Report to Congress on International Economic and Exchange Rate Policies

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

April 9, 2015

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]

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[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.

Contents

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 2014, and where pertinent and available, data through end-March 2015. This Report reviews the macroeconomic and exchange rate policies of economies accounting for 65 percent of U.S. foreign trade and assesses global economic developments more broadly. The Report draws attention to and expresses concern over the impact that an imbalanced mix of macroeconomic policies is having on global outcomes, including a suboptimal composition of global growth and the threat of widening external imbalances. The Report calls for policymakers, especially those in surplus economies, to use the full set of policy tools at their disposal (monetary, fiscal and structural) to support growth and realize the collective G-20 objective of strong, sustainable and balanced global growth.

The U.S. economy expanded at a robust 3.6 percent annual rate during the second half of 2014, supported by continued strong growth of private demand. Labor market conditions improved considerably in the latter half of the year, with the average pace of job growth accelerating sharply to its fastest pace in 20 years and the unemployment rate falling to its lowest level in almost seven years. Inflation slowed, largely reflecting a steep drop in oil prices over the period. Although GDP growth appears to have slowed in the first quarter of 2015, in part reflecting the temporary effects of severe winter weather, an array of economic indicators suggests that the underlying momentum of the recovery remains intact and growth is expected to remain strong through the end of this year.

In contrast to solid U.S. performance, global economic outcomes have been disappointing and remain of concern. Not only has global growth failed to accelerate, but there is worry that the composition of global output is increasingly unbalanced. Weak global growth importantly reflects an insufficiently comprehensive mix of macroeconomic policies in some key countries, which leaves substantial scope for efforts to support domestic demand. Alongside strengthening U.S. economic activity, lackluster growth abroad, and falling commodity prices the broad nominal trade weighted dollar appreciated by 7.9 percent in the second half of 2014, with another 4 percent appreciation in the first quarter of 2015.

The global economy should not again rely on the United States to be the only engine of demand. Doing so will not lead to a pattern of strong, sustainable and balanced global growth, the very aim of the G-20. To achieve this objective, many countries need to implement a balanced policy mix. Excessive reliance on any single lever of policy is not enough. Rather, policymakers need to use all levers, including fiscal stimulus where fiscal space exists, to complement monetary policy accommodation. In conjunction, many countries also need to implement structural reforms to help boost potential growth and address persistent stagnation. Balanced approaches to macroeconomic policy are particularly needed in large surplus countries, notably in Germany, China, Japan, and Korea – consistent with agreed G-7 and G-20 commitments.

The Report emphasizes that the key priority for the euro area is to bolster domestic demand growth. In the face of ongoing disinflation, the European Central Bank (ECB) has taken forceful steps to support growth and combat downward price pressures. Complementing these monetary measures with supportive national fiscal policies, and appropriate structural reforms, would help deliver the strongest boost to domestic demand. Such a policy mix would help ensure a balanced composition of GDP growth, and would avoid the risk that growth becomes excessively reliant on the external sector. Already the euro area's current account surplus tops $300 billion (2.3 percent of euro area GDP), nearly all of which is accounted for by Germany (7.8 percent of German GDP). It remains vital that the euro area contribute to global demand by taking all necessary steps to build its own domestic demand momentum.

The Report also flags weak domestic demand in Japan as an ongoing concern and calls for a balanced macroeconomic policy approach there as well. Domestic demand fell by 1.5 percent over the course of 2014, as Japanese policy did not sufficiently offset the impact of the increase in the consumption tax on demand. Going forward the government needs to deploy all three policy levers – fiscal, monetary, and structural – to secure a balanced and durable recovery and ensure monetary stimulus is appropriately supporting the growth of domestic demand. Over-reliance on monetary policy without appropriate support from fiscal policy and structural reforms will put Japan's recovery and escape from deflation at risk and could generate negative spillovers. As such, Japan's medium-term deficit reduction targets should be sufficiently flexible to respond to weakness in domestic demand growth.

China continues to work its way out of a significant undervaluation that led to large internal and external imbalances, and the Report concludes that fundamental factors for RMB appreciation remain intact, highlighting the need for further strengthening over the medium-term. In recent months, China has benefited from a sizeable terms of trade gain from lower oil prices, with its monthly goods surplus repeatedly reaching new nominal highs. The current account surplus exceeded $200 billion in 2014 (2.1 percent of GDP), up $60 billion from the year before, and is expected to remain on a rising trajectory in the year ahead. Additionally, China continues to see relatively higher productivity growth than its major trading partners. Finally, China's currency needs to appreciate to bring about the necessary internal rebalancing toward household consumption that is a key goal of the government's reform plans and necessary for sustained, balanced global growth. While China has made real progress, with its real effective exchange rate appreciating meaningfully over the past six months, these factors indicate an RMB exchange rate that remains significantly undervalued.

The Report notes China's reduced level of intervention in the foreign exchange market, consistent with the commitment of China's government at the Sixth Round of the U.S.-China Strategic and Economic Dialogue (S&ED). The Report also observes that the RMB is one of the few currencies to remain relatively range-bound against the U.S. dollar over the past year.
In line with its S&ED commitments, China should allow the market to play a greater role in determining the exchange rate and build on the recent reduction in foreign exchange intervention

by durably curbing its activities in the foreign exchange market, including at times when there is market pressure for further appreciation.

The Report looks forward to progress on China's plan to subscribe to the IMF's Special Data Dissemination Standard (SDDS) for economic and financial data, including foreign exchange reserve disclosure, but highlights that more needs to be done to enhance transparency. In line with the practice of most other G-20 nations, China should disclose foreign exchange market intervention regularly to enhance its exchange rate and financial market transparency.

Lastly, the Report notes that the Korean authorities have intervened to resist won appreciation in the context of a large and growing current account surplus, now at 6.3 percent of GDP. Korea also has substantial foreign exchange reserves, as well as significant fiscal space. Estimates based on valuation-adjusted reserves show that the Korean authorities intervened heavily last summer. After reducing their presence in the foreign exchange market from August through November, Korean authorities appear to have substantially increased intervention in December and January, a time of appreciation pressure on the won. Refraining from intervention and allowing more space for won appreciation would help with rebalancing and encourage a reallocation of productive resources to the non-tradables sector. Treasury has intensified its engagement with Korea on these issues. We have made clear that the Korean authorities should reduce foreign exchange intervention, limiting it to the exceptional circumstance of disorderly market conditions, and allow the won to appreciate further. The authorities should also increase transparency of foreign exchange operations.

Based on the analysis in this report, Treasury has concluded that no major trading partner of the United States met the standard of manipulating 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 as identified in Section 3004 of the Act during the period covered in the Report. Treasury continues to closely monitor developments and policy implementation in economies where growth is weak and exchange rate adjustment is incomplete, and continues to push for comprehensive adherence to all G-7 and G-20 and IMF commitments. These include the recent G-7 commitments to orient fiscal and monetary policies towards domestic objectives using domestic instruments and to not target exchange rates. They also include the G-20 commitments to move more rapidly toward market-determined exchange rate systems and exchange rate flexibility, to avoid persistent exchange rate misalignments, to refrain from competitive devaluation, and to not target exchange rates for competitive purposes.

Introduction

This report focuses on international economic and foreign exchange developments in the second half of 2014. Where pertinent and when available, data and developments through end-March 2015 are included.

Exports and imports of goods to and from the ten economies analyzed in this report accounted for 65 percent of U.S. merchandise trade in 2014.

U.S. Macroeconomic Trends

The U.S. economy expanded at a robust 3.6 percent annual rate during the second half of 2014, supported by strong growth of private demand. Labor market conditions improved considerably in the latter half of the year, with the average pace of job growth accelerating sharply and the unemployment rate, as of February 2015, at its lowest level in almost seven years. Inflation slowed, largely reflecting a steep drop in oil prices over the period. Favorable underlying fundamentals suggest that the economy will continue to grow at an above-trend pace through the end of this year and into 2016.

U.S. GDP Growth Momentum Remains Solid

The U.S. economic recovery strengthened in the second half of 2014. Real GDP expanded at a robust 3.6 percent annual rate over the final two quarters of the year, accelerating markedly from the 1.2 percent pace in the first two quarters. Robust growth in consumption, private fixed investment, and government spending accounted for the faster pace of expansion. Consumer spending rose at a 3.9 percent pace over the final two quarters of 2014, double the 1.8 percent pace of the first half of the year, and the pace of private fixed investment more than doubled to 3.5 percent during the final two quarters of 2014 from 1.5 percent during the first two quarters of the year. Growth of government spending accelerated to 1.2 percent during the latter half of last year from a 0.4 percent pace in the first half. The trade balance was little changed on average in the second half of 2014 compared with the first half of the year. However, the change in private inventories swung from providing a modest boost to GDP growth in the first half of the year to acting as a slight drag on growth in the second half.

Although GDP growth appears to have slowed in the first quarter of 2015, in part reflecting the temporary effects of severe winter weather, an array of economic indicators suggests that the underlying momentum of the recovery remains intact and growth is expected to remain strong through the end of this year. The improvement in labor market conditions along with the recent sharp decline in energy prices have been a boon for consumers, helping to lift consumer confidence to its highest level in a decade. Household wealth has risen considerably over the past year and credit conditions are improving. In addition, spending at all levels of government is expected to make a small positive contribution to economic activity after being a drag on growth in recent years. A consensus of private forecasters is projecting real GDP growth of 2.8 percent over the four quarters of 2015.

Recovery in the Housing Sector Was Mixed

The recovery in the housing market was mixed during 2014 and early 2015, as single-family home building remained subdued but sales of existing single-family homes rebounded and multi-family construction spending returned to its pre-recession range. Residential investment rose 3.3 percent at an annual rate, on average, over the third and fourth quarters of 2014, accelerating from a 1.8 percent pace during the first half of 2014 but still well below the double-digit advances posted in mid-2013. The outlook for housing remains generally favorable, as continued improvement in labor markets is expected to help boost housing demand this year. Although rising home prices have eroded housing affordability, it remains higher than its historical average. Falling mortgage rates have also helped boost affordability. The average interest rate for a 30-year fixed rate mortgage fell by 61 basis points between January and December of 2014, from 4.48 percent to 3.87 percent – after rising almost a full percentage point between May and December of 2013 – and had fallen a further 17 basis points to 3.7 percent as of early April 2015. For much of the past three years, the pace of household formation – a key determinant of housing demand – had remained below its long-term average, but it accelerated sharply in the fourth quarter of 2014, moving above its long-term average to the highest level in nine years.

