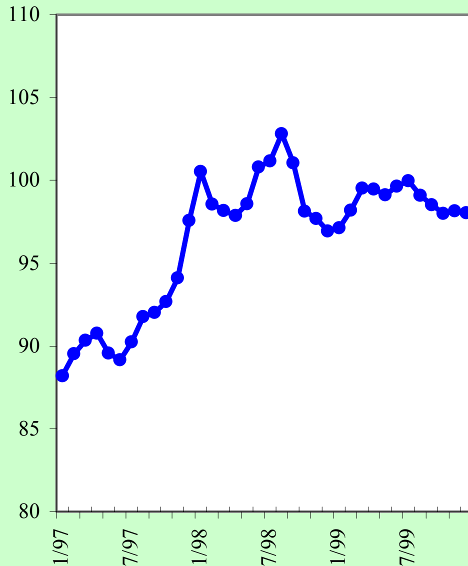
U.S. Department of the Treasury

Update to the Annual Report to Congress on International Economic and Exchange Rate Policies

Updates the Annual Report Submitted September 3, 1999 and covers the period: July 1, 1999 to December 31, 1999

Real Value of the Dollar

Federal Reserve Board Staff Real Broad Dollar Index 3/73=100 (larger values indicate appreciation)



This report reviews developments in U.S. international economic policy, including exchange rate policy, during the period from July 1, 1999 through December 31, 1999. This report is required under Section 3005 of the Omnibus Trade and Competitiveness Act of 1988 (the "Act").

EMBARGOED FOR RELEASE UNTIL:

4:30 p.m., March 9, 2000

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Summary

Major Findings

- **The U.S. economy performed strongly over the period July 1, 1999 to December 31, 1999.** The U.S. economy over this period continued to experience a combination of strong output growth, low inflation, and employment expansion not seen in nearly three decades.

- **This robust growth spurred imports while slow growth in major markets helped to keep exports weak. As a result, the U.S. current account deficit increased significantly, and it is likely to continue to increase over the months ahead.**

- **The U.S. growth also fueled strong capital inflows into the United States.** The increased capital inflows helped sustain domestic investment despite low personal savings, but also implied a continued deterioration in the U.S. net international investment position.

- **Treasury determined that none of the major trading partners of the United States manipulated exchange rates under the terms of Section 3004 of the Act during the period under consideration.**

Policy Priorities

- **Maintain sound economic and financial policies in the United States, including our strong dollar policy, which is in the interest of the United States.**

- **Encourage macroeconomic and structural policies supportive of sustained non-inflationary growth by our major trading partners in order to restore an orderly return to more balanced global growth patterns and, over time, contribute to reduced global imbalances.**

- **In particular, encourage Japan to take supportive macroeconomic policies and implement structural and financial sector reforms; in Europe, encourage appropriate macroeconomic policies and structural reforms that encourage investment and employment.**

- **Put in place policies that will strengthen the international financial architecture and reduce the risk of future crises.**

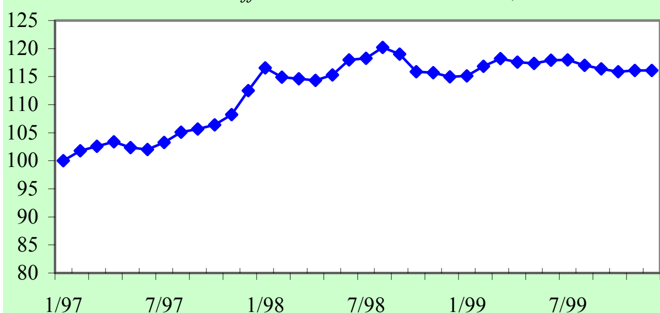
- **Continue efforts to open foreign markets to U.S. exports while maintaining a commitment to open markets that has been so important to our economic success.**

- **Continue to monitor the policies and practices of U.S. trading partners for evidence of currency manipulation as countries balance the goals of reserve accumulation to cover short-term liabilities and of movement of the exchange rate to an appropriate level.**

Economic Policy and Currency Market Developments in Key Economies

United States

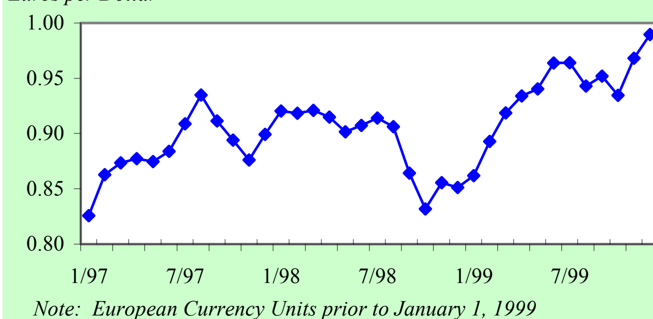
During the period covered by this report, the Federal Reserve Board staff's nominal dollar index indicates that the nominal value of the dollar depreciated 1.6% on a trade-weighted basis, following a 2.6% appreciation in the first half of 1999. During the second half of 1999, the Federal Reserve staff's real effective dollar exchange rate depreciated 1.6%, after a 2.8% appreciation from the first half of the year. Dollar movements initially reflected prospects for more balanced global growth, particularly among the major economies. The 3rd quarter was marked by sizeable portfolio flows into Japanese assets. However, sustained economic growth in the United States supported demand for U.S. assets and the dollar in the 4th quarter, and during the period of this report, the Federal Reserve raised interest rates twice, by 25 bps in August and November. U.S. and global financial markets entered the Y2K rollover period without dislocation.



Euroland

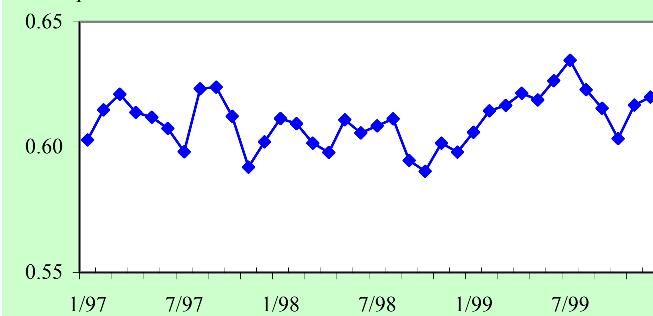
Since June, the dollar has appreciated 2.7% against the euro in nominal terms, 3% in real terms. On a trade-weighted basis, the euro has fallen, 5.9% in nominal terms and 1.8% (through October) in real terms. On November 4, 1999, the European Central Bank raised rates 50 bps to three percent. Market participants attributed the euro's weakness to a widening in the gap between expected U.S. and Euroland growth rates and investment flows out of Europe and into Japan and the United States.

