Report to Congress on International Economic and Exchange Rate Policies

U.S. Department of the Treasury
Office of International Affairs

May 25, 2012

This Report reviews developments in international economic and exchange rate policies and is submitted pursuant to the Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C. § 5305 (the "Act").[1]

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

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Key Findings

The Omnibus Trade and Competitiveness Act of 1988 (the "Act") requires the Secretary of the Treasury to provide semiannual reports on the international economic and exchange rate policies of the major trading partners of the United States. Under Section 3004 of the Act, the Report must consider "whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade." This Report covers developments in the second half of 2011, and where pertinent and available, data through mid-May 2012. Treasury has concluded that no major trading partner of the United States met the standards identified in Section 3004 of the Act during the period covered in the Report.

The pace of annualized U.S. economic growth accelerated in the fourth quarter of 2011 to 3.0 percent, but moderated to 2.2 percent in the first quarter 2012. Private final domestic demand, however, increased at an annual rate of 2.7 percent in both the fourth and first quarters. Labor market conditions continue to improve; 4.25 million private sector jobs have been added since February 2010; and the unemployment rate has fallen to 8.1 percent, its lowest level in more than three years. Boosting growth, creating jobs, and putting public finances on a sustainable path are priorities of the Administration. The Administration's American Jobs Act proposal and the extension of payroll tax cuts and unemployment benefits are designed to provide support to the economy, while not jeopardizing longer-term efforts to rein in the federal budget deficit. The Administration's deficit reduction plan would cut the deficit to less than 3 percent of GDP by FY2018, and would put the debt-to-GDP ratio on a declining path for the remainder of the 10-year budget window.

Global economic growth weakened in the second half of 2011. Strains from Europe's sovereign debt crisis and stresses in some European banking sectors weighed on confidence and economic activity. In addition, the rise in oil prices in the first half of 2011 weighed on the pace of growth in the latter half of 2011. In emerging markets, the effects of the policy tightening that was introduced in 2011 in response to concerns about inflation also reduced growth. In early 2012, the global environment improved as a result of efforts by central banks, such as the ECB's long-term refinancing operations (LTRO) liquidity injection, and extended policy stimulus from the Federal Reserve, the Bank of Japan, and the Bank of England. In late April, tensions in the euro area sovereign debt market rose again and conditions worsened through mid-May.

Risks to the outlook remain elevated. Conditions in Europe continue to pose a risk to the U.S. recovery. European first quarter GDP numbers showed a stabilization in activity across the euro area as a whole, but with marked divergence between the core countries, where output returned to modestly positive growth after a weak fourth quarter, and the periphery, which remained mired in recession. However, the latest high-frequency business surveys (e.g., Purchasing Managers Index (PMI)) indicate that, even in the core economies, growth momentum has begun to slow again. Amidst this deteriorating macro backdrop and ongoing political uncertainty in Greece, market pressures on Spain and Italy have renewed, pushing Spanish longer-term borrowing rates up close to the peaks achieved in the fourth quarter of 2011. While oil prices have moderated recently, the price of oil remains elevated. A reversal of the recent moderation remains a risk to the global outlook.

Global growth has also been hindered by insufficient demand rebalancing. There has been a significant reduction in current account surpluses and deficits. But as noted in the IMF's April 2012 *World Economic Outlook*, this reflects in part a sharp drop in consumption relative to pre-crisis trends in countries with external deficits and the decline has not been offset by higher domestic demand growth in countries with external surpluses. The net result has been a decline in the pace of global demand growth relative to its pre-crisis trend, slowing the recovery.

This report reviews the exchange rate policies of nine economies accounting for 70 percent of U.S. foreign trade. All of the major advanced economies have fully flexible exchange rates. Japan has not intervened since its unilateral operations last October/November. Among major emerging market economies, a select few, notably in East Asia, have more tightly managed exchange rates, with varying degrees of management. This Report highlights the need for greater exchange rate flexibility in these economies and particularly in China.

Over the past decade, China resisted very strong market pressures for RMB appreciation, reflected in the substantial accumulation of foreign currency reserves. Over that period, China's real effective exchange rate exhibited persistent and substantial undervaluation, although the extent of misalignment appears to have narrowed since the RMB resumed its appreciation against the U.S. dollar in June 2010.

Significantly, China's current account surplus has fallen markedly over the past four years, from 9.1 percent of GDP in 2008 to 2.8 percent of GDP in 2011. Some of the reduction reflects weaker demand growth in China's major trading partners, the large impact of rising commodity prices on China's trade surplus and unsustainably high rates of domestic investment in China. However, some of the improvement reflects structural adjustments in the Chinese economy, continued wage increases in the manufacturing sector, and the effects of RMB appreciation. China is gradually allowing necessary external adjustments to take place, as indicated by the decline in China's current account surplus together with real appreciation of the RMB since June 2010 and China's steps to gradually open its capital account.

Nevertheless, the underlying factors that distort China's economy and constrain global demand growth remain. China accumulated $373.1 billion in additional foreign exchange reserves in the first three quarters of 2011. Reserve accumulation slowed in the fourth quarter to $11.7 billion, but increased again to $74.8 billion in the first quarter of 2012. At the end of March 2012, China held $3.3 trillion in foreign reserves, equivalent to 45 percent of China's GDP in 2011.

From June 2010, when China moved off its peg against the dollar, through May 15, 2012, the RMB appreciated by a total of 8.0 percent against the dollar, and by 12.5 percent bilaterally on an inflation-adjusted basis. Since China initiated currency reform in July 2005, the RMB has appreciated 40 percent bilaterally against the dollar after adjusting for inflation. Nonetheless, in 2012, through May 15, the RMB has been virtually flat against the dollar.

At the May 2012 U.S.-China Strategic and Economic Dialogue (S&ED), Chinese authorities stated that China will continue to enhance exchange rate flexibility, letting supply and demand play a more basic role, and re-iterated their determination to implement fully their G-20 commitments to move more rapidly to a market-determined exchange rate system and avoid persistent exchange rate misalignments. Recently, China widened the daily RMB trading band, a move that has the potential to increase exchange rate flexibility and adjustment if it is implemented in a way that allows the value of the exchange rate to better reflect market forces. China has also taken steps to liberalize its capital account, including by increasing the ability of portfolio investors to invest in Chinese assets and the ability to externally raise and use renminbi funds for investment in China.

With the global economy continuing to face headwinds as it recovers from the financial crisis, it is important that China follow through on these commitments. Greater RMB flexibility would encourage increased exchange rate flexibility in other Asian economies and thus further promote a strong and sustained global recovery.

Based on the appreciation of the RMB against the dollar since June 2010, the balance of payments adjustment evidenced in the decline in China's current account surplus, and China's commitments in the G-20 and S&ED that it will move more rapidly to a more market-determined exchange rate system, Treasury has concluded that the standards identified in Section 3004 of the Act during the period covered in this Report have not been met with respect to China. Nonetheless, the available evidence suggests the RMB remains significantly undervalued and we believe further appreciation of the RMB against the dollar and other major currencies is warranted. Treasury will continue to closely monitor the pace of RMB appreciation and press for policy changes that yield greater exchange rate flexibility, level the playing field, and support a pronounced and sustained shift to domestic-demand led growth.

Introduction

This Report focuses on international economic and foreign exchange developments in the second half of 2011. Where pertinent and when available, data and developments through mid-May 2012 are included.

Exports and imports of goods to and from the areas whose economies and currencies are discussed in this Report accounted for 70 percent of U.S. merchandise trade in 2011.

U.S. Macroeconomic Trends

Real GDP grew by 3.0 percent on an annualized basis during the final quarter of 2011 and by 1.6 percent for the year as a whole. The expansion accelerated markedly in the second half of the year as the factors weighing on growth earlier in 2011 (the tragedy in Japan and higher oil prices) receded. During the first quarter of 2012, the pace of growth moderated somewhat to an annual rate of 2.2 percent, as the pace of private inventory accumulation slowed and business investment declined. Growth of consumer spending, residential investment, and exports accelerated in the first quarter. Although job growth has picked up in the two most recent quarters, the unemployment rate remains elevated. Even with a modest trend of improvement in certain indicators, the housing sector remains weak. Headline inflation has moderated over the past year. Food and energy price increases have begun to slow in recent months and the rise of business input costs has been stabilizing.

The economy is expected to expand at a moderate pace through the end of 2012. A consensus of private forecasters currently expects real GDP to grow at a 2.2 percent annual rate in the second quarter of this year, and 2.3 percent over the four quarters of 2012. The deeper crisis now facing Europe is a significant risk to the U.S. outlook as our recovery remains vulnerable to events abroad. A tightening of financial markets in Europe can adversely impact the willingness of U.S. banks to lend and invest. Our trade connections with Europe are broad and deep.