Fiscal Headwinds Diminished

After posing a large drag on growth from mid-2009 through 2013, total government spending made a small positive contribution to economic activity over the course of 2014. At the federal level, government expenditures added an average 0.1 percentage point per quarter to real GDP growth over the final two quarters of 2014, after subtracting an average 0.4 percentage point per quarter during the first two quarters of the year. Fiscal conditions at the state and local level continued to improve and supported growth for a second straight year in 2014, after three years of subtracting from growth. In the second half of 2014, state and local government expenditures contributed 0.2 percentage point on average to real GDP growth, up from an average quarterly contribution of 0.1 percentage point during the first half of the year.

Labor Market Conditions Continued to Improve, and Inflation Slowed

The pace of job creation picked up throughout 2014 and the unemployment rate moved notably lower. Nonfarm payroll employment increased by 281,000 per month on average during the last six months of 2014, stepping up from an average monthly increase of 239,000 over the first six months of the year. The pace of job growth moderated in the first quarter of 2015 but at an average monthly gain of 197,000 was still strong. Roughly 11.5 million jobs have been created since February 2010, reflecting a gain of 12.1 million in the private sector and a net loss of 578,000 in the public sector. However, over the past year or so, the public sector has been creating jobs on a net basis. Between January 2014 and June 2014, the unemployment rate fell by 0.6 percentage point to 6.1 percent and over the following nine months, through March 2015, had fallen an additional 0.7 percentage point to 5.5 percent, the lowest level in nearly seven years. About two-thirds of the improvement in the unemployment rate over the past year was due to declining long-term unemployment. Even so, the long-term unemployment rate (reflecting workers without a job for 27 weeks or more) remains elevated at 1.6 percent, well above its pre-recession average of 1 percent (from 2001-2007).

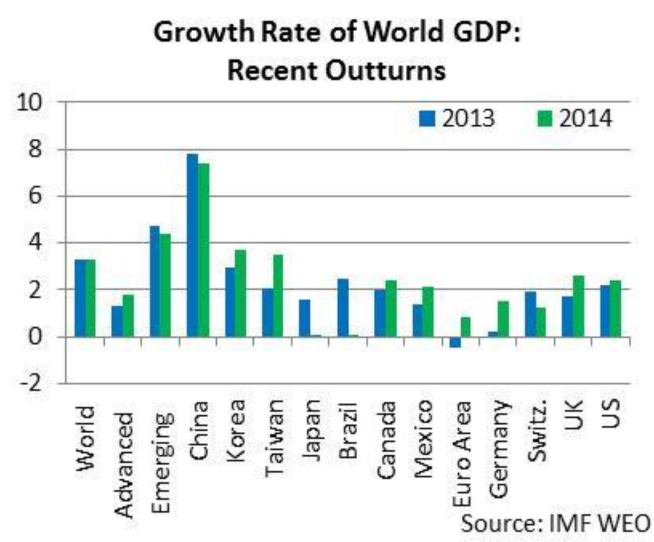
Headline inflation slowed sharply during the latter half of 2014, largely reflecting the decline in energy prices, while core inflation remained low and stable. The consumer price index was flat during the year ending in February 2015, down from a 1.1 percent advance in the year ending in February 2014. Core consumer inflation (which excludes the volatile food and energy categories) was 1.7 percent over the year ending in February 2015, up slightly from the 1.6 percent rate over the year-earlier period. Core inflation has been roughly stable around that level for the past three years. Growth of compensation costs remained subdued. The Employment Cost Index (ECI) for private-industry workers rose 2.3 percent over the year ending in December 2014, remaining well below gains averaging 3.5 percent annually in the decade prior to the last recession. Persistent labor market slack and the low level of capacity utilization are among the factors that have restrained wage growth and inflationary pressures.

Putting Public Finances on a Sustainable Path Remains a Priority

The federal deficit continued to narrow in FY 2014, declining to 2.8 percent of GDP from 4.1 percent of GDP FY 2013. Since peaking in 2009, the deficit has fallen by 7.0 percentage points – the most rapid pace of fiscal consolidation for any five-year period since the demobilization following World War II. The President's FY 2016 Budget would trim the deficit slightly further on net to 2.5 percent of GDP over the latter half of the 10-year budget period—well below the 40-year average of 3.2 percent of GDP. The primary deficit (non-interest outlays less receipts) is projected to become a primary surplus in FY 2022, at which point it will no longer be adding to federal debt. Publicly-held debt as a share of the economy is expected to stabilize in the current fiscal year and decline steadily to 73.3 percent of GDP in FY2025.

The Global Economy

In contrast to solid U.S. performance, global economic outcomes have been disappointing and remain of concern. Not only has global activity failed to accelerate, but there is a growing worry that the composition of global output increasingly unbalanced. Weak global growth importantly reflects an insufficiently comprehensive mix of macroeconomic policies in some key countries, which leaves substantial scope for efforts to support domestic demand.

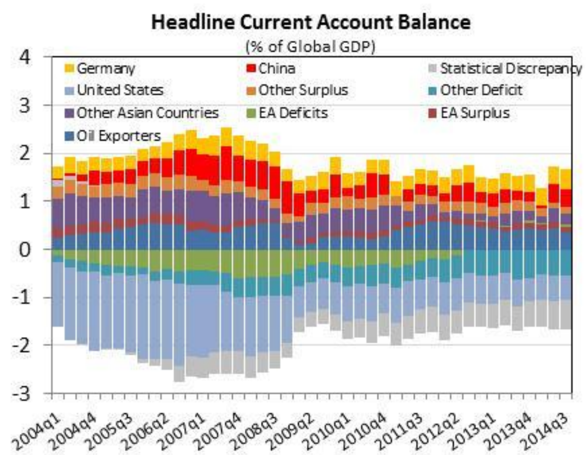


Global economic growth was 3.3 percent in 2014, the same as in 2013. However, this aggregate measure masks significant variations in performance driven by both economy-specific and global factors. Euro area growth turned positive in 2014, though it was driven by just a few economies – most notably, Germany and Spain. In contrast, growth in France was flat and economic activity in Italy contracted last year. Economic growth lost momentum in Japan as it struggled to rebound from the April 2014 consumption tax increase. Some advanced economies including the United States, Canada, and the United Kingdom have seen strong growth, serving as key drivers of growth globally.

There were also marked differences in performance among emerging market economies last year. Growth in China continued to moderate as the economy undertakes a necessary rebalancing toward a greater reliance on domestic demand. Economic growth lost momentum in Brazil, and the impact of sanctions and low oil prices is taking a large toll on growth in Russia. In contrast, after a slowdown associated with a deceleration in investment, growth in Korea is picking up, and the recovery in India is accelerating.

Looking forward, divergent developments are likely to remain. Low oil prices are positive for the global economy in aggregate, although they will negatively impact growth in major oil exporters. Growth in China is expected to continue to slow and Russia is contracting sharply, with regional growth implications, while growth in India should continue to improve. The January IMF projections foresee the global economy expanding 3.5 percent in 2015, 0.2 percentage points higher than 2014. Real GDP in the advanced economies is projected to expand by 2.4 percent in 2015 compared with 1.8 percent in 2014, driven by strong growth in the United States, and a continued but modest acceleration of growth in the euro area. Real GDP growth in emerging markets and developing economies is projected to continue trending down, from a post-crisis peak of 6.2 percent in 2011 to 4.3 percent in 2015, led by a continued moderation of growth in China, a sharp contraction in Russia, and ongoing weakness in Brazil.

Global Rebalancing



The global economy should not again rely on the United States to be the only engine of demand. Doing so will not lead to a pattern of strong, sustainable and balanced global growth, the very aim of the G-20. To achieve this objective, many countries need to implement a balanced policy mix. Excessive reliance on any single lever of policy is not enough. Rather, policymakers need to use all policy levers, including fiscal stimulus where space exists, to complement monetary policy accommodation, in order to boost domestic demand and reduce output gaps. In conjunction, they also need to implement structural reforms to help boost potential growth and address persistent stagnation. Balanced approaches toward macroeconomic policy, consistent with G-7 and G-20 commitments, are especially important in large surplus countries including Germany, China, Japan and Korea.

Notably, Germany, China, and Korea are poised to see further increases in their already large external surpluses. Each of these economies will benefit significantly in 2015 from lower oil prices (see Annex 1) and Germany has seen its real effective exchange rate depreciate over the past year. Japan's external surplus in 2014 was modest, but it is expected to rise in 2015. Excessive surpluses reflect a reluctance to consume or invest domestically and should be a red flag to policymakers that domestic demand is falling short, with adverse consequences for growth. Moreover, these rising surpluses are a further argument to take strong action to rebalance global demand.

Reserve Accumulation

Global foreign-currency reserves declined in dollar terms in the second half of 2014, largely due to valuation effects associated with currency moves. Though China appears to have sharply reduced its average monthly increase in reserves in recent months, and at sometimes appears to have sold foreign currency, Chinese reserves remain at a very high level relative to the rest of the world, comprising roughly one-third of global reserves. India's foreign exchange reserves reached an all-time high in March 2015 as the central bank purchased foreign currency to moderate the impact of large foreign investment inflows on the rupee. Russia's foreign reserves have declined markedly as the Central Bank of Russia has attempted to stem the sharp fall in the ruble in the face of large capital outflows. Switzerland's low level of dollar reserve growth in 2014 does not reflect that reserves increased significantly in euro terms in December – and grew further in the first quarter of 2015.

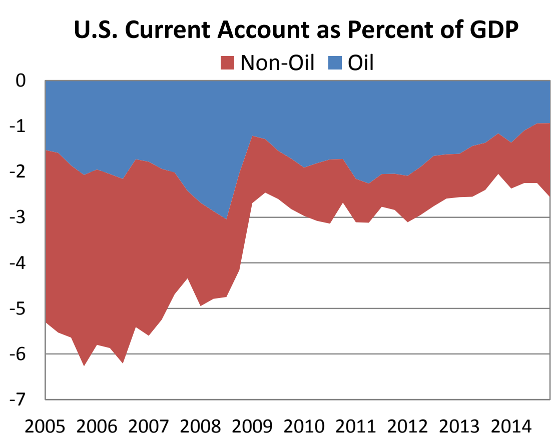
Foreign Currency Reserve Accumulation Major Holders				
	Latest	Average Monthly increase, $ billions		
	Reserves $ billions	Jan 2009 to Dec 2012	2013	2014
Global	11,686	77.3	58.8	-0.5
China	3,843	28.4	42.5	1.8
Japan	1,192	4.0	0.8	-0.2
Saudi Arabia	721	4.2	5.8	0.7
Switzerland	537	8.8	1.7	0.9
Taiwan	418	2.3	1.1	0.2
Brazil	354	3.6	-1.1	0.5
Korea	353	2.4	1.6	1.5
India	316	0.3	0.6	2.2
Russia	302	1.3	-2.2	-10.7
Singapore	249	1.7	1.1	-1.3

The reduced pace of reserve accumulation is a welcome development. Small amounts of foreign reserves may be needed for day-to-day transactions, while some economies may want to hold a stock of reserves to intervene if necessary to contain a disorderly depreciation. However, excessive reserves have both a domestic cost as well as global costs in that they distort the international monetary system and are often symptomatic of intervention to prevent adjustment needed to avoid large global imbalances.

