

# **Report to Congress on International Economic and Exchange Rate Policies**

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

November 27, 2012

This Report reviews developments in international economic and exchange rate policies and is submitted pursuant to the Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C. § 5305 (the “Act”).<sup>1</sup>

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

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## Key Findings

The Omnibus Trade and Competitiveness Act of 1988 (the "Act") requires the Secretary of the Treasury to provide semiannual reports on the international economic and exchange rate policies of the major trading partners of the United States. Under Section 3004 of the Act, the Report must consider "whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade." This Report covers developments in the first half of 2012, and where pertinent and available, data through early November 2012.

U.S. real GDP has grown at a 1.7 percent annual pace through the first three quarters of 2012. The economy continues to face a number of headwinds, including an uptick in oil prices; a summer drought; and the ongoing crisis in Europe, which among other things has slowed growth of global trade. Ongoing fiscal contraction at all levels of government has weighed on the pace of growth as well. Private final domestic demand has increased more rapidly, however, at an annual rate of 2.0 percent in 2012, with consumer spending remaining steady and residential investment starting to pick up. Since February 2010, 5.0 million new jobs have been created in the private sector. Boosting growth, creating jobs, and putting public finances on a sustainable path are priorities of the Administration. The Administration is aiming to cut the deficit to less than 3 percent of GDP by FY2018, and put the debt-to-GDP ratio on a declining path.

Global economic growth weakened further during the spring and summer of 2012, as several economies in Europe slipped into recession and growth slowed sharply in some emerging market economies. The IMF's latest outlook projects global growth to decelerate to 3.3 percent in 2012, down from 3.8 percent in 2011 and 5.1 percent in 2010. The main downside risk remains the situation in the euro area. The European Central Bank's Outright Monetary Transactions announcement in September, the launch of the European Stabilization Mechanism, and steps toward banking union have helped to reduce financial stress in the euro area, but important challenges remain.

Some progress has been made to reduce global imbalances. Nominal external imbalances have not returned to their pre-crisis highs. The United States and other external deficit economies have increased saving, and many emerging market economies with external surpluses have taken steps to increase domestic demand. Cyclical factors, however, such as weak growth, continue to play a key role in compressing imbalances.

This report reviews the exchange rate policies of nine economies accounting for 70 percent of U.S. foreign trade. All of the major advanced economies have fully flexible exchange rates. Switzerland is the only advanced economy to have a managed exchange rate. In September 2011, the Swiss National Bank placed a ceiling on the euro/Swiss franc exchange rate following surging safe-haven capital inflows resulting from the euro area crisis and deflationary pressures. The openness of the Swiss economy and the small size of its financial markets limited the effectiveness of monetary policy measures in the face of massive capital inflows, contributing to the change in exchange rate policy.

Among major emerging market economies, several have managed exchange rates, with varying degrees of management. This Report highlights the need for greater exchange rate flexibility in these economies and most notably in China. It also emphasizes the need for greater transparency and more timely disclosure of official actions in the foreign exchange market.

From June 2010, when China moved the renminbi (RMB) off its peg against the dollar, through early November 2012, the RMB has appreciated by 9.3 percent against the dollar and 12.6 percent on a real, inflation-adjusted basis. China's trade and current account surpluses both have fallen to 2.6 percent of GDP from a peak of 8.8 and 10.1 percent of GDP, respectively. Because of these changes, estimates of the remaining degree of undervaluation have narrowed over the past two and a half years.

In April 2012, The People's Bank of China announced a widening of the RMB daily trading band against the dollar. At the May 2012, Fourth U.S.-China Strategic and Economic Dialogue meeting the Chinese authorities committed to steadily promote the market-based reform of interest rates to enhance their role in optimizing resource allocation and monetary policy transmission, and committed to expand the Qualified Foreign Institutional Investor quota to \$80 billion. Chinese authorities also implemented changes in June and July 2012 to give banks greater flexibility over deposit and lending rates.

Reserve accumulation, an indicator of the degree of Chinese intervention in the currency market, has slowed markedly since the third quarter 2011. Reserve growth averaged \$18.7 billion per quarter in the four quarters ending September 30, 2012, compared to an average \$140 billion per quarter during the four preceding quarters. This decline reflects a combination of decreased capital flows to emerging markets, including to China, sparked by increased risk aversion and the euro-area crisis, China's own slowdown and the decline in China's trade and current account surpluses.

