

**Report to Congress on
International Economic and Exchange Rate Policies
May 2008**

This report reviews developments in international economic and exchange rate policies, focusing on the second half of 2007,¹ and is required under the Omnibus Trade and Competitiveness Act of 1988 (the “Act”).² This report includes an appendix updating issues related to Sovereign Wealth Funds.

Major Findings:

- Global growth remained strong in 2007, as strong growth in emerging market and developing countries more than offset moderating growth in advanced economies. A slowdown in global growth is expected in 2008, in response to ongoing financial market turbulence. Emerging market economies are likely to be less affected by the turbulence than advanced economies – though not immune.
- U.S. economic growth slowed significantly in the last quarter of 2007 and the first quarter of 2008. Job growth moderated in the second half of 2007 and the unemployment rate rose to 5.0 percent in April 2008 from a low of 4.4 percent in March 2007. The financial market stress that began in the sub-prime mortgage market in August 2007 quickly spread beyond the mortgage sector.
- The Federal Open Market Committee (FOMC) cut its target for the federal funds rate by 325 basis points, between September 2007 and April 2008. The Fed also created new tools to increase liquidity in credit markets. The Administration and Congress enacted a \$150 billion fiscal stimulus package to support the economy.
- Substantial progress was achieved in 2007 in reducing the U.S. current account deficit. It fell to 4.9 percent of GDP in the fourth quarter of 2007, down from 6.8 percent in the fourth quarter of 2005. Foreign demand for U.S. dollar assets remains strong, notwithstanding weaker demand in August and September 2007 at the onset of the financial market turmoil.
- Less progress has been made in reducing global imbalances. China’s external surplus continues to remain excessively large. Increases in oil prices have pushed the external surpluses of many oil exporters higher. Germany and Japan also continue to have large external surpluses.
- This report examines the exchange rate policies of 19 countries and the Euro-area. Collectively, these economies accounted for nearly 85 percent of U.S. foreign trade in goods and services in 2007.

¹ More recent significant developments are also discussed if information is available.

² The Treasury Department has consulted with IMF management and staff in preparing this report.

- The dollar depreciated in the second half of 2007 and the first quarter of 2008, particularly against many major currencies, reflecting the weakening U.S. growth outlook, significant changes in relative interest rates, and the financial turmoil in general.
- Oil-exporting countries in the Gulf have seen a positive terms of trade shock in view of rising oil prices. Inflation has increased in these countries. Apart from Kuwait, which has a large dollar component in its foreign exchange rate basket, other GCC countries have firmly adhered to their dollar pegs.
- China's economic imbalances — domestic and external — continue to increase. Inflation has risen above 8 percent, which may be in part due to excessive creation of liquidity in view of China's rigid management of the renminbi (RMB). China's current account surplus increased by an estimated \$111 billion in 2007 and is now roughly 11 percent of GDP. Official reserves increased by \$462 billion in 2007 and by an additional \$154 billion in the first quarter of 2008.
- To address these challenges, China needs to intensify its efforts to rebalance its economy: boosting domestic demand and consumption-led growth; reforming its financial system; and achieving greater monetary policy autonomy through rapid RMB appreciation and greater flexibility of the foreign exchange regime.
- Hence, Chinese exchange rate practices justifiably remain a focal point for the international community. The appreciation of the RMB increased against the U.S. dollar in the latter half of 2007 and early months of 2008. By mid-April 2008, the RMB had appreciated by 18.4 percent since the change in exchange rate policy on July 21, 2005. But the RMB's appreciation against the yen has been more modest and the RMB has depreciated against the euro. China's exchange rate practices constrain greater currency flexibility elsewhere in emerging Asia.
- On balance, while the recent accelerated appreciation of the RMB against the dollar is welcome, the pace of appreciation needs to continue in order to address the continuing substantial undervaluation of the RMB and the risks China is creating for itself, the Asian region, and the world economy in which China is playing a greater role. Treasury has been reinforcing that message to Chinese authorities on a frequent basis both bilaterally and multilaterally and will continue to do so.
- In Malaysia, a persistently large current account surplus coupled with still low domestic investment suggests an undervalued currency that has contributed to macroeconomic imbalances.
- In conclusion, Treasury has not found that either China or any other major trading partner of the United States met the requirements for designation under Section 3004 of the Act during the reporting period, July 2007 – December 2007.³

³ The Act states, *inter alia*, that: "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

Introduction

This report focuses on international economic and foreign exchange developments in the second half of 2007. However, where pertinent and when available, data through mid-April 2008 are included and discussed in this report.

Exports and imports of goods and services to and from the countries whose economies and currencies are discussed in this report accounted for about 85 percent of total U.S. trade in 2007.

U.S. Macroeconomic Trends

The economy slowed toward the end of 2007, buffeted by the decline in residential building and related financial market turmoil, as well as significant increases in energy prices. Job growth moderated, and the unemployment rate moved higher. Headline inflation picked up as energy prices surged but core inflation remained contained. Financial markets became increasingly unsettled during the late summer of 2007, reflecting concerns about the quality of debt instruments backed by subprime mortgages. The Federal Reserve cut the federal funds interest rate target by 50 basis points in September. Additional rate cuts followed in October, December, January, March and April 2008. Yields on long-term securities fell in the second half of 2007 and continued to trend down in early 2008. The economy is expected to remain weak through the first half of 2008 but improve in the second half when measures enacted under the Economic Stimulus Act of 2008 take effect.

Slowing Economy

Real GDP growth slipped to a 0.6 percent annual rate in the fourth quarter of 2007 from the rapid 4.4 percent pace averaged in the second and third quarters. Growth moderated across all spending categories, but a large part of the slowdown was due to a drop in private inventory investment, which subtracted 1.8 percentage points from fourth-quarter real growth after adding 0.8 percentage points in the third quarter. Consumer spending – which accounts for 70 percent of economic activity – eased to a 2.3 percent annual rate of growth in the fourth quarter from 2.8 percent in the third quarter. Business investment activity also cooled at the end of 2007, with real outlays for equipment and software up by just 3.1 percent at an annual rate, half the pace recorded in the third quarter. On the plus side, growth of business spending on structures remained solid, while exports continued to post strong gains.

The ongoing contraction in residential construction remained a drag on the economy in the fourth quarter. Real residential investment plunged by 25 percent at an annual rate, shaving 1.3 percentage points from real GDP growth. That followed a 21 percent drop in the third quarter that subtracted 1.1 percentage points from real growth. Over the four quarters of 2007, declining residential investment reduced real GDP growth by nearly a full percentage point, about the same as in 2006.

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.”

Recent data indicate that housing activity continued to contract in early 2008. Housing starts fell to a 17-year low in March, with starts of single-family homes down a steep 63 percent from their January 2006 peak. Sales of new single-family homes also fell to a 17-year low in March and resales of existing single-family homes remained near their lowest point in the past 10 years. Home prices continued to fall below year-earlier levels in February. Forward-looking indicators suggest that housing will weigh on growth throughout 2008. Inventories of unsold homes are at historically high levels, building permits remain well below starts, and homebuilder optimism is close to an all-time low. Mortgage delinquencies and foreclosures have risen sharply over the past year and are projected to climb further in 2008, adding to the inventory overhang and putting additional downward pressure on home prices.

Labor market conditions also weakened in the second half of 2007. Job growth moderated to 76,000 per month on average, down from an average monthly gain of 107,000 in the first half of the year. The unemployment rate rose to 5.0 percent in December, up from a recent low of 4.4 percent in March 2007. Real wages began to fall in late 2007 as consumer price inflation accelerated. Over the twelve months of the year, real hourly earnings for production workers declined by 0.7 percent. Real earnings rose by 1.8 percent during 2006 after falling in 2004 and 2005. The labor market deteriorated further in early 2008. Nonfarm payroll employment fell by 260,000 in the first four months of the year – the first decline since August 2003. The unemployment rate was 5.0 percent in April 2008.

Overall Inflation Up, but Core Remains Contained

Headline inflation accelerated in late 2007 but core inflation remained contained, staying within the narrow range that has prevailed over the past four years. Consumer prices rose 4.1 percent over the twelve months ended in December, up from around 2.5 percent in the first half of the year. Energy prices accounted for most of the increase, although food price inflation also moved higher. Core consumer inflation (excluding food and energy) was 2.4 percent over the twelve months of 2007, down from 2.6 percent during 2006. Both headline and core consumer inflation remained roughly stable at their late-2007 rates through the first quarter of 2008.

Financial Stress Emerged

In August 2007, financial markets came under significant stress that was triggered in large part by growing concerns about the quality of instruments backed by sub-prime mortgages. Concern quickly spread beyond the traditional home-mortgage lending sector, and especially affected banks, which had extended credit to mortgage lenders directly and through financing conduits. Difficulties in determining the scope of the potential losses led to a sharp reduction in liquidity, resulting in pronounced swings in asset prices and private lending rates. The Federal Open Market Committee (FOMC) cut its target for the federal funds rate by a total of 325 basis points starting with a 50 basis point reduction at its September 2007 meeting and concluding most recently with a 25 basis point reduction at its April 2008 meeting. At the end of April 2008 the target rate was 2.00 percent – the lowest since November 2004. Along with traditional monetary tools, the Fed has also employed a variety of new tools to increase liquidity in credit markets.

Long-term interest rates on U.S. Government securities fell in the second half of 2007, due in part to safe-haven buying in response to the financial market turmoil that began last summer. The yield on the 10-year Treasury note fell from around 5.25 percent in June to 3.9 percent by year's end. In early April 2008, the 10-year rate was around 3.5 percent, the lowest since mid-2003. Despite lower rates, credit conditions for households and businesses remained tight through late 2007 and into early 2008. Spreads over Treasuries for corporate debt widened at the end of 2007. Interest rates for conforming mortgages continued to move in tandem with the 10-year Treasury in the latter half of the year, but the spread has since widened notably. The average interest rate for a 30-year conforming fixed-rate mortgage fell from a recent high of 6.73 percent in July to a low of 5.5 percent by late January but rose to 5.9 percent in April. Rates for jumbo mortgages remained elevated late last year even as those for conforming loans fell, causing the spread between the two products to widen to about 100 basis points from the more typical 20-to-25 basis point spread prior to the onset of financial market turmoil in mid August. The jumbo-conforming spread has continued to widen and in late-April was around 145 basis points.

Federal Budget Deficit Will Rise in 2008

The Federal budget situation improved in FY2007, but will deteriorate in FY2008 as a result of the slowing economy and the economic stimulus package enacted in early February. In FY2007, the Federal deficit narrowed by \$85 billion to \$163 billion. As a percent of GDP, the FY2007 Federal deficit fell to 1.2 percent, down from 1.9 percent in FY2006 and its recent peak of 3.6 percent in FY2004. The Federal deficit has averaged 2.3 percent of GDP over the past four decades. The improvement in the federal fiscal situation reflected strong receipts growth and relatively slow growth of outlays. In FY2008, the budget deficit is projected to grow to \$410 billion (2.9 percent of GDP), partly due to the effects of the economic growth package and the slowing economy. The deficit is expected to ease to \$407 billion (2.7 percent of GDP) in FY2009, eventually returning to a small surplus in FY2012.

First quarter 2008

Real GDP grew by 0.6 percent at an annual rate in the first quarter of 2008. A large swing in inventories accounted for much of the increase, contributing 0.8 percentage point to the rise in real GDP. Growth in most other major components slowed. Export growth remained solid but net exports (exports less imports) added only 0.2 percentage point to real GDP growth after contributing 1.2 percentage points on average in the prior three quarters. Consumer spending moderated to a 1.0 percent annual rate from 2.3 percent in the fourth quarter, and business investment fell by 2.5 percent. Residential investment plunged by nearly 27 percent in the first quarter, subtracting more than 1 percentage point from real GDP growth for a third straight quarter. Excluding both inventories and exports but including imports, final sales to domestic purchasers – a measure of domestic demand – fell by 0.4 percent in the first quarter. That was the first quarterly decline for this measure since 1991.

The Global Economy

Global economic growth remained strong in 2007, at 4.9 percent, as booming growth in the emerging market and developing economies offset a moderation in growth in the advanced economies. Growth in the emerging markets was 7.9 percent in 2007, led by continued strong increases in growth in China and India. Consumer price inflation in the advanced economies declined to 2.2 percent in 2007 from 2.4 percent in 2006. In contrast, rising food and energy prices helped push inflation up from 5.4 percent in 2006 to 6.3 percent in 2007 in emerging and developing countries; the first increase in these countries in 15 years.

A pronounced slowdown in global growth is expected in 2008 as a result of continued financial market turbulence and the downturn in U.S. growth. The International Monetary Fund (IMF) is forecasting growth to slow to 3.7 percent in 2008.⁴ The IMF estimates that expected losses and writedowns on U.S. assets could be as high as \$945 billion with global banks bearing half of this total.⁵

Thus far, emerging markets have been less affected by the financial turmoil than the advanced economies. Private net capital inflows into emerging markets more than doubled in 2007. The Morgan Stanley Capital International (MSCI) emerging market stock index rose by 36 percent in 2007, well above the 7 percent increase in the MSCI developed country stock index. The divergence is even greater when focusing on the second half of the year. The MSCI developed country stock index fell by 1 percent in the second half of 2007, whereas the emerging market index rose by 17 percent. Credit spreads in emerging markets increased, however, as the crisis unfolded in August, and have continued to rise. The EMBI+ spread ended the year up 70 bps, the first increase since 2002. Most of this increase occurred in the second half of the year. Strong economic fundamentals, better institutional foundations, and stockpiles of international reserves make many emerging markets less vulnerable than during previous periods of global financial turbulence.