U.S. International Accounts

Current Account

The U.S. current account deficit remained stable in 2014 at 2.4 percent of GDP, the same ratio as the previous year. This marks a 3.4 percentage point of GDP narrowing of the current account deficit since reaching a peak of 5.8 percent in 2006. The deficit in the trade of goods increased during 2014, but this was offset by an increase in the trade of services surplus and an increase in receipts of income on U.S.



investments abroad. Much of the reduction in the current account deficit in recent years has been due to a decrease in the oil trade deficit, driven by increased domestic oil production and, in the second half of 2014, lower oil prices. Since reaching a peak of 3 percent of GDP in 2008, the oil deficit fell to 0.9 percent of GDP in the final quarter of 2014.

At the end of the third quarter of 2014, the U.S. net international investment position was $-6.2 trillion or -35 percent of GDP, a decline of nearly 3.4 percentage points of GDP from the second quarter of 2014. The value of U.S.-owned foreign assets was $24.6 trillion, while the value of foreign-owned U.S. assets was $30.7 trillion. The fall in the net international investment position was driven in part by valuation effects that lowered the value in dollar terms of U.S. assets held abroad, and the continued accumulation of foreign-owned U.S. assets.

U.S. Balance of Payments and Trade ($ billions, seasonally adjusted unless indicated)	**2013**	**2014**	**Q4-13**	**Q1-14**	**Q2-14**	**Q3-14**	**Q4-14**
Current Account							
Balance on goods (for details, see lower half of table)	-701.7	-735.8	-169.1	-181.3	-188.2	-181.1	-185.2
Balance on services	225.3	231.1	56.6	57.8	58.0	57.2	58.2
Balance on primary income	199.7	217.9	54.6	52.5	54.9	59.8	50.6
Balance on secondary income (unilateral transfers)	-123.5	-123.8	-29.5	-30.0	-22.0	-34.8	-37.0
Balance on current account	***-400.3***	***-410.6***	***-87.3***	***-101.0***	***-97.3***	***-98.9***	***-113.5***
Balance on current account as % of GDP	***-2.4***	***-2.6***	***-2.1***	***-2.4***	***-2.3***	***-2.3***	***-2.6***
Capital and Financial Account (net borrowing = -)							
Net capital transfers	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Net direct investment flows	113.3	260.1	7.1	155.7	15.5	10.4	78.5
Net portfolio flows–equity	360.7	267.3	187.4	-12.4	88.1	42.5	149.1
Net portfolio flows–debt	-361.7	-412.4	-184.8	-124.8	39.7	-122.2	-205.0
Net other investment flows–loans	-185.6	7.6	-66.9	-54.1	-34.9	79.0	17.6
Net other investment flows–currency, trade credit, etc.	-296.4	-207.1	-86.5	-57.4	-126.4	-6.6	-16.7
Net reserve asset flows**	-3.1	-3.6	-2.8	-1.0	0.8	-0.9	-2.5
Derivatives	2.2	-53.5	2.9	5.3	-2.8	-24.3	-31.7
Balance on capital and financial account	***-370.2***	***-141.6***	***-143.5***	***-88.7***	***-20.1***	***-22.0***	***-10.8***
Memo Items							
Statistical discrepancy***	30.0	269.0	-56.1	12.2	77.1	76.9	102.7
Change in foreign official assets in the United States	286.1	115.3	98.4	28.3	52.3	47.6	-12.9
Current Account Detail: Trade in Goods							
Exports of goods							
Agricultural products	136.2	144.2	37.8	36.8	36.6	34.4	36.3
Industrial supplies and materials (including petroleum)	492.1	501.3	128.8	123.2	127.0	129.7	121.3
Capital goods except autos	534.6	550.3	134.9	134.5	137.2	139.2	139.4
Automotive products	152.6	159.5	38.6	37.2	39.8	42.3	40.2
Consumer goods except autos and food	188.4	198.5	47.4	48.3	50.1	50.2	49.9
Other goods plus nonmonetary gold	89.1	81.4	19.6	20.4	19.0	19.1	22.9
Total exports of goods	***1,592.8***	***1,635.1***	***407.1***	***400.4***	***409.6***	***415.0***	***410.1***
Imports of goods							
Agricultural products	116.0	126.6	29.1	30.1	32.4	32.2	32.0
Industrial supplies and materials (including petroleum)	686.6	671.0	167.7	174.7	170.4	166.8	159.1
Capital goods except autos	557.8	595.7	142.3	143.0	148.7	151.1	152.9
Automotive products	309.6	328.5	79.8	77.4	83.3	83.6	84.3
Consumer goods except autos and food	533.9	559.3	135.4	135.1	140.6	139.1	144.6
Other goods plus nonmonetary gold	90.5	89.8	21.9	21.6	22.4	23.3	22.5
Total imports of goods	***2,294.5***	***2,370.9***	***576.2***	***581.7***	***597.9***	***596.1***	***595.3***
Balance of trade in goods	***-701.7***	***-735.8***	***-169.1***	***-181.3***	***-188.2***	***-181.1***	***-185.2***

Source: Bureau of Economic Analysis (BEA) via Haver Analytics.

Notes: *Latest quarter calculated by inference; this line contains items with a longer reporting lag than other lines.

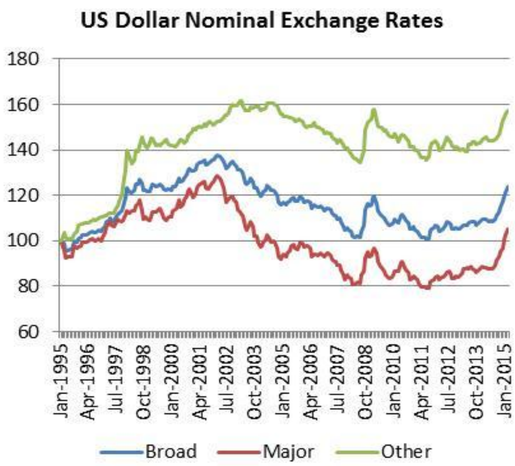
**Includes only US acquisition of assets and has no direct liability counterpart.

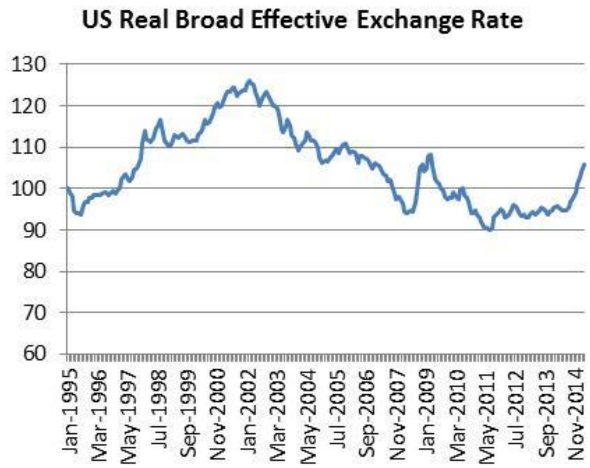
***Amount needed to make the current account balance with the capital and financial account; by definition, current account - capital and financial account + statistical discrepancy = 0.

The Dollar in Foreign Exchange Markets

In the second half of 2014, the dollar appreciated steadily against both major and emerging market currencies. On a broad, trade-weighted basis, the dollar appreciated 13.6 percent between end June 2014 and end-March 2015. Among advanced economies, appreciation has been the largest against the euro – 25 percent between end-June and end-March. But it has also appreciated notably against the pound sterling, Canadian dollar, Japanese yen, and many emerging market currencies.

On a real (inflation-adjusted) effective basis, which reflects real purchasing power abroad, the U.S. dollar appreciated 11.4 percent between end-June 2014 and end-March 2015. The broad trade weighted dollar remains well below its peak in the early 2000s.





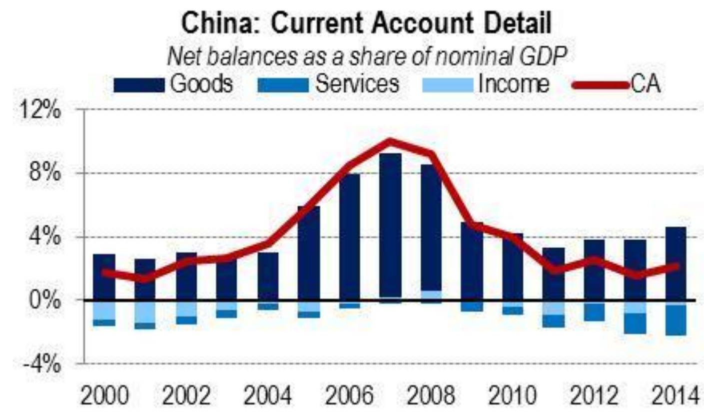
Analyses of Individual Economies

Asia

<u>China</u>

After a slight rebound in mid-2014, China's economy slowed moderately in the fourth quarter. Annual GDP growth softened to 7.4 percent in 2014, the lowest rate since 1990. Data from the first two months of 2015 indicate a continued slowdown. At the National People's Congress in March 2015, the Chinese leadership announced a GDP growth target of 7 percent for 2015, down from 7.5 percent in 2014. Looking ahead, China should avoid a return to dependence on external demand to fuel growth, while consumption should replace investment as the key driver of domestic demand.

Progress toward internal rebalancing has been slow to materialize. Investment in China remains very high at nearly 50 percent of GDP, while private consumption has increased only incrementally in recent years and stands at about 35 percent of GDP. The property market slowdown, which accelerated in mid-2014, poses a risk to growth as it will reduce investment in the housing sector, with attendant linkages to household consumption and the financial sector. In the short term, China has the policy tools to support growth, but should focus on those that assist in rebalancing, such as increasing social spending and consumption. Over the medium term, the Chinese leadership has committed to take steps toward interest rate liberalization, factor price reform, and improving market access for private and foreign firms, all of which would contribute to unwinding China's large internal imbalances.