The January 2000 *Consensus* forecast of 1999 Euroland growth is 2.2%, compared with 2.7% growth in 1998. Despite this slowdown, there are signs that the foundations of a more dynamic European economy are starting to fall into place. New European financial markets, deregulation of the telecommunications market, and steps, by some, to improve labor market flexibility. Indeed, in four countries that have moved the furthest with structural reforms, real fixed investment in the 1990s has risen between three and ten times faster than for the Euro-area as a whole. Nevertheless, additional work remains to implement the complete reform agenda. In addition, European authorities should strive to maintain a supportive macroeconomic environment. In a reformed European economy, policy makers will need to be open to the possibility that the traditional inflation relationships could well shift.



United Kingdom

During the period covered by this report, the dollar experienced a 1.1% nominal depreciation and 0.8% real depreciation against the pound. On a trade-weighted basis, the nominal value of the pound appreciated 1.8% (1.5% in real terms). Market participants attributed the continuing appreciation of the pound to strong UK growth relative to continuing sluggish growth in Europe and tight monetary policy in the UK relative to the Euro-11. In response to the gradually rising global demand, strong UK consumption and a tightening local housing market, the Bank of England raised interest rates twice (in September and November) by 25 bps each time. Interest rates in the UK remain approximately 250 bps higher than interest rates in Euroland.

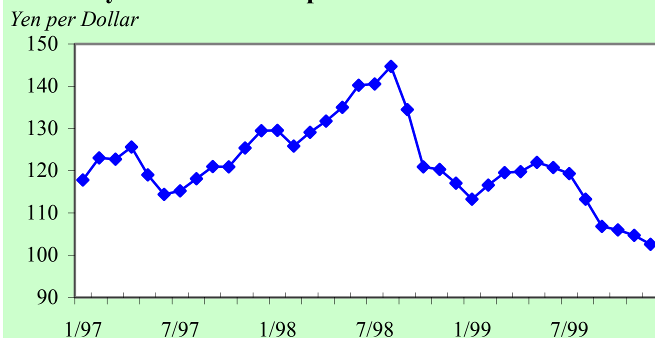


Japan

In the second half of 1999, the dollar depreciated 15% against the yen in nominal terms, and in real terms, depreciated 13.6%. More broadly, the nominal value of the yen appreciated 18.9% on a trade-weighted basis in the final six months of 1999. The real, trade-weighted yen appreciated 14.1%. The Japanese

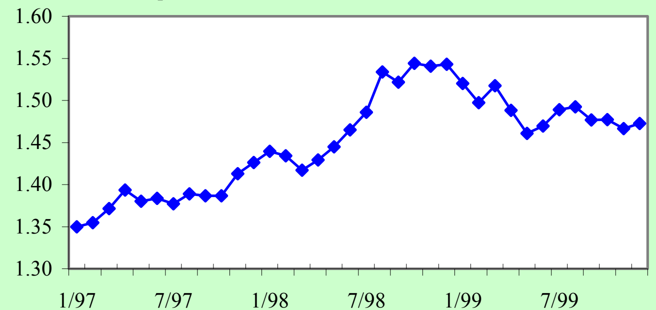
authorities responded to the upward pressure on the yen with several rounds of unilateral foreign exchange market intervention, which was the main factor in boosting Japan's foreign exchange reserves to $288 billion, up from $246 billion at the start of the period. Nevertheless, market participants attributed this appreciation to continuing interest in Japanese equities, capital inflows (primarily from Europe), and a perceived rebound in the economy. Japan's current account surplus narrowed from ¥15.8 trillion ($121 billion) in 1998 to ¥12.2 trillion ($108 billion) in 1999, primarily due to a widening of the deficit in services, transfers and investment income.

Japan's economy slowed in the second half of 1999 after a brief rebound in the first half of the year, and the January *Consensus* growth forecast for 2000 is 0.7%. As a result, the need for structural reforms and achieving sustained, domestic demand-led growth is even greater in Japan than in Europe. Efforts at deregulation have made little progress outside of the telecommunications, banking, and retail sectors. Yet, in these sectors, the benefits of deregulation are now clear. While important progress has been made in financial sector liberalization, more work remains in accelerating the disposal of bad assets. The percentage of households owning a cellular phone has increased from 3% in 1993 to about 60% in 1999. New investment in mobile communications, at ¥1.5 trillion, is equal to planned new investment in the domestic Japanese auto industry. Extending the success of deregulation efforts in these three areas will also require a sustained, supportive macroeconomic environment. The Japanese economy must still close a significant output gap before Japan is to achieve the kind of dynamic market-driven growth its people deserve and its demographic requires.



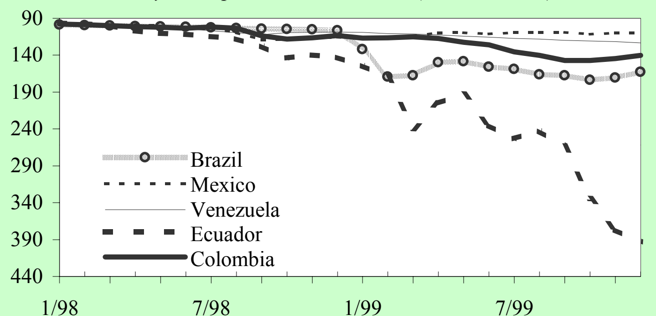
Canada

During the period covered by this report, the nominal value of the U.S. dollar appreciated 0.2% against the Canadian dollar; the real value of the U.S. dollar appreciated 0.8%. On a trade-weighted basis, the Canadian dollar has depreciated 1.5% (in both nominal and real terms) in the last half of 1999. Despite this recent depreciation, for all of 1999, the nominal, trade-weighted value of the Canadian dollar appreciated 5.3% (3.6% in real terms). Market participants attributed the year-long appreciation to Canada's large trade surplus, low inflation and higher commodity prices, and they attributed the recent depreciation to concerns about inflation.



Latin America: Overview of Selected Countries

In the second half of 1999, the region benefited from a recovery in oil and other commodity prices, and an easing of global financial pressures as reflected in a decline in Latin American sovereign spreads over Treasuries. Most economies in the region began to show signs of growth in the second half, and are expected to record moderate expansions in 2000. Ecuador, and to a lesser extent Venezuela, showed more economic weakness due to country-specific factors.



- **Brazil.** During the period of this report, the Brazilian economy was considerably stronger than most analysts had predicted after the devaluation and floating of the currency. Despite a 33% depreciation of the real from December, 1998 to December, 1999, consumer price inflation over that period was only 8.9%. That limited pass-through reflected in part cautious central bank policy, as the central bank reduced the overnight interest rate from 21% in July only to 19% at end-1999. High levels of foreign direct investment ($29 billion vs. an estimated current account deficit of $24 billion) helped to support the exchange rate, which was largely stable in the second half of the year, despite a slower than expected adjustment in the trade account. The economy grew by 0.8% in 1999, up from 0.05% growth in 1998. Brazil is expected to have met its target of a

3.1% of GDP non-interest fiscal surplus for the year. Long-term borrowing costs on international markets fell, with the spread over Treasuries on Brazil's 30-year bond narrowing from 767 basis points in July to 533 basis points at end-1999.