Capital Flows of Emerging Market and Developing Economies

	2006	2007	2008f
Net Private Capital Inflows (\$ Bil)	231.9	605.0	330.7
Current Account (\$ Bil)	698.0	738.1	814.7
Increase in Reserves (\$ Bil)	752.8	1,236.2	1,004.1

Note: "f" indicates forecast.

Source: IMF, *World Economic Outlook*, April 2008

Private net capital inflows are expected to slow this year, but remain well above the \$177 billion average for 2001-06. In addition, the aggregate current account surplus in emerging markets and developing economies, which rose to \$738 billion in 2007, is expected to increase to \$815 billion in 2008. This would mark the seventh consecutive annual increase in the current account surplus for this group of countries. Emerging markets added \$1.2 trillion to their already

⁴ See IMF's *World Economic Outlook*, April 2008, <http://www.imf.org/external/pubs/ft/weo/2008/01/>. Forecasts of aggregate world GDP growth use purchasing power parity weights. These weights were revised at the end of 2007.

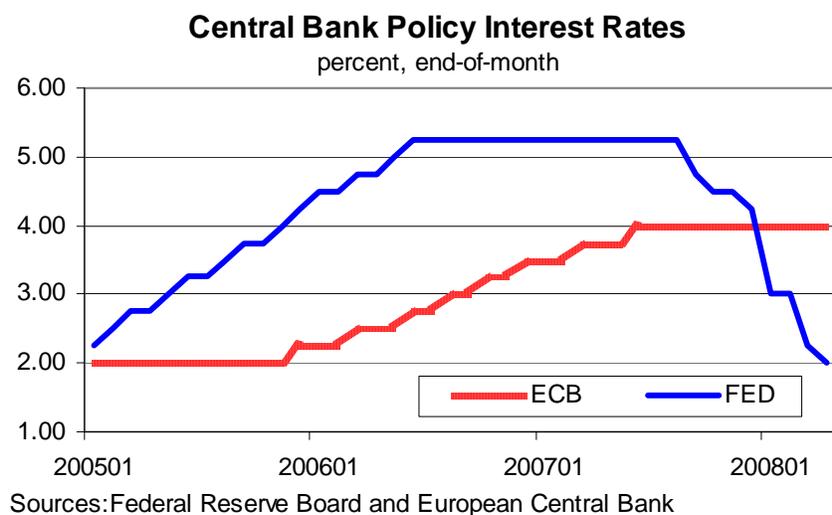
⁵ IMF, *Global Financial Stability Report*, April 2008, <http://www.imf.org/External/Pubs/FT/GFSR/2008/01/>.

substantial foreign exchange reserves in 2007 and are expected to add an additional \$1 trillion this year.

Nevertheless, there are no indications that the emerging markets have fully decoupled from the advanced economies. The IMF expects economic growth in emerging markets to slow to 6.7 percent in 2008. Growth is expected to weaken in all regions except for the Middle East and Africa. Countries dependent on exports to the United States are likely to be most negatively affected. Financial markets in the emerging economies are also showing more signs of strain. The emerging market MSCI index has fallen by 7.4 percent since the end of 2007. The EMBI+ spread rose 52 bps between the end of 2007 and mid-April. Emerging market economies with large current account deficits financed by bank lending or portfolio flows and high domestic credit expansion are particularly vulnerable to a reversal in investor sentiment. Many emerging market economies, most notably those whose exchange rates are pegged to the dollar, have also seen inflation accelerate.

Economic growth in most of the advanced economies slowed in the last part of 2007. Among the major advanced economies, only the United Kingdom had a higher growth rate in 2007 than in the previous year.

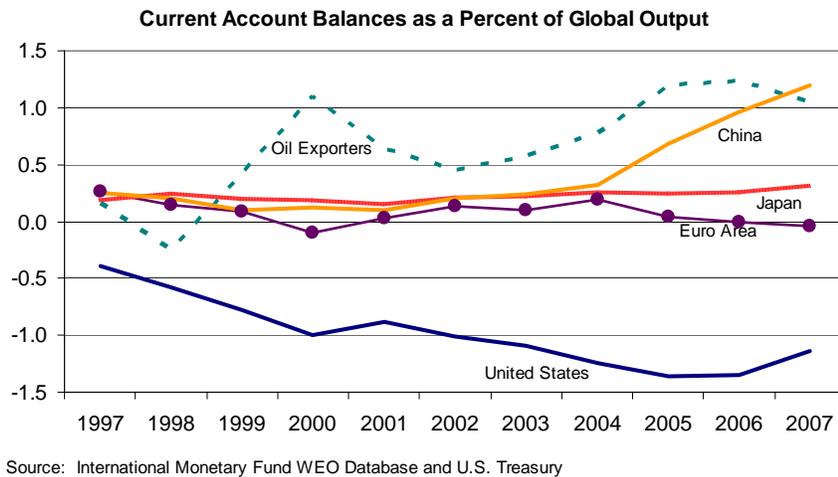
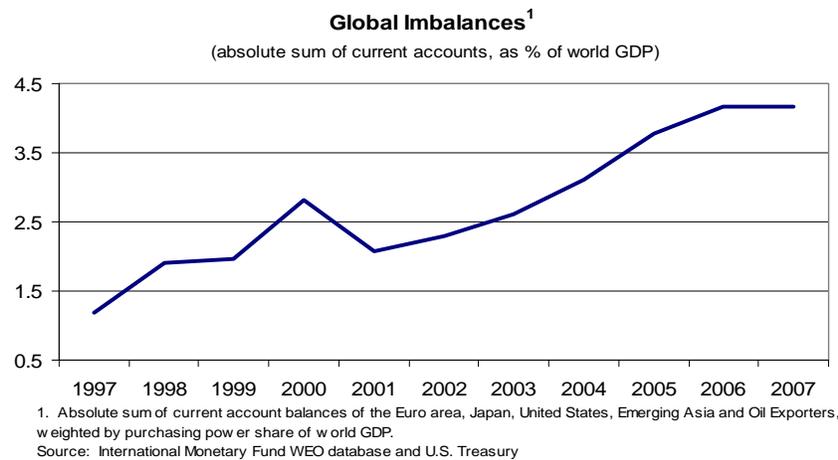
The IMF expects growth in the Euro-area to fall to 1.4 percent this year from 2.6 percent in 2007.⁶ Despite the growth slowdown, most forecasters expect a further decline in the unemployment rate, already at a 25-year low. Euro-area inflation accelerated in the second half of 2007, ending the year at 3.1 percent, above the ECB's definition of price stability. Inflation was 3.6 percent on a year-over-year basis March 2008 and is expected to remain elevated over the coming months. Because of inflation concerns, the ECB has maintained its key policy rate at 4 percent since June 2007. The difference in policy between the ECB and the FOMC has led to a divergence between interest rates in the United States and interest rates in the Euro-area.



⁶ The April Consensus Forecast is for 1.5 percent growth and the Blue Chip forecast is for 1.6 percent growth in the Euro-area in 2008.

The Japanese economy grew by 2.1 percent in 2007. The IMF expects growth to decline to 1.4 percent in 2008, whereas Consensus Forecasts and the Blue Chip forecasts predict a slightly lower growth rate – 1.3 percent.⁷ Inability to mount a robust demand-led recovery has prevented Japan from fully escaping persistent deflationary pressures. Rising energy prices pushed February’s headline inflation to 1.0 percent (year-over-year), its highest level in 10 years, but core inflation, excluding food and energy, remains negligible.

After rising steadily between 2002 and 2006, global imbalances declined marginally last year. As a share of global output, the U.S. current account deficit declined from 1.4 percent in 2006 to 1.1 percent in 2007. In contrast, the current account surplus of the emerging Asian economies rose to 1.6 percent of global GDP, more than offsetting the US current account deficit.⁸ The current account surplus for China alone rose to 1.2 percent of global GDP in 2007. The combined current account surplus of the oil exporting economies fell from 1.2 percent of GDP in 2006 to 1.0 in 2007, primarily as a result of a decline in the current account surplus of Russia.⁹



⁷ Based on April surveys.

⁸ Emerging Asia consists of China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand.

A reduction in global imbalances requires a reorientation of domestic demand toward the surplus countries. In the United States, the growth rate of domestic demand has slowed in recent quarters. Euro-area domestic demand growth rose in 2006 and early 2007 but it has weakened recently. The growth rate of domestic demand accelerated in both China and Saudi Arabia in 2005 but fell in 2006 and 2007. Stronger domestically sourced demand growth is needed in China, where the external surplus continues to rise, some oil exporting countries, and Japan to help ensure better balanced global growth.

The International Accounts for the United States

U.S. Current Account

Balance of Payments and Trade						
(\$ billions, seasonally adjusted unless otherwise indicated)						
	2006	2007	2007			
			Q1	Q2	Q3	Q4
Current Account:						
Balance on Goods	-838.3	-815.4	-201.7	-205.1	-200.5	-208.1
Balance on Services	79.7	106.9	23.1	25.6	28.0	20.8
Balance on Income 1/	36.6	74.3	7.4	12.6	21.3	33.0
Net Unilateral Current Transfers	-89.6	-104.4	-27.0	-23.2	-26.2	-8.1
Balance on Current Account	-811.5	-738.6	-198.2	-190.1	-177.4	-172.9
Balance on Current Account as % of GDP	-6.2	-5.3	-5.9	-5.5	-5.1	4.9
Major Capital Flow Components (financial inflow +)						
Net Bank Flows	-20.2	-78.9	-29.8	-67.0	-34.1	52.0
Net Direct Investment Flows	-54.8	-131.0	-68.9	-28.3	42.7	-76.5
Net Securities Sales	647.3	516.2	180.5	205.8	-75.5	205.4
Net Liabilities to Unaffiliated Foreigners by Non-banking Concerns	152.2	182.4	45.8	16.2	142.9	-22.5
Memoranda:						
Statistical Discrepancy	-17.8	83.6	16.2	34.7	67.0	-56.6
Change in Foreign Official Assets in the United States	440.3	412.7	152.2	70.5	38.9	151.2
Trade in Goods						
Balance	-787.1	-815.4	-207.8	-211.3	-218.9	-200.3
Total Exports	894.6	1149.2	269.3	278.5	297.1	304.3
of Which:						
Agricultural Products	64.9	84.2	18.2	19.7	22.6	23.7
Capital Goods Ex Autos	362.3	445.9	106.7	107.5	114.4	117.4
Automotive Products	98.6	120.9	27.9	29.5	32.2	31.4
Consumer Goods Ex Autos and Food	116.1	146.4	35.2	35.8	37.7	37.7
Industrial Supplies and Materials 2/	233.1	315.5	72.0	77.6	81.5	84.5
Total Imports	1681.8	1964.6	471.0	483.6	497.7	512.3
of Which						
Petroleum and Products	251.9	331.0	70.9	78.2	82.0	99.9
Capital Goods Ex Autos	379.3	444.7	109.3	109.4	112.7	113.3
Automotive Products	239.5	258.9	63.4	63.1	67.1	65.4
Consumer Goods Ex Autos and Food	411.5	474.9	118.4	117.3	118.3	120.9

1/ Including compensation of employees

2/ Including petroleum and petroleum products

Source: BEA, Bureau of Census

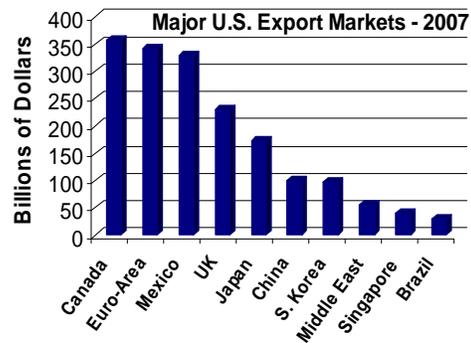
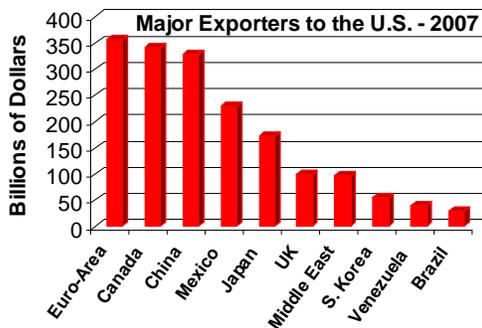
⁹ The oil exporters consist of Algeria, Angola, Azerbaijan, Bahrain, Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Syria, Turkmenistan, United Arab Emirates, Venezuela, and the Republic of Yemen.

In 2007 the U.S. current account deficit was \$738.6 billion, or 5.3 percent of U.S. GDP. In dollar terms, the deficit reached a high of \$863.2 billion (at a seasonally adjusted annual rate or “saar”) in the fourth quarter of 2005. It declined to \$776.5 billion in the first half of 2007 and further to \$700.6 billion in the second half of 2007. By the fourth quarter of 2007, the current account deficit was \$691.6 billion. Relative to U.S. GDP, the current account deficit declined from a high of 6.8 percent of GDP in the fourth quarter of 2005 to 4.9 percent in the fourth quarter of 2007.

The 2007 current account balance consisted of a deficit in the balance of trade in goods of \$815.4 billion; a surplus in the balance of trade in services of \$106.9 billion, a surplus in net factor income of \$74.3 billion, and a deficit in net transfer payments of \$104.4 billion.

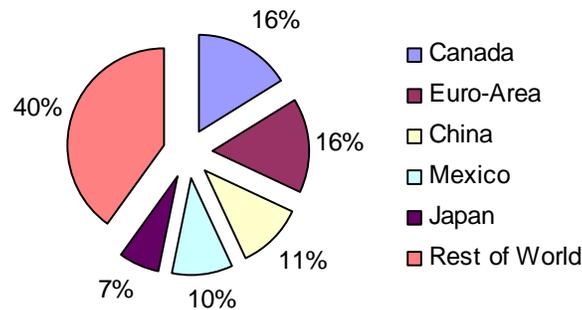
In the first half of 2007, the value of exports of goods totaled \$547.8 billion. Exports rose to \$601.4 billion in the second half of 2007, an increase of 9.8 percent. The value of imports of goods totaled \$954.6 billion in the first half of 2007 and \$1,010.0 billion in the second half of 2007, for an increase of 5.8 percent. U.S. exports of services totaled \$228.6 billion in the first half of 2007 and 250.6 billion in the second half of 2007, an increase of 9.6 percent.