Source: SAFE, China NBS, Haver

Since the global financial crisis, China's current account surplus fell significantly, from 10 percent of GDP in 2007 ($353 billion) to approximately 1.5 percent of GDP ($148 billion) in 2013. However, China's current account surplus increased to 2.1 percent of GDP ($220 billion) in 2014, highlighting the challenges associated with sustaining progress on external rebalancing in the face of a weaker domestic outlook. China's goods trade surplus, based on non-seasonally-adjusted balance of payments data, was $476 billion in 2014, up more than $100 billion from the previous year. The goods trade surplus surged in the second half of 2014 and early-2015, with five of the last eight months through February 2015 setting new records. These surpluses were driven by continued export growth and significant import weakness, both in volume and value. A large increase in the services deficit limited the increase in China's overall surplus.[2] The U.S.-China bilateral merchandise trade deficit was $343 billion in 2014, up from $319 billion in 2013.

Source: Bloomberg, BIS

Over the medium term, China's currency needs to appreciate further to bring about the necessary internal rebalancing towards household consumption. In this regard, China's bilateral and multilateral commitments – including in the context of the 2014 Strategic and Economic Dialogue (S&ED) in Beijing – to reduce foreign exchange intervention as conditions permit, and allow the market to play a greater role in determining the exchange rate, remain critical. The real test of this commitment will be whether China refrains from intervening even when there is appreciation pressure on the RMB.

At the November 2014 G-20 summit in Brisbane, Australia, President Xi announced that China will subscribe to the IMF's Special Data Dissemination Standard (SDDS) for reporting foreign

[2] Rising tourism explains a part of the increase in the service deficit, but the bulk of the recent increase stems from a higher deficit in "other business services."

exchange reserves as well as other economic data. As explained in the October 2014 Report, the SDDS commitment is a much-needed step toward increasing the transparency of China's foreign exchange reserves. More generally, to promote exchange rate and financial market transparency China should disclose foreign exchange market intervention regularly and contribute to the IMF's aggregate Currency Composition of Foreign Exchange Reserves (COFER) database.[3]

Over 2014, the RMB depreciated by 2.4 percent against the dollar. Year-to-date, the RMB is flat, after depreciating through February but sharply appreciating in mid-March. On a trade-weighted basis and adjusted for relative inflation, China's real effective exchange rate appreciated by more than 10 percent in the past six months, the fastest pace since 2009.

Source: PBOC, SAFE, FRB, U.S. Treasury estimates. Val-adjusted est. based on data released quarterly. January and February not yet available.

China does not publish its foreign exchange intervention, in contrast to other economies with major international currencies. However, it is possible to construct estimates of foreign exchange market intervention using data that China does publish. On balance, foreign exchange intervention proxies[4] indicate that after large-scale foreign exchange purchases in the first quarter of 2014, the People's Bank of China (PBOC) reduced foreign exchange intervention through November 2014. Such proxies indicate that the PBOC gradually shifted to foreign exchange sales toward the end of the year to support the RMB, amid capital outflows and a slowing domestic economy. They also show modest foreign exchange purchases in January, followed by roughly the same amount of sales in February.[5]

There were several short-term factors that put pressure on the RMB against the dollar in recent months. First, the PBOC cut the benchmark lending rate in November 2014 and February 2015 amid concerns about weak domestic demand, especially as investment began to slow.[6] Second, non-FDI net capital outflows nearly doubled in Q4 to $102 billion from $54 billion in Q3. Third,

[3] See Box 1 in the October 2014 Report.

[4] Analysts look closely at several estimates from publicly available data, including: net foreign exchange assets of the PBOC, which excludes valuation changes (i.e. booked at historical cost); valuation-adjusted estimates of the net foreign exchange assets of PBOC; and the foreign exchange position of Chinese financial institutions (banks and the PBOC). The foreign exchange position of Chinese financial institutions includes the foreign exchange assets of both the central bank and commercial banks, and is considered the most reliable indicator of foreign exchange activity in China. All three estimates are included in the chart on monthly foreign exchange intervention proxies.

[5] Foreign exchange reserves increased modestly in 2014 by 0.6 percent, and stand at almost $4 trillion, equivalent to over 40 percent of China's GDP, or about $2940 per person, well beyond established benchmarks of reserve adequacy.

[6] Following the November interest rate cut, the RMB depreciated against the dollar and shifted from the strong side of the RMB reference rate to the weak side.

there were anecdotal reports of unwinding of carry trades based on one-way RMB appreciation expectations and corporate hedging of foreign exchange liabilities.

Notwithstanding 10 percent real effective appreciation over the past six months, fundamental factors point to the need for further RMB appreciation over the medium-term. In recent months, China has benefited from a sizeable terms of trade gain from lower oil prices, with its monthly goods surplus repeatedly reaching new nominal highs. The current account surplus exceeded $200 billion in 2014 (2.1 percent of GDP), up $60 billion from the year before, and is expected to remain on a rising trajectory in the year ahead. Furthermore, China's net foreign direct investment (FDI) inflows continue to reach annual sums of $160 to $200 billion. China's nominal basic balance (current account surplus plus net foreign direct inflows), a measure of stable net balance of payments inflows, also grew in 2014, reaching approximately 4 percent of GDP, and is expected to increase further in 2015. China continues to see relatively higher productivity growth than its major trading partners, which suggests that continuing appreciation is necessary over time to prevent the exchange rate from becoming more undervalued. While China has made real progress, with its real effective exchange rate appreciating meaningfully over the past six months, these factors indicate an RMB exchange rate that remains significantly undervalued. A stronger RMB is needed to avoid widening imbalances, as well as support the shift away from investment-led and capital-intensive industries and support greater consumption by increasing household purchasing power and shifting production to domestically-oriented goods and services.

Japan

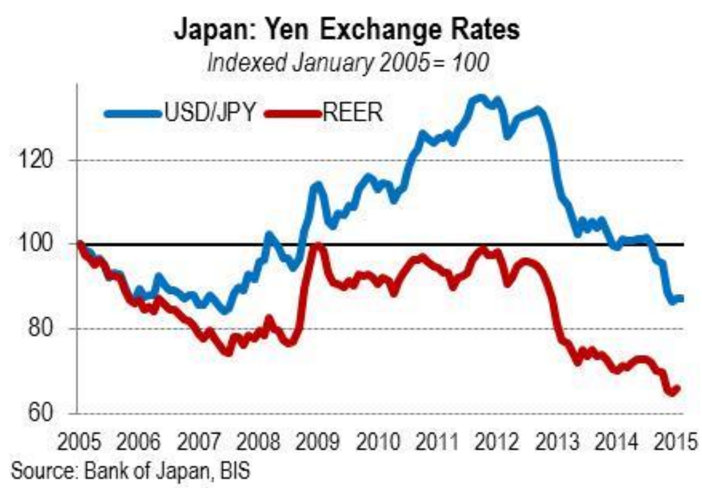
Since taking office in December 2012, Prime Minister Shinzo Abe has led a policy shift to end decades of deflation and restore growth in Japan through his "three arrows" economic program. The first two arrows of monetary and fiscal stimulus were actively deployed at the launch of the program, with the promise of a third arrow of structural reforms to follow. Aggressive monetary policy and initially supportive fiscal policy contributed to a modest recovery from a slump in late-2012. However, growth fell sharply in the second quarter of 2014 after Japan increased the consumption tax from 5 to 8 percent. The fall in private spending after the tax hike was more persistent than the government expected. Domestic demand in the fourth quarter of 2014 was about 1.5 percent below its level in the fourth quarter of 2013.

Doubts remain about the durability of Japan's recovery and the strength of domestic demand. Headline inflation, inclusive of the consumption tax hike, has so far more than offset modest increases in nominal wages, and – absent new government actions to boost demand –fiscal policy will once again be significantly contractionary this year as past stimulus measures roll off. Going forward, the government needs to pursue a balanced macroeconomic policy approach to avoid excessive reliance on exports and support a recovery driven by domestic demand while redoubling efforts to promote meaningful structural reforms necessary to raise long-term growth in Japan.

In order to escape long-standing deflation, the Bank of Japan (BOJ), under Governor Haruhiko Kuroda, has undertaken significant monetary stimulus. Beginning in April 2013, Kuroda committed the BOJ to achieving a 2 percent inflation target within a two-year time frame after unveiling a program of "quantitative and qualitative easing" (QQE) aimed at doubling the monetary base. Core inflation rose to a high of 1.5 percent (excluding the impact of the consumption tax hike) one year after the program's launch. But core inflation began to falter over the latter half of 2014 after the consumption tax hike, prompting the BOJ in late-October to further expand its program of asset purchases and raise the annual growth target of the monetary base from ¥60-70 trillion to ¥80 trillion.[7]

Barring further stimulus, fiscal policy will continue to be contractionary in 2015 even with Prime Minister Abe's decision to delay a second scheduled increase in the consumption tax from October 2015 to October 2017. The Cabinet Office projects the primary deficit of the general government will fall from 5.2 percent of GDP in fiscal year 2014 to 3.3 percent in fiscal year 2015.[8] With net public debt of 140 percent of GDP and gross public debt of 250 percent of GDP, Japan's government needs a credible strategy to control its debt in the medium- to long-term, but a premature emphasis on rapid fiscal consolidation could compromise Japan's recovery and with it the broader reform program. With zero growth in real GDP in 2014, the contractionary effects of fiscal consolidation before recovery has durably taken hold are concerning.

Japan maintains a floating exchange rate regime and has not intervened in foreign exchange markets in over three years. In the G-7 statement of February 2013, Japan joined the other G-7 countries in pledging to base economic policies on domestic objectives using domestic instruments, and to avoid targeting exchange rates. Japan was also part of the subsequent G-20 consensus and statement at the February 2013 Finance Ministers and Central Bank Governors meeting in Moscow that countries would not target exchange rates for competitive purposes. These statements were affirmed by G-20 Leaders in September 2013 at the St. Petersburg Summit. Since the G-7 and G-20 statements, Japanese official have ruled out purchases of foreign assets as a monetary policy tool.