- **Colombia.** The economy contracted an estimated 5% in 1999, its first year of recession since 1942, largely due to weak commodity prices, reduced international capital market access, high interest rates from last year's defense of the peso, and concerns about security. The recession and tight monetary policy helped contain consumer price inflation to 9.3% in 1999, the lowest rate in 25 years, down from 16.7% in 1998 and 17.7% in 1997. The 1999 fiscal deficit widened to an estimated 6.3% of GDP, despite attempts by the Pastrana government to rein it in, largely reflecting policies implemented by the previous government and cyclically low revenues. The central bank abandoned the exchange rate band on September 26, 1999 after adjusting/devaluing twice in the previous 12 months, and the peso appreciated 6.6% between the time it was floated and end-December. Interest rates declined after the float, with the benchmark DTF 90-day rate closing the year at 16.1%, down from 19.5% in October. In December, Colombia and the IMF announced a 3-year, Extended Fund Facility program that seeks to bring the fiscal deficit down to 3.6% of GDP in 2000, 2.5% in 2001, and 1.5% in 2002. According to *Consensus Forecast*, GDP is expected to grow 2.4% in 2000.

- **Argentina**. Argentina's economy contracted an estimated 3.2% in 1999 due in large part to reduced access to international credit markets, weak agricultural commodity prices, and the Brazilian recession and devaluation. But signs of recovery were apparent in the second half of the year, and analysts expect growth will exceed 3% in 2000. Argentina remains committed to its currency board type arrangement, and the new government inaugurated in December pledged to maintain the system and to enact supporting fiscal and other economic reforms. Confidence in the banking system remained strong, reflected in steady deposit growth in 1999 (6.7% year-on-year as of December 1), unlike during 1995's recession, when deposits fell 18% in the first three months of the year. In the second half of 1999, Argentina's access to international capital markets improved along with other Latin American borrowers, reflecting better growth prospects and easing of global financial pressures. In December, the government began negotiations with the IMF on a new 3-year program based on fiscal consolidation and structural reform.

- **Mexico.** A strong U.S. economy, higher world oil prices, falling real domestic interest rates, and improvement in emerging market debt markets supported an estimated real GDP growth of 3.6% in 1999. Mexico's prudent macroeconomic policies and its high degree of economic integration with the United States helped it to achieve the fastest growth rate of any major Latin American economy in both 1998 and 1999. Foreign direct investment of about $10.5 billion and equity portfolio inflows of $4 billion covered the estimated current account deficit of $13.6 billion (2.8% of GDP) and contributed to a nominal appreciation of the peso in 1999. The real peso exchange rate, measured on a CPI basis, is now at the same level as in December 1994 and is 10% appreciated relative to its 30-year average. Monetary restraint and the peso's strength helped bring inflation down to 12.3% December/December in 1999 vs. 18.6% in 1998.

Real GDP Growth: Selected Latin American Countries
% change over a year ago

	Mexico	Brazil	Venezuela	Argentina
1Q/98	7.49%	0.73%	9.38%	6.41%
2Q/98	4.44%	1.39%	1.70%	6.68%
3Q/98	4.98%	0.25%	-5.29%	3.33%
4Q/98	2.59%	-2.16%	-4.94%	-0.60%
1Q/99	1.86%	0.65%	-9.34%	-2.97%
2Q/99	3.21%	-0.22%	-8.93%	-4.90%
3Q/99	4.56%	-0.18%	-5.85%	-4.15%
4Q/99	n.a.	3.13%	-4.53%	n.a.

Source: Haver Database

Currency Values: Selected Latin American Countries
Domestic currency units per Dollar

	1/99	7/99	12/99	Jul-Dec Change
Brazil (Reais/$)	1.50	1.80	1.84	-2.3%
Mexico (Pesos/$)	10.13	9.37	9.4	-0.6%
Venezuela (Bolivares/$)	569.2	610.6	643.7	-5.4%
Ecuador (Sucres/$)	7,107.3	11,693.5	18,143.4	-55.2%
Columbia (Pesos/$)	1,569.4	1,822.1	1,887.0	-3.6%

- **Ecuador**. Ecuador's economy in 1999 was hit by natural disasters, low oil prices in the first half of 1999, compounded by weak economic policy, and political turbulence. The economy continued to contract in the second half of 1999 and the Government of Ecuador estimates that GDP declined by 7.5%, while inflation surged to 60.7%. The 1999 nonfinancial public sector deficit was an estimated 4.2% of GDP (helped by higher oil prices in the second half of 1999), an improvement over the 6.5% of GDP deficit in 1998. In addition, the GOE provided some $2 billion in support for insolvent banks. Reflecting continuing financial and budgetary pressures and a poor policy framework, Ecuador has been unable to meet its external payments and stopped payments on Brady bonds. It subsequently has fallen into arrears on some Eurobond issues. Ecuador was engaged in discussions with the IMF during all of 1999, but due to insufficient policy reform was not able to conclude negotiations for an IMF program.

- **Venezuela**. The economic slowdown continued in the second half of 1999, and the Government of Venezuela estimates that 1999 GDP shrank 7.2%. The recession reflected factors common to other Latin American countries–including global financial turbulence, high local interest rates and weak commodity prices–as well as uncertainties about economic policy under the new government. Unlike most other Latin American countries, there was little sign of economic rebound in the second half of 1999 when conditions were worsened by a natural disaster late in the year. The central government fiscal deficit was 3.3% of GDP in 1999, according to the GOV (boosted by higher oil prices in the second half of 1999) compared to a deficit of 5.8% of GDP in 1998. The exchange rate and external accounts were supported by the surge in oil prices in the second half of 1999, contributing to a $5.5 billion (5.5% of GDP) current account surplus.

Emerging Asia

After surging in the first half of 1999, growth in emerging Asia slowed somewhat in the second half. For 1999 as a whole, however, emerging Asia's recovery was much stronger than anticipated. Economic recoveries were supported by accommodative monetary and fiscal policies, coupled with continued strong demand for exports. Domestic demand showed signs of rebounding and is expected to replace exports as the main source of growth in 2000. Although the economic outlook has improved significantly, the need for reforms remains critical, particularly in the banking and corporate sectors, and governments need to guard against becoming complacent.

- All countries posted growth in 1999, from less than ½% in Indonesia to as high as 9½% in South Korea. Except in Korea, where the government is likely to tighten policies to moderate growth, further growth in the region is expected in 2000.