The largest exporters of goods and services to the United States as well as the largest export markets (goods and services) of the United States are shown below. The five largest exporters to the United States (Euro-area, Canada, China, Mexico and Japan) accounted for 61.3 percent of all imports into the United States in 2007. The second five largest accounted for a combined 13.8 percent of total imports. The five largest export markets for the United States in 2007 were Canada, the Euro-area, Mexico, the United Kingdom, and Japan, accounting for a combined total of 58 percent of total U.S. exports. The second five accounted for an additional 15.6 percent of all U.S. exports in 2007.



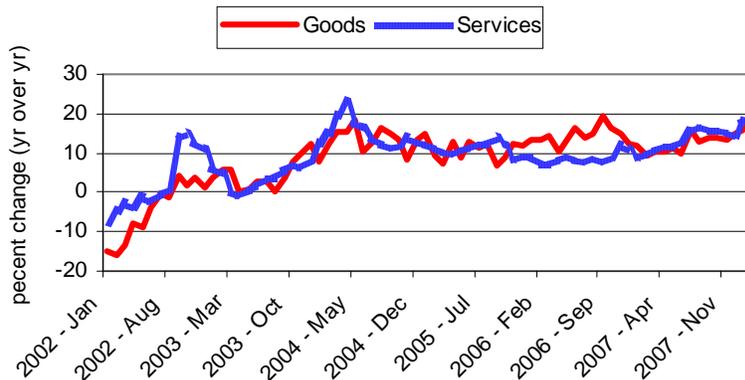
The five largest trading partners (based on the sum of exports of goods and services plus imports of goods and services) of the United States in 2007 were: Canada (\$639.6 billion); the Euro-area (\$631.7 billion); China (\$421.1 billion); Mexico (\$390.7 billion); and Japan (\$277.8 billion).

Largest Trading Partners of the United States - 2007



The last few years have seen the strongest U.S. export performance in a decade. Exports of goods increased an average of 7.4 percent in 1999 and 2000. Exports of goods declined by 6.0 percent on average in 2001 and 2002, before increasing to an average growth rate of 9.5 percent between 2003 and 2005. Over the course of 2006 and 2007, export growth of goods averaged 13.3 percent annually. A similar pattern is seen in the growth of U.S. exports of services, with an average growth over the last several years of 11.1 percent compared to an overall decade-long average of 7.1 percent.

Exports of Goods and Services



Source: Census Bureau/Haver Analytics

In the second half of 2007, U.S. exports (BOP basis) totaled \$601.4 billion. Of this, exports of capital goods accounted for 38.5 percent, exports of industrial supplies 27.6 percent and exports of consumer goods 12.5 percent. Imports (BOP basis) in the second half of 2007 totaled \$1,010 billion, of which 33 percent were industrial supplies (including petroleum and petroleum products), 23.7 percent were consumer goods and 22.4 percent were capital goods. Imports of petroleum and petroleum products totaled \$181.9 billion in the second half of 2007 compared to \$149.2 billion in the first half, an increase of 21.9 percent.

Capital and Financial Accounts

By balance of payments accounting definition, the counterpart to the balance on the current account is the balance on the capital and financial account. Since by definition the current

account balance is the difference between domestic capital formation and domestic saving, the net of flows in the capital and financial account are equal to the excess of net capital formation over domestic saving.

Data for 2007 show that U.S. residents invested more abroad in the form of direct investment than foreign residents invested in the United States. Net outflows of FDI were \$131.0 billion in 2007; consisting of \$204.4 billion of FDI in the United States by non-residents and \$335.4 billion in outbound FDI in foreign countries by U.S. residents. In addition, increases in foreign assets of U.S. banks exceeded increases in their foreign liabilities by \$78.9 billion. These combined outflows (current account, FDI, bank flows) were financed by foreign net private purchases of U.S. securities of \$284.3 billion, foreign official purchases of securities of \$412.7 billion, and \$182.4 billion in net inflows by non-banks to non-affiliates.

The U.S. Treasury's International Capital Reporting System (TIC), which records cross-border transactions data, shows continued strong demand for U.S. financial assets, even if the negative months of August and September 2007 are included (those months saw significant outflows during the onset of the financial turmoil). Total net foreign demand for U.S. long-term securities was \$1,006 billion in 2007 compared to \$1,143 billion in 2006 and \$1,012 billion in 2005.

Net International Investment Position¹⁰

The U.S. Net International Investment Position (NIIP), with direct investment valued at current cost, widened from minus \$2,238.4 billion (18.0 percent of GDP) at the end of 2005 to minus \$2,539.6 billion (19.2 percent of GDP) at the end of 2006.¹¹ Financial flows widened the NIIP by \$833.2 billion over 2006. Valuation changes, however, moderated this significantly. Dollar depreciation offset \$220.7 billion of financial flows while equity and other asset price changes offset another \$347.6 billion.

Although the NIIP with direct investment valued at current cost widened in 2006, as a percent of GDP, this was only in comparison to the ratio in 2005, which had narrowed due to strong valuation effects. The ratio has been broadly stable since 2001. The NIIP, with direct investment estimated at the market value of owners' equity, has narrowed significantly since 2001. The changes in both series over the period from 2001 to 2006 reflect significant valuation changes, particularly gains from price increases on U.S. holdings of foreign equity and from gains on appreciation of foreign currencies against the dollar.

Even though the value of foreigners' holdings of U.S. assets was around \$2.5 trillion greater than the value of the U.S.-owned foreign assets in 2006, U.S. investors earned \$74.3 billion more on their foreign investments than earnings paid out to foreigners on their U.S. investments. For the last several years net earnings on direct investment have been large enough to offset outflows of income payments on other forms of international investment.

¹⁰ NIIP is a critical measure in analyzing the sustainability of the current account deficit. A growing negative NIIP must stabilize as a percent of national output in the long-run or it will become impossible to service the external debt out of current or future production.

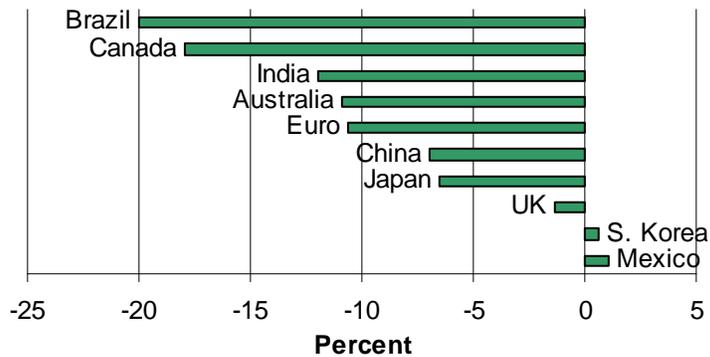
¹¹ Data for year-end NIIP 2007 will be released in June 2008.

Year-end	NIIP (% GDP) estimated at	
	Current Cost	Market Value
2000	-14.1	-16.1
2001	-19.0	-23.1
2002	-19.9	-23.4
2003	-19.5	-21.3
2004	-19.6	-20.5
2005	-18.0	-17.2
2006	-19.2	-16.2

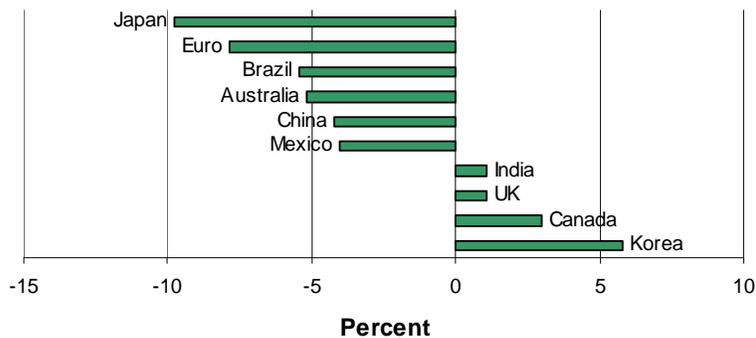
The U.S. Dollar

In the second half of 2007, the dollar depreciated by 7.7 percent against the euro to \$1.4603 and by 9.9 percent against the yen to ¥111.71. By mid-April 2008, the dollar had declined a further 7.9 percent against the euro and 9.8 percent against the yen. The dollar's depreciation mainly reflected unfavorable changes in relative growth expectations and ensuing developments in interest rate differentials.

Change in U.S. Dollar's Value 2007

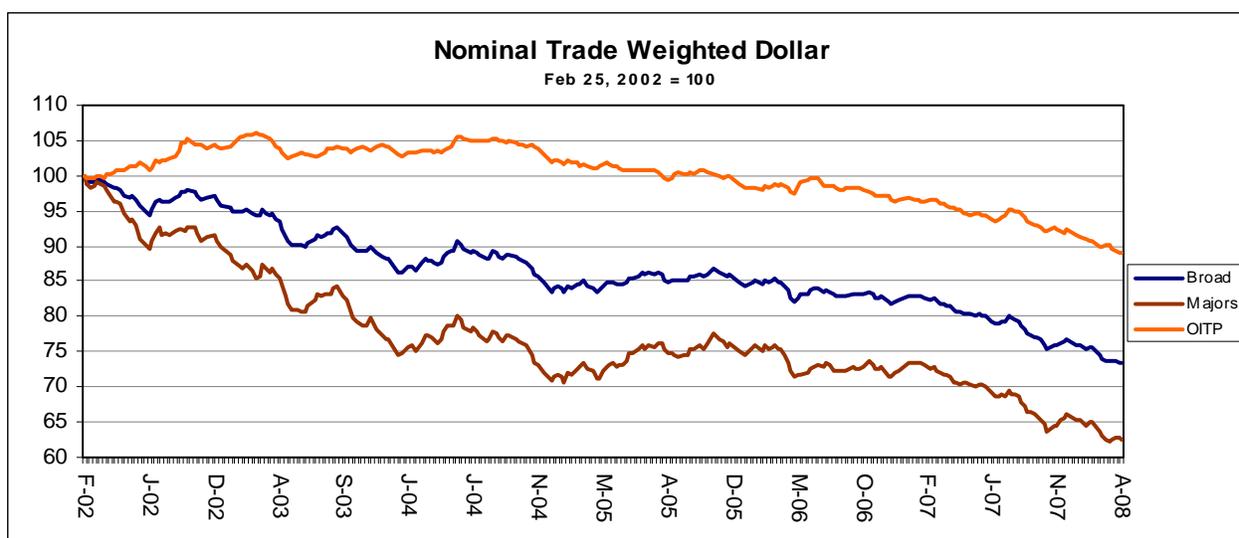


Change in U.S. Dollar's Value to 4/15/2008



In the second half of 2007, the dollar fell by 4.8 percent on a nominal effective basis and by 5.1 percent in real effective terms. Through mid-April 2008, the dollar had fallen an additional 3.5 percent in nominal effective terms. In real effective terms the dollar fell by 3.2 percent in the first quarter of 2008.

Between February 2002 and December 2007, the dollar fell by 45.8 percent against a basket of the major currencies, but only 10.1 percent against a basket of “other important trading partners” (OITP) currencies. However, since July 2005 when China began allowing greater flexibility in its exchange rate, the difference in the dollar’s depreciation against the two currency baskets has been somewhat less pronounced, though the difference is still significant. Between July 2005 and December 2008 the dollar fell by 15.1 percent against the major currencies and 8.9 percent against the OITP currencies.



Economic Fundamentals

As 2007 progressed, the U.S. economic outlook became increasingly clouded by the negative trend in the housing market, accompanying downgrades of subprime mortgage-backed securities and structured credit products, and declining consumer confidence. Write-downs and increased provisioning pressured bank balance sheets, and concerns about counterparty risk exposure drastically reduced credit availability. Over the same period, Japanese data showed only a modest softening of economic conditions, while European data continued to indicate relatively strong macroeconomic prospects.

As U.S. growth prospects weakened, market participants increasingly priced in further monetary easing by the Federal Reserve. However, neither the European Central Bank nor the Bank of Japan was expected to follow suit. In the event, neither changed their policy rates.

- In mid-August, the Federal Reserve lowered its discount rate by 50 basis points to 5.75 percent. The FOMC issued an inter-meeting policy statement that was perceived as

emphasizing downside growth risks but left the federal funds target rate unchanged at 5.25 percent.