Despite these encouraging developments, the process of adjustment remains incomplete, and more progress is needed. China's exceedingly high foreign exchange reserves, the persistence of trade and current account surpluses, despite China's favorable cyclical position compared to advanced economies operating well below potential output, and the limited degree of appreciation of the RMB relative to the rapid productivity gains in the traded goods sector, suggest that the real exchange rate of the RMB remains significantly undervalued, and further appreciation of the RMB against the dollar and other major currencies is warranted. Chinese authorities acknowledge the need for continued exchange rate reform, and have reaffirmed their commitment to move more rapidly toward a market-determined exchange rate at the G-20 Leaders' Summit in Los Cabos, Mexico, in June 2012; and at the G-20 Finance Ministers/Central Bank Governors Meeting in Mexico City in November 2012.

Based on the analysis in this report, Treasury has concluded that no major trading partner of the United States met the standards identified in Section 3004 of the Act during the period covered in the Report. Treasury will continue to closely monitor exchange rate developments in all the countries covered in this report, with particular attention to the pace of RMB appreciation, and press for policy changes that yield greater exchange rate flexibility, improve transparency, level the playing field, and support a strong, sustainable, and balanced global economy.

## **Introduction**

This Report focuses on international economic and foreign exchange developments in the first half of 2012. Where pertinent and when available, data and developments through early November 2012 are included.

Exports and imports of goods to and from the nine economies analyzed in this Report accounted for 70 percent of U.S. merchandise trade in the first nine months of 2012.

## **U.S. Macroeconomic Trends**

### *U.S. Economic Growth Continued at a Moderate Pace*

Real GDP grew by 1.7 percent at an annual rate during the first three quarters of 2012, following a 2.0 percent increase over the four quarters of 2011. The economy continues to face a number of headwinds, including a pickup in energy prices, the effect of severe drought conditions on agricultural output, and the ongoing sovereign debt crisis in Europe. Consumer spending rose at a 2.0 percent annual rate from the end of 2011 through the third quarter of 2012, in line with the pace recorded during the four quarters of 2011. Growth of residential investment picked up smartly to a 14.4 percent pace from 3.9 percent during 2012. However, business fixed investment moderated. Growth of equipment and software investment slowed from 11.4 percent over the four quarters of 2012 to 3.4 percent at an annual rate during the first three quarters of 2012. Business spending on structures also slowed during the first three quarters of 2012, growing by 2.8 percent compared to 6.9 percent during 2012. Severe drought conditions cut into farm inventories during the spring and summer months. The change in private inventories reduced real GDP growth in the first three quarters of the year by 0.3 percentage point per quarter on average. In 2011, the change in private inventories reduced growth by 0.1 percentage point. Growth of exports and imports has moderated this year, and net exports have been roughly neutral for GDP growth on balance after adding slightly less than 0.1 percentage point to growth in 2011.

Ongoing fiscal contraction at all levels of government continued to weigh on growth during the first half of 2012. Altogether, government consumption and investment subtracted 0.4 percentage point on average from both the first and second quarters, somewhat less than the 0.7 percentage point quarterly drag averaged during 2011. In the third quarter, however, federal spending rose, boosted by a jump in defense outlays, making a positive (0.7 percentage point) contribution to real GDP growth for the first time since early 2010. The state and local sector was essentially neutral for growth after being a drag on economic activity for the past three years – the longest stretch of falling state and local expenditures in post-war history.

The economy is expected to expand at a moderate pace through the end of 2012 and gradually strengthen over the course of 2013. A consensus of private forecasters currently expects real GDP to grow at a 1.8 percent annual rate in the fourth quarter of this year, and increase by 2.4 percent over the four quarters of 2013.

### *The Housing Sector Stabilized*

Activity in the housing market has firmed over the past few quarters, supported by improving house prices, declining inventories, and record-low mortgage rates. A variety of indicators continued to show improvement, including housing starts and home sales, both of which have been trending higher for the past five quarters. Housing starts rose to 872,000 at an annual rate in September 2012, the highest level in over four years, up nearly 35 percent from a year earlier and over 80 percent above the 478,000 starts in April 2009, the lowest level since data have been collected starting in 1959. Sales of new single-family homes have risen 27 percent over the past year, reaching 389,000 at an annual rate in September 2012. Sales of existing single-family homes (94 percent of all home sales) increased 11 percent over the past year to roughly 4.2 million at an annual rate in September. The inventory of homes available for sale continued to decline. At the end of September the supply of new single-family homes on the market fell to a 4.5-month supply, in line with its long-term average, and there was a 5.9-month supply of existing homes for sale. Residential investment has contributed positively to GDP growth in each of the past six quarters following a five-year period of subtracting from GDP growth. The pickup in housing activity has helped lift house prices recently. Several house price measures have posted year-over-year gains in recent months. The S&P/Case-Shiller 20-city house price index rose 2.0 percent year-over-year in August 2012, contrasting with the 3.7 percent decline in this measure in the year through August 2011. Likewise, the FHFA house price index rose 4.8 percent over the same period, compared with a 3.9 percent decline in the year through August 2011. Despite these improvements, housing demand continues to be tempered down by elevated unemployment, the low level of household formation, and tight lending conditions.