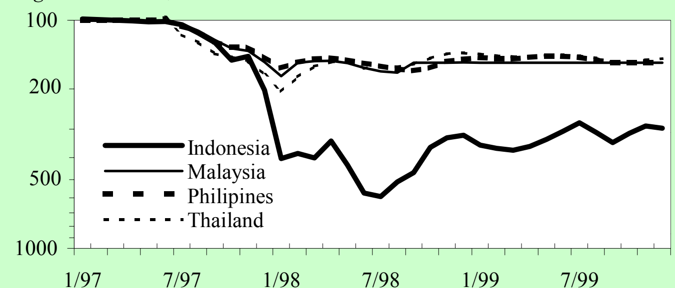
- Growth was primarily export-led during the reporting period, boosted by continued strong demand from the United States and resurgent intraregional trade. Electronics exports, which are a significant share of exports in many countries, benefited from Y2K-related demand. Imports continued to recover, from a much reduced base, and are expected to accelerate in 2000 as domestic demand recovers.

- With export growth strong, and imports recovering from the sharp fall in domestic demand in 1997-98, all countries in the region recorded current account surpluses in 1999, though in most cases the surpluses were smaller than in 1998. The expected rebalancing of growth toward domestic demand should lead to stronger import growth and a further reduction of external surpluses in 2000.

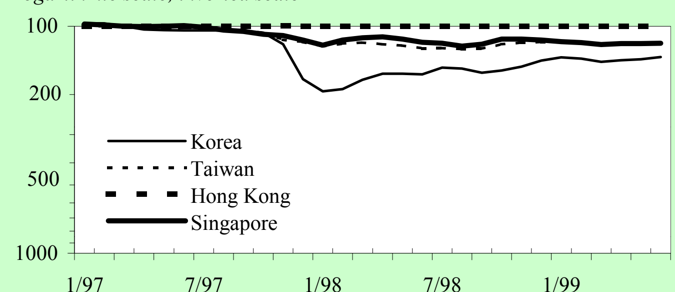
- With the exception of the Thai baht and the Indonesian rupiah, regional currencies were fairly stable relative to the U.S. dollar, fluctuating in a range of less than 10%. On a real trade-weighted basis, currencies changed little for some (Korea, Indonesia, and Singapore) and were up to 10% weaker for others (Philippines and Thailand).

- Although there has been progress in implementing reforms, concern remains that as recoveries take hold, the pace of reform will slow. Bank recapitalization is incomplete, and a large corporate debt overhang continues in most economies. Despite accommodative monetary policies, private credit growth has been anemic. Incomplete bank and corporate sector restructuring could become a serious constraint to domestic investment.

Currency Movements: Selected ASEAN Countries
Domestic currency units per dollar, Mar. 1997 = 100
Logarithmic scale, inverted scale



Currency Movements: NIEs
Domestic currency units per dollar, Mar. 1997 = 100
Logarithmic scale, inverted scale



In the previous Foreign Exchange Report dated September 3, 1999, **Singapore** was examined as a potential exchange rate manipulator. While Singapore's current account surplus is large (at 17.3% of GDP), it is smaller than the 1998 surplus (at 20.8% of GDP). In addition, the bilateral trade deficit with Singapore has declined every year since 1996, from $5.6 billion in 1996 to $3.3 billion in 1999. In 1999, the U.S. had larger bilateral deficits with 20 other countries in the world; in 1996, there were only 10.

Emerging Asia (continued)

In addition to Singapore, **Indonesia, Thailand**, and **Philippines** had current account surpluses during the period covered by the report. However, central banks either replenished reserves or accumulated reserves due to international borrowing.

- **Indonesia.** Indonesia's current account surplus declined slightly to 3½% of GDP in 1999, down from 4% in 1998. The surplus reflects a sharp drop in imports due to declining investment, the latter the result of financial sector weakness and political and economic uncertainty. During the reporting period, intervention by the central bank was generally limited to sterilizing the monetization (i.e., turning into local currency) of loans from international financial institutions.

- **Thailand.** Thailand's current account surplus fell to 9% of GDP in 1999 from 12½% in 1998 as domestic demand recovered, with the help, in part, of two fiscal stimulus packages in 1999. While the current Thai administration has stated it is following a floating exchange rate regime, it has occasionally intervened to keep the currency within a broad range and rebuild reserves. Net foreign exchange reserves (less IMF credits) increased by approximately $3 billion over the period (rising from 21% of M2 to 24½% and currently equal to 135% of short-term debt), but still remain below pre-crisis levels.

- **The Philippines.** The Phillipines' current account surplus is estimated to have risen to 8% of GDP in 1999 from 2% in 1998, due to a 19% increase in exports. However, *Consensus* forecasts a decline in the surplus to 2½% of GDP in 2000 as domestic demand strengthens. The central bank intervened to replenish reserves over the course of the year, with the ratio of net foreign exchange reserves to short-term debt rising to 117%.

U.S. Economy

Overview of the U.S. Economy

The U.S. economy continued to exhibit strong growth and low inflation during the period covered by this report (the final two quarters of 1999). U.S. GDP expanded 5.7% in the 3rd quarter of 1999, and preliminary data show 6.9% growth in the 4th quarter. If confirmed, growth for all of 1999 would be 4.1%, down only slightly from 4.3% in 1998. This strong growth has helped to keep unemployment at 30-year lows. The unemployment rate in December 1999 was 4.1%, down from 4.3% in July. The CPI inflation rate (year over year) reached 2.7% in December, up from 2.1% in July. However, the "core" rate of inflation (excluding food and energy) declined slightly from 2.0% in July to 1.9% in December. During the second half of the year, U.S. interest rates on the benchmark 10-year Treasuries continued to increase, from 5.9% in July to 6.5% in December. While the personal savings rate has fallen to 1.4% of GDP, the budget surplus has helped to maintain total national savings.

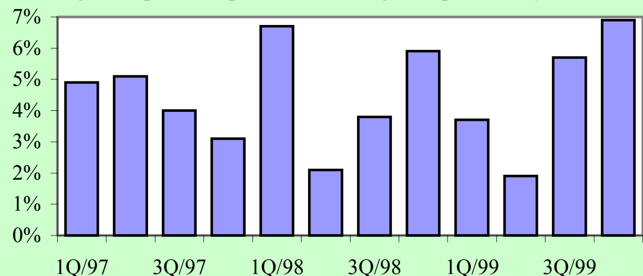
The strong U.S. growth relative to the rest of the world and relatively high U.S. private sector investment gave rise to an increasing U.S. current account deficit. It is important that the rest of the world take steps to increase growth in order to achieve a more balanced global expansion, while we must work to increase U.S. national savings.