U.S. Economic Growth Continued at a Moderate Pace

Economic growth accelerated in the fourth quarter of 2011 to an annual rate of 3.0 percent. According to the advance estimate, growth moderated to an annual rate of 2.2 percent in the first quarter of 2012. Personal consumption expenditures were the main driver of growth in the latest quarter, but a surge in residential investment, and pickup in export growth also contributed to the rise in GDP. A contraction in the government sector resulted in a drag on growth and non-residential fixed investment also declined. Nonetheless, the persistent strength of underlying private demand over both quarters suggests that private sector fundamentals continue to improve. Private domestic final demand (the sum of consumption, business fixed investment, and residential investment) rose 2.7 percent in both the fourth and first quarters.

The Housing Sector Remained Weak

Conditions in the housing market have improved somewhat since mid-2011, but housing demand continues to be weighed down by elevated unemployment, uncertainty about housing prices, and the limited availability of housing finance for all but the most credit-worthy borrowers. Among the indicators that have shown improvement recently are housing starts and home sales, both of which have trended higher since the fall of 2011. Housing starts averaged 609,000 at an annual rate in 2011 — an improvement compared to the 587,000 starts averaged over all of 2010. In April 2012, housing starts rose to 717,000 at an annual rate, a nearly 30 percent increase on a year-over-year basis. Sales of new single-family homes in March 2012 averaged 328,000 at an annual rate, still very low by historical standards but up 7.5 percent from a year earlier. Sales of existing single-family homes averaged 3.8 million in 2011, up 2.5 percent from 3.7 million in 2010. Existing home sales were 4.0 million at an annual rate in March 2012. The inventory of homes available for sale continues to decline, but is still very high relative to sales. At the end of March there was a 5.3-month supply of new homes on the market, and a 6.3-month supply of existing homes (94 percent of all home sales) available for sale. Concerns persist about a large shadow inventory of homes (either in foreclosure or with mortgages more than 90 days past due) with the potential to add significantly to the number of homes available for sale in the future, putting additional downward pressure on prices. Nonetheless, house price measures have shown signs of stabilization in recent months and in some cases have increased on a year-over-year basis. Although the S&P/Case-Shiller 20-city house price index fell 3.5 percent below its year-earlier level in February, the FHFA house price index rose 0.5 percent over the same period.

Labor Market Conditions Continued to Improve

The pace of job creation has accelerated since mid-2011. On average, nonfarm payrolls increased by 176,000 per month in the three months ending in April, down a bit from the pace seen early in 2012 but similar to the pace seen in the fourth quarter of 2011 (164,000) and a substantial pickup from the rate of growth in the third quarter of last year (128,000). Nearly 3.75 million jobs have been created since February 2010, including 4.25 million in the private sector. The unemployment rate fell by a full percentage point between August 2011 and April 2012 to 8.1 percent, the lowest level in more than three years. Despite these gains, private employment is still 4.6 million lower than at the start of the recession in December 2007 and the unemployment rate is 3.1 percentage points higher. Some progress has been made in reducing long-term unemployment, but the share of the unemployed out of work for 27 weeks or more remains extremely high: this rate had fallen from a record level of 45.6 percent posted in May 2010 to 41.3 percent as of April 2012.

Energy Prices Have Eased from Recent Peaks and Inflation Rates Are Stabilizing

Energy prices rose sharply early last year, moderated during the summer, but rose again in the first quarter of 2012. The front-month futures price of West Texas Intermediate (WTI) crude oil reached a peak of nearly $114 per barrel in late April 2011 and the Brent price rose to $127 per barrel. The U.S. average retail price for regular gasoline climbed to $3.97 in May 2011. Prices began rising again last fall, with the WTI crude oil price topping out at $110 per barrel in February 2012 and the Brent price reaching $126 per barrel in March 2012. The average retail price for gasoline rose to $3.94 per gallon in April. Since these recent peaks, energy prices have declined: as of mid-May, crude oil had fallen roughly $15 per barrel, and gasoline had declined 19 cents to $3.75 per gallon.

Rising energy prices and a pickup in food price inflation pushed headline inflation measures higher in 2011 and early 2012, but more recently, prices appear to have stabilized. Core inflation has risen since early 2011 but remains moderate by historical standards, and persistent slack in labor markets, as well as low capacity utilization, have helped contain inflationary pressures. Over the year that ended in April 2012, the consumer price index rose 2.3 percent, slowing from a 3.2 percent increase in the same period last year. Core consumer prices (excluding food and energy) advanced 2.3 percent. Core inflation has accelerated from 1.3 percent over the year ended in April 2011, but twelve-month gains have been roughly stable around 2.25 percent since the end of 2011. Compensation cost growth also remained contained; over the year ending in March 2012, the Employment Cost Index (ECI) for private-industry workers rose 2.1 percent.

Fiscal Consolidation is a Priority

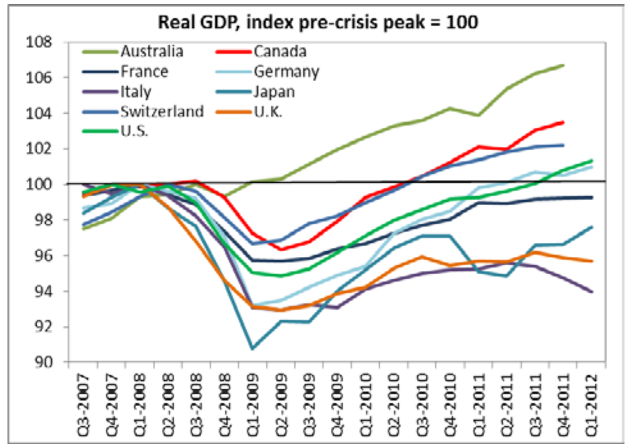
The Administration is firmly committed to putting U.S. government finances on a sustainable trajectory. In the near term, however, the economy needs additional support. In early September 2011, the President proposed the American Jobs Act, which would provide $447 billion in targeted support for the economy next year in the areas of job creation, job training, unemployment insurance reform, and infrastructure investment. Last December, the 2 percentage point employee payroll tax cut and unemployment benefits included in the 2010 tax legislation were each extended for two additional months and in late February, both measures were extended for the remainder of 2012. These short-term initiatives would not jeopardize longer-term efforts to rein in the federal deficit. The Administration is committed to putting the federal budget on a sustainable path over the medium to long term. The Budget Control Act enacted in August 2011 was an important first step in this direction. It put in place historic cuts in discretionary spending that will generate nearly $1 trillion in savings over the next ten years. The President's FY2013 Budget proposes a comprehensive and balanced deficit reduction plan that will reduce the 10-year deficit by more than $5 trillion, including the roughly $1 trillion in spending cuts included in the Budget Control Act. The Administration's deficit reduction plan would cut the deficit to less than 3 percent of GDP by FY2018, and put the debt-to-GDP ratio on a declining path for the remainder of the 10-year budget window. The primary deficit – receipts less outlays, excluding net interest – is projected to reach balance in FY2018, at which point spending will no longer add to the national debt.

The Global Economy

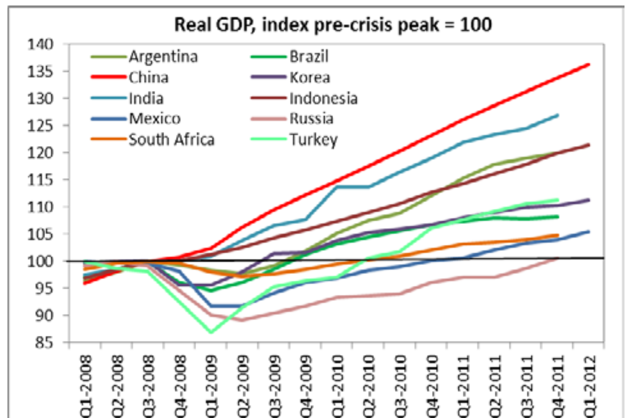
Global economic growth weakened in the second half of 2011 as a result of rising oil prices, supply chain disruptions from natural disasters in Asia, and strains in Europe's sovereign debt and financial markets. In emerging markets, the effects of previous policy tightening were also a factor in reducing growth in the latter half of 2011. By early spring 2012 conditions had improved, but more recently renewed strains appeared in the euro area financial markets. Worsening conditions in Europe and volatile oil prices pose downside risks to the global economic outlook.

Growth Weakens in the Second Half of 2011

As noted in the December 2011 Report, by late summer 2011 strong headwinds were buffeting the global economy. Growth weakened in most of the advanced economies (AEs) in the second half of 2011. Among the major AEs output declined in the fourth quarter in Germany, Italy, and the UK, and stagnated in Japan. In the euro area strains in sovereign debt and financial markets weighed on confidence and economic activity. Nearly three years after the recovery began, output in many AEs has yet to return to its pre-crisis level. The slow pace of growth has hindered the recovery of labor markets. Among the AEs shown in the chart, only Australia, Canada, Germany, and Switzerland have seen employment expand beyond pre-crisis levels.

