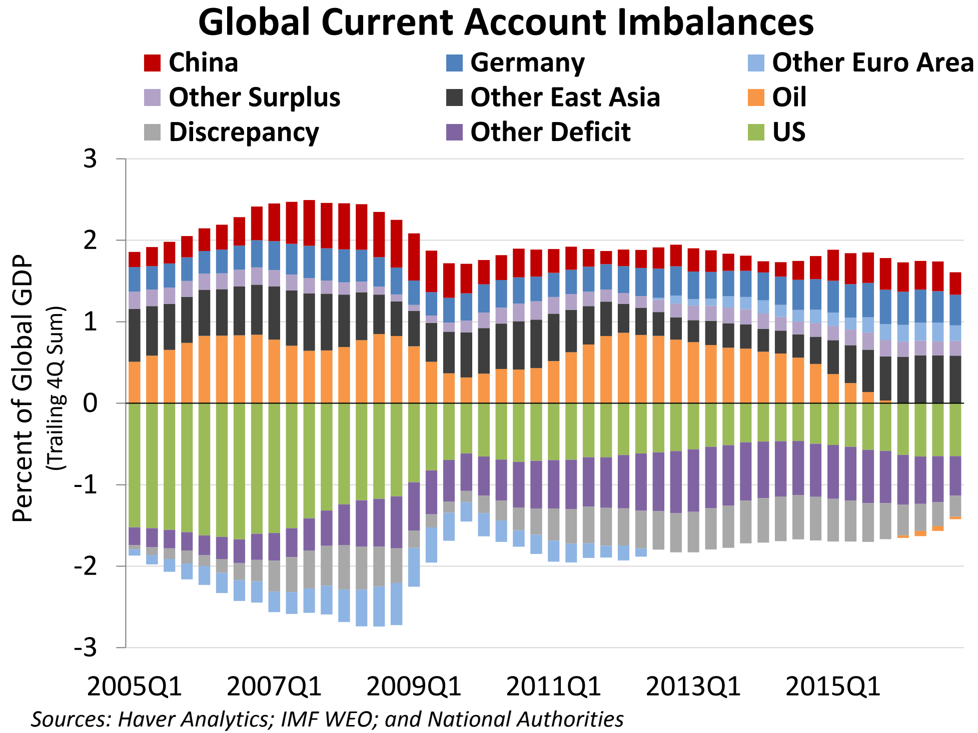
Sources: National Authorities; Haver Analytics.

An uptick in term premia over late 2016 and early 2017 suggests some firming in forward-looking growth expectations, while the rise in oil prices has helped diminish headline deflationary pressures. However, the recovery from the global financial crisis has been markedly slow and the growth outlook remains unimpressive by historical standards. The IMF, in its January 2017 forecast, projects that advanced economies will pick up modestly over the next two years, expanding to 1.9 percent in 2017 and 2 percent in 2018. While this would represent an improvement over the middling 1.6 percent average pace of growth since 2011, it is still well below the 2.7 percent pace of growth advanced economies averaged from 1990-2006. Emerging market economy growth is expected to pick up to 4.5 percent in 2017, remaining a bit below the 4.9 percent pace it has averaged since 2011.

Global Imbalances

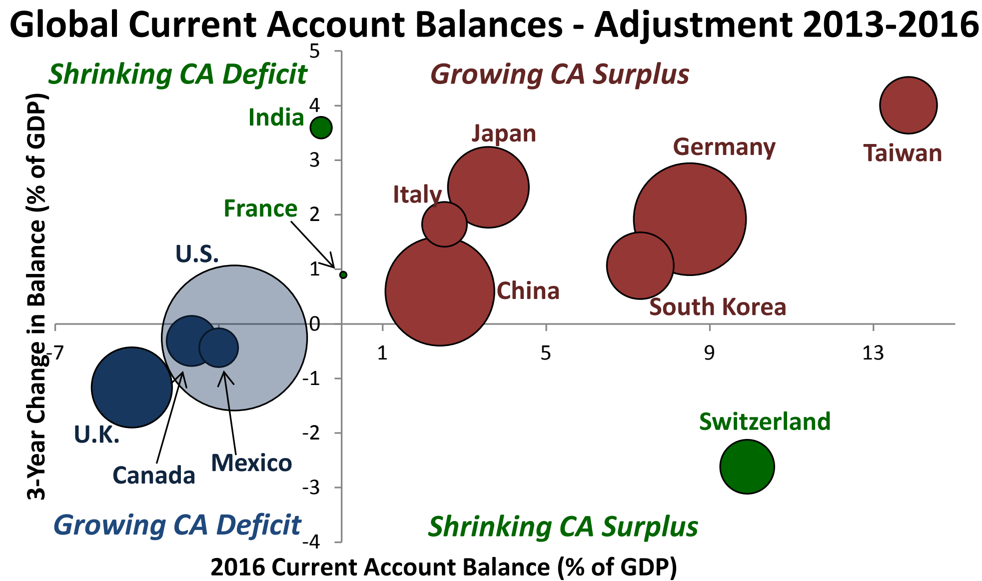
The distribution of global demand remains highly imbalanced, with large and sustained external surpluses in a handful of economies, which has the effect of absorbing demand from the rest of the world and dampening global aggregate demand. Though global current account imbalances are well below their pre-crisis level, progress in reducing imbalances has stalled, with global imbalances as of end-2016 at roughly the same level as in mid-2014 (after rising modestly and then falling back over the last couple of years). Imbalances have been contained in part over the last 18 months by lower oil prices. More broadly, global imbalances have fallen since the global financial crisis due primarily to compression of imports in deficit economies rather than stronger demand in surplus economies.

The very large surpluses of Germany, Japan, Korea, Taiwan, and Switzerland have each remained significant as a share of GDP in the second half of 2016. The surpluses (excess of saving over investment) of these economies totaled around $710 billion over the four quarters of 2016. China's surplus declined from 2.8 percent of GDP in 2015 to 1.8 percent of GDP in 2016, though external rebalancing in China has reversed somewhat since the



Sources: Haver Analytics; IMF WEO; and National Authorities

trough in China's reported current account surplus in 2013. Outside of a few smaller exceptions (India, France, and Switzerland), none of the United States' 12 major trading partners have contributed to global rebalancing over the last three years, as large surplus economies have generally seen their surpluses expand. This indicates that these economies are absorbing demand from the rest of the world to sustain stronger growth at home than would otherwise be the case.