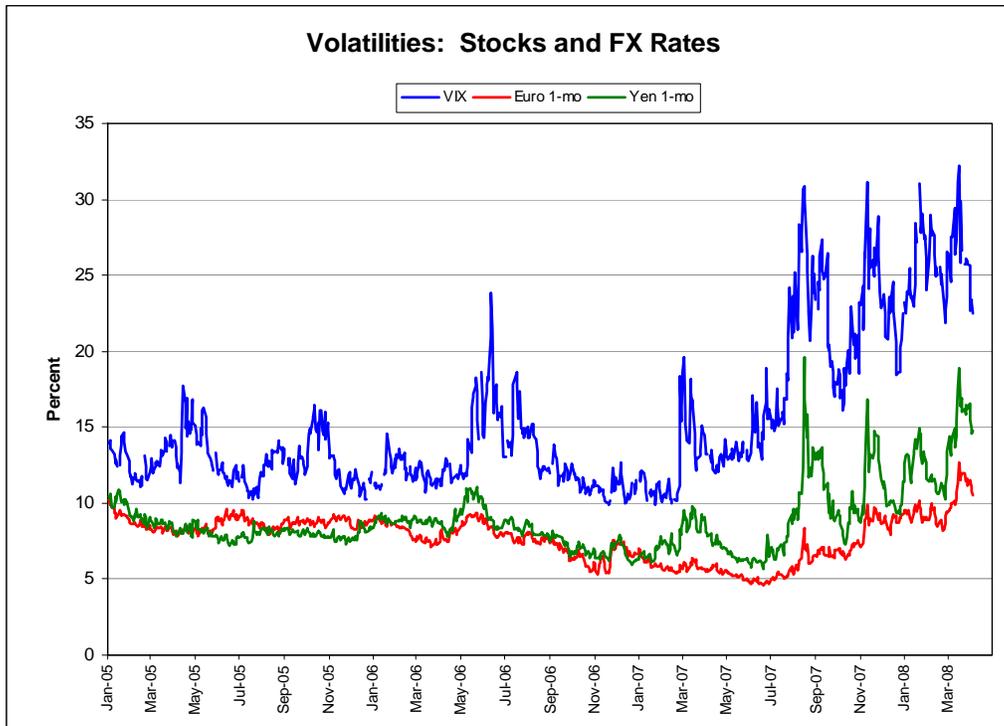
- Expectations for monetary easing grew after the release of the August non-farm payroll data showed a decline and the two prior months' payrolls were revised down. In September, the FOMC cut the federal funds target rate by 50 basis points. At its October and December meetings, the FOMC lowered the target rate by a further 25 basis points each time, to 4.25 percent at the end of 2007.
- The FOMC lowered its target for the federal funds rate an additional 125 basis points in January 2008, 75 basis points in March, and 25 basis points in April to bring the target rate to 2.00 percent at the end of April.
- Meanwhile, Consensus Economics forecast for the U.S. economic growth in 2008 was revised down from 2.0 percent in January 2008 to 1.3 percent in April 2008.

Further, sentiment toward the dollar was negatively affected by market perceptions regarding global imbalances, but the impact on exchange rate movements was limited. Market participants questioned the sustainability of exchange rates – particularly in China – that were perceived as constraining global adjustment, but they saw little prospect for near-term shifts to more market-determined exchange rates. Nevertheless, year-end rebalancing and position squaring and repatriation by U.S. multinationals supported the dollar in December, notwithstanding the negative sentiment.

Demand for higher-yielding currencies of commodity-exporting countries grew amid a generalized strong increase in commodity prices globally during the latter half of 2007 that has extended into 2008. Many of these currencies briefly dropped sharply in early August in a bout of risk reduction, but they soon resumed their upward trend

Market Conditions

The dollar dropped in the summer of 2007 as volatility increased markedly in all asset classes and credit market conditions deteriorated. Concerns about credit exposure and tightness in funding markets persisted throughout this time, but safe-haven demand for dollar assets emerged briefly in early August in an episode of generalized reduction of risk positions and yen-financed carry positions in non-dollar currencies. After spiking at that time, and then moderating temporarily, implied volatility on major currency pairs rose throughout the second half of 2007. Notwithstanding several spikes in volatility in the dollar-euro and dollar-yen currency pairs, the currency market has been orderly and has experienced substantially less volatility than other asset classes.



Country Analyses

Argentina

Argentina intervenes frequently in the foreign exchange market to achieve exchange rate stability and to build international reserves. Intervention has been on both sides of the market. In the first half of the year, the Argentine central bank actively bought dollars in the foreign exchange market and then partially sterilized these purchases through the issuance of central bank paper. The average weekly purchase in the first half of 2007 was \$385 million. This number fell to \$73 million in the second half of 2007. Between the end of July and mid-October, when the peso was under some depreciation pressure, the central bank reversed its purchasing trend and sold an average of \$82 billion. Average monthly purchases in the other months of the second half of the 2007 declined by half compared to the first half of 2007.

Management of the exchange rate is also influenced by capital controls. Capital controls remain in effect on both local and foreign currency dollar inflows. Residents are limited in the amount of foreign currency they can bring freely into the country and foreigners are required to keep dollar inflows in the country for a minimum of one year, with 30 percent held on deposit in an interest-free account at a local financial institution. Argentina maintains these controls to limit both potential volatility in the foreign exchange market and the amount of potential foreign exchange market intervention the central bank must engage in to maintain dollar/peso stability. In October 2007, the Central Bank introduced new control measures, restricting all foreign entities from participating in Central Bank public debt offerings.

Argentina's foreign currency reserves totaled \$44.2 billion at the end of December 2007, an increase of 6.5 percent or \$2.7 billion in the second half of 2007. Reserve holdings came under

pressure during the tighter global liquidity conditions in the summer of 2007, and fell to \$41.1 billion at the end of September from the July peak of \$42.5 billion as the central bank sold dollars to support the peso. Reserves subsequently rose in the last quarter of 2007.

The Argentine peso depreciated 3.0 percent against the U.S. dollar in 2007. The peso/dollar rate rose from 3.05 at the end of December 2006 to 3.15 at the end of December 2007. The average daily change against the dollar was 0.11 percent in either direction, suggesting that the exchange rate is tightly managed. Between the end of 2007 and mid-April 2008 the peso was roughly unchanged against the dollar.

The nominal effective exchange rate (NEER) depreciated by 10.8 percent in 2007, due to the nominal depreciation against other major trading partners such as Brazil, China, Chile, and EU countries. Given higher inflation in Argentina vis-à-vis its trading partners, the real effective exchange rate (REER) depreciated by 2.4 percent in 2007. Administrative measures to suppress inflation may be keeping the REER undervalued.

An undervalued exchange rate, as well as accommodative monetary and fiscal policies, helped stimulate the economy following the 2001-2 financial crisis, but recently the economy has shown signs it may be overheating. Although official inflation rates moderated to 8.5 percent in 2007, compared to 9.8 percent in 2006, independent estimates of current inflation range from 20 to 25 percent. Administrative price controls on 70 percent of the items in the CPI basket might be contributing to lower official inflation, but systematic underreporting of CPI inflation is widely suspected by market analysts. Nominal interest rates on central bank repo transactions increased by 200 basis points in 2007, from 8.25 percent at the end of 2006 to 10.25 at the end of 2007, suggesting that ex post real interest rates were negative and, therefore, unlikely to restrain rising underlying inflationary pressure.

Argentina's economy continued its rapid expansion in 2007, driven by strong real growth in private consumption (9.0 percent) and investment (14.4 percent). Real GDP grew by 8.7 percent in 2007, up from 8.5 percent in 2006. The overheating economy resulted in imports growing faster than exports in 2007, even though prices of Argentina's exports rose significantly and the government maintained an undervalued exchange rate. The current account surplus decreased from \$7.7 billion in 2006 (3.5 percent of GDP) to \$7.3 billion (2.7 percent of GDP). The U.S. bilateral trade surplus with Argentina increased to \$1.4 billion in 2007 from \$800 million in 2006.

Brazil

Brazil has a flexible exchange rate regime and relies on inflation targeting to guide monetary policy. The *real* continued to strengthen during the second half of 2007, appreciating 8.4 percent in nominal terms, from 1.93 to 1.78 *reais* to the dollar, while the real effective exchange rate appreciated 11.5 percent. As of December 31, 2007, the *real* had appreciated by 122 percent relative to the dollar since reaching a low in October 2002, likely reflecting the negative overshooting during the 2002 crisis, structural improvement in export competitiveness, a 7 percent cumulative improvement in the terms of trade in 2006 and 2007, and a sharp rise in capital inflows in 2007.

Concerned about excessive appreciation of the *real*, the authorities announced in March 2008 that exporters would be allowed to keep all proceeds from exports offshore (where they were previously limited to 30 percent), that taxes on foreign exchange transactions for exporters would be lifted, and that a 1.5 percent tax on foreign portfolio investments in domestic fixed income funds and government bonds would be imposed to moderate capital inflows.

While Brazil's current account surplus had remained remarkably robust to the strong recovery of the *real*, it began to move decisively from surplus to deficit during 2007. On a seasonally-adjusted basis, Brazil's current account surplus was \$3.5 billion (0.5 percent of GDP) in the second half of 2007, down from a surplus of \$4.8 billion (0.8 percent of GDP) in the first half of 2007, and the current account has been in deficit every subsequent month since September 2007. The trade surplus fell slightly from \$23.3 billion (3.8 percent of GDP) to \$16.7 billion (2.5 percent of GDP) over the same period. Meanwhile, Brazil's bilateral trade balance with the United States moved from a surplus of \$1.2 billion in the first half of 2007 to a deficit of \$172 million in the second half of the year. The \$1 billion surplus for the whole year is the smallest since 2001.

Meanwhile, the financial account surplus, which had swelled from \$10 billion to \$60 billion between the second half of 2006 and the first half of 2007, retreated to \$28 billion in the latter half of 2007 as record foreign direct investment inflows in the first half of the year normalized and Brazilian companies increased their investments abroad. Net foreign portfolio investment inflows, however, continued unabated in the second half of 2007, matching the \$24 billion during the first half and putting upward pressure on the currency.

The strong *real* has served as a valuable disinflation tool, especially as the inflation outlook has deteriorated in recent months. Year-on-year inflation rose from 3.8 percent in June 2007 to just below the central bank's 4.5 percent midpoint target by December.

The central bank increased net international reserves rapidly during 2007, although the pace of reserve accumulation slowed somewhat during the latter half of the year. Gross reserves increased to \$180.3 billion by December 2007 from \$147.1 billion in June – an increase of \$33 billion, compared to a \$61 billion increase in the previous six months. The goal of reserve accumulation is to smooth out exchange rate fluctuations and to improve the country's external sovereign position. Gross reserves covered about 93 percent of gross external debt in Q4 2007, up from 77 percent in Q2 2007 despite a rise in private external debt. The central bank has a broad objective of increasing reserves in the medium run, but has not committed to a specific numerical target in terms of a reserve coverage ratio.

Canada

Canada has freely floating, market-determined currency. Canada's monetary authorities have not intervened in the foreign exchange market since September 2000, when they did so in coordination with other G-7 members to support the euro.

During the second half of 2007, the Canadian dollar appreciated 7.6 percent against the U.S. dollar. Strong commodity prices, which favor the Canadian economy, and falling U.S. interest

rates brought the Canadian dollar to record highs against the U.S. dollar in early November 2007. Since peaking at an exchange rate of 0.92 C\$/US\$, the Canadian dollar has weakened by 9.9 percent as of mid-April 2008, to 1.02 per dollar. On a real trade-weighted basis, the Canadian dollar appreciated 6.2 percent during the second half of 2007.

The Canadian economy grew 2.7 percent in 2007. Growth slowed in the fourth quarter reflecting the impact of the U.S. downturn and appreciation of the Canadian dollar. Growth in service industries more than made up for a contraction in goods-producing industries.

The Bank of Canada, which is operationally independent of the government, bases its monetary policy on an inflation target range revised every three to five years. The current target range of 1 to 3 percent was first established in 1993 and most recently renewed in November 2006. Inflation was 1.4 percent year-over-year in March, down from 2.0 percent at the end of September 2007 and 2.3 percent at the end of March 2007. The deceleration in inflation primarily reflected a slower rise in gasoline prices. The favorable inflation environment has allowed the Bank of Canada to steadily reduce its target for the overnight rate from 4.5 percent in October 2007 to 3.0 percent in April 2008, in response to weaker global growth.

Canada's trade surplus was little changed in 2007 compared to 2006. Canada posted a small current account deficit (\$523 million) during the fourth quarter of 2007, the first deficit since the second quarter of 1999. A lower goods surplus, and record travel deficit, contributed significantly to the emergence of this small deficit. The U.S. bilateral trade deficit with Canada was \$31.5 billion during the second half of 2007, compared to a deficit of \$35.4 billion during the first half of 2007, as strong growth (4.7 percent) in U.S. exports to Canada was aided by the strength of the Canadian dollar and a slowing U.S. economy reduced import growth in the United States.

Mexico

Mexico has a flexible exchange rate and employs an inflation-targeting monetary policy regime. The Mexican peso ended 2007 at 10.9 pesos per U.S. dollar, down about 1 percent from 10.79 at the end of June 2007. The J.P. Morgan real effective exchange rate for the peso was roughly unchanged. The peso depreciated by 8.2 percent against the euro, 8.5 percent against the Canadian dollar, and 10.5 percent against the Japanese yen, over the same period. The peso's stability against the dollar and its decline relative to major world currencies reflects Mexico's close trading and financial ties to the U.S. economy. Through mid-April 2008, the peso had risen by 3.6 percent against the dollar to 10.52.

As the U.S. economy weakened in late 2007, economic growth in Mexico similarly decelerated. Real GDP grew at an annual rate of 3.0 percent during the fourth quarter after growing around 5.3 percent in both the second and third quarters. At the same time, supply shocks on certain key food items (mainly corn and tortilla) have caused inflation to rise above the Bank of Mexico's 3.0 percent target. Year-over-year headline inflation was 4.0 percent in the first half of 2007 and moderated only somewhat to 3.8 percent during the second half.

Mexico's current account remained close to balance throughout 2007. Strong export growth was offset by import growth and stagnating remittances. The value of Mexican oil exports grew by

over 55 percent over this period despite falling volumes. Merchandise imports also rose on a year-over-year basis; however, the fourth quarter saw import growth stall at 0.6 percent after expanding at an average rate of 4.1 percent in the first three quarters. Remittances from abroad stagnated, growing only 1.3 percent year-over-year in the second half of 2007 and falling by nearly 9 percent between the third and fourth quarters. The bilateral merchandise trade surplus with the United States increased to \$40.4 billion during the second half of 2007 from \$33.8 billion in the first half of the year.