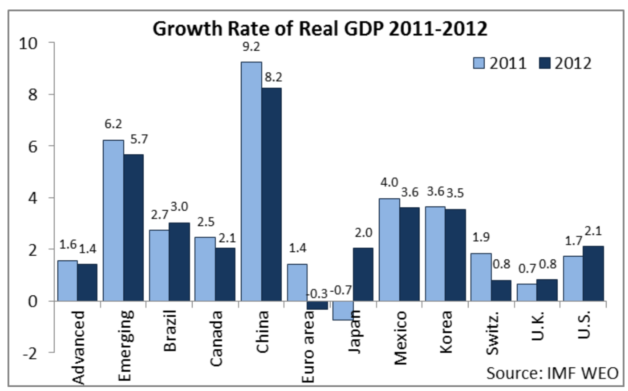


Growth in the emerging market economies (EMEs) also slowed in the second half of 2011. Among major emerging market economies, only Indonesia and Russia had higher growth rates in the second half of 2011 than in the first half. In all of these EMEs, however, output continued to expand. By the end of 2011 output in all the major EMEs had surpassed its pre-crisis peak.



Note: Real GDP in China, India, and Indonesia did not decline duirng the crisis.

In the final months of 2011, the global growth outlook deteriorated significantly. However, economic conditions held up better than expected in early 2012, aided in part by policy actions in Europe, especially by the European Central Bank (ECB). By early in the second quarter of 2012, the global outlook once again deteriorated led by worsening strains in euro area financial markets.



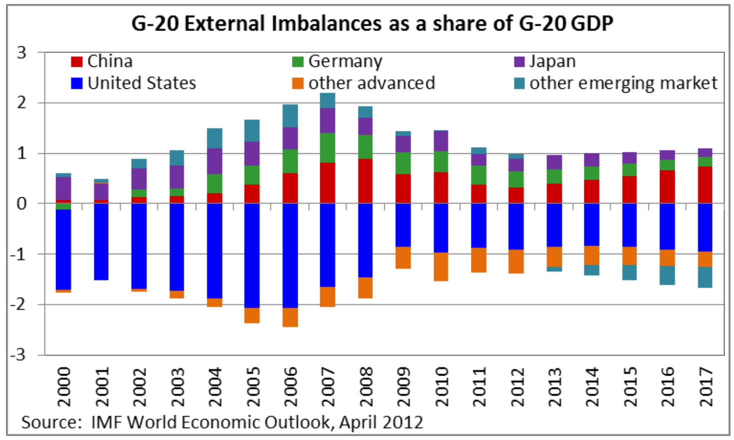
Most forecasters still expect economic growth to weaken in 2012 compared to the previous year. In April the IMF projected global growth in 2012 at 3.5 percent, down from 3.9 percent in 2011. Growth in the advanced economies, projected at 1.4 percent, will be held down by recessionary conditions in the euro area combined with weak growth in the rest of Europe. In contrast, growth in the United States is expected to pick-up in 2012. Growth is also expected to slow in the emerging market and developing economies. The slowdown is project to be most severe in emerging Europe, which will be affected by the recession in the euro area.

Uncertainty around the near-term outlook remains elevated as downside risks are substantial. The escalation of financial pressures in the euro area again highlights the need for comprehensive policy actions to ward off contagion and restore confidence. As the Leaders of the G-8 noted in their May 2012 summit declaration, “all of our governments need to take actions to boost confidence and nurture recovery including reforms to raise productivity, growth and demand within a sustainable, credible and non-inflationary macroeconomic framework.”

Further supply-driven oil price increases would also have a negative effect on global growth. Over the past two months, crude oil prices have fallen and global oil inventories have risen but prices remain high. The IMF also cites the possibility of overly abrupt fiscal contractions as another potential drag on growth.

Some Progress on Global Rebalancing

At the Pittsburgh Summit in September 2009, Leaders of the G-20 launched a Framework for Strong, Sustainable, and Balanced Growth. The goal of the Framework was to help ensure a better balanced global economy that was less prone to crisis. Since then there has been some progress on rebalancing. Most notably, external imbalances have not returned to their pre-crisis highs and the IMF is projecting that imbalances will widen moderately over the medium-term.



Cyclical factors, such as weak global growth, continue to play a role in compressing imbalances. Structural factors, however, also appear to be having an effect. For example, the household saving rate in the United States has risen and consumption has declined relative to its pre-crisis trend. Other countries with external deficits have also increased their saving relative to consumption. But, as the IMF noted in the April 2012 *World Economic Outlook*, the decline in consumption by external deficit countries has not been offset by higher domestic demand growth in the external surplus economies. As a result, there has been a substantial decline in global demand relative to pre-crisis trends, holding back global growth.

Reserve accumulation data also indicate the need for greater rebalancing on the part of many external surplus economies. The December 2011 Report noted that reserve accumulation by most major emerging market holders had declined in the late 2011 as a result of increased global risk aversion, weaker capital flows to EMEs and downward pressure on EME currencies. The December Report also noted that once the period of global financial stress had eased that reserve accumulation would likely resume at its previous pace.

The table to the right shows the monthly accumulation of foreign currency reserves by the ten largest holders. Reserve accumulation declined in the latter part of 2011 in nearly all EMEs, and reserves contracted in many of these economies.

Foreign Currency Reserve Accumulation: Major Holders

	March 2012	Monthly increase, $ millions		
	Reserves $ millions	Feb 2009 to Jul 2011	Jul 2011 to Dec 2011	Dec 2011 to Mar 2012
China	3,304,971	45,973	-12,827	41,274
Japan	1,210,477	3,151	29,851	-3,436
Saudi Arabia	545,509	2,265	7,029	12,096
Russia	452,646	3,817	-7,339	3,828
Taiwan	393,871	3,675	-3,044	2,775
Brazil	354,580	5,230	1,427	3,800
Korea	307,578	3,556	-1,142	3,115
Hong Kong	283,925	3,357	1,375	3,032
India	260,069	1,636	-4,645	-955
Switzerland	253,718	6,564	7,485	-2,611

Since the end of December, however, reserve accumulation has returned to its earlier post-crisis levels in most EMEs. India is an exception. Reserves continued to decline into 2012 as the Reserve Bank of India intervened to limit depreciation of the rupee. The IMF's new reserve adequacy metric indicates that most major emerging market economies have reserves in excess of levels adequate to cover potential balance of payments shocks.

Reserve holdings by Japan and Switzerland rose sharply in the latter part of 2011 but have declined since then. The rise in global risk aversion that led to downward pressure on many EME currencies resulted in safe haven inflows into Japan and Switzerland. Both countries intervened to limit appreciation of their currencies in 2011, and Switzerland imposed a floor on its bilateral exchange rate with the euro. Reserves in both countries fell in early 2012, largely as a result of valuation changes.

U.S. International Accounts

U.S. Balance of Payments and Trade ($ billions, seasonally adjusted unless indicated)	2010	2011	Q1-11	Q2-11	Q3-11	Q4-11
Current Account						
Balance on goods	-645.9	-738.3	-181.4	-189.7	-180.9	-186.3
Balance on services	145.8	178.3	42.4	44.5	46.2	45.3
Balance on income (including employee compensation)	165.2	221.1	52.9	57.3	60.6	50.3
Net unilateral current transfers	-136.1	-134.6	-32.3	-35.5	-33.5	-33.3
Balance on current account	***-470.9***	***-473.4***	***-118.3***	***-123.4***	***-107.6***	***-124.1***
Balance on current account as % of GDP	***-3.2***	***-3.1***	***-3.2***	***-3.3***	***-2.8***	***-3.2***
Capital and Financial Account (financial inflow = +)						
Net official assets	355.5	46.8	44.6	87.5	16.8	-102.1
Net bank flows	-337.9	477.9	266.6	82.0	87.4	41.8
Net direct investment flows	-115.1	-178.4	-60.8	-86.0	-6.5	-25.1
Net sales of securities	225.0	-27.4	-57.3	-100.5	53.2	77.1
Net liabilities to unaffiliated foreigners by nonbank concerns	84.9	13.5	-53.0	31.3	-2.9	38.0
Other*	41.9	60.6	15.8	20.7	5.4	18.8
Balance on capital and financial account	***254.1***	***393.0***	***156.0***	***35.0***	***153.4***	***48.6***
Memo Items						
Statistical discrepancy	216.8	80.5	-37.7	88.5	-45.8	75.5
Change in foreign official assets in the United States	349.8	164.8	48.8	95.1	21.8	-0.9
Current Account Detail: Trade in Goods						
Exports of goods						
Agricultural products	107.7	126.1	32.2	32.2	30.9	30.8
Industrial supplies and materials (including petroleum)	406.2	517.7	124.0	128.8	133.8	131.1
Capital goods except autos	446.6	491.4	117.5	122.2	125.6	126.1
Automotive products	112.0	132.5	32.0	32.1	34.5	33.9
Consumer goods except autos and food	165.9	176.3	42.4	44.1	44.5	45.3
Other goods	50.3	53.3	13.2	13.4	13.4	13.2
Total exports of goods	***1,288.7***	***1,497.4***	***361.4***	***372.9***	***382.7***	***380.4***
Imports of goods						
Agricultural products	92.5	108.2	25.8	27.3	27.1	28.1
Industrial supplies and materials (including petroleum)	623.8	783.0	187.9	202.5	197.8	194.8
Capital goods except autos	450.0	513.3	123.2	128.4	129.0	132.8
Automotive products	225.6	255.0	63.8	58.0	66.6	66.6
Consumer goods except autos and food	486.6	516.8	128.3	130.9	128.3	129.3
Other goods	56.1	59.3	13.7	15.5	14.8	15.2
Total imports of goods	***1,934.6***	***2,235.7***	***542.8***	***562.6***	***563.5***	***566.7***
Balance of trade in goods	***-645.9***	***-738.3***	***-181.4***	***-189.7***	***-180.9***	***-186.3***

Source: Bureau of Economic Analysis (BEA).