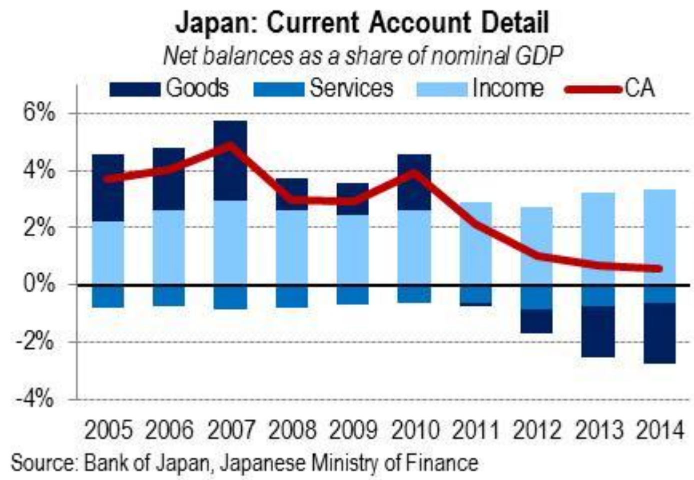
The yen depreciated substantially from late-2012 through 2013 against the U.S. dollar and on a real trade-weighted basis in anticipation of monetary easing and the BOJ's subsequent adoption of QQE. After a brief period of appreciation in early-2014, yen depreciation resumed in August 2014 on the back of divergent economic prospects and policies in the United States and Japan. Following the BOJ's decision to accelerate its program of asset purchases at the end of October 2014, the yen entered another period of sharp depreciation, falling from ¥108 against the dollar in

[7] The measure of core inflation on which the BOJ bases its policy targets excludes fresh food but includes energy.
[8] The Japanese government follows a fiscal year that runs from April through March.

October to ¥119 in December. The yen has since settled around ¥120, bringing the nominal exchange rate of the yen against the dollar to levels last observed in 2007 before the Global Financial Crisis.

In its last Article IV Consultation Report for Japan from July 2014, when the yen was at ¥102, the IMF assessed the yen's real effective exchange rate to be broadly consistent with the economy's medium-term fundamentals, while noting the very large uncertainty about its assessment given the major changes to Japan's economic policies and lags between exchange rate moves and the variables that influence the IMF's assessment. Since then, Japan's trade weighted real exchange rate has depreciated 9 percent.

Japan's nominal goods trade balance moved into deficit in 2011 for the first time since 1980 as exports slowed following production disruptions stemming from the tsunami and imports increased due to higher commodity prices and rising demand for imported fuel and reconstruction materials. After reaching roughly 3 percent of GDP in early 2014, the trade deficit has since narrowed as exports responded to yen depreciation over the course of the second half of the year and Japan's import values have shrunk on the back of the fall in commodity prices.



After recording a deficit in the first half of the year, the current account balance increased in the second half of 2014 on growth in overseas income and a recovery in net exports, showing a surplus of 0.5 percent of GDP for the year as a whole. Japan's bilateral trade surplus with the United States totaled $67.0 billion in 2014, down slightly from $73.4 billion in 2013. The IMF projects that Japan's current account surplus will increase in 2015 as exports continue to rise and import values continue to respond to the fall in commodity prices.

As Japan takes policy steps to bring about a durable recovery and escape deflation, the authorities need to pursue a balanced macroeconomic policy that bolsters growth of domestic demand. Establishing durable domestic demand growth will depend on rises in real wages and growth in business and residential investment, as well as supportive fiscal policy in the near term. Over-reliance on monetary policy and an excessive tightening of fiscal policy will put Japan's recovery and escape from deflation at risk, and could generate negative spillovers. As such, Japan's medium-term deficit reduction targets should be sufficiently flexible to respond to weakness in domestic demand growth.

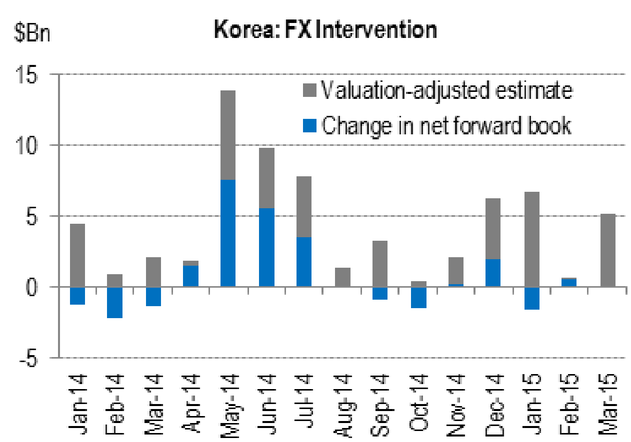
Ambitious structural reforms to increase Japan's growth potential should include measures to raise household income through greater labor force participation, including reducing the tax penalties that limit spousal earnings. They also would include measures to facilitate new domestic opportunities for activity and investment, by opening up domestic sectors – particularly services – to new products and new competition through deregulation, as well as measures to encourage more effective use of land, especially land now classified as agricultural. Since unveiling its revised growth strategy in June 2014, the Abe administration has taken important steps, such as an overhaul of corporate governance and agricultural collectives, but the government's ability to deliver ambitious reforms to other politically sensitive areas remains in question. Agreement on the Trans-Pacific Partnership (TPP) would be an important step to lead to internal reforms such as deregulation in areas including agriculture and medical services that could support growth.

South Korea

Korean annual economic growth has slowed to around 3 percent after averaging close to 5 percent in the initial post-crisis period (2009-2011). Deceleration in investment, which makes up 30 percent of GDP, has been particularly pronounced. Korea's elevated household debt – currently above 150 percent of gross disposable income – and a conservative fiscal stance have weighed on consumer spending and domestic demand.

President Geun-hye Park announced in February 2014 a sweeping economic reform agenda that targets a potential growth rate of 4 percent, an employment rate of 70 percent of the population, and per capita income of $40,000 (compared with approximately $24,000 at present). This plan seeks to reduce Korea's dependence on exports and largely targets the services sector, where productivity growth has lagged the export sector.

Following President Park's cabinet re-shuffle in June 2014, and in response to economic headwinds, the government announced a fiscal stimulus package of 11.7 trillion won ($11 billion), as well as targeted incentives to boost household income, investment, and the growth of the services sector. This fiscal stimulus, combined with two 25 basis point rate cuts by the Bank of Korea in August and October, helped boost domestic demand in the second half of 2014. Growth picked up markedly during the third quarter of 2014, but stalled in the fourth quarter as public sector construction slowed and private consumption softened. For 2014 as a whole, domestic demand contributed 2.2 percentage points and net exports 1.1 percentage points to overall GDP growth of 3.3 percent. The government also announced, in September 2014, that it will further increase 2015 budget expenditures by 5.7 percent (year-on-year) to support domestic demand. The fiscal deficit is projected to widen from 1.7 percent of GDP in 2014 to 2.1 percent in 2015. On March 12, 2015, the Bank of Korea announced a further 25 basis point reduction in the policy rate.



Source: Bank of Korea, FRB, U.S. Treasury estimates.
Forward data for March not yet available.

South Korea officially maintains a market-determined exchange rate, and its authorities intervene with the stated objective of smoothing won volatility. In February 2013, Korea joined the rest of the G-20 in committing to refrain from competitive devaluation and to not target its exchange rate for competitive purposes. The Korean authorities have intervened on both sides of the market, but the sustained rise in their reserves and net forward position indicates that they have intervened on net to resist won appreciation. Unlike many other major emerging markets and industrialized economies, Korea does not publicly report foreign exchange market intervention. However, market participants derive estimated intervention from Korea's balance of payments data and changes in Korea's published foreign exchange reserves and forward positions.

Valuation-adjusted estimates of foreign exchange purchases indicate substantial net purchases of foreign exchange to limit won appreciation since May 2014.[9] The summer of 2014 saw heavy intervention, followed by a relative lull from August through November. Intervention appears to have accelerated in December and January, a time of appreciation pressure on the won.

Market participants believe that Korea typically intervenes when there is pressure in the market for the won to appreciate. In the second quarter of 2014, the won appreciated to close to 1000 to the dollar; it is widely believed that, in response, Korea intervened to prevent appreciation through 1000. In the first quarter of 2015, the won has not strengthened through 1075 against the dollar.

Korean official comments on November 7, 2014 noting the intention to manage the won against the Japanese yen helped drive the won weaker, and since late November the won has traded in a tight 9.1 to 9.4 band against the yen. The Ministry of Strategy and Finance later issued a press release clarifying that Korea intended to strengthen "monitoring efforts" in response to exchange rate movements of "major currencies". Since June 2014 through February 2015, the won depreciated 9 percent against the dollar and was unchanged in real effective terms. The real exchange rate remains well below its pre-global financial crisis level.

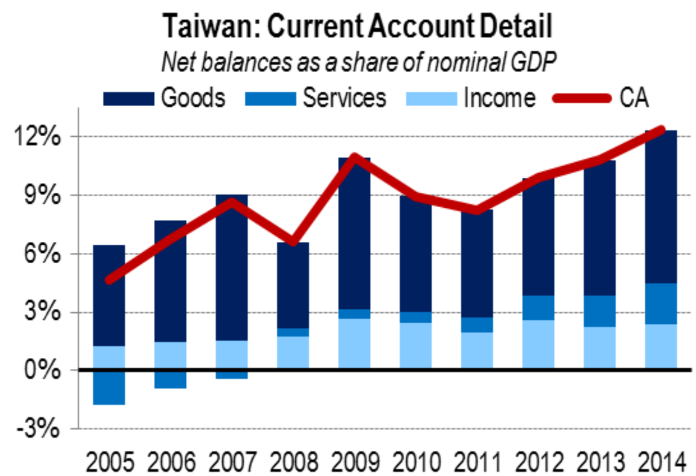
Korea's intervention has taken place in the context of a large current account surplus. Korea's bilateral trade surplus in goods with the United States totaled $14 billion in the second half of 2014, larger than the $9.6 billion surplus from the same period the year before.

[9] Korean intervention can manifest itself either as a rise in headline reserves or as a rise in the central bank's forward position. (A long forward position indicates a future inflow of foreign exchange reserves, and consists of the long position in forwards and futures in foreign currencies, including the forward leg of currency swaps.)