Following a relatively modest increase during the first half of 2007, international reserves jumped by \$8.1 billion to reach \$78.0 billion at the end of December, reflecting record-high global oil prices. Pemex, the state-controlled Mexican oil company, is obligated by law to sell its foreign currency earnings to the Bank of Mexico to service the country's foreign debt. Reserves accumulate, therefore, when the foreign currency obtained by the Bank of Mexico is greater than foreign debt payments. While reserves have posted double digit growth since December 2006, the gross external debt position of the public sector has risen only marginally.

Venezuela

Venezuela maintains a pegged exchange rate to the U.S. dollar. The official nominal exchange rate was 2.15 bolivars to the U.S. dollar at the end of December 2007, effectively constant since the end of December 2005. The currency was redenominated on January 1, 2008, when the authorities eliminated three zeros. The exchange rate vis-à-vis the U.S. dollar remained effectively the same. The newly denominated currency is called the 'strong bolivar.'

The government adopted a fixed exchange rate and introduced price and foreign exchange controls in 2003 following a period of rapid exchange rate depreciation, capital outflows, and falling international reserves. The fixed exchange rate regime succeeded in avoiding a payments crisis but has reduced foreign exchange available for imports and has resulted in distortions and the development of a parallel market.

The government maintains the peg through tight controls on capital movements and the supply of available foreign exchange. Purchases of foreign exchange in Venezuela are subject to approval by CADIVI, the government's foreign exchange authority. However, CADIVI's supply of foreign exchange to the market has not kept up with demand. The amount of foreign exchange CADIVI provided for private sector imports accounted for only about 50 percent of recorded private imports in the first half of 2007, with the remainder of imports being financed in the parallel market. The parallel rate depreciated to 5.6 strong bolivars to the U.S. dollar as of the end of December 2007, a depreciation of 40 percent in the second half of 2007.

The parallel rate has appreciated since October and was quoted at 3.2 strong bolivars per U.S. dollar in April 2008, an appreciation of 43 percent since the start of the year and 51 percent since October, but still well weaker than the official rate. The appreciation seen in the parallel market was due to significant issues of dollar-denominated bonds and structured notes in the domestic market. Since November 2007, the government's main tool for influencing the parallel rate has been bond sales where the authorities issue U.S. dollar-denominated debt to satisfy demand for U.S. dollars and mop up excess liquidity.

The most recent bond sales have created, in effect, a dual exchange rate, since the implicit rate the latest bonds were sold at was 2.8 strong bolivars to the dollar. Importers and selected individuals can access dollars at the official rate, while all others must buy either on the parallel market or via bond sales. The gap between the official rate (2.15) and the parallel rate (currently 3.2) suggests that the official pegged rate is overvalued. This assessment is supported by booming import growth and declining non-oil exports.

J.P. Morgan's index of the real effective exchange rate of the strong bolivar shows an appreciation of 2.9 percent during the second half of 2007. The real appreciation is due to Venezuela's high inflation rate, which rose to 22.4 percent in December 2007, up from 17 percent in December 2006 despite extensive price controls. Inflation during the first quarter of 2008 accelerated further and totaled 8.1 percent for the quarter. High inflation is due primarily to continued accommodative monetary policy, with the 90-day deposit rate rising from 10 percent in 2006 to 11 percent in 2007 (14 percent at end-March 2008) but with real interest rates moving even further into negative territory because of the increase in inflation.

An overvalued exchange rate and an overheating economy are eroding Venezuela's current account surplus, which stood at 10 percent of GDP at the end of 2007, compared with 15 percent at the end of 2006 and 18 percent at the end of 2005. The fall in the size of the surplus comes notwithstanding an 83 percent increase in Venezuela's oil export price over this same period. Foreign currency reserves rebounded from their downward slide in the first half of 2007 and ended the year at \$23.7 billion (5.4 months of goods and services) despite periodic transfers to the off-budget state development agency, FONDEN.

Bilaterally, the U.S. has a trade deficit with Venezuela, which increased by 46 percent in the second half of 2007. The deficit reached almost \$30 billion for the year, up from \$28 billion in 2006 due primarily to rising prices for Venezuelan crude. Oil accounts for approximately 12 percent of the overall Venezuelan economy, 90 percent of exports, and 46 percent of government revenue. Real GDP rose 8.4 percent in 2007 led by investment growth of 25 percent and real private consumption growth of 19 percent.

Euro-area

The value of the euro is market-determined. Average daily trading volume in the euro is equivalent to \$1.2 trillion.¹² The European Central Bank (ECB) has not intervened in the foreign exchange market since November 2000 when it defended the euro against further depreciation.

The objective of ECB monetary policy is to maintain price stability defined as an inflation rate close to but less than 2.0 percent over the medium term. Despite hawkish comments on inflation, the ECB has held its main policy rate steady since June 2007 because of tight liquidity conditions and concerns for asset quality in the wake of the financial market turmoil affecting U.S. and European markets.

¹² Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in April 2007, Bank for International Settlements, September 2007; <http://www.bis.org/publ/rpfx07.htm>.

Reflecting interest rate cuts by the U.S. Federal Reserve, the policy rate spread favoring the euro has expanded to 2.00 percentage points since September 2007. Just prior to September 2007, the policy interest rate spread had favored the U.S. dollar by 125 basis points. Similar large-scale changes in interest rate spreads have occurred in other instruments and other maturities. The combination of a significant downgrading of near-term U.S. economic prospects but fairly resilient Euro-area growth and the large swing in interest rate spreads has been reflected in currency markets. The euro appreciated 7.7 percent against the dollar during the second half of 2007, and a further 7.6 percent through mid-April. On a real effective basis the euro appreciated by a lesser 3.6 percent in the second half of 2007 and by 3.0 percent in the first quarter.

The euro/dollar exchange rate has, at times, experienced sharp fluctuations, but in general volatility throughout 2007 and 2008 has been near the norm. Similar trends are observed in bid-ask spreads. On the other hand, trading volumes in the currency pair has increased in 2008.

Despite strong appreciation of the euro against the U.S. dollar, the Euro-area's current account remains close to balance. Partly that is because the euro's real effective appreciation in 2007 was a more manageable 4.0 percent. Bilaterally with the United States, the Euro-area external surplus grew slightly in the second half of 2007 to \$46.8 billion, up about \$7 billion from the first half of 2007 – notwithstanding the slowdown in U.S. growth and the euro's appreciation vis-à-vis the U.S. dollar. The Euro-area is the United States' second largest trading partner.

Official foreign reserves of the Euro-system increased approximately \$72 billion to \$511 billion between July and December of 2007, an increase of 16.4 percent. The increase reflects interest earned and valuation changes.

Norway

Norway maintains a freely floating exchange rate. Norway's central bank has said it will intervene in foreign exchange markets to influence the kroner if the exchange rate is deemed out of line with fundamentals or foreign exchange rate markets become thinly traded. However, it has not intervened since January 1999. The freely floating exchange rate regime allows the central bank to pursue an independent inflation-targeting monetary policy regime.

The Norwegian kroner appreciated 8.3 percent against the dollar during the second half of 2007 while the kroner's real effective exchange rate index appreciated 2.8 percent during the same period. Between the end of 2007 and mid-April 2008, the kroner appreciated an additional 9.7 percent against the dollar.

Management of the Pension Fund – Global (PF-G) – the custodian of Norway's oil and gas savings – influences currency developments. By investing the PF-G's resources overseas, Norway reduces the upward pressure that oil and gas-related earnings inflows might have on the exchange rate. At the end of 2007, the PF-G's market value was \$375 billion (88 percent of total 2007 GDP, or 118 percent of non-oil and gas GDP and growing rapidly).

By law, the real return on the PF-G's investments abroad (estimated at 4 percent) can be used for current government consumption while the principal remains as a retirement fund for future

generations. Some of the PF-G return is already being used to service retirement benefits through the current government budget. Oil production is expected to peak in 2008 and halve by 2030. Revenue accruing to the PF-G is inadequate to meet the needs of a rapidly aging population. Consequently, there is increasing pressure to reform the pension system to avoid the need to draw down PF-G principal.

Norway is a major oil and gas exporter and a key player in the oil services industry. Its current account surplus during second half of 2007 was \$37.3 billion (18 percent of GDP), compared to \$26.8 billion (14.5 percent of GDP) in the first half of 2007 and \$30.4 billion (18.1 percent of GDP) in the second half of 2006. Excluding the oil and gas sectors, Norway had a current account deficit of 4.8 percent of GDP during the second half of 2007, down from 5.2 percent during the corresponding period in 2006. Merchandise exports in the second half of 2007 were up 6.5 percent over the same period in 2006 while imports increased 10.9 percent. Norway had a bilateral merchandise trade surplus of \$2.1 billion with the United States in the second half of 2007, down from \$2.3 billion in the corresponding period of 2006.

Foreign exchange reserves increased \$4.2 billion to \$60.3 billion during the second half of 2007.

Russia

The exchange value of the Russian ruble is managed by the Central Bank of Russia against a reference basket of the U.S. dollar and euro. The U.S. dollar and the euro's shares in the basket are 55 percent and 45 percent, respectively. The central bank continues to closely manage the exchange rate in an effort to simultaneously meet an inflation target and limit real exchange rate appreciation. The ruble appreciated 4.5 percent against the dollar and 0.5 percent against the basket during the second half of 2007. The ruble depreciated by 0.8 percent in the second half of 2007 on a nominal effective basis but appreciated by 1.8 percent on a real effective basis because of Russian inflation. In the Russia's Article IV report published in October 2007, the IMF estimated Russia's real exchange rate to be undervalued by as much as 20 percent.

The Central Bank of Russia's intervention to moderate nominal exchange rate appreciation continued during the second half of 2007, albeit at a relatively slower pace compared to the first half. Total international reserves climbed from \$406 billion at the end of June to \$474 billion at the end of December. Reserves surpassed \$500 billion in early 2008, in part due to the appreciation of the euro vis-à-vis the U.S. dollar.

Russia's current account surplus increased slightly in nominal dollar terms between the second half of 2006 and the second half of 2007, from \$39.4 billion to \$40.5 billion. However, the current account surplus as a share of GDP declined from 7.2 percent to 5.5 percent of GDP over this period. Russia's bilateral trade surplus with the United States decreased from \$7.6 billion in the second half of 2006 to \$6.1 billion second half of 2007. Net inflows of private sector capital fell from a breakneck pace of \$66.5 billion in the first half of 2007 to \$14.2 billion in the second half of the year. Balance of payments estimates for the first quarter of 2008 show a \$22.9 billion outflow of private capital, reflecting in part global financial conditions and larger than usual loan repayments.

In the last several years, commensurate increases in households' demand for rubles have helped mitigate the inflationary impact of the sizeable increases in domestic monetary aggregates related to large inflows of foreign exchange. This was reflected in a sustained decline in foreign currency deposits in the banking sector. However, the share of foreign currency deposits in the banking system has shown some signs of stabilizing at around 13-15 percent of total deposits since approximately June 2007. Meanwhile, M2 growth has moderated only slightly from the first half of 2007, increasing 43 percent (year-over-year) in December 2007. Aided by these factors, inflation has continued to rise, reaching 11.8 percent (year-over-year) as of the end of December 2007 and 13.3 percent as of the end of March 2008. A loosening of fiscal policy toward the end of 2007 and liquidity injections by the Central Bank to calm volatile financial markets appear to have exacerbated inflationary pressures. More recently, authorities have offered to place public funds on deposit to ensure that banks have adequate liquidity to fund their operations.

Switzerland

Switzerland has a freely floating exchange rate. Its market-determined exchange rate allows the central bank to pursue an independent inflation-targeting monetary policy.

The Swiss franc appreciated 7.7 percent against the U.S. dollar in the second half of 2007. The pace of appreciation accelerated in early 2008. The Swiss franc appreciated by 12.3 percent against the dollar between the end of December and mid-April. In contrast, the real effective value of the franc increased by only 0.7 percent during the second half of 2007. The smaller movement in the real effective value of the franc occurred because the franc was flat against the euro over the second half of the year and CPI inflation remained relatively low at 2.0 percent year-over-year to December 2007.

Switzerland is a small open economy that is heavily influenced by conditions in the Euro-area, with about 60 percent of its exports destined for the Euro-area. Also, because Swiss interest rates were viewed as relatively low in 2006 and 2007, the Swiss franc was a popular funding currency in Europe for "carry trades" and tended to depreciate vis-à-vis the euro. While the pace of interest rate normalization stalled late in 2007, the central bank did raise the center of its policy rate band by 25 basis points to 2.75 percent in September, and the franc has likely benefited from safe haven flows given recent market volatility. The JP Morgan real effective exchange rate index rose 4.9 percent in the first three months of 2008. Foreign exchange reserves rose by \$6.5 billion to \$43.9 billion in the second half of 2007.

Switzerland has had a large and persistent current account surplus — equal to 19.5 percent of GDP in 2007. The surplus is driven by robust financial services income (mostly banking fees and services derived from its role as an international financial center) and investment income from large foreign direct investments. The current account surplus was \$82.5 billion in 2007, compared with \$61.3 billion (15.8 percent of GDP) in 2006. The U.S. merchandise trade surplus with Switzerland was \$573 million in the second half of 2007 compared with \$60 million in the corresponding period in 2006. Swiss goods exports (excluding precious metals) increased by 9.9 percent in the second half of 2007 over the corresponding period in 2006, while imports grew by 10.8 percent. The counterpart to the current account surplus is now largely net foreign

investment abroad, which was \$14.8 billion in the second half of 2007, down from \$21.4 billion during the corresponding period in 2006.

United Kingdom

The value of the pound is market determined. The UK's current macroeconomic framework does not entail management of the exchange rate. The Bank of England (BOE) has not intervened to influence the value of the pound since 1992.