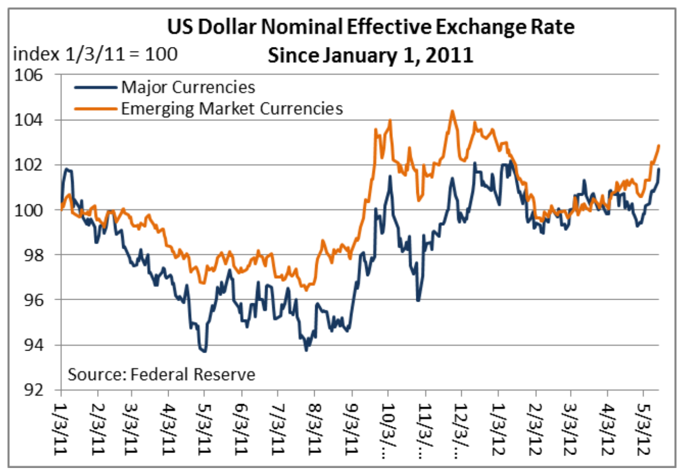
Notes: *Latest quarter calculated by inference; this line contains items with a longer reporting lag than other lines.
Current account + capital and financial account + statistical discrepancy = 0.

The U.S. current account deficit narrowed to 3.1 percent of GDP in 2011 from 3.2 percent in 2010 (see table next page). In dollar terms, the deficit increased to $473 billion in 2011 from $471 billion the previous year. The surplus in the services trade and the balance on income rose but were offset by a larger deficit in goods trade.

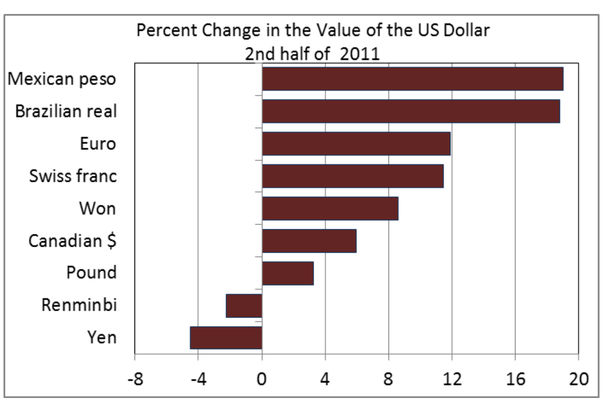
The current account deficit both as a share of GDP and in dollar terms narrowed between the first and second halves of the year as a result of strong export growth. U.S. exports of goods and services grew by 51 percent from their trough in the second quarter of 2009 through the third quarter of 2011. Exports fell by 0.6 percent in the fourth quarter of 2011 as global economic growth faltered. Imports have grown more slowly since their low during the crisis, rising 46 percent between the second quarter of 2009 through the third quarter of 2011. Imports, however, continued to rise in the fourth quarter (increasing by 0.5 percent) as U.S. economic growth strengthened.

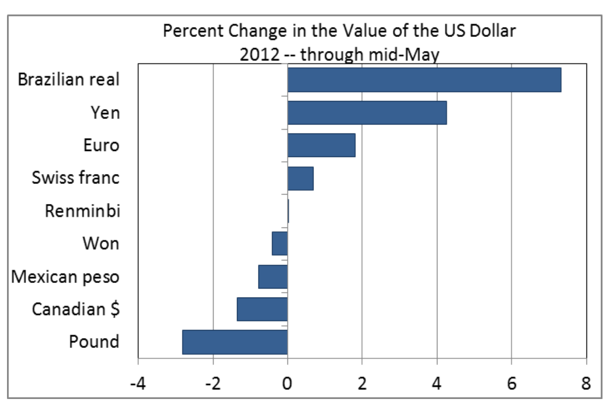
The Dollar in Foreign Exchange Markets

On a nominal effective basis, the dollar rose by 6.0 percent against the major currencies in the second half of 2011 and rose by 6.2 percent against the emerging market currencies. In 2012, through mid-May, the dollar appreciated by 0.9 percent against the major currencies and depreciated by 0.4 percent against the emerging market currencies.



In the second half of 2011, the dollar appreciated against all of the currencies discussed in this Report, with the exception of the yen and the renminbi. The appreciation reflected an increase in safe-haven demand in response to rising concerns of a global economic slowdown and ongoing stress in European debt markets. In early 2012 the risk environment improved as a result of efforts by central banks, such as the ECB's long-term refinancing operations (LTRO) liquidity injection, and extended policy stimulus from the Federal Reserve, the Bank of Japan, and the Bank of England. In late April tensions in the euro area sovereign debt market rose again resulting in a reversal in risk sentiment. As a result, although the dollar weakened in early 2012 it reversed course in the second quarter.





Analyses of Individual Economies

Asia

<u>China</u>

The Chinese economy continued to expand rapidly in 2011, growing by 9.2 percent in real terms, slowing modestly from 10.4 percent in 2010. Growth moderated further to 8.1 percent on a year-over-year basis in the first quarter of 2012, and recent data point to continued slowing in near-term growth, as credit and investment appear to have slowed further and external demand remains relatively weak. Authorities, however, have scope for further policy easing, and most economic forecasters expect real GDP growth will remain about 8 percent for the year. The most recent IMF and the World Bank forecasts were for Chinese real GDP growth of 8.2 percent in 2012.

In 2010 and through much of 2011, rising goods and property price inflation led China to tighten monetary and credit policy. Over the last six months, however, with consumer inflation in China declining from its mid-2011 peak, housing price increases tapering off, and external demand slowing, China has gradually loosened monetary policy to support growth. Since November, the People's Bank of China (PBOC) has cut the share of deposits that commercial banks are required to hold as reserves at the central bank by 1.5 percentage points, reducing the required reserve ratio for large commercial banks to 20 percent.

Chinese leaders have identified shifting away from growth driven by exports toward a greater reliance on domestic consumption as a critical goal for sustaining growth in the medium to long term. This shift also is needed to support strong, sustainable, and more balanced growth in the global economy. At the Fourth U.S.-China Strategic and Economic Dialogue (S&ED) meeting in May 2012, Chinese authorities reiterated this commitment and highlighted a number of specific and complementary policies to achieve the goals of increasing household incomes and consumption spending.

At the S&ED, China stated that it intends to cut import tariffs on certain consumer goods this year, and expand the coverage, to all regions and sectors, of its pilot program to reduce the tax burden on services in order to accelerate development of the services sector. In a move that will help to both level the playing field with private companies and unlock some of the large retained profits of state-owned enterprises (SOEs), China also stated its intention to raise the SOE dividend payout rate and increase the number of SOEs that pay dividends. Greater SOE dividends could give the Chinese government more resources to strengthen the social welfare system, which would boost household confidence and income security, thereby raising household spending. In addition, China stated that it would promote market-based reform of interest rates in China. A rise in real deposit rates could lead to an increase in Chinese household consumption, as low real bank deposit rates have meant that Chinese households earned very little on their savings, requiring them to save more to meet their financial goals.

Exchange rate adjustment is a necessary part of the rebalancing of growth toward domestic consumption that China hopes to achieve, as Chinese authorities have acknowledged. At the May 2012 S&ED, Chinese authorities stated that China will continue to enhance exchange rate flexibility, letting supply and demand play a more basic role, and reiterated their determination to implement fully their G-20 commitments to move more rapidly to a more market-determined exchange rate system and avoid persistent exchange rate misalignments. According to estimates from the most recent (July 2011) IMF Article IV consultation with China, the RMB was, at that time, estimated to be undervalued on a real trade-weighted basis by 3 to 23 percent, depending on the model used. With the world economy continuing to face headwinds as it recovers from the global financial crisis, it is important that China follow through on its commitments to increase flexibility.

On April 14, the PBOC announced a widening of the renminbi (RMB) daily trading band against the dollar in the Mainland currency market, from ± 0.5 percent to ± 1.0 percent. The trading band limitation applies to *intra-day* movements of the RMB against the dollar. In making the announcement, the PBOC stated that it was widening the band, "in order to meet market demands, promote price discovery, enhance the flexibility of RMB exchange rate in both directions, [and] further improve the managed floating RMB exchange rate regime based on market supply and demand with reference to a basket of currencies." If implemented in a way that allows the value of the exchange rate to better reflect market forces, the widening of the band could contribute to exchange rate adjustment and rebalancing, which would be positive for China, the United States, and the global economy.