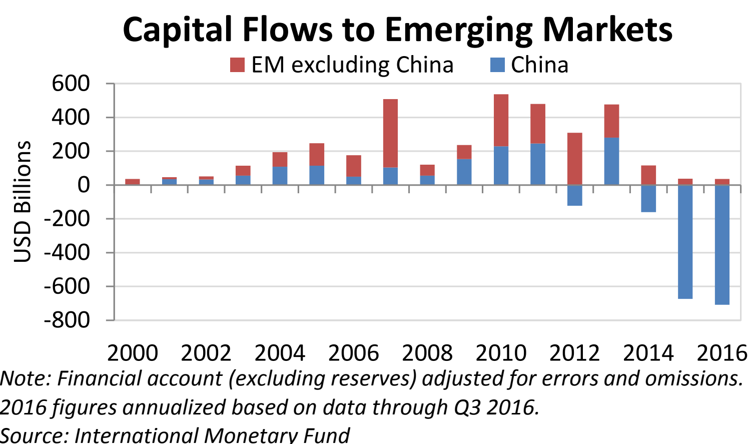


Sources: Haver Analytics; IMF WEO; National Authorities
Note: Size of bubble is relative to share of global imbalances

This weak and imbalanced pattern of global aggregate demand highlights the urgency of deploying all policy levers to boost strong, sustainable, balanced, and inclusive growth. Inadequate macroeconomic policy support has been a persistent feature of the global policy landscape following the financial crisis. Monetary policy responses have been forceful generally, but they need to be buttressed by additional fiscal support to deliver a stronger boost to domestic demand. Policy space exists as exceptionally low long-term interest rates provide governments with more fiscal breathing room than under historically normal circumstances. This policy prescription is particularly relevant for many key economies with large external surpluses where investment has exhibited notable weakness in recent years. While the slowdown in global trade growth is in part a consequence of the weakness of global demand (and particularly investment), it is exacerbated by the failure of economies to dismantle trade barriers that prevent a level playing field globally. Stronger efforts to create a more level playing field for private firms vis-à-vis state-owned enterprises in several key economies, notably China, would also help make growth stronger and trade more fair.

Capital Flows

As in 2015, private capital flowed out of China in 2016, while net capital flows to other emerging markets were largely flat in the aggregate. Net private outflows from China continued to be driven by Chinese capital leaving the country rather than a broader flight of foreign private capital. Net outflows from China have been driven in part by increased direct investment overseas by Chinese corporates, including state-owned enterprises. However, the pace of outflows has remained considerably below that seen in the second half of 2015, and tightened enforcement of capital controls appears to have helped stem outflows in early 2017.

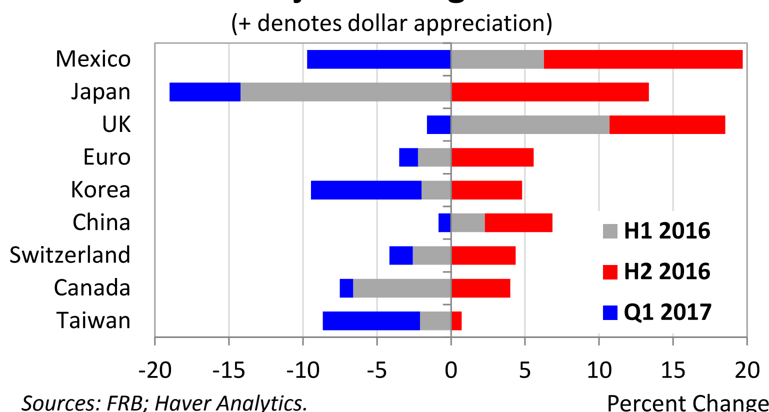


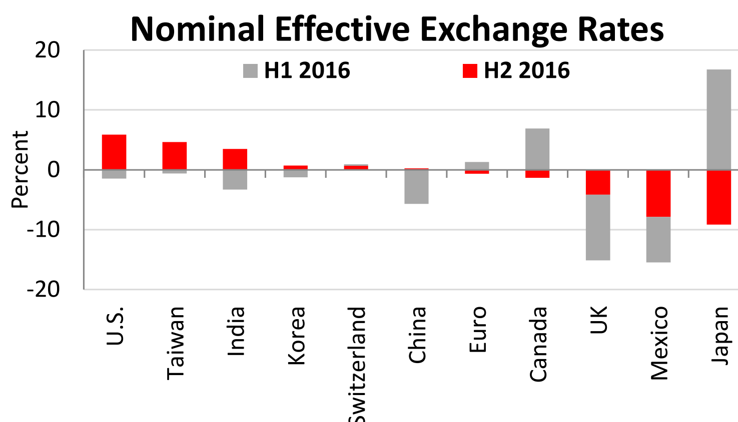
Note: Financial account (excluding reserves) adjusted for errors and omissions. 2016 figures annualized based on data through Q3 2016.
Source: International Monetary Fund

Other emerging markets continued to receive modest net capital inflows in the second and third quarter of 2016. Despite a deceleration of inflows in the third quarter, private capital recorded a net inflow into emerging markets excluding China in 2016, in line with the modest net inflow recorded in 2015. Portfolio inflows into debt assets continued into the third quarter, while inflows into equity assets were also positive, albeit small. The capital flows appeared to be broadly dispersed across the major emerging market economies and across regions. Emerging market sentiment was supported in part by the firming of commodity prices, as major oil producers reached agreement on a global production freeze, raising prices and alleviating stresses on commodity exporters.

At the end of 2016, and again in March 2017, the Federal Reserve raised the policy interest rate corridor, as widely expected, without causing any notable turbulence in U.S. or global financial markets.

Foreign Exchange Markets





The dollar appreciated on a nominal, trade-weighted basis by 5.4 percent over the second half of 2016, more than reversing a near 1 percent depreciation in the first half of the year. The dollar's strength was broad-based, appreciating against most major and emerging market currencies alike. The majority of the dollar's appreciation in the second half of the year took place following the U.S. election in November.

Most advanced economy currencies outside the United States depreciated on a nominal, trade-weighted basis in the second half of 2016. In part this reflected the broad strengthening of the dollar. It also reflected country-specific developments: the British pound depreciated an additional 4 percent in the second half of 2016 (after depreciating 11 percent in the first six months of the year), as markets continued to process the implications of the June referendum outcome. The Japanese yen depreciated 9 percent in the second half of 2016, partly retracing upward movements in the first half of the year, as the Bank of Japan (BOJ) kept the 10-year yield around zero (consistent with its new monetary policy regime), even as yields in the U.S. and other major economies rose late in the year.

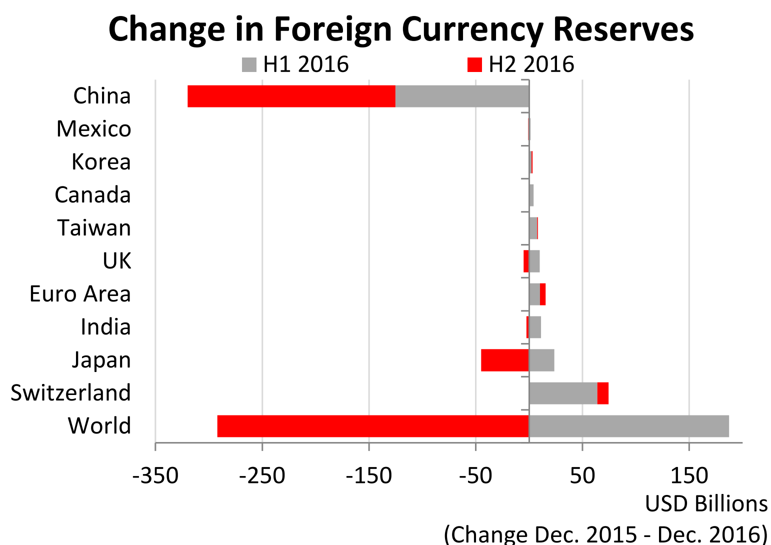
Emerging market currencies continued to follow different paths into the end of 2016 based on regional developments. The Mexican peso depreciated sharply following the U.S. election, bringing the cumulative 2016 decline to almost 15 percent. Other emerging market currencies showed more resilience to U.S. policy developments, including the normalization of monetary policy by the Federal Reserve, as the Taiwanese dollar and

Indian rupee appreciated 4.6 percent and 3.5 percent, respectively, on a broad, trade-weighted basis in the second half of the year.