After appreciating 2.5 percent in nominal terms against the dollar in the first half of 2007, the pound depreciated 1.2 percent against the dollar in the second half of 2007 as a weakening growth outlook resulted in increasing expectations of monetary policy easing. The pound continued to depreciate against the dollar in early 2008, falling by 1.1 percent by mid-April. The nominal effective exchange rate of the pound depreciated 6.6 percent in the second half of 2007, on the weakening UK growth outlook, compared to a nominal effective appreciation of 0.6 percent in the first half of 2007.

The BoE is responsible for the conduct of monetary policy and maintains an inflation target of 2.0 percent. In the second half of 2007, the BoE raised its target interest rate 25 basis points (bps) to 5.75 percent on July 5, citing inflationary pressures, with year-over-year inflation, in the range of 2.5 percent, exceeding its target. The BoE held interest rates at this level until December 6, when it lowered its target rate by 25 bps to 5.5 percent on signs that growth had begun to slow and that difficult financial market conditions could pose a risk to future growth. Inflation at the end of December 2007 stood at 2.1 percent year-over-year, down from 2.4 percent at the end of June 2007.

The UK's current account deficit increased from \$93.7 billion (3.9 percent of GDP) in 2006 to \$115.4 billion (4.2 percent of GDP) in 2007. The U.S. bilateral trade deficit with the UK increased from \$912 million in the first half of 2007 to \$5.7 billion in the second half of 2007, driven by a similarly-sized decline in exports and increase in imports.

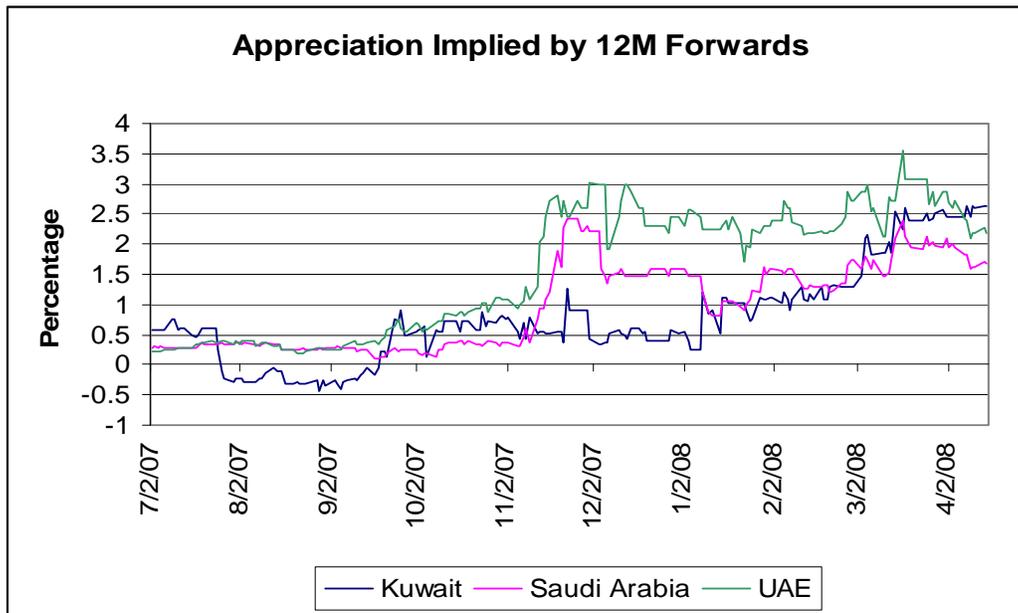
At the end of December 2007, the UK held \$57.2 billion in foreign exchange reserves, up from \$52.8 billion at the end of June 2007. Foreign exchange reserves are largely held on a precautionary basis to meet any change in exchange rate policy in the future, if required, or in the event of unexpected shocks.

The Gulf Cooperation Council Countries

Six countries make up the Gulf Cooperation Council (GCC): Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. With the exception of Kuwait, the exchange rates of the GCC countries are pegged to the U.S. dollar. Kuwait dropped its peg in May 2007 in favor of a basket of currencies. The GCC countries have benefited significantly from the robust global economy of the last several years and particularly from the sharp rise in the price of oil, which has boosted the value of their oil exports and significantly expanded government revenues. Despite the sizable and favorable increase in the terms of trade and their burgeoning external surpluses, their real effective exchange rates are lower today than in 2002. However, in

Qatar and UAE, some real exchange rate adjustment is beginning to take place in the form of higher inflation whereas in Saudi Arabia the real effective exchange rate continues to be weak, notwithstanding an acceleration of inflation. Higher food prices, rising domestic liquidity, and increased domestic spending have each contributed to the rising pace of CPI inflation.

Rising inflationary pressures have intensified discussion in the region as to whether the GCC countries should revalue their currencies or adjust their exchange rate regimes. Financial markets have priced in small rates of appreciation against the U.S. dollar over the coming 12 months. GCC officials continue to publicly state their commitment to maintaining their current exchange rate regimes. Consistent with their exchange rates regimes, GCC central banks have cut their policy interest rates in line with reductions in the U.S. federal funds rate.



Saudi Arabia

The Saudi riyal has been unofficially pegged to the U.S. dollar since 1986 (officially since 2003), and the country's central bank, the Saudi Arabian Monetary Agency (SAMA), has publicly stated that the peg to the U.S. dollar provides both external and internal stability. However, high and rising oil prices and the inability to fully sterilize the large increase in oil export revenues, combined with global food price pressures, have dramatically increased inflationary pressure in the last two years. This has led to market speculation that Saudi Arabia might change its exchange rate regime or re-peg its currency at a different rate. From January 2003, members of the GCC agreed to fix their exchange rates against the dollar to maintain constant bilateral exchange rates until the planned adoption of a common GCC currency in 2010. Saudi officials have publicly reiterated their commitment to the peg to the U.S. dollar.

Saudi Arabia is among the most oil-dependent economies in the world, with more than 90 percent of its export earnings from oil and priced in dollars. Many of these dollar earnings from oil exports go into special accounts and thus never enter into the domestic financial system,

though the amounts and the accounts are unknown. However, some of the dollars are absorbed into the Saudi economy where, given the peg and the inability to sterilize foreign exchange inflows fully, they result in an expanding domestic money supply. That has certainly been the case since the prolonged rise in oil prices starting in 2002. The M2 measure of Saudi Arabia's money supply has expanded rapidly and, as a result, inflation has increased. In 2007, Saudi consumer price inflation was 4.1 percent compared to 2.3 percent in 2006. By February 2008, it had reached a 27-year high of 8.7 percent year-over-year.

The real value of the Saudi riyal has continued to depreciate despite the rise in inflation. On a real effective basis the riyal was roughly unchanged in the second half of 2007. In the first quarter of 2008, however, the riyal depreciated by 4.7 percent in real terms. This is on top of a cumulative 20 percent real depreciation between February 2002 and June 2007. Because of the peg, the nominal value of the riyal has fallen in line with the declines in the value of the U.S. dollar since February 2002.

Higher domestic government spending in response to surging oil revenues, along with some speculation regarding de-pegging or revaluation of the riyal, have placed significant upward pressure on the nominal value of the riyal. Net foreign assets held by SAMA increased almost \$60 billion in the second half of 2007, to \$300.9 billion from \$242.8 billion, and rose another \$30 billion to \$330.7 billion by February. (The government sells dollars from its oil revenues to SAMA in return for domestic currency deposits.) SAMA's official reserves (less gold) grew to \$33.8 billion in December 2007 from \$23.9 billion in June 2007, but decreased slightly to \$33.6 billion in February.¹³

Saudi Arabia's current account surplus fell to 25.1 percent of GDP in 2007 from 27.9 percent in 2006. Saudi Arabia's merchandise trade surplus with the U.S. rose to \$14.5 billion in the last six months of 2007 from \$10.7 billion in the first six months of 2007. These changes largely reflect high and rising world oil prices, especially in the second half of 2007, rather than the real depreciation of the riyal.

China

Chinese authorities have continued to closely manage the RMB against the U.S. dollar, though they have allowed increased appreciation and flexibility. The recent acceleration in appreciation is a welcome development. However, overall gains remain insufficient. The recent faster pace of appreciation should be maintained, as the currency remains substantially undervalued, particularly on a real effective basis and upward market pressures on the currency remains strong. The central bank's foreign exchange intervention to manage the currency's movements reached record levels in 2007, alongside a record-high current account surplus. China's exchange rate policy continues to support large-scale domestic liquidity creation, which threatens monetary and price stability. The associated sterilization of foreign exchange intervention by the Chinese central bank is a drag on financial sector reform. In addition, the current exchange rate policy hinders the transmission of economy-wide price signals that are important for the government's macroeconomic rebalancing agenda.

¹³ Saudi Arabia has assets in other accounts available to it which are not counted as part of the country's official reserves.

Officially, the RMB is managed with reference to a basket of the currencies of China's largest trading partners. In practice, the RMB's movements are tightly managed against the U.S. dollar, with daily fluctuations kept well within the official 0.5 percent intra-day trading band. Within this framework, appreciation accelerated against the U.S. dollar in the second half of 2007 and the pace of appreciation increased further in the early months of 2008. The RMB gained 2.5 percent against the U.S. dollar in the first half of 2007 and 4.2 percent in the second half of 2007. This contrasts to 3.7 percent RMB appreciation against the U.S. dollar in the entire first year after the end of the exchange rate peg, including the initial 2.1 percent revaluation on July 21, 2005. At the end of 2007, the RMB had gained 13.3 percent against the U.S. dollar since the end of the dollar peg. As of April 15, the RMB was up a cumulative 18.4 percent against the U.S. dollar. Chinese domestic inflation has been greater than inflation in the United States in the second half of 2007, and, on a real, bilateral basis, the RMB has appreciated 22.7 percent since July 2005.¹⁴

The People's Bank of China (PBOC) intervenes in the foreign exchange market to limit movements of the RMB exchange rate. Although China does not publish data on its foreign exchange intervention, statistics on foreign exchange reserve accumulation provide an indication of the volume and pace of the PBOC's foreign exchange purchases.¹⁵ Official reserves increased by \$462 billion from the end of 2006 to the end of 2007, a 43 percent increase. In the first quarter of 2008, foreign exchange reserves have risen by \$154 billion. By any measure, China has more than sufficient foreign exchange reserves. The current level of \$1.68 trillion is 51 percent of 2007 GDP, 20 months of imports, and 28 percent of China's level of external debt plus M2 at the end of 2007.

Against this backdrop and with domestic saving rising even further over investment, disequilibrium in China's international balance of payments continued to deepen in 2007. China's 2007 global trade surplus grew by 48 percent over the 2006 level, to \$262 billion.¹⁶ China's current account balance for 2007 is estimated to be roughly 11 percent of GDP, up from 9.5 percent of GDP in 2006. On a bilateral basis, China's trade surplus with the United States grew 10.2 percent, reaching \$256 billion.¹⁷ There was indication of slower growth of the U.S.-China bilateral balance in the second half of 2007. Growth in U.S. imports from China slowed to 6.2 percent year-over-year in the second half of 2007, down from 15.3 percent year-over-year growth in the first half of the year. Growth of U.S. exports to China remained strong at about 18 percent. U.S. exports to China were \$78.2 billion in 2007. In the meantime, China's exports to Europe continue to grow rapidly, and the Euro-area's trade deficit with China increased 21 percent in 2007, to 109.6 billion euros.

¹⁴ Data on Chinese wage rates are incomplete, but the data that exist suggest rising wages in the manufacturing sector, in part due to a new labor law that went into effect this year.

¹⁵ The authorities have instituted measures to limit convertibility of foreign currency or to extend foreign currency holding by commercial entities, with the likely net effect of slowing increases in official foreign exchange reserve holdings. For example, it has been reported that in the second half of 2007, commercial banks were required to meet increases in the required reserve ratio by depositing U.S. dollars with the PBOC.

¹⁶ Official data. This figure is not adjusted for re-export trade between China and its trading partners via Hong Kong.

¹⁷ Based on U.S. data.

The combination of large current and capital account inflows and commensurate foreign exchange intervention could lead to large increases in domestic liquidity, as the PBOC buys excess foreign exchange with RMB, adding to the domestic money supply. To counter this, the PBOC partially re-absorbs (“sterilizes”) the RMB liquidity created by its foreign exchange purchases by selling securities to the public and through upward adjustments to the required reserve ratio for commercial banks. At the end of 2007, there were 3.5 trillion yuan of PBOC bills outstanding. The PBOC also increased the use of repurchase agreements in 2007, with 620 billion yuan outstanding at the end of the year. Together, central bank bill issuance and repurchases agreements kept about 4.1 trillion yuan of liquidity out of circulation at the end of 2007, an amount equivalent to one third of China’s total foreign exchange reserve holdings. The authorities raised the required reserve ratio on 10 occasions in 2007 by a total of 5.5 percentage points. The impact of required reserve ratio increases on domestic liquidity is less certain, given widespread unofficial reports that banks were obliged to fulfill some of the required reserve increases with foreign currency. The central bank reports that about 2 trillion yuan of liquidity was frozen by required reserve increases in 2007.

China now faces rising inflation risk, due in part to its current exchange rate policy. Inflation is on the rise across the spectrum of price indices in China, and public inflation expectations appear to be rising. China’s CPI inflation rose to 6.5 percent year-over-year at the end of 2007, and PPI climbed to 5.4 percent year-over-year. Data through March 2008 show CPI and PPI inflation at 8.3 percent and 8.0 percent, respectively, year-over-year. The existing exchange rate policy places priority on managing the level of the currency, thereby straining the monetary authorities’ ability to control domestic liquidity and limiting their ability to adjust interest rates to guide economic activity. Instead, the credit control measures (e.g., restrictions on bank lending) and required reserve increases implemented to reduce monetary growth create an unstable money multiplier, adding uncertainty to the outlook for monetary aggregates. Further, Chinese economists have indicated a possible impact on nominal price levels due to unpredictable changes in money demand, as savers anticipate future inflation and seek higher returns in asset markets.