China's current account surplus has fallen markedly over the past four years, from 9.1 percent of GDP in 2008 to 2.8 percent in 2011. Between 2010 and 2011, China's current account surplus narrowed from $237.8 billion (4.0 percent of GDP) to $201.7 billion (2.8 percent of GDP). China's merchandise trade surplus in 2011 was $243.5 billion — roughly the same dollar value as the $254.2 surplus in 2010, but falling as a share of GDP from 4.3 percent in 2010 to 3.3 percent in 2011. Preliminary data indicates that for the first quarter of 2012, China's current account surplus totaled $24.7 billion, although for seasonal reasons China's first quarter surplus usually is lower than in other quarters.

China's stated effort to encourage structural changes to support stronger domestic consumption, along with apparent steady wage increases in the manufacturing sector and the lagged effect of appreciation of China's real effective exchange rate, have begun to play a role in reducing the current account surplus. Nevertheless, cyclical elements such as weakness in demand from advanced economies and changing terms of trade have also been significant contributors to the decline of China's current account surplus. In addition, both the reduction in China's external imbalance and recent Chinese growth have relied heavily on a continued massive, and likely unsustainable, increase in investment relative to GDP. Without further structural reform, the IMF projects China's current account surplus will widen again after 2012, rising to 4.3 percent of its own GDP and roughly doubling relative to global output by 2017.

Sustaining strong growth both at home and in the world will require China to take further policy measures to increase the growth of consumption – which as a share of GDP remains near historically low levels – including measures that will raise household incomes and give China's households sufficient confidence to spend a greater share of their incomes. Allowing RMB appreciation is a critical part of this process. A stronger RMB directly raises the purchasing power of Chinese households, encouraging greater household spending. It also encourages domestic investment and production to shift toward sectors – including services sectors – that focus on meeting Chinese household demand rather than sectors oriented toward exports. While exchange rate reform may not be sufficient in itself to bring about a rebalancing of the Chinese economy, rebalancing cannot take place without it.

From June 2010, when China moved off of its peg against the dollar, through May 15, 2012, the RMB appreciated by a total of 8.0 percent against the dollar. Because inflation in China has been higher than in the United States, the RMB has appreciated more rapidly against the dollar on a real, inflation-adjusted, basis, appreciating 12.5 percent since June 2010 and about 40 percent since China initiated currency reform in 2005. In 2012, through May 15, the RMB has been virtually flat against the dollar, depreciating by 0.36 percent.

Pressures for further appreciation – from China's current account surplus, foreign direct investment (FDI), and net capital inflows – remained strong in the first three quarters of 2011. According to China's balance of payments data, China accumulated $373.1 billion in additional foreign exchange reserves in the first three quarters of 2011 – $88.8 billion more than in the first three quarters of 2010. Reserve accumulation slowed to $11.7 billion in the fourth quarter of 2011, as developments in Europe spurred an increase in global risk aversion, capital flows to emerging economies fell or even reversed, and market expectations that Chinese authorities would continue to allow RMB appreciation under these circumstances declined substantially. Reserve accumulation, however, increased again to $74.8 billion in the first quarter of 2012. As of end-March 2012, the PBOC held $3.3 trillion in foreign reserves, equivalent to 45 percent of China's 2011 GDP, or about $2,450 for every Chinese citizen.[2] China's foreign exchange reserves are nearly three times larger in dollar terms than the reserves held by Japan, the economy with the second largest holdings ($1.21 trillion, 21 percent of GDP). When compared to larger aggregates, as reported by the IMF, China's stock of reserves is almost as large as the total amount of foreign exchange reserves held by all advanced economies combined, and accounts for nearly half of all of the foreign exchange reserves held by emerging and developing economies.

Although reserve accumulation provides some indication, China does not publish intervention data, in contrast to most of the largest economies. Even when reported with a lag, such data provide valuable information to market participants and promotes more transparent and effective functioning of international currency and financial markets.

China's real effective exchange rate (REER) – a measure of its overall cost-competitiveness relative to its trading partners – has appreciated steadily since China initiated currency reform in mid-2005, after declining between 2001 and 2005. From July 2005 to April 2012, China's real effective exchange rate appreciated 27.4 percent. The REER appreciated particularly rapidly in the last several months of 2011, resulting in total REER appreciation of 6.2 percent over the course of 2011. Over the first four months of 2012, China's REER has depreciated by 0.5 percent.

Chinese authorities have stated their intention to gradually move towards greater convertibility of the RMB under the capital account. This shift will require China to reduce the extensive capital

[2] In addition, China has transferred (or swapped) some of its accumulated foreign exchange reserves to commercial banks, as well as capitalizing the China Investment Corporation (CIC), its sovereign wealth fund. China's state sector as a whole – including the PBOC, state-owned banks, and CIC – holds roughly $3.9 trillion in foreign currency assets.

controls that it currently has in place that restrict the free flow of cross-border capital and investment. China has been making some limited progress in this area recently. Under the framework of the S&ED, China more than doubled the total dollar amount that foreigners can invest in China's stock and bond markets under its Qualified Foreign Institutional Investor (QFII) program from $30 billion to $80 billion. China also has gradually allowed some offshore banks and financial institutions to invest RMB holdings into the domestic interbank bond market, piloted a version of its QFII program that allows for use of RMB raised offshore, and made it easier for domestic Chinese firms to raise funds in the offshore market by issuing offshore RMB-denominated bonds. These policies represent steps in the direction of greater opening of China's financial sector, though significant restrictions still remain in place.

Over the past decade, China resisted very strong market pressures for RMB appreciation, reflected in the substantial accumulation foreign currency reserves. Over that period, China's real effective exchange rate exhibited persistent and substantial undervaluation, although the extent of misalignment appears to have narrowed since the RMB resumed its appreciation against the U.S. dollar in June 2010. The decline in China's current account surplus over the past three years, together with the real appreciation of the RMB since June 2010 and China's steps to gradually open its capital account, indicate that China has gradually been allowing the necessary external adjustments to take place. At the same time, this process of adjustment remains incomplete, and more progress is needed. China's exceedingly high foreign exchange reserves relative to those of other economies, the persistence of its current account surplus and the incomplete appreciation of the RMB, especially given rapid productivity growth in the traded goods sector, suggest that the real exchange rate of the RMB remains significantly undervalued and further appreciation of the RMB against the dollar and other major currencies is warranted. China's large and continued foreign reserve accumulation has prolonged the misalignment in its real effective exchange rate and hampered progress toward global rebalancing, including among economies that compete with China for exports.

It is in China's interest to allow the exchange rate to continue to appreciate, both against the dollar and against the currencies of its other major trading partners. Continued appreciation by China would allow the exchange rate to serve as a tool to encourage consumption so as to maintain strong, sustainable growth, enable the adjustment needed for broader financial sector reform, and support China's stated goal of strengthening domestic consumption. While rebalancing the Chinese economy may create challenges in the short run for manufacturers that rely excessively on external demand, it is important to recognize that the longer the currency remains undervalued, the greater will be the misallocation of resources that will eventually have to be corrected.

In addition to promoting domestic demand-led growth in China, greater RMB flexibility also would encourage increased exchange rate flexibility in other Asian economies that are trying to maintain trade competitiveness vis-à-vis China. Thus, greater RMB flexibility would further promote a strong and sustained global recovery and remove distortions from the international monetary system.

Japan

The yen foreign exchange market is one of the largest and most liquid in the world, accounting for about 19 percent of the roughly $4 trillion in daily global foreign exchange transactions, according to surveys by the Bank for International Settlements (BIS). Japan maintains a floating exchange rate regime, but its authorities intervened unilaterally on two occasions in the second half of 2011 to limit yen appreciation. Following the joint G-7 intervention in March 2011 to steady disorderly market conditions following the Tohoku earthquake and tsunami, the yen appreciated against the U.S. dollar and other currencies on Japan's repatriation of capital and renewed investor appetite for safe-haven assets. Japanese authorities intervened on August 4, 2011, and again on October 31, citing speculative and disorderly exchange rate movements. The Japanese authorities bought $59 billion in foreign exchange during the August 4 intervention and $116 billion from October 31 through November 4.

Since June 2011 the yen has appreciated against the dollar, but there were significant swings in the exchange rate during this period. Although the yen depreciated to ¥/$78.2 from 75.8 on October 31 following Japan's intervention, yen appreciation resumed during the fourth quarter of 2011 and first quarter of 2012, with the yen reaching a high of ¥/$76.2 on February 1, 2012. Following the Bank of Japan (BOJ) announcement of the adoption of a 1 percent yearly inflation goal and the expansion of its domestic asset purchase program by $123 billion on February 14 and buoyed by increasingly market confidence in economic recovery in the United States, the yen depreciated almost 7 percent against the dollar over a 30-day period, weakening to ¥/$83.7 on March 14. Since late March 2012, market uncertainty regarding the BOJ's ability to take the monetary policy steps necessary to meet its 1 percent inflation target and safe-haven flows contributed to a renewed yen appreciation; the yen traded at ¥/$80.2 on May 15. To date, Japan has not intervened in 2012.