In the first quarter of 2017, the dollar reversed course, depreciating 3.0 percent on a nominal, trade-weighted basis in the first quarter of the year, retracing at least a portion of its movement in the second half of 2016 against all other currencies covered in the Report. Conversely, several emerging market currencies started 2017 on a stronger foot: The Mexican peso retraced some of its 2016 decline, rising over 9 percent through end-March on a nominal, trade-weighted basis as the central bank implemented measures to defend the peso and enhance liquidity, and as statements from U.S. officials allayed concerns over regional economic relationships. In Asia, the Korean won and Taiwanese dollar appreciated roughly 5.5 and 4.4 percent, respectively, close behind the peso as the strongest performing emerging market currencies in early 2017.

Treasury judges that foreign exchange markets have generally functioned smoothly, including around the U.S. election in November and increases in the Federal Reserve's policy rate corridor in both December and mid-March. The U.S. dollar continues to be the world's principal currency in international trade, with it being bought or sold in 88 percent of all currency trades according to the most recent (2016) BIS Triennial Survey of foreign exchange activity.

Foreign Exchange Reserves



Note: Includes valuation effects
Sources: International Monetary Fund; Haver Analytics

Global foreign currency reserves declined on net over 2016 by roughly $105 billion, down from roughly $10.9 trillion at the end of 2015. Reserves rose globally by almost $190 billion over the first half of 2016, but then declined by over $290 billion in the second half of the year. Notwithstanding this volatility, the net decline in global reserves in 2016 extends the notable fall witnessed over 2015, as many economies engaged in dollar and other reserve asset sales to stem or slow the depreciation of their currencies. At an individual economy level, the 2016 annual change in reserves was roughly commensurate with changes in 2015, outside of China, where the drawdown on reserves was much smaller in 2016 than 2015.

China accounts for nearly the entirety of the global reserve decline again in 2016, and Chinese reserves fell by over $300 billion to around $3 trillion by the end of 2016. Reserve

holdings among other economies covered in this Report, except Japan, all increased through the second half of 2016 and on net over the year.

China, Korea, Taiwan, and Switzerland do not publish their foreign exchange intervention activities so it is not possible to separate precisely transactions from valuation adjustments. These economies continue to maintain ample – or more than ample – amounts of foreign currency reserves, when compared to either their stock of short-term liabilities or domestic GDP.

Table 1: Foreign Exchange Reserves

	FX Reserves as % of short term debt	FX reserves as % of GDP
India	427%	15%
China	399%	27%
Mexico	334%	16%
Korea	330%	26%
Taiwan	277%	82%
Switzerland	63%	96%
Japan	45%	23%
Canada	13%	5%
Italy	5%	2%
UK	2%	4%
Germany	2%	1%
France	2%	2%

Reserves and GDP for 2016, short-term debt as of 2016Q3
Sources: National Authorities; World Bank; International Monetary Fund; Haver Analytics

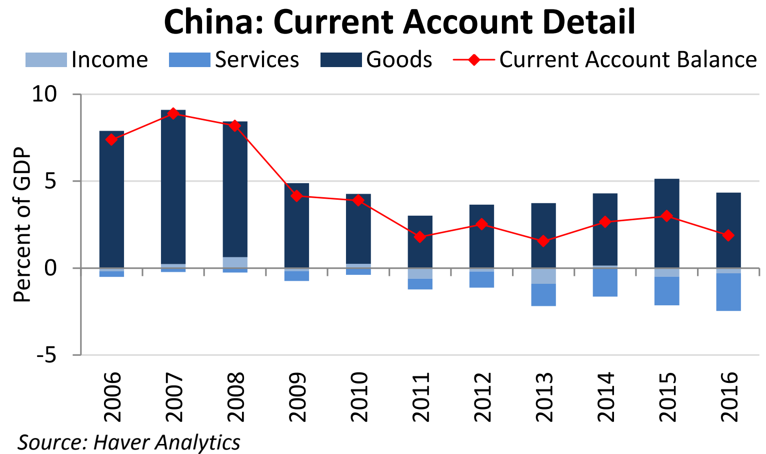
Economic Developments in Selected Major Trading Partners

China

China engaged in large-scale, one-way foreign exchange intervention for roughly a decade to resist RMB appreciation even as its trade and current account surpluses soared. China allowed the RMB to strengthen only gradually, so that the RMB's initial deep undervaluation took an extended period to correct. The distortion in the global trading system resulting from China's currency policy over this period imposed significant and long-lasting hardship on American workers and companies.

China's current account surplus, though it has declined significantly as a share of GDP from its peak of 10 percent of GDP in 2007, remains among the largest in the world in nominal terms at over $200 billion. China's trade and current account surpluses declined in 2016, and the RMB remained under downward pressure throughout the year due to sizable capital outflows estimated at around $700 billion. China's current account surplus was 1.8 percent of GDP in 2016, down from 2.8 percent of GDP in 2015. The narrowing of the current account surplus was driven by an increase in the services trade deficit and a decline in the goods trade surplus. Chinese exports declined, as export volume increased 1.8 percent but value declined 0.7 percent in 2016. During the same period, goods import

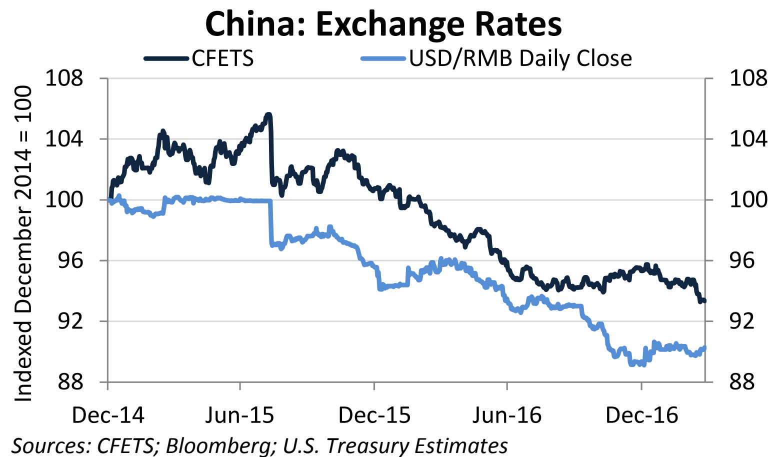
volumes grew 3.6 percent, but declined 0.4 percent in nominal terms reflecting lower prices on commodity imports. Tourism imports (travel spending abroad) continued to drive China's services trade deficit, which grew from 1.6 percent of GDP in 2015 to 2.2 percent of GDP in 2016.