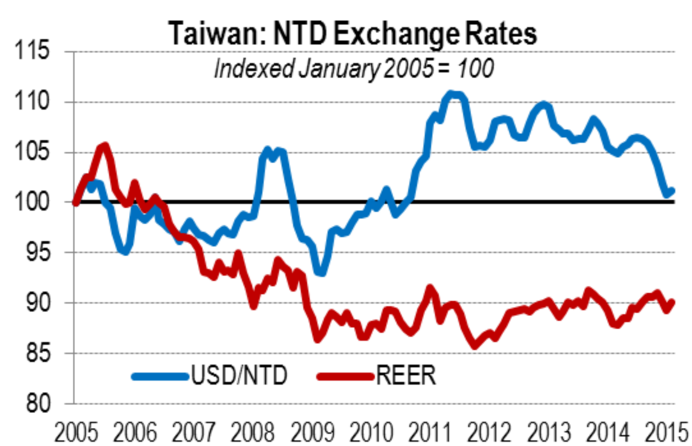
In July 2014, the IMF's External Sector Report assessed that the Korean won remains undervalued. Going forward, though planned fiscal stimulus and broader economic rebalancing efforts should continue to help support domestic demand, the authorities need to refrain from intervening in the foreign exchange market and allow the exchange rate to adjust, especially given expected benefits from a terms of trade improvement due to the decline in oil prices. Given Korea's sizeable current account surplus, substantial reserves, and undervalued currency, we have made clear that Korea should reduce foreign exchange intervention, limiting it only to the exceptional circumstance of disorderly market conditions, and allow the won to appreciate further. Appreciation would help with rebalancing and encourage reallocation of production resources to the non-tradables sector. Importantly, the Korean authorities should increase transparency of foreign exchange operations, and ensure that macroprudential measures, to the extent needed, focus on reducing financial sector risks – in design, timing, and description – rather than alleviating upward pressure on the exchange rate.

Taiwan

Net exports and moderately stronger domestic consumption supported GDP growth in Taiwan of 3.7 percent in 2014, up from 2.2 percent in 2013. Consumer prices rose by 1.4 percent in 2014, although lower global oil prices led to moderate deflation in the first two months of 2015. Taiwan faces low real wage growth while investment's share of economic activity has remained stagnant despite low borrowing rates. While the fiscal deficit of the central authorities is a modest 1.3 percent of GDP, fiscal expansion is constrained as Taiwan's public debt approaches a legislatively mandated limit of 40.6 percent of GDP on central borrowing. This underscores the need for implementation of growth-enhancing structural reforms, as well as moving towards a more fully market-determined exchange rate, to support more balanced growth.



Source: Central Bank of the Republic of China



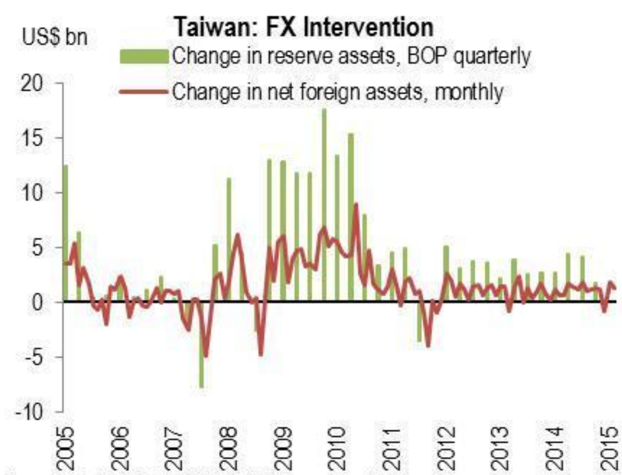
Source: Central Bank of the Republic of China, BIS

Taiwan has a large and rising current account surplus, which reached 12.4 percent of GDP in 2014, up from 10.7 percent in 2013. Taiwan's goods and services trade surplus totaled $52.7 billion in 2014, up 20 percent from 2013, and the income surplus increased to $15.5 billion, up from $14.2 billion a year earlier. Alongside the growing current account surplus, domestic demand also improved moderately in 2014, particularly in the third quarter of 2014, due to strong investment.

Taiwan maintains a managed floating exchange rate regime, and the central bank states that the New Taiwan Dollar (NTD) exchange rate is determined by the market, except when the market is disrupted by seasonal or irregular factors. The NTD depreciated 5.7 percent against the dollar in 2014, with most of the depreciation occurring in the fourth quarter, and appreciated 1.2 percent in the first three months of 2015. The real effective exchange rate as calculated by the Bank for International Settlements (BIS) appreciated 0.1 percent in 2014. Taiwan's foreign exchange reserves grew by $2.2 billion to $419 billion in 2014, and stood at $415 billion as of end-March 2015. Taiwan's foreign exchange reserves are well in excess of adequate levels by any metric. They are equivalent to 79 percent of GDP, 19 months of imports, and 2.6 times the economy's short-term external debt.

Despite its large current account surplus, Taiwan's foreign reserve accumulation has been limited by significant capital outflows, in large part prompted by policy changes. Since a change in leadership in mid-2013, Taiwan's Financial Supervisory Commission has been actively encouraging overseas expansion of Taiwan's banking and insurance sectors. In early 2015, Taiwan's legislature approved amendments making it easier for banks and insurance companies to invest in and acquire assets abroad. Taiwan residents (including banks and insurance companies) increased their overseas assets by $84 billion in 2014, compared to an overall financial account deficit of $53 billion.

Although not a member of the IMF, Taiwan uses the IMF's Special Data Dissemination Standard (SDDS) framework to provide data on many aspects of its economy, including the real, fiscal, financial, and many external sector accounts. However, Taiwan does not publish data on international reserves that conform to the SDDS reserves template. Now that mainland China has announced it will subscribe to the SDDS, Taiwan will soon be the only major emerging market economy in Asia not to report reserves data based on the SDDS template.



Source: Taiwan Central Bank, US Treasury estimates

Taiwan also does not disclose its foreign exchange market intervention. Looking at publicly available statistics, Taiwan appears to intervene on both sides of the market but, on net, much more to resist appreciation. Intervention appears to be in excess of what would be expected if the central bank were adhering to its mandate of only intervening when the market is disrupted by seasonal or irregular factors, although the authorities appear to be intervening less since the post-crisis period. The change in foreign assets on the central bank's reporting of Factors Responsible for Changes in Reserve Money (which excludes valuation changes resulting from foreign exchange fluctuations) was positive throughout 2014 apart from December, signaling the purchase of foreign exchange to weaken the NTD. Analysts have estimated that average monthly intervention in 2014 was approximately $1 billion.

The IMF does not release an assessment of the valuation of Taiwan's currency. However, the Peterson Institute for International Economics (PIIE) estimated in November, 2014 that Taiwan's real effective exchange rate would need to appreciate by 14 percent to reach its fundamental equilibrium level[10].

Policies to stimulate consumption and investment, including moving towards a more fully market-determined exchange rate, further liberalizing the services sector, and removing trade and investment barriers, would help rebalance the Taiwanese economy. Given Taiwan's sizeable current account surplus, substantial reserves, and undervalued currency, the authorities should move towards a more fully market-determined exchange rate, limit foreign exchange interventions to the exceptional circumstances of disorderly market conditions, and allow the NTD to appreciate, as well as increase the transparency of reserve holdings and foreign exchange market intervention.

Europe

Euro Area

The euro, which is a freely floating currency, depreciated sharply against the dollar in the second half of 2014, by 13.2 percent, and it continued its rapid pace of depreciation in the first quarter of 2015, falling another 10 percent to its lowest level against the dollar in 11 years. On a real trade-weighted basis the euro has depreciated by a smaller amount because many other currencies also have declined against the dollar. Real depreciation totaled 3 percent in the second half of 2014, and by a further 6.8 percent in 2015 through February. Cyclically divergent economic prospects and the euro area's reliance primarily on monetary policy to stimulate growth are major factors in the euro's sizable depreciation.

The euro area's recovery has lagged substantially that of other developed countries, in part because euro area policymakers have not used all available policy tools to support demand growth. There are some tentative signs of economic improvement in recent months influenced by lower oil prices and support from the European Central Bank's (ECB) policies. But the durability of any gains remains in question. Euro area GDP grew by 0.3 percent quarter-on-quarter in the fourth quarter of 2014, up from 0.2 percent in the third quarter. In year-on-year terms, output expanded by 0.9 percent in the fourth quarter, up from 0.8 percent in the third quarter. Credit conditions have modestly improved, with household and corporate borrowing rates falling slightly and the decline in private sector credit growth easing.

The fourth quarter expenditure breakdown revealed that growth depended importantly on external demand, though private consumption did pick up. Net exports of goods and services contributed 0.2 percentage points, year-on-year, to growth, the same level as in the third quarter. Within domestic demand, private consumption contributed (0.8 percentage points year-on-year), supported by lower oil prices and a modest improvement in labor market conditions. Investment

[10] The PIIE's semiannual fundamental equilibrium exchange rate (FEER) calculations examine "the extent to which exchange rates need to change in order to curb any prospectively excessive current account imbalances back to limits of ±3 percent of GDP."

growth, on the other hand, continued to be a net drag on the economy (-0.3 percentage points year-on-year), slightly worse than in the third quarter (-0.2 percentage points year-on-year).

Even with a moderate pickup in private consumption, euro area growth remains unbalanced and considerable headwinds to recovery remain. Domestic demand is still nearly 5 percent below its pre-crisis peak, and unemployment remains high at 11.2 percent. While the pace of fiscal consolidation has slowed, the region's fiscal stance remains only neutral, and bank deleveraging, low real wage growth, and weak investment continue to weigh on economic activity. Inflation continued to fall in the second half of 2014, and by December was in negative territory (-0.2 percent), with negative year-on-year changes in the consumer price index continuing through March. Although the fall in commodity prices has been a large factor in the decline of headline inflation, core inflation has declined as well, which is reflective of the weak demand environment.

The ECB has taken significant steps to support growth and combat the disinflationary pressures. In January 2015 it announced a large quantitative easing program (the Public Sector Purchasing Program or PSPP). However, reliance on a single lever of policy raises concerns, especially as lower oil prices and a much weaker currency will feed increased net exports on top of an already large external surplus of over $300 billion (2.3 percent of GDP). The lower price of oil alone could boost the euro area's current account surplus by over $100 billion (see Annex 1). In this respect, and especially given its status as a surplus region, the euro area should not be absorbing even more demand from the rest of the world. Accordingly, euro area economies need to take stronger actions, using a balanced set of tools (including fiscal and structural), to provide support to domestic demand. Such a policy mix would help ensure a balanced composition of GDP growth, and would avoid the risk that growth becomes excessively reliant on the external sector. It remains vital that the euro area contribute to global demand by taking all necessary steps to build its own domestic demand momentum.