### *Labor Market Conditions Continued to Improve*

Job creation has proceeded at a steady pace thus far in 2012. On average, nonfarm payrolls increased by 173,000 per month in the four months ending in October, accelerating slightly from the 146,000 average monthly gain in the first half of the year. Nearly 4.5 million jobs have been created since February 2010 through October 2012, including 5.0 million in the private sector. The unemployment rate fell by 0.6 percentage point between December 2011 and October 2012 to 7.9 percent, the lowest level in more than three and a half years. Despite these gains, private employment is still 3.9 million lower than at the start of the recession in December 2007 and the unemployment rate is 2.9 percentage points higher. Some progress has been made in reducing long-term unemployment, but the share of the unemployed out of work for 27 weeks or more remains high. This rate stood at 40.6 percent as of October 2012, down from a record level of 45.4 percent in April 2010.

### *Energy Prices Trended Higher, but Inflation Remained Moderate*

Energy prices trended higher during the first half of 2012. They subsequently eased but trended higher again in late summer. Nevertheless, they remain below their peaks earlier in the year. The front-month futures price of West Texas Intermediate (WTI) crude oil averaged \$90 per barrel in October, down from a high of \$106 per barrel in March but roughly \$3 above its year-earlier level. The U.S. average retail price for regular gasoline rose sharply during the spring, peaking at \$3.94 per gallon in early April, but as of late October stood at \$3.57 per gallon.

Rising energy prices and a pickup in food price inflation pushed headline inflation measures higher in early 2012, but headline inflation has moderated more recently. Core inflation has risen since early 2011 but remains moderate by historical standards and the pace of increase has slowed recently. Persistent slack in labor markets, as well as low capacity utilization, have helped contain inflationary pressures. Over the year that ended in September 2012, the consumer price index rose 2.0 percent, slowing from a 3.9 percent increase in the previous twelve months. Core consumer prices (excluding food and energy) also advanced 2.0 percent, matching the rate in the corresponding year-earlier period. The three-month gain in the core CPI was 1.2 percent (annualized) in September, down from gains of around 2.5 percent in the spring and the smallest three-month rise since December 2010. Compensation cost growth has also moderated; over the year ending in September 2012, the Employment Cost Index (ECI) for private-industry workers rose 1.9 percent, compared with a 2.2 percent rise in the twelve months through September 2011.

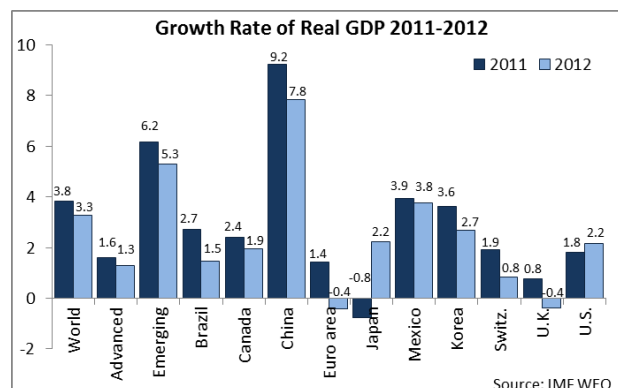
### *Fiscal Consolidation Remains a Priority*

The federal budget deficit narrowed to \$1.1 trillion (7.0 percent of GDP) in FY2012 from \$1.3 trillion (8.7 percent of GDP) in FY2011. The deficit has declined by roughly 3 percentage points as a share of the economy from a peak of 10.1 percent in FY2009. Putting federal finances on a more sustainable course in a way that supports growth and creates jobs in the near term is important to both maintaining the recovery and ensuring stronger growth over the long term. The Administration’s FY2013 budget proposal would cut the deficit to less than 3 percent of GDP by FY2018, and put the debt-to-GDP ratio on a declining path. The primary deficit – receipts less outlays, excluding net interest – would reach balance in FY2018. Importantly, the budget would achieve these goals in a way that preserves room for the programs needed to support the most vulnerable citizens and enhances our long-run competitiveness through targeted investments in education, infrastructure, and research and development.