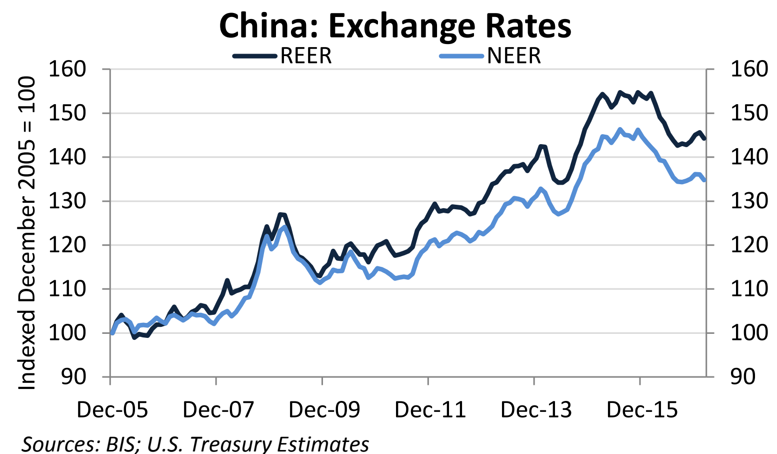
Source: Haver Analytics

Bilaterally with the United States, China runs a very large goods trade surplus but a small services deficit. In 2016, China's goods trade surplus with the United States fell somewhat, from $367 billion in 2015 to $347 billion, according to U.S. Census data. Both exports to and imports from China fell in 2016, with a larger import decline, leading to a smaller bilateral deficit. The U.S. services trade surplus with China increased by $4 billion to $37 billion bringing the overall trade deficit (goods and services) to $310 billion.

China's currency weakened in 2016 by several measures. The CFETS basket – the most commonly referenced nominal trade-weighted basket – weakened 6.1 percent in 2016 and 10.1 percent from its peak in August 2015 to end-2016. Meanwhile, the RMB depreciated 6.5 percent against the dollar in 2016 and 10.6 percent from August 2015 to end-2016. On a real, trade-weighted basis, China's currency depreciated 5.7 percent in 2016. This depreciation occurred in the context of an estimated $700 billion in net capital outflows and an estimated $435 billion in foreign exchange sales by China to mitigate depreciation pressures.



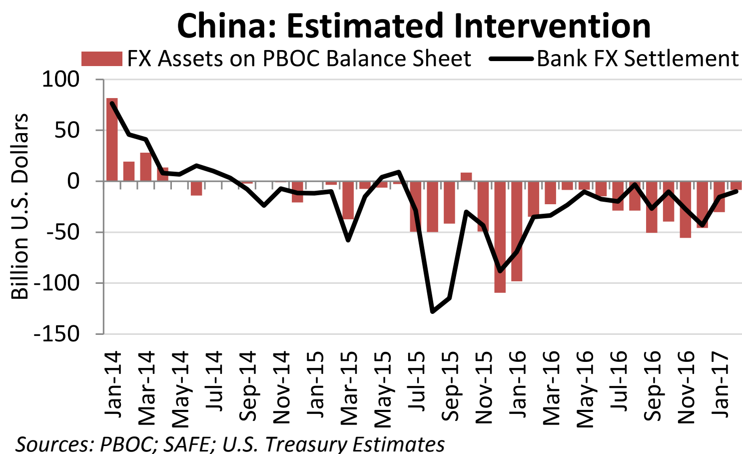
Sources: CFETS; Bloomberg; U.S. Treasury Estimates



Sources: BIS; U.S. Treasury Estimates

While China does not publish its foreign exchange intervention, using data that China does

publish, Treasury estimates that China intervened heavily in the foreign exchange market to prevent a more rapid RMB depreciation. Treasury estimates that from August 2015 through February 2017, China sold around $800 billion in foreign currency assets to prevent rapid RMB depreciation. The pace of net foreign exchange sales appears to have abated somewhat in early 2017 amid strengthened enforcement of existing capital controls and stronger economic activity indicators. Despite these sizeable foreign currency sales since August 2015, China still has ample foreign reserves of roughly $3 trillion as of end-February 2017.



Sources: PBOC; SAFE; U.S. Treasury Estimates

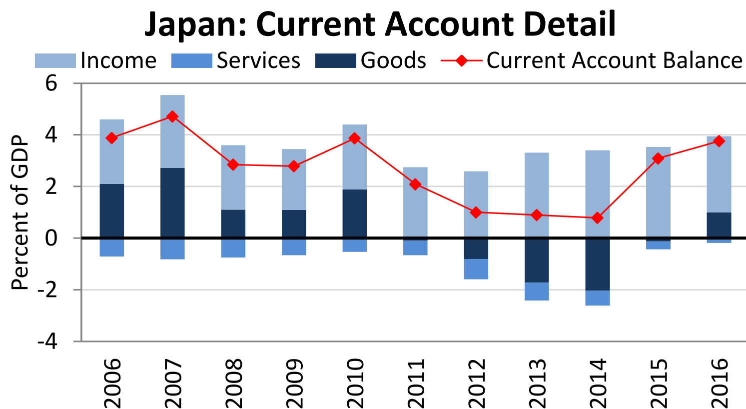
Market participants remain highly sensitive to signals from the Chinese authorities on the exchange rate, highlighting the importance of clear communication of policy actions and greater transparency. China should make further efforts to clarify its exchange rate and reserve management operations and goals, and continue to underscore that devaluation will not be used to support domestic growth. China will need to demonstrate that its lack of intervention to resist appreciation over the last three years represents a durable policy shift by letting the RMB rise with market forces once appreciation pressures resume.

Treasury is concerned by the lack of progress made in reducing the bilateral trade surplus with the United States. China continues to pursue a wide array of policies that limit market access for imported goods and services, and maintains a restrictive investment regime which adversely affects foreign investors. Further opening of the Chinese economy to U.S. goods and services as well as faster implementation of reforms to rebalance the Chinese economy toward greater household consumption would aid in reducing the bilateral imbalance.

Japan

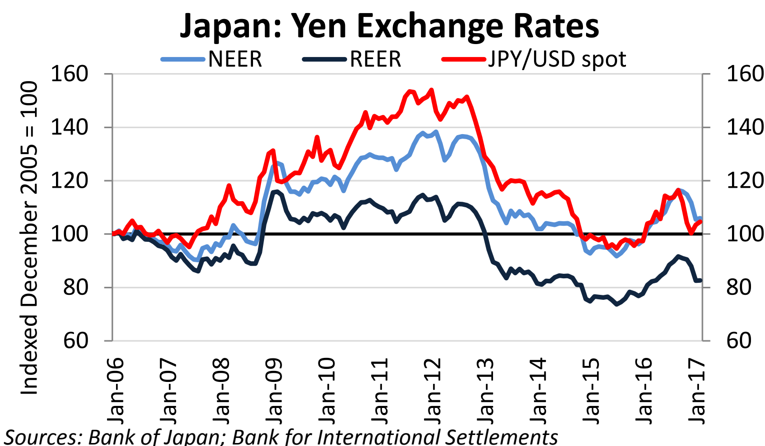
While Japan has run consistent current account surpluses for decades, the trade balance was in deficit between 2011 and 2015 before reverting to surplus in 2016. Japan's current account surplus widened in 2016 to 3.7 percent of GDP or $183 billion, a substantial increase from 3.1 percent in 2015 and the highest annual surplus since 2010. The current account surplus is largely due to Japan's net foreign income surplus, although the trade balance is an increasingly important driver. Japan's seasonally adjusted trade balance (goods and services) turned to a surplus in late-2015 and widened in 2016 on contracting imports. While the trade balance appears to have peaked in mid-2016, Japan continues to register surpluses not seen since the Great East Japan Earthquake in 2011.