IMF Article IV Consultation

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

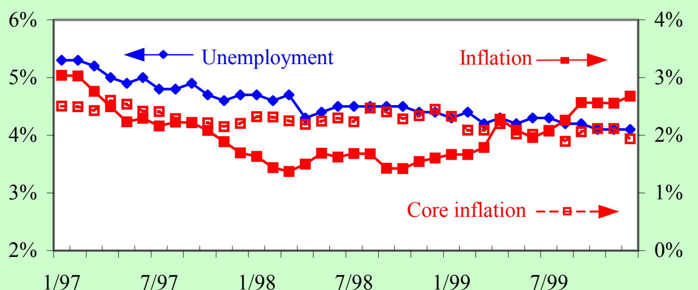
The IMF staff noted that the United States has been the principal engine of global growth during the recent period of global financial turbulence and that "U.S. monetary policy played a key role in stabilizing international financial markets." The staff also noted that "[o]ver the past year and a half, the appreciation of the U.S. dollar has shifted demand abroad, helping to avert overheating in the United States and mitigating the adverse effects of the global economic turbulence." IMF staff, however, cautioned that the orderly return of more balanced global demand growth patterns would be a policy challenge for both the United States and its trading partners. Consistent with a broad effort by the United States to enhance the transparency of the IMF, the United States is part of a pilot program recently established by the IMF's Executive Board to release the staff reports on their Article IV reviews. The staff report was released to the public on August 5, 1999 and is available on the IMF's web site.

U.S. Real Gross Domestic Product
% change over previous quarter, SAAR (4Q/99 is preliminary)



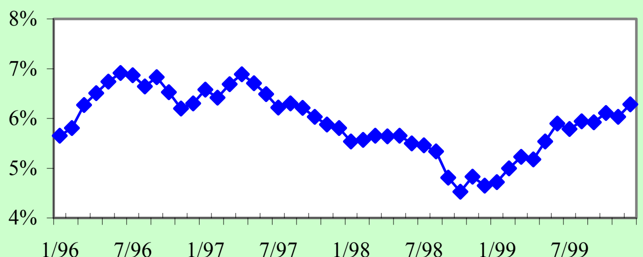
Source: Bureau of Economic Analysis (BEA)

U.S. Civilan Unemployment Rate and U.S. Inflation Rate
Unemployment (left); Inflation (year-on-year % change in prices, right)



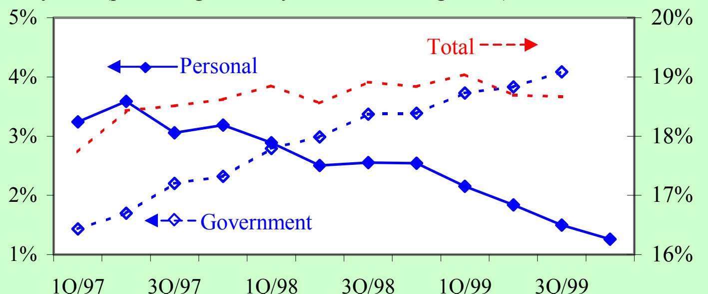
Source: Bureau of Labor Statistics

U.S. Interest Rates
% (10 year Treasuries)



Source: U.S. Treasury

U.S. Savings Rate
% of GDP (personal/gov't on left axis; total on right axis)



Source: BEA (4Q prelim. data available for personal savings only)

Trade Flows

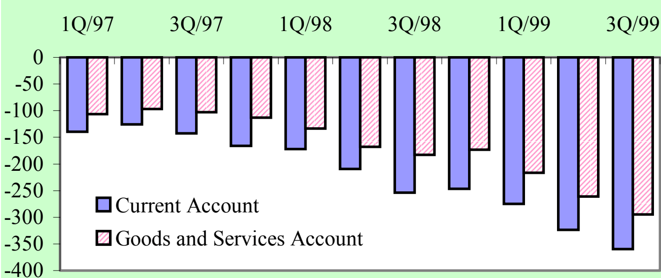
The disparity in growth between the U.S. and the rest of the world continued in the second half of 1999, helping to drive significant expansions of both the trade and current account deficits, despite recent increases in exports. The U.S. economic expansion has continued at a vigorous pace while many trading partners are either in only the early stages of the recovery or are experiencing persistent slow growth.

The current account deficit rose from $275 billion SAAR (seasonally adjusted at annualized rates) in the 1st quarter of 1999 to $360 billion SAAR in the 3rd quarter of 1999 (full current account data are only available through the 3rd quarter of 1999). For all of 1999, the goods and services deficit increased to $271 billion, or 2.9% of GDP.

U.S. exports of goods and services increased 2.6% in 1999. Export growth, however, was concentrated in our NAFTA trading partners and the crisis-Asian economies (Indonesia, Philippines, South Korea, and Thailand). In the emerging markets in Asia (Singapore, Hong Kong, Taiwan, and Malaysia plus the four crisis countries), where financial crisis and recession had led to a sharp compression of imports, U.S. merchandise exports still have not recovered to monthly averages in 1997. Strong economic growth in the United States generated robust demand for imports. Although import growth was stronger in 1994, and nearly as strong in 1995, when imports grew 12.5% and 11.3% (respectively), despite slower U.S. growth during those two years. Import growth in 1999 was 12%.

U.S. External Balances

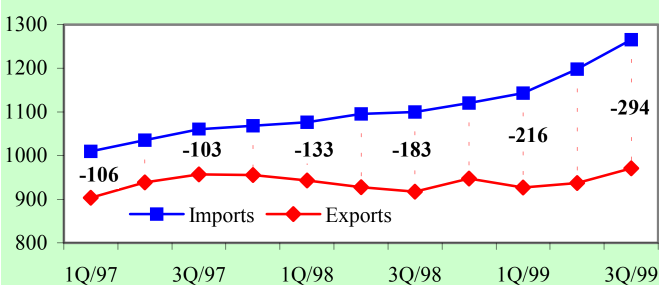
Billions of U.S. $, SAAR (Balance of Payments, BOP, Basis)



Source: Bureau of Economic Analysis, Bureau of the Census

U.S. Trade in Goods and Services

Billion of U.S. $, SAAR (BOP Basis, trade balances in bold)



Source: Bureau of Economic Analysis, Bureau of the Census

U.S. Trade in Goods and Services

Billions of U.S. $ (BOP basis)

	Exports		Imports	
	Level	Change	Level	Change
1993	641.8	4.2%	711.7	9.0%
1994	702.1	9.4%	800.5	12.5%
1995	793.5	13.0%	891.0	11.3%
1996	849.8	7.1%	954.1	7.1%
1997	938.5	10.4%	1043.3	9.3%
1998	933.9	-0.5%	1098.2	5.3%
1999	958.5	2.6%	1229.8	12.0%

Source: Bureau of Economic Analysis, Bureau of the Census

U.S. Bilateral Merchandise Trade Balances

Billions of U.S. $ (nsa, Census basis)