## **The Global Economy**

Global economic growth weakened during the spring and summer of 2012. It was held back in part by headwinds from Europe and by a slowdown in the pace of demand growth in some large emerging market economies. The IMF projects global growth in 2012 will fall to 3.3 percent from 3.8 percent in 2011. Among the economies covered in this report, only Japan and the United States are projected to have higher growth rates in 2012 than in 2011.

Growth in the advanced economies overall is projected to be anemic, with output rising 1.3 percent. Output in the euro area and the United Kingdom is projected to decline this year.



Although much stronger than advanced economy growth, output growth in the emerging market economies is projected to moderate nearly a full percentage point to 5.3 percent in 2012 from 6.2

percent last year. Europe has been an important factor in the slowdown in emerging market growth, reducing external demand. Other factors include the effects of past policy actions aimed at reducing overheating and weaker than expected domestic demand growth in some economies.

Three years after the recovery from the financial crisis began, output in many advanced economies has yet to return to its pre-crisis level. In Italy, output has fallen for the past four quarters and is now only 0.3 percent above its trough. Output in France has been stagnant for four quarters. Output in the United Kingdom fell in the first half of 2012 but rose in the third quarter. Japan's economy also has been struggling to find a steady footing. Australia experienced the mildest recession among the advanced economies and has seen the strongest recovery, with output rising 9.8 percent above its trough.

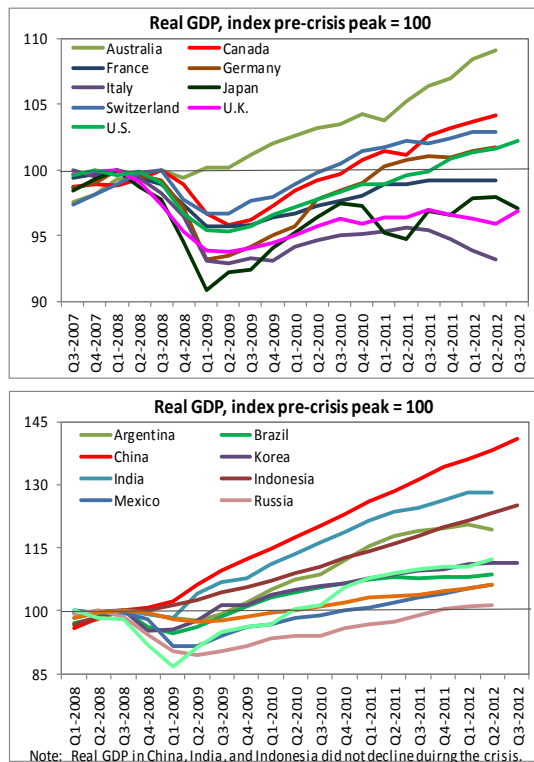
In contrast, output in all the G-20 emerging market economies has expanded beyond its pre-crisis level. Nevertheless, there has been a slowdown in growth in many of these emerging markets over the past few quarters.

Uncertainty around the near-term outlook remains elevated. While a principal risk remains the situation in the euro area, European leaders have offered significant proposals to strengthen their institutions. The ECB's announcement of Outright Monetary Transactions (OMT), the launch of the External Stabilization Mechanism, country reforms, and the European Commission's plan to establish a banking union have helped reduce financial stress in recent months. Rapid implementation of these proposals and continued progress on economic reforms will be essential to restoring economic growth in Europe.

Global economic growth could also be negatively affected if policymakers in the United States do not take actions to moderate the sharp fiscal adjustments implied under current legislation while putting into place a more balanced set of policies to ensure gradual fiscal consolidation over the medium-term. Uncertainty also remains about the extent of the slowdown in growth in emerging market economies and the effectiveness of the policy response.