Japan's goods trade surplus with the United States in 2016 was $69 billion, roughly unchanged from 2015. As Japan runs a services trade deficit with the United States, Japan's overall bilateral trade surplus (goods and services) was $56 billion in 2016, a marginal increase from $55 billion in 2015. Treasury is concerned by the persistence of the large bilateral trade imbalance between the United States and Japan.



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

The level of the dollar-yen exchange rate ended 2016 virtually unchanged from where it started the year despite considerable variation over the year. The yen appreciated to a 2016 high of JPY/USD 99 in mid-August, following repatriation of overseas retained earnings at fiscal-year's end in March and safe haven inflows in the aftermath of the UK referendum in June. The yen then traded in a range of JPY/USD 100-105 until the U.S. election in November, after which the yen depreciated against the dollar. On a real effective basis, the yen appreciated 6.3 percent in 2016. It appreciated 1.0 percent in the first two months of 2017. There is little evidence that the yen is overvalued. The real effective yen is twenty percent weaker than its 20-year historical average, and the IMF's most recent assessment found the yen to be "broadly consistent with medium-term fundamentals." Japan has not intervened in the foreign exchange market in over five years. Treasury's expectation is that in large, freely-traded exchange markets, intervention should be reserved only to very exceptional circumstances with appropriate prior consultations, consistent with Japan's G-7 and G-20 commitments.



Sources: Bank of Japan; Bank for International Settlements

Japan has experienced five consecutive years of real GDP growth, but the average rate has been just 1.2 percent. Domestic demand growth the past three years has been especially weak, averaging just 0.5 percent.

Japanese authorities continue to seek a durable exit from deflation. The BOJ in 2016 shifted its policy framework from targeting monetary base expansion to "yield curve control," or targeting short-term interest rates as well as 10-year government bond yields. The BOJ also adopted an "inflation-overshooting commitment" to further support inflation

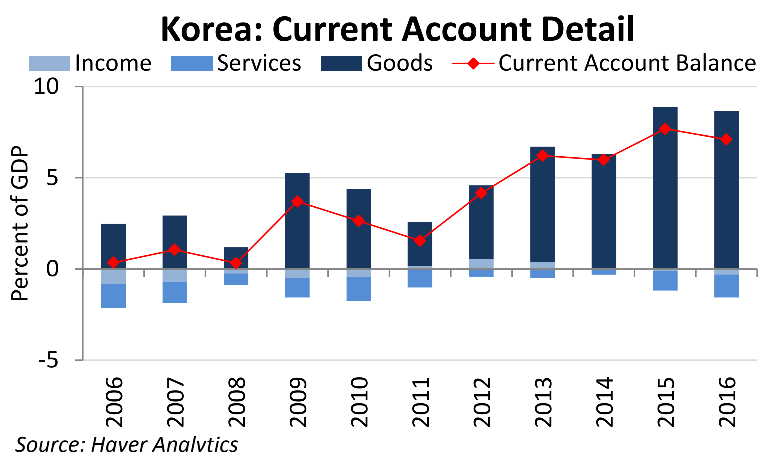
expectations. The recent rise in energy prices has helped boost headline inflation, but the domestic economy has not been strong enough to generate sufficient demand-pull inflation.

On the fiscal front, in May 2016 the government postponed until October 2019 a planned further increase in the consumption tax rate. In August, the government announced a stimulus package of 1.3 percent of GDP. The IMF estimates this package will provide a modest fiscal impulse for 2016 and 2017.

Given continued weak demand growth and exceptionally low inflation, it remains important that the authorities combat these trends using all policy levers. This means complementing accommodative monetary policy and flexible fiscal policy with continued implementation of structural reforms focused on the labor market, raising productivity, and improving the long-term economic outlook.

Korea

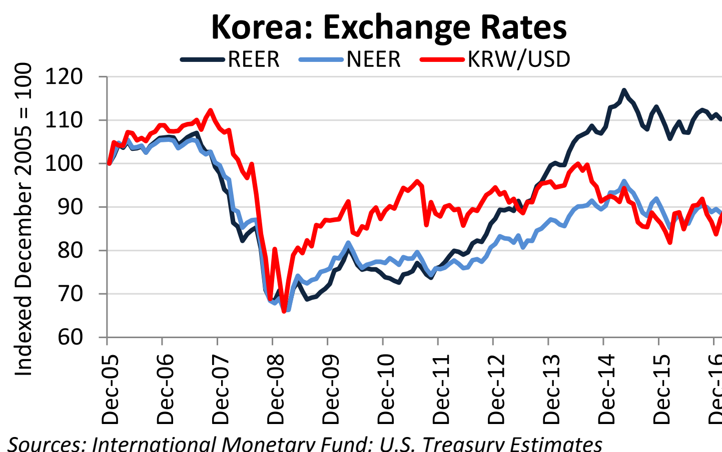
Korea's current account surplus increased materially following the global financial crisis, peaking at 7.7 percent of GDP in 2015, driven predominately by goods exports. The current account surplus declined slightly to 7.0 percent of GDP in 2016. The decline was largely due to a widening of the services deficit and a decrease in the goods surplus.



Source: Haver Analytics

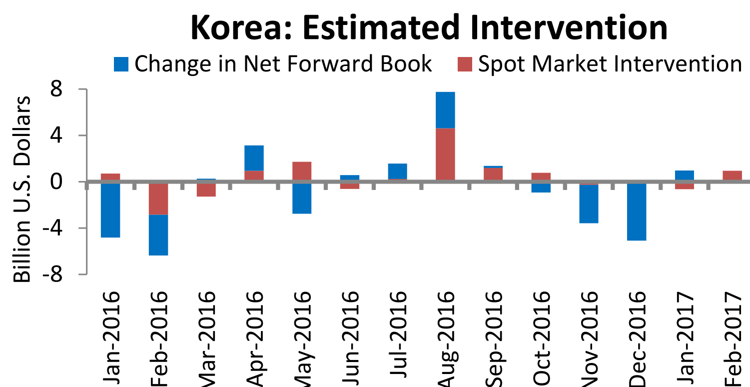
Korea's goods trade surplus with the United States totaled $28 billion in 2016, while the combined goods and services surplus was lower at $17 billion. In the last six months of 2016, Korea's goods trade surplus with the United States totaled $11 billion. The combined goods and services surplus was $6 billion over the same period. Treasury is concerned by the persistence of the large bilateral trade imbalance between the United States and Korea.