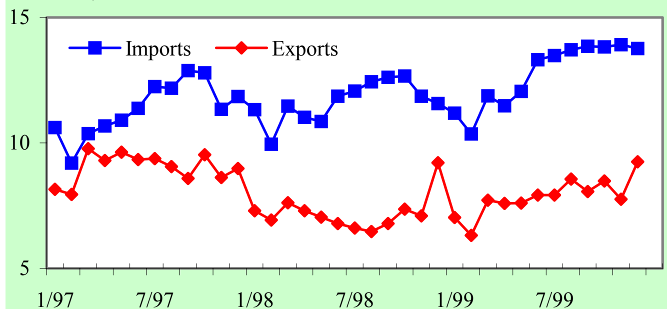
	China	Japan	Canada	Mexico	SA	EU
1Q/97	-9.7	-13.4	-4.6	-4.0	0.9	-0.8
2Q/97	-11.5	-12.6	-3.8	-4.3	2.2	-3.8
3Q/97	-15.3	-14.8	-3.9	-3.4	2.1	-6.5
4Q/97	-13.2	-15.4	-4.2	-2.9	4.0	-5.6
1Q/98	-11.5	-15.3	-3.0	-2.7	3.4	-2.1
2Q/98	-13.6	-15.6	-3.3	-4.5	3.5	-7.0
3Q/98	-17.3	-15.5	-5.3	-4.4	2.8	-8.6
4Q/98	-14.5	-17.6	-5.1	-4.2	3.4	-9.7
1Q/99	-13.6	-16.4	-6.9	-6.0	1.1	-5.8
2Q/99	-15.7	-17.2	-6.7	-6.4	-0.2	-10.5
3Q/99	-20.1	-19.8	-9.1	-6.5	-2.3	-13.8
4Q/99	-19.2	-20.5	-9.4	-4.0	-1.7	-13.7

Source: Bureau of Economic Analysis, Bureau of the Census
Quarterly non-seaonsally adjusted (nsa) data can be volatile.

The overall rise in the U.S. goods and services deficit was also reflected in the bilateral merchandise deficits. In particular, U.S. surpluses with South American (SA) countries turned to deficits as those countries experienced recession. By the end of 1999, U.S. trade balances with virtually all regions except Mexico worsened significantly (as shown in the table above).

U.S. Merchandise Trade with Emerging Asia

Billions of U.S. $, n.s.a



Source: Bureau of Economic Analysis, Bureau of the Census

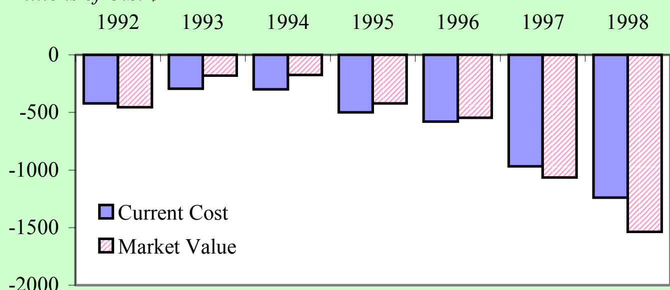
Capital Flows

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

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

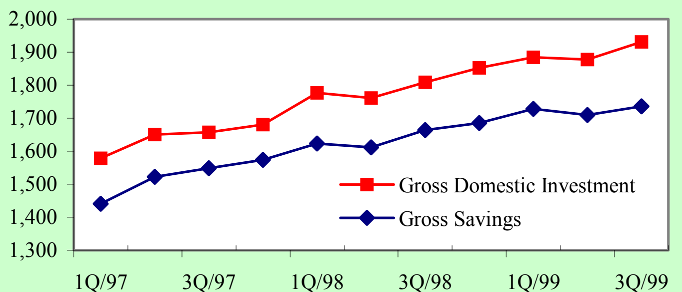
The stock of U.S. assets owned by foreigners is increasing. The value of foreign investment in the United States now exceeds the value of U.S. investments in other countries. The U.S. net international investment position (NIIP) at year end 1998 was negative $1,239 billion with direct investment valued at the current cost of replacing plant, equipment and other tangible assets, compared to negative $968 billion at year end 1997. With direct investment valued at the current stock market value of owner's equity, the U.S. NIIP at year end 1998 and 1997 was negative $1,537 billion and negative $1,066 billion, respectively. The larger increase on this basis primarily reflects the continued large increases in U.S. equity prices. A growing negative U.S. NIIP implies that a larger amount of the return generated by assets in the United States will be payable to foreigners in the future. It is vital that the current high level of business investment be employed productively to support both future repayments to foreign investors and increased standards of living in the United States. In that regard, it is interesting to note the high level of profits enjoyed by U.S. businesses has been facilitated by accelerating productivity growth. In fact, labor productivity growth (in the nonfarm business economy) has averaged 2.0% or more in each of the past four years.

U.S. Net International Investment Position
Billions of U.S. $



Source: Bureau of Economic Analysis

U.S. National Savings and Investment
Billions of U.S. $, SAAR



Source: Bureau of Economic Analysis

Capital Flows in the United States
Billions of U.S. $, s.a., details might not equal totals due to rounding

	1Q/98	2Q/98	3Q/98	4Q/98	1Q/99	2Q/99	3Q/99
Net Capital Flows	**38**	**44**	**33**	**102**	**70**	**119**	**104**
Net Porfolio Flows	**98**	**60**	**-14**	**-3**	**74**	**4**	**73**
U.S. acquisition of foreign assets*	-21	-47	-5	-55	-6	-81	-59
Foreign acquisition of U.S. assets	119	107	-9	51	80	85	132
Foreign Official	11	-11	-46	24	5	-1	12
Private**	108	118	38	27	75	86	120
Net Banking Flows	**-50**	**6**	**44**	**15**	**14**	**-8**	**31**
Assets	-1	-28	-33	37	28	-43	0
Liabilties	-49	34	77	-22	-14	35	31
Net Direct Investment	**-10**	**-22**	**3**	**90**	**-18**	**123**	**0**
U.S. direct investment abroad	-37	-43	-22	-31	-41	-32	-45
Foreign direct investment in the United States	27	21	25	121	23	154	44

Source: Bureau of Economic Analysis

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

** Net purchases of U.S. Treasury securities, net nonbank liabilities to foreigners, net purchases of gov't non-Treasury securities, and net U.S. currency flows.

U.S. Exchange Rate Policies

G-7 Statements on Exchange Rate Policies

During the reporting period, July 1, 1999 to December 31, 1999, G-7 Finance Ministers and Central Bank Governors reaffirmed their standing commitment to the importance of progress in a more balanced pattern of growth among the G-7 economies and cooperating closely in the exchange rate markets.