### *Progress on Global Rebalancing*

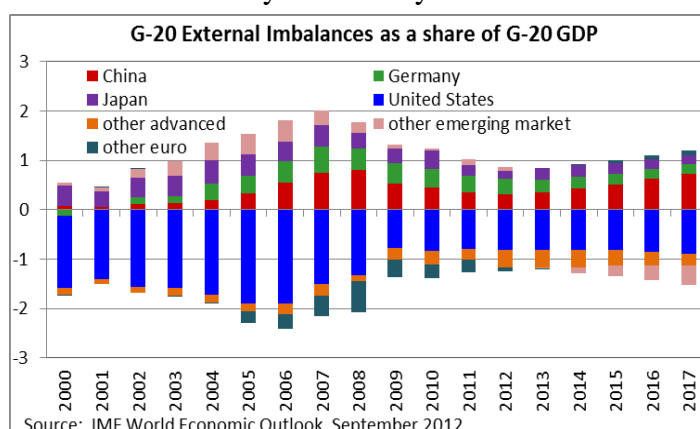
Global rebalancing is an important component of strengthening global demand. At the Pittsburgh Summit in September 2009, Leaders of the G-20 launched a Framework for Strong, Sustainable, and Balanced Growth. The goal of the Framework was to help ensure a more balanced global economy that was less prone to crisis. Since then there has been some progress on rebalancing. Most notably, nominal external imbalances have not returned to their pre-crisis





highs and the IMF is projecting that imbalances will widen only moderately over the medium-term.

The United States and other external deficit economies have increased saving, and many emerging market economies with external surpluses have taken steps to increase domestic demand. Cyclical factors, however, such as weak growth, continue to play a key role in compressing imbalances.



Foreign currency reserve accumulation by most major emerging market holders declined in the second half of 2011 as a result of increased global risk aversion, weaker capital flows, and downward pressure on emerging market currencies. Chinese foreign currency reserves, for example, fell by \$12.8 billion a month in the last five months of 2011.

Accumulation has resumed in 2012, although at a slower pace than in the 2009 to mid-2011 period. Saudi Arabia is the only emerging market economy for which the pace of reserve accumulation has been increasing, reflecting rising oil prices. India's foreign currency reserves have fallen since July 2011 as the Reserve Bank of India intervened on several occasions to limit depreciation of the rupee, although the pace of intervention has been reduced in 2012. Despite the slowdown in reserve accumulation, the IMF's reserve adequacy metric indicates that many major emerging market economies have reserves in excess of levels adequate to cover potential balance of payments shocks.

Foreign Currency Reserve Accumulation: Major Holders				
	October 2012	Average Monthly increase, \$ millions		
	Reserves \$ millions	Feb 2009 to Jul 2011	Jul 2011 to Dec 2011	Dec 2011 to Oct 2012
China	3,285,095	45,973	-12,827	11,550
Japan	1,196,844	3,151	29,851	-2,394
Saudi Arabia	613,373	2,265	7,029	9,761
Russia	476,380	3,817	-4,781	2,492
Switzerland	456,124	6,564	7,485	18,501
Taiwan	399,216	3,675	-3,044	1,367
Brazil	369,212	5,230	1,427	2,893
Korea	314,255	3,556	-1,142	1,602
Hong Kong	291,210	3,357	1,375	1,702
India	260,465	1,636	-4,645	-247

Latest data are for September 2012 for China, Saudi Arabia, Russia, Brazil, and Hong Kong

The rise in global risk aversion that led to downward pressure on many emerging market currencies resulted in safe haven inflows into Japan and Switzerland. Japan intervened in August 2011 and again in late October and early November to limit appreciation of the yen. These interventions resulted in the sharp increase in reserve accumulation shown in the table above, although the interventions had only a temporary effect on Japan's exchange rate. Japan has not intervened thus far in 2012. Its reserves have fallen largely as a result of valuation changes.

The worsening euro crisis in the summer of 2011 led to massive capital inflows to Switzerland. In September 2011, Switzerland imposed a ceiling on the value of the Swiss franc against the

euro. Swiss foreign currency reserves have risen sharply since then. In the first ten months of 2012, Swiss foreign currency reserves increased by an average of \$18.5 billion a month.

## U.S. International Accounts

The U.S. current account deficit rose to 3.1 percent of GDP in 2011 from 3.0 percent in 2010. In dollar terms, the deficit increased to \$466 billion in 2011 from \$442 billion the previous year. The surplus in the services trade and the balance on income rose but were offset by a larger deficit in goods trade.