China’s economy grew by 11.9 percent in 2007, a twelve-year high. Preliminary estimates show that net exports, investment and consumption contributed 2.7, 4.3, and 4.4 percentage points to growth, respectively. Limited progress has been made towards the authorities’ goal of rebalancing growth away from exports and investment and towards consumption. Recent trade data for 2008 indicates a possible moderation in the growth of China’s trade surplus, though seasonal factors and one-off events have influenced the outcomes, so the picture is yet unclear.

In a welcome development, China has allowed the RMB to appreciate more quickly against the U.S. dollar. However, China’s record current account surplus and unprecedented foreign exchange reserve accumulation in 2007 suggest that the RMB remains significantly undervalued indicating that the pace of appreciation seen in the first quarter of 2008 needs to continue.

India

India’s exchange rate arrangement is a managed float. The Reserve Bank of India (RBI), India’s central bank, emphasizes “price stability and well-anchored inflation expectations while ensuring

a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.” These objectives are implemented by adjusting market liquidity through repurchase and reverse repurchase agreements, open market operations, and the cash reserve ratio applied to banks. The RBI also intervenes in the foreign exchange market to impact the nominal exchange rate, thereby providing the RBI with another tool to meet its objectives.

Against the U.S. dollar, the rupee appreciated 3.4 percent in the second half of 2007 and 12.3 percent for all of 2007. In real effective terms, as calculated by the JP Morgan index, the rupee depreciated by 1.6 percent in the second half of 2007, but appreciated by 7.6 percent for all of 2007. The rupee depreciated by 1.1 percent against the dollar between the end of December and mid-April 2008.

In response to strong capital inflows, the RBI sought to slow rupee appreciation through intervention. Its foreign exchange reserves rose by \$60.4 billion in the last six months of 2007 to \$266.5 billion, reflecting purchases of \$8.0 billion per month in the second half of 2007. Foreign exchange reserves increased an additional \$32.6 billion to \$290.1 billion at the end of the first quarter of 2008.

Economic growth slowed to 5.5 percent on a seasonally-adjusted annualized basis in the second half of 2007. Growth slowed in services (8.2 percent) and manufacturing (3.2 percent) while increasing slightly in agriculture (3.8 percent) relative to the first half of the year. Wholesale prices increased 3.8 percent (year-over-year) in December 2007. Wholesale price inflation has picked up early in 2008, reaching 4.6 percent (year-over-year) in February, in line with global trends. The RBI left its policy interest rate unchanged from July through December but raised the cash reserve ratio (CRR) by 50 basis points in August and again in November to end the year at 7.5 percent. With inflationary pressures emerging, the RBI announced plans to increase the CRR by half a percentage point in two stages of a 25 basis points, effective April 26 and May 10.

Net imports continue to be a drag on growth. Merchandise exports and imports each grew by 18 percent during the second half of 2007, and the merchandise trade deficit increased to \$43 billion from \$36 billion in the first half of the year. The current account deficit was a seasonally adjusted \$3.1 billion (1.2 percent of GDP) in the second half of 2007, compared with \$7.6 billion (3.1 percent of GDP) in the first half of 2007. The U.S. merchandise trade deficit with India narrowed to \$1 billion in the second half of 2007, from \$5.4 billion in the first half of the year.

Capital inflows nearly doubled in the second half of 2007, easily financing the current account deficit and leading to further reserve accumulation. Direct investment (FDI) inflows for the first half of 2007 topped \$11 billion, while Indian entities invested \$5 billion abroad. Net portfolio inflows increased to more than \$25 billion, versus \$9.3 billion for first half of the year and \$9.5 billion for all of 2006. Commercial borrowings abroad remained robust, at \$18.4 billion for the second half of 2007, but shifted into short-term borrowings, with roughly even distribution between short and medium/long-term borrowings. Total external borrowing was \$16 billion in the first half of the year, of which more than 80 percent was in medium/long term loans.

Japan

Japan maintains a floating exchange rate regime. Japanese authorities have not intervened in the foreign exchange market since March 2004.¹⁸ The yen trades in a deep market in which daily transactions average \$530 billion.¹⁹ Over the past ten years, the yen-dollar exchange rate has moved between ¥147 and ¥97 per dollar, and fluctuated between ¥122 and ¥108 over the July – December 2007 period.

The yen appreciated 9.9 percent against the dollar between the end of June and the end of December, closing at ¥111.71 on December 31. In real effective terms, the yen strengthened 5.1 percent over the period.²⁰ The yen has strengthened further in 2008 – moving to ¥101.33 on April 15 – an appreciation against the dollar of nearly 10 percent since the end of December.

Even though Japan has not intervened, Japan's foreign exchange reserves continue to rise, reflecting interest earnings and valuation effects (as the value of other currencies have risen against the dollar and as bond prices have risen as interest rates have fallen). Foreign exchange reserves totaled \$948.0 billion at the end of December 2007, up from \$892.8 billion at the end of June, a 6.1 percent increase. By the end of the first quarter of 2008, reserves had risen to \$987.7 billion.

Japan's current account surplus increased 25.7 percent in 2007, rising to \$214.6 billion from \$170.7 billion in 2006. The surplus also widened in the second half of the year relative to the first half (\$111.7 billion versus \$102.9 billion). As a share of GDP, however, the surplus was the same at the end of the fourth quarter of 2007 (5.0 percent) as it was at the end of the second quarter. The surplus continues to be dominated by net income flows from Japan's overseas direct and portfolio investments, which account for more than 60 percent of the surplus. Japan's merchandise trade surplus also increased in 2007, widening to \$91.4 billion from \$67.8 billion in 2006, and rose 22.5 percent year-over-year in the second half of 2007. Japan's merchandise trade surplus with the U.S., however, narrowed to \$82.8 billion in 2007 from \$88.5 billion in 2006, and contracted 6.1 percent from the second half of 2006 to the second half of 2007.

Net outflows of private capital (the sum of net domestic and foreign outflows) slowed in the second half of the year compared to the first half, falling to \$86.9 billion from \$96.0 billion. This was still considerably higher than the \$47.1 billion net outflow recorded over the July to December 2006 period. The “yen carry trade”, in which investors borrow yen at a low interest rate to invest in higher return foreign currency assets, which was prominent for much of 2007, appears to have diminished during the latter part of the year. Incentives for investing in overseas assets were reduced by a narrowing of interest rate differentials between Japan and the United States, increased aversion to risk following the financial market turbulence in the second half of 2007, and the fact that yen appreciation imposed losses on many outstanding carry trades. Some unwinding of the yen carry trade as well as reassessment of relative near-term economic

¹⁸ The Ministry of Finance determines the timing and magnitude of foreign exchange interventions, and the operations are carried out by the Bank of Japan.

¹⁹ Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in April 2007, Bank for International Settlements, September 2007; <http://www.bis.org/publ/rpfx07.htm>.

²⁰ Using the Bank of Japan's index.

prospects of the major economies likely accounts for the yen's cumulative appreciation of 15 percent against the dollar since August 2007.

Japan's longest post-war economic recovery continued through the second half of 2007, but the pace of growth remained moderate and the economy has yet to decisively exit price deflation. Real GDP expanded 2.0 percent in 2007, a deceleration from the 2.4 percent pace in 2006. Although Japanese GDP grew at a rate of 3.6 percent, quarter-over-quarter annualized, in the fourth quarter of 2007, early data for 2008 suggest a significant slowing of the economy. Industrial production appears to have peaked in the fourth quarter of 2007 and the labor market is weakening. Consumer prices rose 0.1 percent year over year in 2007, but core prices (excluding food and energy) declined 0.3 percent. In February 2008, the CPI increased at its fastest rate in nearly ten years (1.0 percent year over year), but this was largely due to higher energy prices. Excluding food and energy, the CPI fell 0.1 percent year over year in February. The strengthening of the yen since mid-year 2007 has likely exerted downward pressure, other things being equal, on overall prices.

Malaysia

Malaysia maintained a fixed exchange rate against the dollar prior to July 21, 2005, when it revalued and began a managed float. Bank Negara Malaysia (BNM), the central bank, has stated that the Malaysian currency (ringgit) will reflect fundamentals over the medium term, and there is no explicit exchange rate target. Officially, the BNM intervenes in both directions to smooth out excessive volatility in the ringgit exchange rate, as measured against a basket of currencies.

In the second half of 2007, the ringgit appreciated by 3.7 percent against the U.S. dollar, and by 6.5 percent over the course of the year. The ringgit appreciated a further 4.4 percent by mid-April 2008. Since Malaysia abandoned the peg in July 2005, the ringgit has appreciated by 18.3 percent against the dollar. The real effective exchange rate has appreciated 4.5 percent since the end of the peg through the first quarter of 2008, according to the BIS' CPI-based index. According to JP Morgan's PPI-based real effective exchange rate index, the ringgit has depreciated by 0.1 percent since the end of the peg.

After foreign exchange reserves increased by 19.3 percent in the first half of 2007, foreign exchange intervention dropped sharply in the second half of the year. Official reserves, as of the end of December 2007, were up three percent (\$3.0 billion) over end June 2007, including interest earnings and valuation adjustments. In the first three months of 2008, however, reserves grew by \$18.9 billion, an increase of 18.7 percent.

Total Malaysian exports grew by 4.2 percent year-over-year and imports grew 6.4 percent year-over-year in the second half of 2007, compared to, respectively, 1.3 and 3.6 percent year-over-year in the first half of 2007. Weaker external demand for electronics contributed to the slowdown. Exports were equal to 94 percent of GDP in 2007, down from 103 percent in 2006. Malaysia's overall merchandise trade surplus was \$29.2 billion in 2007, and its surplus with the United States stood at \$21.1 billion for 2007, down from \$24.0 billion in 2006.

Overall saving in the Malaysian economy remains high, despite stronger domestic consumption growth and a recent pick-up in investment. Real gross fixed capital formation increased 10.2 percent in 2007, the highest rate since 2000, due to both strong public and private investment. However, investment as a share of GDP remains substantially below its level in the early 1990s, at 21.8 percent of GDP in 2007 compared to an average of 41.6 percent from 1993 to 1997, prior to the 1997/98 Asian Financial Crisis. Studies have identified the regulatory burden and a shortage of skilled labor as barriers to greater investment in Malaysia.

The structural trade surplus has combined with the saving-investment imbalance to produce a persistent current account surplus in Malaysia, which in the second half of 2007 totaled 16.2 percent of GDP, and 15.4 percent of GDP for all of 2007. The current account surplus in 2006 was 16.3 percent of GDP.

In past reports, we have pointed to the growing current account surplus and rapid accumulation of foreign reserves as signs of imbalances in the Malaysian economy that may reduce welfare and growth. Recent indicators continue to suggest that imbalances remain. The current account surplus continues to primarily reflect the sharp fall in private investment after the Asian financial crisis. Private fixed capital formation as a share of GDP continues to be 20 percentage points below its 1997 high, and remains low even after adjusting for the unusually large investment share in the mid-1990s. Large public saving, at roughly 15 percent of GDP in the last two years, contributes to the overhang with overall saving remaining relatively constant, at around 35 percent of GDP.

Another contributing factor to the rising current account surplus is Malaysia's increasing terms of trade, with the prices of commodity exports such as petroleum, natural gas, palm oil and rubber rising sharply in the last two years. This is reflected in a change in the composition of Malaysia's export basket, with electronics comprising 47 percent of exports in the second half of 2007, down from 51 percent in 2006 and 53 percent in 2005. The trade balance, at around 20 percent of GDP, has not changed significantly in magnitude and continues to drive the current account surplus.

Foreign exchange reserves have continued to increase, although intervention has been intermittent and in both directions. While the majority of intervention has added to foreign reserves, reserves fell in both the second half of 2005 and in September 2007, as Bank Negara intervened to slow the pace of ringgit depreciation. A persistently large current account surplus coupled with still low domestic investment suggests an undervalued currency that has contributed to macroeconomic imbalances.

Singapore

The Monetary Authority of Singapore (MAS) uses the exchange rate as its operational monetary policy tool for maintaining price stability. Singapore is a highly open economy, with exports and imports of goods totaling approximately 400 percent of GDP. The MAS manages the Singapore dollar (SGD) against an undisclosed basket of currencies of its major trading partners, and since

April 2004 has had a policy of “modest and gradual” nominal appreciation against this basket.²¹ In the second half of 2007, the SGD appreciated 5.9 percent against the U.S. dollar, but only 1.7 percent on a nominal effective basis, using JP Morgan’s index. On a real effective basis, the SGD depreciated 1.5 percent in the second half of 2007. On April 10, 2008, in response to inflationary pressures, the MAS reaffirmed its exchange rate policy but reset the midpoint of the band at the current market rate, which led to a one-off 1.5 percent appreciation in the effective nominal exchange rate.

Though the MAS uses the exchange rate as its operational monetary policy tool, and the nominal effective rate appreciated 1.7 percent, inflation steadily accelerated to 4.3 percent (year-over-year) by the end of 2007, up from 1.3 percent in June. By March 2008, inflation was 6.7 percent, a 26-year high. In order to maintain domestic money growth within reasonable ranges, Singapore’s sterilization operations – through foreign exchange swaps, direct borrowings, and repos – are significant. In the second half of 2007, the MAS’s foreign reserves increased by \$19 billion, while reserve money increased by just slightly over \$2 billion. Although Singapore’s prices are strongly influenced by export prices – through an exchange rate mechanism that keeps domestic inflation slightly below U.S. levels – the country’s large current account surplus is at least partially attributable to the government’s national savings decisions. These savings may exceed levels that Singapore’s public would choose for itself.