In 2016, the won depreciated 2.6 percent against the dollar, but appreciated 0.7 on a real effective basis. Year-to-date in 2017, through February, the won has appreciated 6.8 percent against the dollar and 3.1 percent on a real effective basis. In its last analysis, the IMF maintained its assessment that the won is undervalued.



Sources: International Monetary Fund; U.S. Treasury Estimates

Korea does not publish its foreign exchange market intervention. Treasury estimates that in the second half of 2016 the Korean authorities intervened both to resist appreciation and to resist depreciation of the won, and that on net Korea bought an estimated $2.4 billion in foreign exchange. In 2016 overall, Treasury assesses that on net the authorities intervened to support the won, selling an estimated $6.6 billion (0.5 percent of GDP) in foreign exchange, including activity in the forward market.



Sources: Bank of Korea; U.S. Treasury estimates
February 2017 forward book not yet available

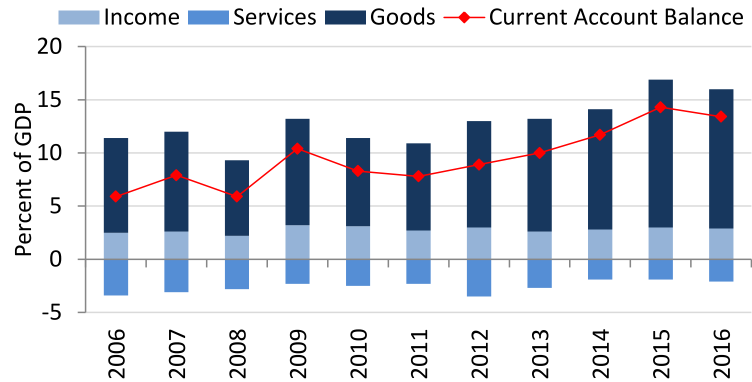
Korea has committed in the G-20 to refrain from competitive devaluation and to not target its exchange rate for competitive purposes. Korea has well-developed institutions and markets, and should limit currency intervention to only exceptional circumstances. Korea maintains ample reserves at $365 billion as of January 2017, equal to more than three times gross short-term external debt and 26 percent of GDP. Treasury also believes that there should be full transparency of foreign exchange operations, and that any macroprudential or capital flow measures should not target the level of the exchange rate.

Korea's trend GDP growth has been slowing over the last several years, and ongoing political uncertainty has led the IMF and the Bank of Korea to further lower their growth forecasts for 2017. Exports continue to play a dominant role in the Korean economy (almost 50 percent of GDP), which highlights the need for Korea to continue rebalancing toward domestic demand – a process that would be helped by won appreciation over the medium-term. Korea should use all policy levers to support growth. The Bank of Korea has cut its policy rate five times since August 2014, most recently in June 2016 to 1.25 percent. The Korean authorities have also announced several fiscal measures in the last six months, but the IMF still projects fiscal consolidation of 0.2 percent of GDP in 2016 and 0.5 percent of GDP in 2017. With a debt to GDP ratio of around 40 percent, Korea has the fiscal space to support the economy more strongly than it has thus far – including through structural fiscal reforms to support household consumption and bring down elevated savings rates – in order to raise domestic demand and avoid reliance on net exports to drive growth going forward.

Taiwan

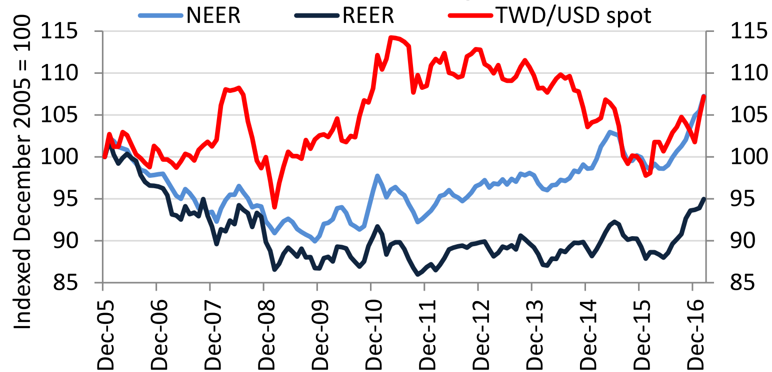
Taiwan has a large current account surplus that has risen significantly over the last decade to become the fifth largest in the world in nominal terms, and has engaged in persistent net foreign currency purchases over the last few years. Taiwan's current account surplus for 2016 was $71.0 billion (13.4 percent of GDP), slightly smaller than the $75.4 billion (14.3 percent of GDP) in 2015. Taiwan's goods trade surplus remained essentially unchanged in 2016 at $27 billion.

In 2016, Taiwan's goods trade surplus with the United States was $13 billion, about $2 billion less than in 2015. The U.S. services trade surplus with Taiwan decreased by $0.5 billion to $4.2 billion in 2016, bringing the overall trade deficit (goods and services) down to $9.1 billion.



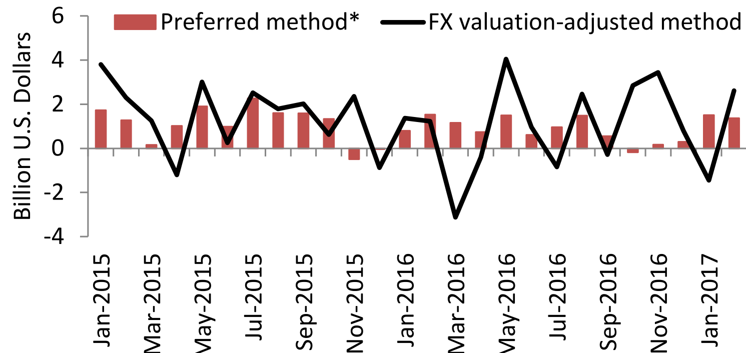
Source: Haver Analytics

In 2016, the new Taiwan dollar (NTD) appreciated 1.4 percent against the dollar, after depreciating 3.9 percent in 2015. In the first three months of 2017, the NTD further appreciated by 7.0 percent. The currency appreciated 5.0 percent on a real effective basis in 2016. Taiwan officially maintains a managed peg exchange rate.



Sources: Taiwan central bank; BIS

Taiwan does not publish its foreign exchange interventions. Treasury estimates that Taiwan's authorities made net foreign currency purchases in 2016 averaging nearly $1 billion per month. Treasury estimates suggest that Taiwan intervened only minimally in currency markets in the fourth quarter of 2016, but purchased as much as $2.9 billion in foreign currency in January February 2017. Taiwan has abundant foreign exchange reserves, totaling $435 billion (82 percent of GDP and 277 percent of short-term external liabilities) at the end of 2016, an increase of $8 billion from the end of 2015.