<b>U.S. Balance of Payments and Trade</b>						
(\$ billions, seasonally adjusted unless indicated)						
	2010	2011	Q3-11	Q4-11	Q1-12	Q2-12
<b>Current Account</b>						
Balance on goods	-645.1	-738.4	-180.6	-189.3	-194.3	-185.8
Balance on services	150.4	178.5	45.8	43.0	45.9	46.5
Balance on income (including employee compensation)	183.9	227.0	58.5	59.9	47.4	55.5
Net unilateral current transfers	-131.1	-133.1	-31.8	-32.2	-32.7	-33.6
<b>Balance on current account</b>	<b>-442.0</b>	<b>-465.9</b>	<b>-108.2</b>	<b>-118.7</b>	<b>-133.6</b>	<b>-117.4</b>
<b>Balance on current account as % of GDP</b>	<b>-3.0</b>	<b>-3.1</b>	<b>-2.9</b>	<b>-3.1</b>	<b>-3.5</b>	<b>-3.0</b>
<b>Capital and Financial Account (financial inflow = +)</b>						
Net official assets	403.9	92.3	14.7	-105.4	119.6	96.4
Net bank flows	-335.4	522.8	107.2	44.1	96.3	68.9
Net direct investment flows	-122.0	-185.3	-7.1	-35.1	-93.9	-45.8
Net sales of securities	298.1	37.6	60.4	83.2	51.1	-30.3
Net liabilities to unaffiliated foreigners by nonbank concerns	95.9	-5.0	-10.3	25.1	-25.0	-8.4
Other*	42.2	92.8	5.4	51.4	16.7	7.6
<b>Balance on capital and financial account</b>	<b>382.7</b>	<b>555.1</b>	<b>170.3</b>	<b>63.4</b>	<b>164.7</b>	<b>88.5</b>
<b>Memo Items</b>						
Statistical discrepancy	59.2	-89.2	-62.1	55.3	-31.1	28.9
Change in foreign official assets in the United States	398.2	211.8	19.9	-2.9	69.7	83.0
<b>Current Account Detail: Trade in Goods</b>						
Exports of goods						
Agricultural products	107.7	126.2	31.3	31.1	30.5	33.7
Industrial supplies and materials (including petroleum)	406.0	518.7	133.9	132.4	132.6	132.0
Capital goods except autos	447.8	493.2	125.5	126.9	131.2	131.3
Automotive products	112.0	133.1	34.4	34.4	36.5	37.5
Consumer goods except autos and food	165.2	175.0	44.3	44.5	44.1	45.8
Other goods	50.2	51.2	12.8	12.8	13.7	13.8
<b>Total exports of goods</b>	<b>1,288.9</b>	<b>1,497.4</b>	<b>382.2</b>	<b>382.2</b>	<b>388.5</b>	<b>394.1</b>
Imports of goods						
Agricultural products	92.5	108.2	27.1	28.2	28.0	27.6
Industrial supplies and materials (including petroleum)	622.9	782.1	196.6	197.1	199.0	191.1
Capital goods except autos	450.3	513.4	129.5	133.1	137.7	139.9
Automotive products	225.6	255.2	66.3	67.7	73.5	74.7
Consumer goods except autos and food	486.5	517.4	128.5	130.2	128.1	130.0
Other goods	56.1	59.5	14.8	15.2	16.6	16.7
<b>Total imports of goods</b>	<b>1,934.0</b>	<b>2,235.8</b>	<b>562.8</b>	<b>571.4</b>	<b>582.8</b>	<b>579.9</b>
<b>Balance of trade in goods</b>	<b>-645.1</b>	<b>-738.4</b>	<b>-180.6</b>	<b>-189.3</b>	<b>-194.3</b>	<b>-185.8</b>

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.  
Current account + capital and financial account + statistical discrepancy = 0.