- **September 25, 1999.** "We discussed developments in our exchange and financial markets. We shared Japan's concern about the potential impact of the yen's appreciation for the Japanese economy and the world economy. We welcomed indications by the Japanese authorities that policies would be conducted appropriately in view of this potential impact. We will continue to monitor developments in exchange markets and cooperate as appropriate."

Following the end of the reporting period, as this report was being drafted, the G-7 Finance Ministers issued the following statement on exchange rates at the G-7 Ministerial in Tokyo:

- **January 22, 2000.** "We discussed developments in our exchange and financial markets. We welcomed the reaffirmation by the Japanese monetary authorities of their intention to conduct policies appropriately in view of their concern, which we share, about the potential impact of yen appreciation for the Japanese economy and the world economy. We will continue to monitor developments in exchange markets and cooperate as appropriate."

Statement by Secretary Summers

At the recent G-7 Ministerial in Tokyo, Secretary Summers reaffirmed the principles of U.S exchange rate policies:

- **January 22, 2000.** "Let me also note that our policy with respect to the dollar remains unchanged: a strong dollar is in the interest of the United States."

Currency Intervention

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

Emerging Market Exchange Rate Regimes

Elements of Manipulation

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

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

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

- **External Balances.** Persistent global current account surpluses are fundamentally a reflection of an excess of national savings over national investment, but in some cases may also reflect efforts to maintain an exchange rate level that would prevent external adjustment.

- **Exchange Restrictions and Capital Controls.** Restrictive exchange regimes and capital controls can be a concern, particularly where the restrictions are designed to maintain a consistently undervalued exchange rate.

- **Exchange Rate Movements.** Large depreciations of exchange rates, if induced artificially rather than by market forces responding to fundamentals, could suggest an attempt to gain a competitive advantage in trade. Manipulation could also be reflected in the absence of a significant appreciation of the exchange rate when justified by fundamentals. Equilibrium real exchange rates, however, are determined by a number of factors and are therefore difficult to define.

- **Movements in Reserves.** Significant and persistent accumulation of foreign exchange reserves could be a source of concern if it reflects efforts to maintain an excessively competitive exchange rate.

- **Macroeconomic Trends.** When analyzing these economies, Treasury looks at the macroeconomic policy stance and other conditions that are important determinants of exchange rates.

Economy Assessments

As the law requires, economies were closely examined as potential exchange rate manipulators if they had significant global current account surpluses and bilateral surpluses with the United States and maintained a fixed or actively managed exchange rate system during the period of this report. The economies Treasury examined include Taiwan, China, Korea, and Malaysia.

With the exception of China, Hong Kong, and Malaysia, economies in the region maintained floating exchange rate regimes. While most central banks intervened in the foreign exchange markets, this was largely undertaken to rebuild foreign exchange reserves, which were severely depleted during the crisis. This reserve accumulation, with the ratio of reserves as a percent of short-term debt increasing across the region in 1999, has allowed most countries to reduce significantly their vulnerability to external shocks, which in turn has boosted investor confidence and supported local currencies. In most economies, reserves had reached a high enough level that only Indonesia remained in need of exceptional balance of payments support.

- **Taiwan.** Foreign exchange reserves expanded to $106 billion by end-December 1999, an increase of $8½ billion over the reporting period and compared to $90½ billion in December 1998. While Taiwan's reserves – equal to 541% of short-term debt and 20% of M2 – are currently the world's third largest behind Japan and China in U.S. dollars, Taiwan does not have access to IMF balance of payments support and therefore needs to hold more reserves to reduce its vulnerability to external shocks. The Central Bank of China intervened on numerous occasions to hold the New Taiwan Dollar (NTD) within a narrow range against the dollar. Over the period, the NTD, which experienced upward pressure from a growing current account surplus and foreign flows into local equities, appreciated by 3% against the dollar, but depreciated 1% on a real effective basis. The current account surplus reached 2% of GDP in 1999 vs. 1½% in 1998, supported by resurgent Asian demand for Taiwanese exports. The bilateral trade surplus with the U.S., at $16.7 billion in 1999, increased 7% from the previous year. Taiwan's economy weathered the Asian crisis fairly well and is estimated to have grown by 5½% in 1999 following 4½% growth in 1998. Growth is expected to increase to 6½% in 2000.

- **China.** China's net foreign exchange reserves rose $6 billion over the reporting period. Reserves as a percent of M2 were steady at just over 11½% in 1999, little changed over 1998. Reserve growth moderated substantially compared to the rapid accumulation of reserves in 1994-1997. The reserve increase reflects strong export performance, still substantial inflows of FDI ($40 billion in 1999, down from $45 billion in 1998), and the relative effectiveness of efforts begun in late 1998 to tighten China's foreign exchange controls to prevent illegal capital flight. (China's currency is not convertible into foreign currency for most investment purposes.) While the peg to the U.S. dollar remained unchanged, the real effective exchange rate of the yuan depreciated 1½% in the year through September, primarily reflecting ongoing deflation in China. The current account surplus is estimated to have shrunk to 1½% of GDP from 3% in 1998, as recorded imports accelerated amid a crackdown on import smuggling. China's bilateral trade surplus with the U.S. increased to $69 billion in 1999 ($29 billion in the first half of the year; $40 billion in the second half) from $57 billion in 1998. Although China's economy slowed in 1999, official estimates still put GDP growth at 7%. To boost growth, the Chinese government pursued expansionary fiscal and monetary policies, raising civil service salaries and social welfare benefits and lowering the reserve requirement for banks. The *Consensus* forecast is for real GDP growth to rise to 7½% in 2000.

- **Korea.** Net foreign exchange reserves rose by about $17 billion in the reporting period to nearly $68 billion, supported by surpluses on the current and capital accounts. Net reserves are now equal to 184% of short-term liabilities compared to 108% in 1998. As a percent of M2, reserves have risen to approximately 25% from 19% in 1998. The won has strengthened by only 1½% against the U.S. dollar in nominal terms. On a real effective basis, the won was unchanged during the period. Korea's current account surplus as a percent of GDP fell to 6% in 1999 from 12½% in 1998, a reflection of rising imports due in part to the won's appreciation and the country's strong economic recovery. Korea's bilateral trade surplus with the U.S. increased from $7.4 billion in 1998 to $8.3 billion in 1999. Real GDP is estimated to have grown 9½% in 1999, the fastest in the region and one of the fastest in the world. The *Consensus* forecast is for it to slow to 7% in 2000 as the government tightens monetary and fiscal policies. Nevertheless, *Consensus Economics* forecasts a decline in the current account surplus to 2½% of GDP in 2000 because of continued strong growth.