On a real trade-weighted basis, the yen appreciated by 4.9 percent in the second half of 2011 but depreciated by 5.4 percent from December 2011 through April 2012. In its latest Article IV Report for Japan (June 2011), the IMF assessed the yen's real effective exchange rate to be broadly in line with economic fundamentals. In 2011, Japan's foreign currency reserves increased by $184 billion, but have fallen slightly (down $9.9 billion) in 2012 through April on valuation changes. Reserves are now $1.21 trillion, the second-largest stock of reserves in the world behind China's $3.3 trillion.

The Japanese economy continued to recover from the earthquake, tsunami, and nuclear power plant disasters in March. Although real GDP expanded 7.8 percent on a seasonally adjusted annualized basis in the third quarter of 2011 − driven by pent-up personal consumption and a recovery in exports with the restoration of earthquake-damaged supply chains − the economy contracted by 0.7 percent for the year in 2011. Real GDP grew by 4.1 percent in the first quarter of 2012, on strong personal consumption supported by a temporary auto subsidies and reconstruction spending. Private consensus forecasts are for growth of about 2 percent in 2012.

Japan's fiscal outlook is challenging. Since the earthquake, the Japanese Diet has passed four supplemental budgets, totaling about 4 percent of GDP in additional spending, to fund earthquake reconstruction. Japan's government deficit widened from 8.0 percent of GDP in FY 2010 (April-March) to 10.0 percent of GDP in FY 2011. The deficit is expected to remain at roughly the same level in FY 2012 due to continued reconstruction spending. The IMF projects that the government's gross debt will reach 240 percent of GDP in 2013.

On the monetary side, deflation remains a serious concern. Core consumer prices (excluding food and energy) declined by 1.0 percent year-over-year in 2011. Headline consumer prices have generally fallen since early 2009, but have increased on a year-over-year basis so far this year. Price increases have been driven in part by an increase in energy costs — global oil prices have risen at the same time Japan has shut down all of its nuclear reactors, which had previously provided 30 percent of Japan's electricity. To combat entrenched deflation, in February the BOJ committed to monetary easing to meet a newly announced 1 percent inflation goal and announced the expansion of its existing asset purchasing program by $123 billion. In April, the BOJ announced additional purchases of domestic assets of $124 billion and extended the maturity of its government bond purchases.

In 2011, Japan's merchandise trade balance fell into deficit for the first time since 1963 as exports slowed following production disruptions while imports increased on higher commodity prices and demand for reconstruction materials. Japan's 2011 current account balance remained in surplus, at 2.0 percent of GDP, due to relatively stable income from overseas investments. The IMF projects that Japan's current account surplus will expand to 2.2 percent of GDP in 2012 as Japanese exports continue to recover from the earthquake and tsunami. Japan's bilateral trade surplus with the United States totaled $62.6 billion in 2011, up slightly from $60.1 billion in 2010.

In order to support a stronger economic recovery and increase its potential growth, it remains important that Japan take fundamental and thoroughgoing steps to increase the dynamism of the domestic economy, by easing regulations that unduly deter competition in its domestic economy.

South Korea

South Korea officially maintains a market-determined exchange rate, and its authorities intervene with the stated objective of smoothing won volatility. During 2011, the authorities intervened on both sides of the market. In the first eight months of 2011, Korean authorities were net buyers of foreign exchange, and foreign currency reserves rose by $18 billion. In September, the authorities intervened to support the won. For the year 2011, Korea's foreign exchange reserves grew by $11 billion to $298 billion.[3] In 2012 through April, Korea had accumulated an additional $10 billion in reserves.

The won has fluctuated in response to global market developments, depreciating by 10 percent against the dollar in September 2011 as risk aversion among global investors increased and foreign investment positions in emerging markets were unwound. The won strengthened in late 2011 and early 2012 as global markets stabilized before weakening more recently. In 2012, through mid-May, the won appreciated by 0.4 percent against the dollar. According to estimates from the July 2011 IMF Article IV consultation with Korea, the real effective value of the won was about 10 percent undervalued.

The Korean economy continues to recover from the global financial crisis, growing 3.6 percent in 2011, although domestic demand remained weak relative to pre-crisis levels. The global financial crisis hit Korea through a slump in demand for its exports, and net exports and investment have been the main contributors to the Korean recovery. The government largely

[3] The 4 percent growth in Korean foreign exchange reserves over the course of 2011 is the net result of total intervention, interest earnings on existing reserves, and valuation changes on non-US dollar reserve holdings.

withdrew fiscal stimulus in 2010 and 2011 and is targeting a fiscal deficit of 1.1 percent of GDP in 2012 and a return to fiscal balance in 2013. The IMF forecasts growth of 3.5 percent in 2012. Inflationary pressures appear to have peaked, with headline CPI inflation falling to 2.6 percent in April, and the Bank of Korea remains cautious about tightening monetary policy due in part to increased external risks, with continued weakness in advanced economies weighing on exports. The monetary policy rate has stood at 3.25 percent since June 2011, after having been ratcheted up from a low of 2.00 percent in June 2010.

Korea's exports totaled $553 billion in 2011, up from $461 billion in 2010. Exports totaled $135 billion in the first quarter of 2012, up 5 percent relative to the first quarter of 2011. Korea's imports are also at record highs, reaching $521 billion in 2011, up from $421 billion in 2010. Imports totaled $132 billion in the first quarter of 2012, up 8 percent from the first quarter of last year. Korea's current account surplus rose from 3.1 percent of GDP in the fourth quarter of 2010 to 4.0 percent in the fourth quarter of 2011.

Korea continues to maintain a series of measures aimed at reducing short-term external debt and the exposure of the financial system to foreign exchange risk. Short-term external debt has come down from $190 billion at the peak of the financial crisis in 2008 to $136 billion at the end of 2011. Korea's reserves are now more than twice short-term external debt.

The Korean authorities continue to intervene in the foreign exchange market, and the won remains weak compared to its pre-crisis levels. We will continue to press the Korean authorities to limit their foreign exchange interventions to the exceptional circumstances of disorderly market conditions and adopt a greater degree of exchange rate flexibility.

Europe

Euro Area

The value of the euro in foreign exchange markets is market-determined. The euro has experienced large fluctuations since the financial crisis resulting from ebbs and flows in risk aversion associated with financial stresses in the euro area. The euro appreciated by 7.8 percent against the dollar in the first half of 2011, but depreciated by 11.9 percent in the second half of 2011. In 2012, through mid-May, the euro depreciated by 1.8 percent against the dollar. On a real effective basis, the euro depreciated by 3.1 percent in the last half of 2011 and an additional 1.4 percent in the first four months of 2012.

Although the euro area economy grew by 1.5 percent in 2011, output contracted by 1.2 percent on an annualized basis in the fourth quarter. Declining domestic demand, particularly private and government consumption, was the main contributor to the drop in output, but exports also fell, reflecting weaker global demand.

In the first quarter of 2012, euro area real GDP growth was roughly flat, with annualized growth of less and 0.2 percent. There remains a divergence between the core countries, which saw a return of growth, and the periphery countries, which remained mired in recession. During the period, Germany grew 2.1 percent (annualized) while output contracted in Italy by 3.2 percent and in Spain by 1.3 percent. The pace of French growth continued to slow to 0.3 percent. The latest high-frequency business surveys (e.g., Purchasing Managers Indices (PMI)) indicate that, even in the core economies, growth momentum has started to slow again.

The euro area's current account has been close to balance since early 2009. In 2011 the euro area had a current account deficit averaging 0.05 percent of GDP. Despite the near balance in the euro area current account, substantial imbalances remain among euro area countries. The Netherlands and Germany continued to run substantial current account surpluses in 2011, while the current accounts of the other major euro area economies (France, Italy, and Spain) remained in deficit. Over the course of 2011, private capital inflows into many euro area countries running current account deficits fell, with Italy and Spain experiencing private capital outflows in the later part of the year. This has created strong pressure for adjustment. Stronger domestic demand growth in surplus European economies would help to reduce imbalances in the euro area. The new Macroeconomic Imbalances Procedure developed as part of the EU's increased focus on surveillance should help signal building external and internal imbalances; however, the procedure is somewhat asymmetric and does not appear to give sufficient attention to countries with large and sustained external surpluses like Germany.

This year the euro area, in aggregate, is undertaking the most aggressive fiscal consolidation of the advanced economies despite having the smallest cyclically adjusted fiscal deficit and the lowest growth prospects. Most of the major euro area economies have committed to reducing their general government budget deficits to less than 3.0 percent of GDP by 2013, and the German government achieved this target in 2011. Concerns are mounting about the appropriate pace of consolidation and the need to preserve room for countercyclical policy responses while ensuring credible paths to fiscal consolidation over a time frame that is sensitive to cyclical considerations.