Sources: Taiwan central bank; U.S. Treasury estimates
** Using change in net foreign assets and interest income estimates*

The IMF does not currently publish a valuation assessment of the NTD. However, outside analysts have assessed that the NTD is undervalued by as much as 26 percent.[5] Treasury

[5] "Estimates of Fundamental Equilibrium Exchange Rates," William R. Cline, Peterson Institute for International Economics, November 2016.

believes Taiwan should make its foreign exchange operations and reserve management more transparent. Although not a member of the IMF, Taiwan uses the IMF's Special Data Dissemination Standard (SDDS) framework to provide data on many aspects of its economy, including the real, fiscal, financial, and many of the external sector accounts. Taiwan does not, however, publish data on the full details of its international reserves in accordance with the SDDS reserves template, standing out as the only major emerging market economy in Asia not to do so.

Germany and the Euro Area

The euro area is a currency union in which there has been considerable dispersion across members in terms of the quality of economic performance, and this has affected the euro exchange rate such that some individual country real effective exchange rates appear to be undervalued relative to that country's economic fundamentals.

Overall, the euro area grew at a pace of 1.7 percent in 2016, which was a bit slower than the 2.0 percent pace in 2015. Spain and Germany grew faster at 3.2 and 1.9 percent, respectively, but growth was lower in France (1.2 percent) and Italy (0.9 percent, which nonetheless represented Italy's best growth performance since 2010).

The real euro is currently 10 percent weaker than the monthly-average real euro since 2000. On a bilateral basis, over the same time period, the euro is 12 percent weaker against the dollar. Persistent weaknesses in some of the peripheral euro area economies, including Greece, Italy, and others, have contributed to uncertainty about the resilience of the monetary union and have effectively weakened the euro over the last several years, both against the dollar and on a nominal and real effective basis. Euro area monetary policy has had an effect as well, as easing by the ECB has opened a sizable gap in interest rates and bond yields between the United States and the euro area.

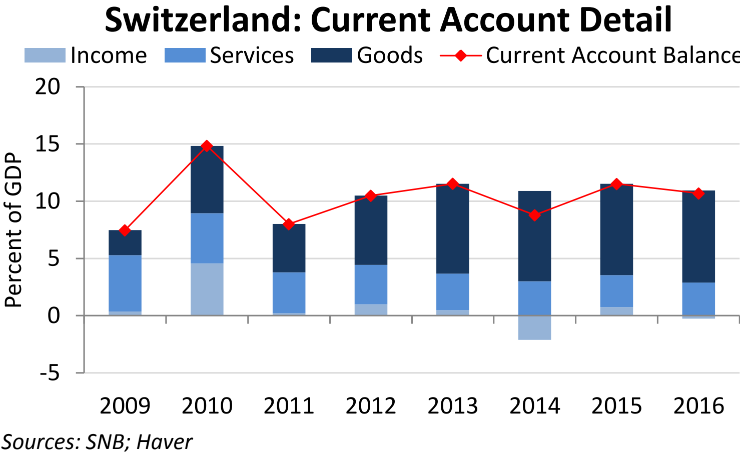
The combination of a relatively weak currency plus weak domestic demand (averaging just 0.5 percent per year the last six years), has led to a significant widening of the euro area's current account surplus from 0.2 percent of GDP in 2009 to 3.4 percent in 2016. Much of this has been driven by a rapid increase in Germany's surplus, which is now the largest nominal surplus in the world at $287 billion. Germany's real effective exchange rate has depreciated by 10 percent since 2009, a shift that would be counterintuitive in light of Germany's large and persistent current account surplus but for its membership in the monetary union. In addition to the exchange rate, Germany's excessively large surplus also reflects weak domestic investment, a declining share of private consumption to GDP, and lower commodity prices.

Germany's bilateral trade surplus with the United States is also very sizable and a matter of concern for Treasury. Treasury recognizes that Germany does not exercise its own monetary policy and that, in the absence of stronger growth elsewhere in the currency union, upward pressure on the nominal and real effective exchange rates may not be strong. Treasury also recognizes that Germany is near full employment. Nevertheless, Germany has a responsibility as the fourth largest global economy and as an economy with a very

large external surplus to contribute to more balanced demand growth and to more balanced trade flows. Pushing demand against inelastic supply will help push up wages, domestic consumption, relative prices against many other euro area members, and demand for imports, and will help appreciate Germany's low real effective exchange rate. This would contribute to both global and euro area rebalancing.

Switzerland

Switzerland has faced persistent pressures from safe haven inflows over the last few years despite the weakness of domestic economic activity and the country's large external surplus. In 2016, Switzerland posted a current account surplus of 10.7 percent of GDP, down from 11.5 percent in 2015. The modest decrease was largely due to a small decline in the income balance, while Switzerland's goods and services surpluses were very close to 2015 levels. Switzerland's role as an international trading and financial services hub contributes to its large current account surplus: For example, the Swiss brokerage industry (which facilitates trade in goods) constitutes 3-4 percent of GDP and is a key component of the trade surplus, even though the actual merchandise may not physically pass through Switzerland.



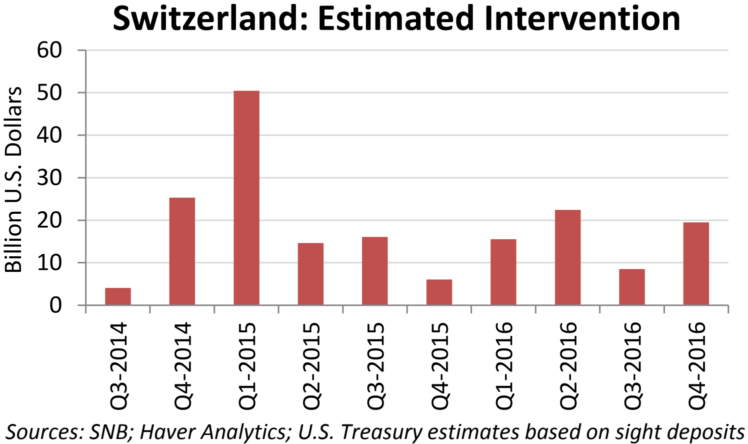
Sources: SNB; Haver

The United States' goods trade deficit with Switzerland was $13.7 billion in 2016, up from $9.2 billion in 2015.

In 2016, Switzerland's nominal effective exchange rate appreciated by 1.4 percent and its real effective exchange rate was roughly flat. During the same period, the Swiss currency depreciated 2.6 percent against the dollar and appreciated 0.7 percent against the euro.

Switzerland continues to rely on monetary policy as its main tool to spur growth and inflation, with negative interest rates and intervention in the foreign exchange market to contain appreciation pressure on the franc. According to its December 2016 quarterly bulletin, the Swiss National Bank (SNB) believes the Swiss franc to be "still significantly overvalued." While Swiss authorities do not publish monthly intervention data, Treasury estimates that SNB net purchases of foreign exchange (specifically, euros) totaled $66 billion in 2016, with a monthly peak of $20 billion in June directly following the UK referendum. In its 2016 annual report, the SNB disclosed that net intervention in 2016 was $68 billion.