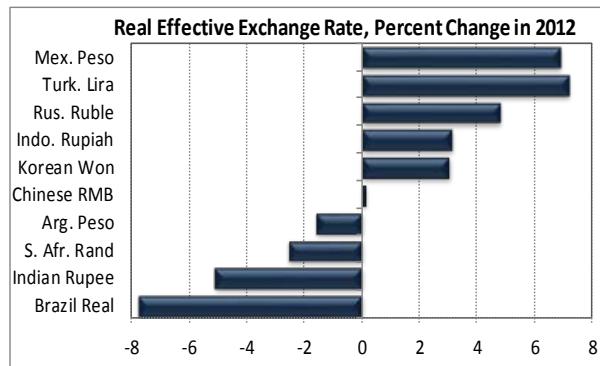
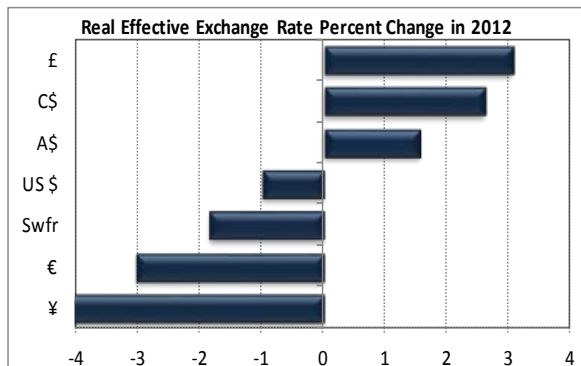
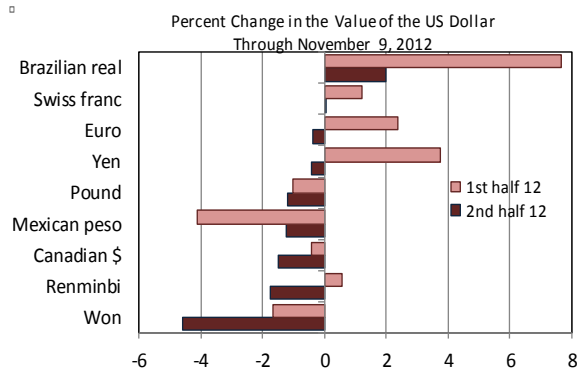
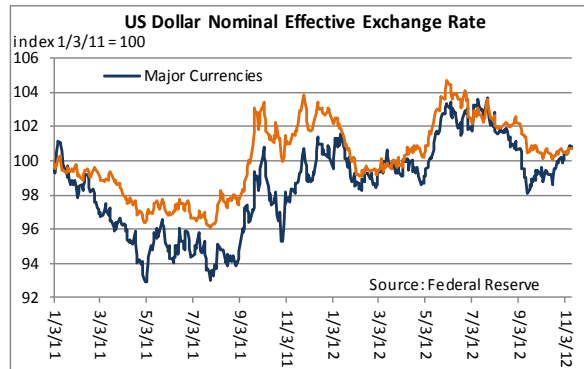
After hitting a trough of 2.5 percent of GDP in the second quarter of 2009, the quarterly current account deficit has remained within a narrow range of 2.7-3.2 percent of GDP, except for the 3.5 percent recorded during the first quarter of 2012. Nominal exports of goods and services grew 45 percent from the trough to the second quarter of 2012, while nominal imports of goods grew 50 percent. In the first half of 2012, nominal exports of goods and services rose 2.3 percent from the previous half, while nominal imports rose 3.1 percent.

## The Dollar in Foreign Exchange Markets

On a nominal effective basis, the dollar appreciated in the first five months of 2012, rising by 3.1 percent against the major currencies and by 1.8 percent against the emerging market currencies. Between the end of May and mid-September the dollar depreciated, falling by 5.2 percent against the major currencies and 4.1 percent against the emerging market currencies. Since then the dollar has reversed course, appreciating by 2.7 percent against the major currencies and 0.3 percent against the emerging market currencies.

During the first half of 2012 the behavior of the dollar relative to the currencies discussed in this Report was mixed, it appreciated most strongly against the Brazilian real but also against the yen, euro, Swiss franc, and renminbi. The dollar depreciated against the Mexican peso, Korean won, Canadian dollar, and UK pound. Since mid-year, through early November, the dollar has depreciated against all of the currencies discussed in this Report, with the exception of the Brazilian real and the Swiss franc, although as noted above the dollar has strengthened in the past few months.

On a real effective basis the three major currencies — the U.S. dollar, the euro, and the yen — have all depreciated in the first 10 months of 2012, as has the Swiss franc. Among the G-20 emerging market currencies, the renminbi, Argentine peso, Brazilian real, and Indian rupee have all depreciated on a real effective basis this year.



## **Analyses of Individual Economies**

### *Asia*

#### **China**

Chinese economic growth has moderated in 2012, with real GDP growth slowing from 9.3 percent in 2011 to 7.7 percent year-on-year in the first three quarters of 2012. Growth in domestic consumption in China has not been sufficient to offset the slowdown in investment and external demand. After a very large stimulus package in 2008-09, Chinese authorities have taken a much more cautious approach to economic stimulus measures in the current slowdown. The most recent IMF forecast, prepared before China released third quarter growth data, was for Chinese real GDP growth of 7.8 percent in 2012.