More balanced growth would also support the internal rebalancing that is still needed between the core and periphery countries. Current account deficits in Italy, Spain, and the smaller economies in the periphery have turned into small surpluses. However, there has not been a corresponding reduction in the surplus of the euro area's large surplus countries. The Netherlands and Germany have continued to run very large current account surpluses since 2011, with Germany's surplus growing to an unprecedented 7.8 percent of GDP in 2014 ($300 billion), with low oil prices pushing this higher.

Key to the adjustment process is achieving stronger domestic demand growth. Reducing stubbornly high unemployment will not be possible otherwise, and achieving sustainable public finance will be more difficult as well in the absence of more robust growth. Stronger demand growth in Germany is absolutely essential, as it has been persistently weak. Germany's relatively low unemployment and recovery to pre-crisis output has relied heavily on increased exports outside the euro area. Domestic demand in Germany was only 1.3 percent stronger in 2014 than in 2013, while overall euro area domestic demand was only 0.8 percent stronger. Investment growth has been particularly weak. There are some signs that demand in Germany may be picking up, but much will depend on the evolution of wage growth, household consumption, and investment over the next several quarters.

A key priority for the euro area moving forward is to build on the modest pickup in economic momentum and accelerate the recovery. While the PSPP program is an important part of the policy mix to increase inflation and output, a balanced approach that includes more determined deployment of fiscal resources where space exists, continued flexibility toward fiscal targets, and demand-enhancing structural reforms will be important as well. And, if inflation remains very low and growth prospects weak, additional policy support for demand will be needed. Finally, deepening euro area financial, economic, and fiscal integration – more centralized risk sharing, greater resource pooling, enhanced cost sharing – would support the ongoing adjustment and make the euro area more resilient to future shocks.

Switzerland

On January 15, 2015, the Swiss National Bank (SNB) abandoned its minimum exchange rate ("floor") of 1.20 Swiss franc per euro and returned to a managed float exchange rate regime. The floor had been in effect since September 2011, following significant franc appreciation against the euro. The SNB cited the divergence in advanced economy monetary policies – which it expects to persist – and the impact on foreign exchange markets as the reason behind eliminating the floor. The floor was an important factor in reducing the degree of deflation during a period of severe stress, but was always meant to be temporary.

The removal of the floor led to an 18 percent appreciation of franc against the euro in the first week, but the franc has subsequently depreciated about 7 percent and has remained relatively stable since. After the removal of the floor, the franc initially appreciated 16 percent against the dollar, but has subsequently retraced much of this appreciation and is now at roughly the same level as prior to the removal of the floor. More broadly, the real effective exchange rate depreciated 0.7 percent in second half of 2014, but since the removal of the floor has appreciated by 9.3 percent (through February).

Consumer prices had been roughly flat over the last two years, but since November 2014 turned down, driven by a sharp decrease in prices of imported goods. At end-February 2015, consumer prices had decreased 0.8 percent on a year-on-year basis, while core prices are flat on year-on-year basis. The SNB expects consumer price deflation of 1.1 percent and 0.5 percent, respectively, in 2015 and 2016, and inflation of 0.4 percent in 2017. The decrease in prices of imported goods has been driven by the decline in global commodity prices as well as the recent appreciation of the franc. To achieve its inflation objectives subsequent to the removal of the exchange rate floor, the SNB lowered its target Libor rate to between -1.25 percent and -0.25 percent and the interest rate on sight deposits (beyond an exemption threshold) to -0.75 percent The SNB also stated that "if necessary… [it will] remain active in the foreign exchange market to influence monetary conditions."[11]

In December 2014 and early January 2015, prior to removal of the floor, the SNB purchased foreign assets[12] to defend the floor, resulting in an increase in SNB's foreign currency reserves

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[12] SNB intervention has been against the euro.

from $480 billion in November to $537 billion (77 percent of GDP) in January. During the second half of 2014, reserves declined $6.6 billion in U.S. dollar terms due to valuation effects (the euro denominated portion of reserves fell in U.S. dollar terms due to euro depreciation).

The Swiss real economy grew 2 percent in 2014, up slightly from 1.9 percent in 2013. Both domestic demand and real net exports contributed positively to growth. The SNB forecasts 2015 economic growth at "just under 1 percent," largely due to the contractionary impact of the appreciated franc. This impact is expected during the first half of 2015 and the SNB also anticipates a rise in the unemployment rate from 3.2 percent in February. Given the slack in the economy, ongoing deflation, the limits on monetary policy, and a healthy fiscal position, Swiss authorities should take full advantage of any room allowed under their fiscal rules.

The current account surplus declined from 10.7 percent of GDP in 2013 to 7.0 percent in 2014, largely due to a decrease in net investment income. While the overall current account balance narrowed, the goods and services trade surplus remained at its 2013 level of 10.9 percent of GDP in 2014. The U.S. trade deficit with Switzerland increased during the second half of 2014 compared to the first half (from $1.8 billion to $2.4 billion) and also compared to the second half of 2013.

United Kingdom

The UK economy grew by 2.8 percent in 2014, taking total output above its pre-crisis peak after six years, and is expected to expand by 2.7 percent in 2015. Household consumption and investment made strong positive contributions to growth, while the growing trade deficit acted as a modest drag. Consumption and investment were both buoyed by a rebound in business and consumer confidence, as well as recovering credit conditions, which helped to unlock private demand that had been pent-up in the wake of the global financial crisis.

The unemployment rate stood at 5.7 percent in January, down from 7.2 percent at the end of 2013. Real wage and productivity growth remained subdued, however, and the outlook for these two key indicators is uncertain. Headline inflation fell to 0.0 percent in February, while underlying inflation (which strips out food and energy prices) stood at 1.2 percent. The low inflation trend has limited upward pressures on wages, suggesting that there may still be some slack in the economy. Finally, the high level of uncertainty surrounding the outcome of the general election on May 7, 2015, the potential for difficult coalition talks, and subsequently the design and implementation of economic policy is broadly perceived as a material downside risk for businesses and investors.

The fiscal deficit continues to narrow. The UK Office of Budget Responsibility (OBR) reported in December that net public sector borrowing had fallen to 5.0 percent of GDP in fiscal year (FY) 2014-15, down from a post-crisis peak of 10.2 percent in FY 2009.[13] According to OBR projections, the deficit is expected to fall further over the next several years before reaching a surplus in 2018. The OBR also estimates that the net stock of public debt peaked at 80.4 percent of GDP in FY 2014-15, and will gradually fall to 71.6 percent by FY 2019-20.

[13] The UK fiscal year runs from April to March.

UK monetary policy remains accommodative. The Bank of England (BOE) has maintained its policy rate at 0.5 percent since 2009 and its quantitative easing program at £375 billion since 2011. BOE officials had suggested last year that they might raise interest rates, though the recent downtrend in prices has pushed back expectations for policy normalization. Market-implied measures and analysts forecasts now indicate that the first BOE rate hike will likely not take place until late 2015 or early 2016.

The UK has a freely floating exchange rate. The pound depreciated by 11.5 percent against the U.S. dollar on a nominal basis between end-June 2014 and end-March 2015. However, on a real effective basis, it appreciated by 3.7 percent in 2014, and by an additional 3.0 percentage points in the first two months of this year. Further, the pound appreciated by around 10 percent on a nominal trade-weighted basis last year, which constitutes a downside risk to inflation outlook. The reasons behind the appreciation of the pound include stronger growth prospects and market expectations of upcoming monetary policy normalization.

The current account deficit widened to 5.6 percent of GDP during the fourth quarter of 2014 from 4.5 percent at the end of 2013. The 2014 deficit is the largest deficit since 1989, reflecting a widening of the income deficit. The goods and services trade deficit remained more modest at 1.8 percent of GDP in 2014, down slightly from 2.0 percent of GDP in 2013. The increase in the income deficit was driven by a reduction in income from FDI abroad as well as an increase in income paid abroad on portfolio and direct investment liabilities. Recent weakness in euro area growth and depreciation of the euro could further widen the UK current account deficit.

Western Hemisphere

<u>Brazil</u>

Brazil's economy has slowed markedly, and real GDP growth was 0.2 percent year-on-year in 2014. The Brazilian Central Bank's (BCB) March, 2015 survey of private economists anticipates recession in 2015, with the economy forecast to contract by 0.7 percent this year. Inflation for 2014 finished the year at 6.4 percent, close to the upper bound of the BCB's target band of 4.5 percent ± 2 percent, and the market consensus in the BCB's March survey was for inflation to increase to 7.9 percent for 2015. The BCB has responded to inflationary pressures by hiking interest rates to 12.75 percent as of March 2015 – a 550 basis point increase since it began tightening in April 2013 – and has reiterated that it will take further action as needed to bring inflation down to target by the end of 2016.

Brazil maintains a floating exchange rate regime, although the authorities have taken measures in recent years to manage the volatility of Brazil's currency, the *real*. In August 2013, in response to sharp depreciation, the BCB announced a formal intervention program, with a stated objective of providing hedging and liquidity to the foreign exchange market. Since that time, the BCB has renewed the program three times, while gradually reducing the size.

The BCB announced that it will allow the swaps program to expire at the end of March 2015, but will roll over current swaps that expire on May 1. As of mid-March, due to the swaps program, the BCB had an accumulated net short U.S. dollar position in the foreign exchange futures market of $114 billion. The BCB also had an approximately $10 billion in outstanding U.S. dollar repurchase contracts, and indicated that it would continue to offer spot sales through repurchase contracts on a discretionary basis as needed to provide liquidity. Brazil's headline foreign exchange reserves totaled $354 billion as of end-February 2015, equivalent to 13 months of import cover, and 635 percent of short term debt.

The *real* has again moved weaker since mid-2014, with depreciation accelerating sharply in the first quarter of 2015. Since June 2014, the *real* has depreciated 31.4 percent against the dollar through mid-March and 9.9 percent in inflation adjusted, trade weighted terms through February (latest data). However, the most recent estimates of *real* valuation have found that the *real* remained overvalued in 2014, so subsequent depreciation may be moving its value more in line with fundamentals[14].

Brazil's current account deficit has steadily widened from near balance in 2007 to an estimated deficit of about 4 percent of GDP in 2014. A weakening of Brazil's terms of trade (reflecting commodity price declines), a widening fiscal deficit, and relatively weak exports of manufactured goods have all contributed to the persistence of the current account deficit. Net foreign direct investment (FDI) has financed about three fourths of the current account deficit in recent years.