Singapore’s official foreign reserves increased \$19 billion in the second half of 2007, reaching \$163 billion or 79 percent of broad money.²² Furthermore, as of the end of 2007 the MAS had a net forward position of \$64 billion, which constitutes an obligation to buy foreign exchange in the future. In addition to the MAS’s official foreign exchange interventions, the government also purchases foreign exchange with proceeds from surplus fiscal funds and compulsory social security savings (Central Provident Fund). These funds are managed by the Government Investment Corporation (GIC) and Temasek, which was originally a holding company for Singapore’s state-owned enterprises, and now makes significant investments abroad. Its total portfolio is valued in excess of \$100 billion.

Singapore’s gross national saving rate of about 47 percent of GDP for the whole of 2007 was among the world’s highest, and reflects extremely high corporate saving and persistent budget surpluses. Gross capital formation, meanwhile, fell from a high of 39 percent of GDP in 1997 to 16 percent of GDP in 2003, before stabilizing at around 20 percent of GDP the past several years. Although Singapore does not have capital controls, and residents are free to invest abroad as well as at home, the country had a net private capital inflow in the second half of the year. However, because of net official outflows totaling nearly 15 percent of GDP – largely a result of overseas investment by the GIC and Temasek – Singapore recorded a capital account deficit of 8.7 percent of GDP in the first half of the year.

High and increasing saving rates, accompanied by falling rates of domestic investment, have led to large and widening structural current account surpluses. The current account surplus has

²¹ The MAS manages the exchange rate within an undisclosed band and can choose to (1) change the midpoint of the band to allow for a one-off adjustment, (2) change the band’s gradient to signal a possible turning point in the monetary policy cycle, or (3) widen the band.

²² Conventional minimum levels of the foreign reserves to M2 (broad money) ratio are 5-20 percent.

exceeded 10 percent of GDP since 1994 and 20 percent of GDP since 2003. The trade surplus was 28.7 percent of GDP in the second half of the year, compared with 30.2 percent of GDP in the same period a year ago. Nonetheless, Singapore continues to run a bilateral trade *deficit* with the United States, amounting to \$4.2 billion in the second half of this year, unchanged from the same period in 2006.

The Singapore economy slowed dramatically, with growth declining at an annual rate of 4.8 percent in the fourth quarter of 2007 following 5.1 percent growth in the third quarter. The slowdown was broad-based, with the manufacturing, construction, and services sectors all slowing down.

South Korea

In recent years, South Korea has maintained a managed floating exchange rate policy, but with a high degree of exchange rate flexibility. The newly-renamed Ministry of Strategy and Finance (MOSF) determines the timing and magnitude of foreign exchange intervention, which is carried out by the Bank of Korea (BOK).²³

The authorities intervened intermittently over the reporting period, largely to stem appreciation of the Korean won. Since the start of 2008, however, there is evidence of intervention of limit depreciation. South Korea's foreign exchange reserves increased \$11.5 billion (4.6 percent) during the second half of 2007, the smallest half-year change since the second half of 2005. At the end of December 2007, South Korea's total foreign exchange reserves stood at \$261.8 billion. Reserves fell slightly in early 2008, declining to \$260.5 billion at the end of April. The change in reserves reflects a combination of exchange market intervention, interest earnings on existing reserves and valuation changes.

The new, pro-growth government, which took office in February 2008, has been critical of speculative transactions in the won.²⁴ The won appreciated steadily versus the U.S. dollar for more than five years through July 2007, strengthening by more than 40 percent. In real effective terms, from trough to peak strength in July 2007, the won appreciated 27 percent.²⁵ The won, along with other high-yielding currencies, depreciated sharply during the credit market turmoil in August 2007 as "carry trades" were unwound. At the end of December 2007, the South Korean currency was 1.3 percent weaker than at the end of June 2007 (KRW936.1 per U.S. dollar versus KRW923.6). Another bout of won weakness began in the early part of 2008 as overseas investors became net sellers of South Korean assets and domestic investors had difficulty borrowing foreign currency. In March 2008, the won depreciated beyond KRW1000 per dollar for the first time since late 2006 and was nearly 11 percent weaker in real effective terms compared to a year earlier. On April 15, the won stood at 991.3 per dollar.

Over the second half of 2007, South Korea's trade surplus declined by \$3.3 billion from the second half of 2006 to \$5.7 billion. South Korea's merchandise trade surplus with the United

²³ The MOSF was named the Ministry of Finance and Economy before administrative reforms earlier this year.

²⁴ On April 15, 2008, Finance Minister Man-soo Kang stated that, "If there is a speculative force (in the foreign exchange market), the government should normalize (the market)."

²⁵ According to the JP Morgan broad real effective index.

States fell to \$3.4 billion from \$5.2 billion over the same period as import growth outpaced export growth. Although South Korea runs an overall surplus in merchandise trade, it has a substantial and growing deficit in services. Driven by a rising net outflow of tourists and students, Korea's services deficit reached a record \$20.6 billion in 2007 and totaled \$10.0 billion between July-December 2007. South Korea's current account balance fell into deficit in the fourth quarter of 2007 for the first time since the first quarter of 2006. In the fourth quarter of 2007, the current account deficit totaled \$1.7 billion or 0.7 percent of GDP.

Although there are recent signs of slowing economic growth, South Korea's economy performed well in the second half of 2007, with real GDP expanding 3.0 percent compared to 2.7 percent in the first half year. Consumer price inflation, however, has been above the BOK's target range of 2.5 to 3.5 percent since December 2007, reaching 3.9 percent on a year-over-year basis in March. The BOK increased its policy interest rate by 25 basis points in both July and August, raising the rate to a six-year high of 5.0 percent.

Taiwan

Taiwan operates a managed floating exchange rate regime. According to the central bank's official policy statement, the exchange rate is market-determined except in instances when "the market is disrupted by seasonal or irregular factors" and the central bank intervenes. Taiwan's foreign exchange reserves increased by \$4 billion (1.6 percent) during the second half of 2007, ending the year at \$270 billion. This increase is in line with what one would expect from interest earnings net of valuation changes. Taiwan's reserves rose by 6.1 percent in the first quarter of 2008, to \$287 billion. Taiwan's central bank has said the increase arises from valuation adjustments resulting from the appreciation of the euro and other currencies against the U.S. dollar. Taiwan does not disclose the currency composition of its foreign exchange reserves.

In the second half of 2007, the Taiwan dollar (NT\$) remained within the 31-35 NT\$/USD trading range in which it had fluctuated for the past six years. The NT\$ appreciated by 1.2 percent against the U.S. dollar in the second half of 2007. Since the end of 2007, the NT\$ has appreciated significantly, rising 7.0 percent against the U.S. dollar by mid-April. The recent trend of appreciation has coincided with victories for the Kuomintang party in the legislative and presidential elections, and the resulting expectation of closer cross-strait economic relations with mainland China. On a real effective basis, the NT\$ depreciated 1.4 percent in 2007 and depreciated a further 0.9 percent in the first quarter of 2008.

Taiwan's merchandise exports to the United States totaled \$19.9 billion and its merchandise imports from the United States totaled \$13.8 billion in the second half of 2007. Merchandise exports to the United States comprised 13.1 percent of Taiwan recorded an overall merchandise trade surplus of \$9.2 billion in the second half of 2007, and a surplus of \$16.8 billion for the year as a whole.

Taiwan's current account balance was 8.3 percent of GDP in 2007. The surplus widened in the second half of the year, rising to 9.6 percent of GDP in the fourth quarter. Taiwan's exports are heavily concentrated in sales of electronics to China, Japan, and the United States, meaning that

small fluctuations in either overall demand within these three large economies or global demand for electronics can create significant changes in Taiwan's income from net exports.

Taiwan's real GDP growth accelerated from an annual pace of 3.1 percent in the first half of 2007 to an annual pace of 10.3 percent in the second half of 2007. Real GDP growth for 2007 as a whole was 5.7 percent, a percentage point higher than the average for 2003-2006. Taiwan's relatively strong GDP growth in 2007, particularly in the second half of the year, was supported by the strength of net exports, which rose 29.7 percent and contributed 3.7 percentage points to overall GDP growth. There are also indications that Taiwan's weak domestic demand is beginning to recover, with consumption growing by 2.6 percent and GDP from services growing by 4.3 percent in 2007.

Reflecting concern over low real interest rates (which were negative in the fourth quarter) and inflationary pressure, the central bank raised the benchmark discount rate in each quarter of 2007 for a total increase of 62.5 basis points during the year. The benchmark rate stood at 3.375 percent at the end of 2007, and as of the end of March 2008, stood at 3.5 percent.

Taiwan continues to experience net capital outflows, driven in large part by Taiwanese households choosing to hold their savings abroad and in foreign currency-denominated assets. This reflects low domestic interest rates and an increase in the types of savings instruments available to households resulting from increased financial sector competition. Structural factors that have increased demand for international asset diversification, including concerns amongst an aging population about the robustness of the public pension system, are also contributing to capital outflows. In the second half of 2007 net capital outflows approximately matched Taiwan's current account surplus, which was reflected in the very small change in official foreign exchange reserves.

Australia

The Australian dollar was floated in 1983, and the Reserve Bank of Australia (RBA) does not consider the exchange rate to be either a target or an instrument of monetary policy. However, the RBA does consider the exchange rate as part of the transmission mechanism of monetary policy, and intervenes when it believes the exchange rate has overshot or when market conditions threaten to become disorderly. The RBA regards overshooting as occurring when the exchange rate has appreciated or depreciated significantly and when the move does not appear to be supported by economic and financial factors. This approach effectively means that the bulk of the RBA's intervention takes place around the cyclical highs and lows in the exchange rate.

In mid-August 2007, in response to what it termed "thin and disorderly conditions in the foreign exchange markets", the RBA intervened by purchasing Australian dollars to stem depreciation. The RBA acknowledged that it was the first time it had purchased Australian dollars since 2001, but did not disclose the size of its intervention. Net foreign exchange reserves increased from US\$27.3 billion at the end of June to \$31.6 billion at the end of December 2007.

The Australian dollar has strengthened substantially over the past seven years. Since hitting its weakest point this decade of over two Australian dollars per U.S. dollar in March 2001, the

Australian dollar has strengthened more than 85 percent. In mid-April the A\$/US\$ exchange rate was 1.08. The Australian dollar weakened temporarily during the financial market turmoil in August 2007, as demand for high-yielding currencies fell, but appreciated more than 11 percent between then and the end of March 2008. Overall, in the second half of 2007, the Australian dollar appreciated 3.3 percent against the U.S. dollar. During the same period, the RBA's real effective exchange rate index rose by 4.0 percent, reaching its highest level in over twenty five years. Australian dollar strength has been spurred by high global demand, and high prices, for commodities, and, to some extent, by capital inflows attracted by higher interest rates. The strength of the Australian dollar, in addition to rapid growth in business investment, helped drive the current account deficit to 7.0 percent of GDP at the end of 2007 compared to 5.9 percent at the end of the second quarter of 2007. Australia's bilateral merchandise trade deficit with the United States narrowed from US\$5.9 billion in the second half of 2006 to US\$5.4 billion in the second half of 2007.

Real GDP expanded 2.4 percent at an annualized rate in the fourth quarter of 2007 following a 4.3 percent growth rate in the third quarter. The consumer price index increased 3.0 percent on a year-over-year basis in the fourth quarter of 2007, compared to 2.1 percent in mid-2007. Inflation increased to 4.2 percent in the first quarter of 2007. Concerned about inflationary pressures, the RBA raised the cash rate target 25 basis points in August and again in November, bring the rate to 6.75 percent. Two further 25 basis point increases in the first quarter have brought the policy rate to 7.25 percent.

New Zealand

New Zealand officially maintains a floating exchange rate. The Reserve Bank of New Zealand (RBNZ) is empowered to intervene in the foreign exchange market in order to help the Bank achieve its policy objective of price stability, but intervenes rarely. New Zealand is a relatively open economy – exports plus imports equal nearly 60 percent of GDP – implying that exchange rate movements can have a significant effect on inflation. The RBNZ states that it may intervene during periods of “extreme market disorder” and to help trim the peaks and troughs of the exchange rate cycle. In June 2007, the RBNZ, citing an “exceptionally high and unjustified” level of the NZD, intervened for the first time since the NZD was floated in 1985. The RBNZ sold NZ\$736 million (about US\$556 million) in June, NZ\$1.5 billion in July and NZ\$138 million in August.

The NZD appreciated 10.4 percent against the U.S. dollar during 2007 with most of the appreciation occurring during the first half of the year. The NZD appreciated by only 1.6 percent in the second half of 2007. Through mid-April 2008, the NZD had appreciated a further 2.1 percent, reaching its strongest level against the U.S. dollar in more than twenty years. The RBNZ's real effective exchange rate index rose by 5.4 percent between the fourth quarter of 2006 and the fourth quarter of 2007. The NZD has been supported by high global prices for New Zealand's commodity exports, as well as capital inflows seeking higher yields.

Foreign currency reserves rose to US\$17.1 billion at the end of December 2007 from US\$16.0 billion at the end of June, an increase of 7.0 percent. New Zealand's current account deficit narrowed from 8.5 percent of GDP at the end of 2006 to 6.9 percent in the fourth quarter of

2007. The bulk of the deficit is due to a wide gap in the income account. In the second half of 2007, New Zealand's income deficit was US\$4.9 billion while its deficit in goods and services stood at US\$1.9 billion. New Zealand's bilateral merchandise deficit with the United States was \$140.5 million in the second half of 2007, up from \$95.1 million in the second half of 2006.