As a result of the persistent intervention, Switzerland's stock of foreign reserves has grown substantially and exceeded 96 percent of GDP at end-2016. While IMF staff concluded in Switzerland's 2016 Article IV consultation that foreign exchange purchases to date have been warranted to address below-target inflation that is largely exchange rate driven – particularly following the January 2015 removal of the exchange rate floor – IMF staff also suggested that future interventions should be limited to managing safe haven inflows, and that more traditional monetary tools (e.g., interest rates) be used rather than intervention to manage inflation. Treasury supports this recommendation. Treasury also encourages the Swiss authorities to publish all intervention data.



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

Fiscal policy in Switzerland remains broadly neutral, despite the weakness of domestic activity – domestic demand fell by 0.2 percent in 2016 – and Switzerland's very low borrowing costs. Swiss authorities point to the country's fiscal rules as constraining the ability of fiscal policy to provide stimulus. However, in Treasury's view, Switzerland retains ample fiscal space, with a general government budget in balance and public debt at 46 percent of GDP. Given the estimated negative output gap, weak domestic demand, and overreliance on monetary policy, there is a strong case for greater use of fiscal tools to support output.

Section 2: Intensified Evaluation of Major Trading Partners

Together, the Omnibus Trade and Competitiveness Act of 1988 (the "1988 Act") and the Trade Facilitation and Trade Enforcement Act of 2015 (the "2015 Act") require the Secretary of the Treasury to provide semiannual reports on the foreign exchange policies of the major trading partners of the United States. Under Section 3004 of the 1988 Act, the Report must consider "whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade." 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.[6]

Key Criteria

Pursuant to Section 701 of the Trade Facilitation and Trade Enforcement Act of 2015, this section 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 (January to December 2016, unless otherwise noted) are provided in Table 1 (on p. 13) and Table 2 (below).

As noted earlier, Treasury's focus is on the 12 largest trading partners of the United States which account for around 70 percent of U.S. trade in goods. No economy below the top 12 trading partners individually accounts for more than 1.5 percent of U.S. goods trade. Treasury's goal is to focus attention on the currency practices of 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.

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[6] Because the standards and criteria in the 1988 Act and 2015 Act are distinct, it is possible that an economy could be found to meet the standards identified in one of the Acts without being found to have met the standards identified in the other. In particular, a finding that an economy met the standards in the 1988 Act of manipulating its currency would require Treasury to examine a wider array of additional facts such as foreign exchange reserve coverage, monetary policy, or inflation developments.

Table 2. Major Foreign Trading Partners Evaluation Criteria

	Bilateral Goods Deficit (USD Bil., Trailing 4Q) (1)	Current Account			Foreign Exchange Intervention		
		Balance (% of GDP, Trailing 4Q) (2a)	3 Year Change in Balance (% of GDP) (2b)	Balance (USD Bil., Trailing 4Q) (2c)	Net FX Purchases (% of GDP) (3a)	Net FX Purchases (USD Bil.) (3b)	Net FX Purchases 8 of 12 Mos.?† (3c)
China	**347.0**	1.8	0.2	196	-3.9	-435	No
Japan	**68.9**	**3.8**	2.9	186	0.0	0	No
Germany	**64.9**	**8.3**	1.5	286	-	-	No
Mexico	**63.2**	-2.7	-0.2	-28	-0.5	-6	No
Italy	**28.5**	2.8	1.8	51	-	-	No
Korea	**27.7**	**7.0**	0.8	99	-0.5	-7	No
India	**24.3**	-0.5	2.1	-11	0.4	10	No
France	15.8	-1.2	-0.3	-30	-	-	No
Switzerland	13.7	**10.7**	-0.8	71	**10.0**	66	**Yes**
Taiwan	13.3	**13.4**	3.4	71	1.8	10	Yes
Canada	11.2	-3.3	-0.1	-51	0.0	0	No
United Kingdom	-1.1	-5.1	-1.1	-138	0.0	0	No
Memo: Euro Area	**125.7**	**3.4**	1.2	403	0.0	0	No

Sources: Haver Analytics; National Authorities; U.S. Census Bureau; and 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 for the four quarters ending December 2016.[7] China has the largest trade surplus with the United States by far, after which the size of bilateral trade surpluses declines very quickly. 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 are the major trading partners that have a bilateral surplus that meets this threshold over the most recent four quarters.

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 are the five economies that had a current account surplus in excess of 3 percent of GDP for the four quarters ending December 2016. In the aggregate, these five economies accounted for more than half of the value of global current account surpluses in 2016. 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.

[7] 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 (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.[8] Columns 3a and 3c in Table 2 provide Treasury's assessment of this criterion.[9] In economies where foreign exchange interventions are not published, Treasury uses estimates of net purchases of foreign currency to proxy for intervention. Switzerland meets this criterion for the last four quarters available, per Treasury estimates.

Summary of Findings

Pursuant to the 2015 Act,[10] 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, have met two of the three criteria for enhanced analysis in this Report or in the October 2016 Report. Additionally, one major trading partner, China, constitutes a disproportionate share of the overall U.S. trade deficit. These six economies – China, Japan, Korea, Taiwan, Germany, and Switzerland – constitute Treasury's Monitoring List. Japan, Germany, and Korea met two of the three criteria in both the October 2016 Report and this Report, having material current account surpluses combined with significant bilateral trade surpluses with the United States. Switzerland met two of the three criteria in both the October 2016 Report and this Report, having a material current account surplus and having engaged in persistent, one-sided intervention in foreign exchange markets. Taiwan met two of the three criteria in the October 2016 Report – 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. To be removed from the Monitoring List, Taiwan must demonstrate a durable, not one-off, and clear improvement in the intervention criteria. This is particularly true in that Taiwan does not disclose intervention data, forcing Treasury to rely on estimates that inherently involve some degree of imprecision. China met only one of the three criteria in this Report, a large bilateral trade surplus with the United States, but this surplus accounts 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.**

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[8] 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.

[9] Treasury used 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 used 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 are not reflective of 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.

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

Regarding the 2015 Act, while no economy met all three of the criteria for the current reporting period, Treasury is determined to watch very closely for any unfair currency practice that creates a burden for U.S. workers and U.S. companies. Though there has been a trend in the last two years towards reduced currency intervention by key trading partners, it is critical that this not represent merely an opportunistic response to shifting global macroeconomic conditions – in particular changes in capital flows which have created depreciation pressures on many emerging market currencies – but a durable policy shift away from foreign exchange policies that facilitate unfair competitive advantage.

The current global configuration of external positions, in which there are pockets of extremely large trade and current account surpluses, is untenable. The United States cannot and will not bear the burden of an international trading system that unfairly disadvantages our exports and unfairly advantages the exports of our trading partners through artificially distorted exchange rates. Treasury is committed to aggressively and vigilantly monitoring and combatting unfair currency practices.

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.

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 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 fixed rate of exchange between its currency and another currency or a basket of currencies. Typically the exchange rate is allowed to move within a narrow predetermined (although not always announced) band. Pegs are maintained through a variety of measures including capital controls and intervention.

Real Effective Exchange Rate (REER) – A weighted average of bilateral exchange rates, expressed in price-adjusted terms.

Trade Weighted Exchange Rate – see Nominal Effective Exchange Rate.