The ECB alleviated funding pressure in the banking sector through the provision of over €1 trillion in three-year funding via long-term refinance operations (LTRO) in December 2011 and February 2012. The ECB continues to provide full allotments of liquidity against eligible collateral to euro area financial institutions. In addition, throughout late 2011, the ECB undertook additional measures, including a €40 billion covered bond purchase program, and loosening the eligibility criteria on collateral. Citing intensified risks to growth, the ECB reduced the main refinancing rate by 25 basis points in November 2011 and by an additional 25 basis points to 1.0 percent in December. The Federal Reserve's U.S. dollar swap lines with the ECB also have played a critical role alongside the ECB's direct efforts by making it possible for Europe's banks to borrow dollars from the ECB and avoid a more rapid reduction in credit. Still, bank access to market funding continues to be heavily impacted by sovereign funding pressures, with many banks located in the most vulnerable euro area economies having little or no access.

A series of European Summits in late 2011 and the first quarter of 2012 resulted in the creation of a new fiscal compact, the acceleration by one year of Europe's permanent crisis response vehicle, the European Stabilization Mechanism (ESM), and a temporary increase in the size of the euro area crisis response firewall to provide a credible backstop for large, vulnerable countries and the financial sector. These represent important steps forward and, together with ECB actions, helped reduce financial stress, and lay the foundations for greater stability. These steps alone, however, cannot solve the fiscal, competitiveness, and growth issues faced by some countries in the euro area. The success of the next phase of the crisis response will hinge on Europe's willingness and ability, together with the ECB, to encourage stability and growth by applying its tools and processes creatively, flexibly, and aggressively, to support countries as they implement reforms and strengthen their banking sectors.

Switzerland

In the years leading up to 2011, the Swiss franc was a freely floating currency, and the Swiss National Bank (SNB) set monetary policy to keep inflation stable at around 2 percent. In 2011, however, a rapid acceleration in the appreciation of the Swiss franc resulted in a series of extraordinary actions and interventions by the SNB culminating in the establishment of a ceiling on the €/CHF exchange rate.

Between October 2007 and April 2011 the franc rose steadily, appreciating at the rate of 0.6 percent per month on a nominal effective basis. The nominal effective pace of appreciation accelerated to a rate of 3.6 percent per month between April and August 2011. The SNB expressed increasing concern that the rapid appreciation of the franc, particularly against the euro, was having negative effects on the economy and stoking deflation risks. The consumer price index declined in the last three months of 2011, with declines continuing into 2012. In April 2012 the deflation rate was 1.0 percent on a year-over-year basis.

The SNB responded to its concerns by flooding the market with liquidity and driving interest rates to near zero. On August 3, 2011 the SNB lowered the upper limit of its target range for the three-month Libor to 0-0.25 percent (from 0-0.75 percent). On August 10, the SNB announced additional measures to increase liquidity and reduce the appreciation of the franc. These included pumping more liquidity into the Swiss money market and conducting foreign exchange swap transactions (a policy last used in late 2008). The franc nonetheless continued to strengthen. On August 11, an SNB official said that a temporary peg to the euro was possible and the comment resulted in a 4.5 percent depreciation of the franc against the euro the following day.

The franc continued to depreciate through August, but by early September started moving upward again. As a result, on September 6, the SNB announced that it was establishing a ceiling on the €/CHF exchange rate. The franc would not be allowed to appreciate beyond 1.20 francs per euro. The SNB said it was "aiming for a substantial and sustained weakening of the Swiss franc," and was prepared to buy foreign currency in "unlimited quantities" to enforce the ceiling.

Following the September 6 announcement, the franc depreciated 1.1 percent against the euro and 9 percent against the dollar through end-December. The CHF/€ exchange rate has hovered around the 1.20 threshold in 2012 through mid-May. The SNB does not publish its market interventions, but stated in March 2012 that "since September 2011, the SNB has rigorously enforced the announced minimum exchange rate against the euro."

The circumstances prompting the actions by the SNB are unique to Switzerland. It is a small open economy that has been disproportionally affected by the financial stresses in Europe, resulting in disorderly movements in the exchange rate. Indirect methods, such as boosting liquidity and lowering interest rates to their lowest level, have failed to stem the appreciation leading to direct, more drastic action.

Switzerland's reserves have increased substantially in the past 3 years. At the beginning of 2009 Switzerland's foreign currency reserves were roughly equal to those of the United States but are now 5 times the size of U.S. reserves. Switzerland's foreign exchange reserves rose by $99.3 billion in the first eight months of 2011. Most of the increase occurred in August reflecting the SNB's actions to stem the rise of the franc. Reserves declined by $45.6 billion through the end of the year and continued to decline in early 2012 reflecting the unwinding of currency swaps and valuation changes.

The current account surplus increased from 13.6 percent of GDP in the first half of 2011 to 16 percent in the second half, with a full year posting of 14.8 percent. Both the goods and services balances are in surplus due to Switzerland's strong presence in precision instruments and pharmaceuticals on the trade side and financial services on the services side. However, the SNB and IMF estimate that, adjusting for ownership of multinational companies and cross-border shopping, the current account surplus for 2011 would decline by about 7 percent of GDP (i.e., a surplus of 7.8 percent instead of 14.8 percent of GDP).

Slower global growth, events in the euro area, and appreciation of the franc negatively affected growth in 2011. Swiss economic growth slowed from 2.7 percent in 2010 to 1.9 percent in 2011. Output grew by 0.4 percent on an annualized basis in the fourth quarter of 2011 as investment and public consumption declined. The IMF projects growth will remain weak in 2012 with the economy expanding by 0.8 percent.

United Kingdom

The United Kingdom (UK) has a freely floating market-determined exchange rate. After depreciating by 3.3 percent against the dollar in the second half of 2011, the pound reversed course, appreciating by 2.8 percent in 2012 through the mid-May. In recent months, investors appear to be treating the pound as a safe haven currency. On a real effective basis, the pound appreciated by 3.6 percent in the second half of 2011, reflecting its nominal appreciation against other currencies excluding the dollar, notably the euro. In the first four months of 2012, the pound depreciated by 2.0 percent on a real effective basis, likely due to the drop in inflation since the start of the year.

The UK economy has been unable to establish a firm recovery. Output contracted 1.2 percent on an annualized basis in the fourth quarter of 2011 and by 0.8 percent in the first quarter of 2012, a technical recession. The downturn in 2011 was due largely to flagging consumption and investment. Negative construction output and subdued services activity were major contributors to the weak result in the first quarter. The UK's Office of Budget Responsibility (OBR) projects growth of 0.8 percent in 2012, in line with the IMF's latest forecast.

The government committed to a fiscal mandate that requires it to balance the cyclically adjusted current budget at the end of a rolling, five-year period, as well as a supplementary target, which requires public sector net debt to fall as a share of GDP between 2014-15 and 2015-16. The government previously committed to meeting its fiscal mandate a year early (2014-15); however, last November, the OBR made significant updates to its economic forecasts, which resulted in upward revisions to its targets, and extended the timeframe to meet its fiscal mandate by two years to 2016-17.

Monetary policy remains accommodative. The Bank of England (BOE) has maintained its historically low policy rate at 0.5 percent and, at its February meeting, increased the size of its quantitative easing (QE) program to £325 billion from £275 billion. The basis for its decision was similar to the rationale for the expansion in QE last October: the weaker global environment – particularly slower growth in the euro area – and tight credit conditions, weak real household incomes, and fiscal tightening. Inflation has remained above the BOE's 2.0 percent target for the past two years largely due to the rise in commodity prices, the VAT increase, and currency weakness. However, it has fallen steadily since peaking at 5.2 percent in September 2011 and stood at 3.5 percent year-over-year in March, as the effect of last year's VAT increase fades.

After narrowing to 0.9 percent of GDP in the second quarter of 2011, the UK's current account deficit rose sharply to 2.8 percent of GDP in the third quarter, as a drop in exports worsened the trade deficit. A rise in exports in the fourth quarter reduced the deficit to 2.2 percent of GDP.

Western Hemisphere

Brazil

Brazil operates under a floating exchange rate regime, although the central bank intervenes regularly and the authorities have repeatedly extended controls on capital inflows over the past two years to contain appreciation of the *real*. After more than two years of steady appreciation from early 2009 to mid-2011, the *real* depreciated 18.8 percent against the dollar in the second half of 2011. In early 2012, the *real* reversed course and appreciated sharply against the dollar, but has depreciated since the end of February, partly due to renewed policy intervention by the authorities. Overall, the *real* has depreciated by 7.3 percent against the dollar in 2012 through mid-May. On a real effective exchange rate basis, the *real* depreciated by 9.2 percent in the second half of 2011 and by an additional 0.8 percent in the four months of 2012.

Preventing significant appreciation of the *real* has been a priority for the Brazilian government, as the authorities have voiced concerns that appreciation of the *real* has decreased the competitiveness of domestic industry and led to an undesirable increase in manufacturing imports, particularly from Asia. After being out of the market for several months while the *real* was depreciating against the dollar, the Banco Central do Brasil (BCB) resumed foreign exchange intervention in early February, and continued to purchase foreign currency even after the *real*'s appreciation trend was reversed. The central bank purchased $9.4 billion in dollars in spot markets from February through mid-April and bought $7 billion in dollars through deliverable forward contracts in February. Also, the central bank has increased its long dollar position in local currency swaps by $1.7 billion since February. Foreign exchange reserve accumulation slowed in the second half of 2011. Reserves increased by $16.2 billion after rising by $50.9 billion in the first half. The pace accelerated in the first quarter of 2012, as a result of renewed exchange market intervention of 2011. Reserves rose by $11.4 billion, reaching $354 billion at the end of March 2012.