Canada

Canada maintains a flexible exchange rate and employs an inflation-targeting monetary policy regime. Headline inflation increased modestly over the course of 2014, reaching 2.4 percent year-over year in October, but fell along with oil prices to 1 percent year-over-year in early 2015, at the bottom of the Bank of Canada's target band of 2 percent ± 1 percent. The Bank of Canada revised in January its forecast for 2015 inflation from 1.6 percent to 0.6 percent because of the lower oil prices but it still expects inflation to bounce back to nearly 2 percent by 2016.

In nominal terms, the Canadian dollar depreciated by 13 percent year-over-year against the U.S. dollar as of end-February. On a real effective basis, the Canadian dollar depreciated 5.6 percent year-over-year through January. Canada's current account deficit was 2.2 percent of GDP in 2014, and the IMF forecasts it will widen to 2.6 percent of GDP in 2015 due to falling terms of trade and a decline in the value of oil exports. Canada had foreign exchange reserves (consisting of U.S. dollar, pound sterling, euro-, and yen- denominated assets) of $63.3 billion as of end-January 2015, 6.7 percent higher year-on-year, representing about 3.5 percent of GDP and 1.5 months of imports.

After third quarter 2014 growth of 3.2 percent quarter-on-quarter (seasonally adjusted, annualized), growth in the fourth quarter decelerated to 2.4 percent quarter-on-quarter, as falling oil prices drove investment and exports lower. Full-year growth for 2014 was 2.5 percent, slightly higher than the 2 percent growth realized in 2013. However, the sharp drop in the price of oil will weigh on Canadian economic activity in 2015, particularly through negative effects on investment. The IMF expects full-year growth to moderate slightly to 2.3 percent in 2015, as

[14] Peterson Institute, November 2014 and IMF, July 2014.

increased non-oil sector investment and lower imports are expected to only partially offset the effects of reduced energy investment and falling terms of trade. The Bank of Canada has called falling oil prices "unambiguously negative" and cut its policy rate by 0.25 percentage points to 0.75 percent in January. The government's ongoing fiscal consolidation effort has been largely successful but, in the context of slowing growth and elevated downside risks, it may become appropriate to adjust fiscal policy at the federal level to provide near-term support to the economy.

Going forward, the Bank of Canada expects the economy to adjust, as lower gasoline prices help to drive consumer spending and manufacturing activity higher, and exports to pick up based on stronger U.S. demand and a weaker Canadian dollar.

Mexico

Growth decelerated in the third quarter of 2014, but picked up slightly in the fourth quarter to 2.7 percent quarter-on-quarter (annualized), supported by Mexico's manufacturing and service sectors, resulting in full year 2014 growth of 2.1 percent. Lower oil prices will act as a constraint on growth this year, including through the government's decision to respond to reduced oil revenue by cutting its 2015 budget by 0.7 percent of GDP. However, the IMF expects overall that growth will increase to 3.2 percent in 2015, as the impact of the stronger U.S. expansion on Mexican manufacturing and exports will outweigh the negative oil price effects. The current account deficit was 2.1 percent of GDP in 2014, and is forecast to narrow slightly to 2 percent of GDP in 2015.

Mexico pursues an inflation-targeting monetary policy regime and maintains a flexible exchange rate, while employing some currency market intervention during periods of sharp volatility (as described below). Inflation was around 4 percent year-on-year for much of 2014, at the top of the central bank's inflation target band of 3 percent +/- 1 percent, due mostly to a tax increase that took effect at the beginning of the year. Inflation decreased to 3.0 percent year-on-year in February 2015. In nominal terms, the Mexican peso depreciated by 14 percent against the U.S. dollar in the year ended in March. On a real effective basis, the Mexican peso depreciated by 4.6 percent year-on-year through February.

In response to the peso's sharp depreciation over the fourth quarter of 2014, the Foreign Exchange Commission (FEC), which consists of officials from the Ministry of Finance and the Bank of Mexico and is responsible for foreign exchange policy, in early December 2014 announced a rules-based program of foreign exchange intervention, with the stated aim to provide liquidity and dampen volatility in the foreign exchange market. The authorities suspended a prior system of daily dollar auctions to manage peso volatility in April 2013. In the new program, the Bank of Mexico initially offered up to $200 million every day at a peso price 1.5 percent weaker than the previous day's reference rate (meaning in effect, that the offer would only be used in a day where the peso depreciated more than 1.5 percent against the dollar). As of mid-March, the mechanism had been activated only twice, auctioning $200 million in each instance. However, as the peso continued to depreciate relatively rapidly, in mid-March 2015, the FEC expanded the program, offering an additional $52 million daily without a minimum price. The FEC indicated that this program will run through June 8, 2015, at which point it will assess whether to continue the program. The Bank of Mexico has not ruled out taking further measures in the event that the peso market becomes disorderly.

Mexico has a comfortable level of foreign exchange reserves at $188.6 billion as of end-January 2015, 10.2 percent higher year-on-year, representing about 14 percent of GDP and 5 months of import cover. Mexico's reserves continue to be backed by the availability of an additional $72 billion from a two-year Flexible Credit Line (FCL) with the IMF, which was last renewed in November 2014. As of March 2015, Mexico has never drawn on this line.

Annex I: Lower Oil Prices and Global Imbalances[15]

Oil prices have fallen sharply over the past 8 years to as low as $45 per barrel in January. Lower priced oil will generate a large and meaningful shift in the dollar value of global transfers related to oil. Figure 1 illustrates the potential transfers assuming an average price of oil in 2015 of $60 per barrel and constant demand, relative to a baseline of $99 per barrel used in the IMF's October 2014 WEO. This exercise also assumes that net imports remain constant at 2014 levels.

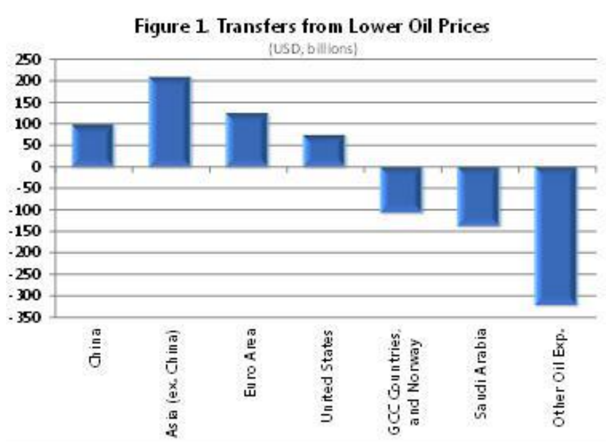

Figure 1. Transfers from Lower Oil Prices

Impact on Oil Exporters:

- Saudi Arabia would experience the largest loss of income, with oil earnings dropping roughly $140 billion.

- Russia would also be hard hit, with losses of about $105 billion.

- GCC (Gulf Cooperation Council) countries, outside Saudi Arabia, would see their collective earnings decline roughly $105 billion.

- Norway's oil revenue would fall nearly $20 billion.

- Several other large oil exporting countries also would face significant reductions in income. Iraq's oil earnings would drop by nearly $40 billion, Nigeria's by around $30 billion, Angola's by about $25 billion, and Venezuela's by roughly $25 billion.

Key Beneficiaries of Lower Oil Prices:

- Asia would see the greatest benefit from lower oil prices, gaining nearly $310 billion.
  - China's savings from lower oil prices would be roughly $100 billion – making it the country with the largest dollar gain from lower oil prices.
  - Japan ($65 billion), India ($40 billion), and Korea ($35 billion) would also see sizeable import savings from lower oil prices.

- Euro Area economies would experience a substantial boon from lower oil prices as well, with a reduction in oil spending of around $130 billion.
  - Germany's oil expenditure would fall by roughly $30 billion, France by $25 billion, and Spain by $15 billion.

[15] Prepared by Jeremy Zook.

- Despite declining oil imports over the past several years, the United States would still see a net benefit from lower prices.
  - U.S. spending on oil imports would be reduced by roughly $75 billion in 2015.

<u>Impact on Global Imbalances:</u>

Current account balances would be significantly affected as well, but probably by a lesser amount than the transfers noted previously.

Oil exporters would receive notably less in oil revenues, and after some period of time, after likely drawing down their sizable reserves to support spending, they would need to adjust their spending and thus imports downward. All told, their external surpluses would shrink.

Conversely, oil importing countries would pay out much less for imported oil and thus their external positions would rise; in some instances such as China, Japan, Germany, and Korea the increases would be sizable. In the United States, the impact would be a sizable reduction in the current account deficit. In time, were the lower prices to persist, some of the associated income gains would be spent and thus result in larger imports of non-oil goods.

Figure 2. Global Current Account Balances - Baseline vs. Oil Adjusted
(USD, billions)

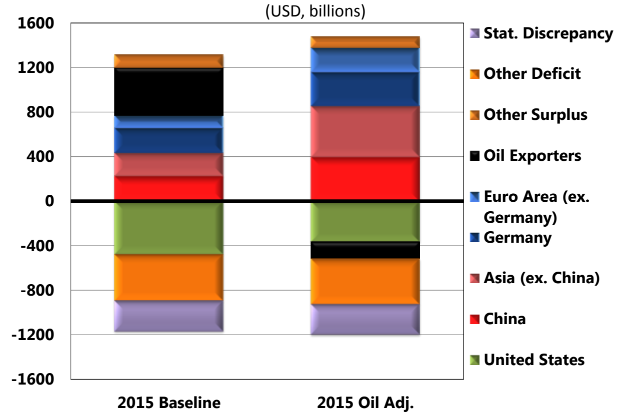

Figure 2 provides an indication of the impact of lower oil prices on global imbalances making the somewhat implausible assumption that the transfers in their entirety pass through directly to current account balances. The baseline for this exercise is the IMF's WEO projections from October 2014, which were based on an assumption of $99 per barrel oil. Under the baseline, oil producers were expected to have a large aggregate surplus, but oil at $60 would extinguish this surplus. Some of the biggest beneficiaries of lower oil prices, Asia and Europe, already maintain aggregate surpluses and would see these surpluses grow larger relative to the baseline. Under this static assumption, the United States would see its deficit reduced.

Glossary of Key Terms in the Report

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

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

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

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

Managed Float – A regime under which an economy 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 an economy's relative to a set of other currencies. The effective exchange rate is an index calculated as a weighted average of bilateral exchange rates. The weight given to each economy's currency in the index typically reflects the amount of trade with that economy.

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

Real Effective Exchange Rate (REER) – 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.