- **Malaysia.** Net foreign exchange reserves rose less than $1 billion in the second half of 1999 to stand at $30½ billion in December, compared to $25½ billion at end-1998. For the year, net foreign exchange reserves as a percent of short-term debt rose to 329% in 1999 from 239% in 1998, while reserves as a percent of M2 held steady at approximately 35%. Malaysia's currency was pegged to the dollar in September of 1998 to prevent nominal depreciation in the midst of the Asian financial crisis. Since then, regional recovery has left the ringgit moderately undervalued in the view of many market analysts, as neighboring currencies have appreciated. On a real, effective basis, the ringgit has depreciated 3% since it was pegged. In September 1998, the government implemented wide-ranging capital controls aimed at eliminating the offshore ringgit market and preventing heavy capital outflows. The most significant of these, a 12-month holding period on portfolio capital, was later replaced by a profit tax that declines with the length of the holding period. Capital outflows in the second half of 1999, including $2 billion in equity outflows, roughly balanced Malaysia's current account surplus during the same period. For the year, Malaysia posted a current account surplus of $12.5 billion, equal to 16% of GDP versus 12½% of GDP in 1998. The bilateral surplus with the U.S. increased to $12 billion in 1999 ($5½ in the first half of the year; $6 billion in the second half through November) from $10 billion in 1998. The *Consensus* forecast is for real GDP growth to rise to 6% in 2000 from 5% in 1999, leading to a modest decline in the current account surplus as a percent of GDP.

Policy Priorities

- **Sound economic and financial policies in the United States, including our strong dollar policy, which is in the interest of the United States.**

- **In particular, sound domestic policies aimed at increasing the level of national savings would ease adjustment of U.S. external imbalances.** Maintaining a budget surplus is essential to this.

- **Encourage policies that promote sustained, domestic demand-led growth in our major industrial trading partners in order to restore an orderly return to more balanced global growth patterns and, over time, contribute to reduced global imbalances.**

- **In particular, encourage Japan to take supportive macroeconomic policies and implement structural and financial sector reforms; in Europe, encourage appropriate macroeconomic policies and structural reforms that encourage investment and employment.** For both Japan and Europe, the right aspiration for policy is to achieve a sustained period of growth above what has recently been considered their potential through encouraging the kind of investments that are necessary to raise the rate at which the economy can expand.

- **Put in place policies that will strengthen the international financial architecture and reduce the risk of future crises.** G-7 leaders have endorsed steps to help prevent financial crises and better respond to them when they occur. These measures are designed to strengthen the international financial institutions, enhance transparency, equip emerging market economies to deal better with risk, share responsibility for resolving crises with the private sector, and protect the vulnerable in society, particularly during crises.

Excerpts from
"Priorities for a 21st Century Global Financial System"
Remarks by Treasury Secretary Lawrence H. Summers
at Yale University, September 22, 1999

More Sustainable Exchange Rate Regimes for Emerging Market Economies

"Looking at the crises of recent years, it is clear to us that a fixed, but not firmly institutionalized exchange rate regime holds enormous risks for emerging market economies in a world where fast-flowing capital and insufficiently developed domestic financial systems coincide.

- The promise of exchange rate stability has helped to encourage excessive foreign currency borrowing, both public and private, on terms which appeared attractive only because borrowers ignored the huge potential costs of an exchange rate move.
- The desire by governments to keep to that promise has led in many cases to still more borrowing to support continued defense of the exchange rate, leaving the country yet more vulnerable down the road.
- And when trouble came, the breaking of the promise has greatly exacerbated the general loss in investor confidence and withdrawal of capital that followed - with a spiraling impact on the debtor country's balance sheet.

It is also clear that when pegged exchange rates do collapse, the costs are visited far more widely than on the country itself - as we saw vividly in the spread of confidence problems across Asia and the emerging market economies as a group.

If international economic theory and experience teach us anything it is the incompatibility between maintaining both a fixed exchange rate and an independent monetary policy. A viable fixed exchange rate regime involves in some form the renunciation of monetary independence.

Going forward, the IMF must bring to the fore in its discussions with countries the challenges that this difficult reality brings to the choice of an exchange rate regime. The Articles of the IMF state that sovereign member countries are free to choose their exchange rate regime. This is as it should be. But the fact is that those policies are not made or implemented in a vacuum.

In particular:

- The IMF must help countries to avoid the trap of a regime that may appear to offer stability but that - if not solidly backed by credible institutional arrangements and consistent domestic policies - may encourage large risks to build up unnoticed.
- It must indicate clearly to the government concerned when domestic policies are on a collision course with the chosen exchange rate regime.
- And for countries that may use the exchange rate anchor as a response to hyperinflation, it must offer advice on how best to exit from this strategy before the costs become unacceptably high.

We further believe that the official sector should help shape the choices facing countries in favor of more sustainable regimes: via changed expectations about how it will respond to future crises.

With this in mind, the IMF's major shareholders agreed last June that it would be inappropriate for the international community to provide large scale official financing for a country intervening heavily to support a particular exchange rate level, except in certain limited exceptional circumstances, such as where the policy is backed by a strong and credible commitment with supporting institutional arrangements.

I would hope that this policy shift would influence country's currency choices going forward. Over time, we believe it should increasingly be the norm that countries involved with the world capital market avoid the "middle ground" of pegged exchange rates with discretionary monetary policies. And where countries choose the middle ground, and their own policies are not sufficient to stem an attack on a particular exchange rate level, the international community should have a compelling rationale before it provides funds for the country to defend it."

Policy Priorities (continued)

Emerging markets can take important steps to reduce their vulnerability to destablizing crises by maintaining sustainable exchange rate regimes. The middle ground of fixed but not institutionalized exchange rates holds enormous risks in today's global financial markets.

(see the box on the previous page –Treasury Secretary Summers, Sept. 22, 1999, in remarks made at Yale University)

- **Continue efforts to open foreign markets to U.S. exports while maintaining a commitment to open markets that has been so important to our economic success.**

- **Continued monitoring of markets for evidence of currency manipulation as countries balance the goals of reserve accumulation to cover foreign liabilities and of movement of the exchange rate to an appropriate level.** In economies with a significant amount of debt denominated in foreign currencies, or where the currency is fixed to another exchange rate, a sufficient level of foreign reserves are required. However, in the context of a floating exchange rate regime, countries can accumulate an excessive level of reserves in an attempt to prevent a currency appreciation. This appreciation can serve an important element in adjustment of both trade and financial flows, and so excessive intervention can, in the long-run, build pressures in an economy. In the coming year, Treasury will continue to monitor the markets for evidence of attempts to suppress the value of a currency.

Appendix

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

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

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

(1) to achieve-

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

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

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

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

SEC.3005. REPORTING REQUIREMENTS.

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

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

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

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

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

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

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

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

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

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

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

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

(8) a report on the size and composition of international capital flows, and the factors contributing to such flows,

including, where possible, an assessment of the impact of such flows on exchange rates and trade flows.

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

SEC. 3006. DEFINITIONS.

As used in this subtitle:

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

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