Brazil has implemented a series of measures to limit capital inflows and upward pressures on the exchange rate since October 2010. Most recently, the authorities broadened the scope of the 6 percent financial operations tax (IOF) on capital inflows to include medium duration external borrowing (between two and five years) by Brazilian residents. Net financial inflows totaled

$10.1 billion in January and February, led by foreign direct investment inflows, but there was some moderation of capital inflows in March and April.

Brazil's current account deficit averaged 2.1 percent of GDP in 2011. Net foreign direct investment averaged 2.7 percent and net portfolio investment averaged 1.4 percent of GDP. Reserve accumulation averaged 2.6 percent of GDP, nearly twice that of portfolio investment.

Brazil's economy grew by 2.7 percent in 2011, well below the 7.6 percent growth rate in 2010, as the government tightened fiscal, monetary, and credit policy in the first half of the year in order to slow accelerating inflation and external demand weakened. The industrial sector was a drag on growth in 2011, in part due to increased import penetration in manufactured goods markets.

After raising its policy rate by 175 basis points in the first seven months of 2011, the BCB reversed course cutting the rate by 150 basis points by the end of December. In 2012 the BCB cut its policy rate by an additional 200 basis points to reach 9 percent at the end of April, slightly above the historical low. The authorities have also provided some fiscal stimulus through a boost to government transfer payments linked to the minimum wage and discretionary stimulus targeted at the industrial sector. The IMF projects the economy will grow by 3.0 in 2012 as the simulative measures take hold.

Inflation reached 7.4 percent on a year-over-year basis in September 2011 but decelerated to 5.1 percent in April 2012, moving closer to the center point of the central bank's target band of 4.5 percent ± 2 percent. Continued high core and services inflation (6 percent and 8 percent, respectively) indicate that latent inflation pressures remain. Brazil's current account deficit was 2.0 percent of GDP over the 12 months ending in March, and it has hovered around this level since 2010.

Canada

Canada maintains a flexible exchange rate. The Canadian dollar depreciated by 6.0 percent against the U.S. dollar in the second half of 2011, mirroring a decline in global commodity prices. The currency has rebounded in 2012, appreciating by 1.4 percent through mid-May. On a real effective basis, the Canadian dollar depreciated by 2.9 percent in the second half of 2011 but appreciated 2.7 percent in the first four months of 2012. The recent appreciation of the Canadian dollar has reflected both a rebound in global commodity prices since end-2011, better than expected macroeconomic data, and market views that the Bank of Canada may begin to raise interest rates as early as 2013.

The Canadian economic recovery continued in the second half of 2011, with domestic demand strengthening in the fourth quarter to 2.9 percent. In 2011, real GDP expanded by 2.5 percent. Exports grew in the second half of 2011, supporting the Canadian economy, while rising private investment was offset to a large degree by declining public investment. The Bank of Canada forecasts growth to moderate to 2.4 percent in 2012 somewhat higher than the IMF's projection of 2.1 percent growth. Going forward, authorities expect relatively high household debt levels to constrain personal consumption growth.

Canada's current account deficit narrowed slightly in the second half of 2011, to 2.4 percent of GDP. In spite of declining commodity prices, export volumes increased, particularly in manufactured goods destined for higher-growth emerging markets. Imports have continued to grow, but at a moderate pace.

The government has continued fiscal consolidation but late in 2011 pushed back by one year the goal of returning to fiscal balance, which is now forecasted to occur by the end of FY2015. The Bank of Canada has maintained its policy rate at 1.0 percent since September 2010, citing subdued core inflation and concerns about the external outlook. The Bank of Canada's target for inflation is 2 percent. Headline inflation decelerated to 2.3 percent in December 2011 from 3.1 percent in June on a year-over-year basis, with core inflation of 1.8 percent.

Mexico

Mexico has a flexible exchange rate and employs an inflation-targeting monetary policy regime. On a real effective basis, the peso depreciated by 10.3 percent during the second half of 2011 as global growth concerns buffeted emerging market currencies and commodity prices declined. In the first four months of 2012, however, the peso appreciated by 4.2 percent on a real effective basis. Similarly, against the dollar, the peso declined 19.1 percent during the second half of 2011 but rose 0.8 percent through mid-May in 2012.

Mexico's foreign reserves increased $14.5 billion in the last half of 2011, reaching a total of $137 billion. Virtually all of this increase was driven by foreign exchange inflows from the state-owned oil company, Pemex. The Bank of Mexico discontinued in November 2011 its monthly auctions of options to purchase foreign exchange, which had previously allowed Mexico to gradually accumulate foreign exchange when the peso was on an appreciating trend. In conjunction with this announcement and as a measure to support liquidity in the foreign exchange market, the Bank of Mexico indicated that it would auction $400 million in foreign exchange on any day in which the peso depreciated against the dollar by more than 2 percent. Through April 2012, the Bank of Mexico has not conducted any auctions. In December 2010, Mexico obtained an augmented precautionary Flexible Credit Line (FCL) from the IMF equivalent to $72 billion, up from $48 billion previously. As of the mid-May 2012, Mexico had not drawn on this line.

Real GDP growth slowed to 1.7 percent on an annualized basis in the fourth quarter of 2011. Growth for all of 2011 was 4.0 percent. Private consumption and (to a lesser extent) investment drove economic growth in the second half of 2011. Oil production remained flat throughout 2011, while manufacturing production has shown strong growth throughout most of the year (excluding the short-lived supply disruptions following Japan's earthquake). Domestic and external demand has remained fairly robust through the first quarter of 2012, and real GDP rose by 5.3 percent on an annualized basis.

The Bank of Mexico has maintained an accommodative monetary policy stance, keeping its target interest rate at 4.5 percent since July 2009. Inflation gradually accelerated in the fourth quarter of 2011 to just over 4 percent as of January 2012 (on a year-over-year basis), but slowed to 3.4 percent by April. The Bank of Mexico maintains an inflation target of 3 percent, with a band of plus or minus 1 percent.

Mexico’s current account deficit was 0.8 percent of GDP in the fourth quarter. Manufacturing export growth has been strong, with total exports rising 11 percent in the fourth quarter, but import growth has kept pace.

Glossary of Key Terms in the Report

Bilateral Real Exchange Rate – The bilateral exchange rate adjusted for inflation in the two countries, usually consumer price inflation.

BIS Effective Exchange Rate– An effective exchange rate index calculated as a geometric weighted average of bilateral exchange rates. The weights are based on manufacturing trade flows and capture both bilateral export and import trade and export competition in third markets. To capture changes in trade patterns over time, the weights are time-varying.

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

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

Federal Reserve Dollar Indexes – The Federal Reserve calculates three effective exchange rate indexes for the dollar. All are weighted averages of the foreign exchange value of the dollar against a group of currencies. The weights are time-varying and are based on U.S. export shares, U.S. import shares, and export competition in third markets. The ***Broad index*** includes the 26 currencies used by the major trading partners of the United States. This index is then split into a Major currency index and an Other Important Trading Partner (OITP) index. The ***Major Currencies Index*** includes seven currencies that are used widely in international transactions (the euro, yen, pound sterling, Australian dollar, Canadian dollar, Swiss franc, and Swedish krona). The ***OITP Index*** includes 19 emerging market currencies. Although these currencies are used by major trading partners of the United States, they do not circulate widely internationally.

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

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

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

Managed Float– A regime under which a country establishes no predetermined path for the exchange rate but the central bank frequently intervenes to influence the movement of the exchange rate against a particular currency or group of currencies. Some central banks explain this as a policy to smooth fluctuations in exchange markets without changing the trend of the exchange rate.

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

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

Real Effective Exchange Rate (REER) **–** The effective exchange rate adjusted for relative prices, usually consumer prices.

Sterilized Intervention – An action taken by the central bank to offset the effect of intervention on the domestic money supply. Intervention in which the central bank sells domestic currency increases the domestic money supply, and is, in essence, expansionary monetary policy. To neutralize the effect of the intervention on the money supply, the central bank will sell domestic government securities, taking an equivalent amount of domestic currency out of circulation. If the intervention involved the purchase of domestic currency, the central bank will buy government securities, placing an amount of domestic currency equivalent to the size of the intervention back into circulation. An intervention is partially sterilized if the action by the central bank does not fully offset the effect on the domestic money supply.

Trade Weighted Exchange Rate – see Nominal Effective Exchange Rate

Unsterilized Intervention –The purchase of domestic currency through intervention in the exchange market reduces the domestic money supply, whereas the sale of domestic currency through intervention increases the money supply. If the central bank takes no action to offset the effects of intervention on the domestic money supply, the intervention is unsterilized.