Chinese leaders have identified shifting away from growth driven by exports toward a greater reliance on domestic consumption as a critical goal for sustaining growth in the medium to long term. China has partially succeeded in shifting away from a reliance on exports for growth, and China's current account surplus has fallen markedly over the past four years, from 10.1 percent of GDP in 2007 to 2.8 percent in 2011. In the first three quarters of 2012, China's current account fell to 2.6 percent of GDP, compared to 2.9 percent in the first three quarters of 2011, as an increase in China's merchandise trade surplus was more than offset by a widening deficit in services trade and declining surpluses in income and transfers. China's trade surplus has declined from 8.8 percent of GDP in 2007 to 2.6 percent of GDP in the first three quarters of 2009.

The effects of sustained appreciation of China's real effective exchange rate, and China's efforts to encourage structural changes in its economy, have begun to play a role in reducing its current account surplus. Nevertheless, both the reduction in China's external imbalance and recent Chinese growth have relied heavily on a massive, and likely unsustainable, increase in investment relative to GDP leading to a worsening of China's internal imbalances even as its external imbalances declined. Consumption remains near historically low levels as a share of GDP. Cyclical elements, such as weakness in demand from advanced economies and changing terms of trade, also have been significant contributors to the decline of China's current account surplus. Without continued currency appreciation and further structural reform, the IMF projects China's current account surplus will widen again after 2012, rising to 4.3 percent of its own GDP and more than doubling relative to global output by 2017.

Maintaining a durable reduction in China's current account surplus while supporting strong, sustainable, and more balanced growth both within China and in the global economy will require China to take further policy measures to increase the growth of consumption. These include measures that will raise household incomes and give China's households sufficient confidence to spend a greater share of their incomes. Allowing further renminbi (RMB) appreciation is a critical part of this process. A stronger RMB directly raises the purchasing power of Chinese households, encouraging greater household spending. It also encourages domestic investment and production to shift toward sectors – including services sectors – that focus on meeting Chinese demand rather than sectors oriented toward exports. While exchange rate reform may not be sufficient in itself to bring about rebalancing of the Chinese economy, rebalancing cannot take place without it.

Chinese authorities have acknowledged the need for continued exchange rate reform and have taken a number of steps in this direction. In April 2012, China's central bank, the People's Bank of China (PBOC), announced a widening of the RMB daily trading band against the dollar in the Mainland currency market, from  $\pm 0.5$  percent to  $\pm 1.0$  percent. The trading band limitation applies to intra-day movements of the RMB against the dollar. In making the announcement, the PBOC stated that it was widening the band "in order to meet market demands, promote price discovery, enhance the flexibility of RMB exchange rate in both directions, [and] further improve the managed floating RMB exchange rate regime based on market supply and demand with reference to a basket of currencies." Further widening of the band over time, if implemented in a way that allows the value of the exchange rate to better reflect market forces, would be positive for China, the United States, and the global economy.

In May 2012, Chinese authorities reiterated their commitment to transform their economic development pattern at the Fourth U.S.-China Strategic and Economic Dialogue (S&ED) meeting, highlighting a number of specific and complementary policies to achieve the goals of increasing household incomes and consumption spending. These policies included market-based interest rate reform; structural tax reforms to lower taxation of consumer goods and accelerate the development of the services sector; and raising the dividend payout rate of state-owned enterprises (SOEs), which would unlock SOEs' large retained profits and ultimately shift resources toward the household sector.

In June and July of 2012, Chinese authorities took concrete steps on interest rate reform by providing banks in China greater flexibility in determining the rates that they offer to their customers. Previously, administratively determined interest rates announced by the PBOC set a ceiling on deposit rates, with no flexibility to offer higher deposit rates, and set a floor on lending rates, with banks forbidden from lending at rates more than 10 percent below the announced rate. With the reforms in 2012, however, banks now are permitted to offer deposit rates up to 10 percent above, and lending rates up to 30 percent below, the official benchmark interest rates. Continuing to move toward market-based interest rates will help remove distortions in the economy that result when administratively determined interest rates do not accurately reflect the true cost of capital. A rise in real deposit rates also could lead to an increase in Chinese household consumption, because low real bank deposit rates have meant that Chinese households earned very little on their savings, which requires them to save more to meet their financial goals.

At the June 2012 G-20 Leaders Summit in Los Cabos, Mexico, and the November 2012 G-20 Finance Ministers and Central Bank Governors Meeting, G-20 members, including China, reaffirmed their commitment to "move more rapidly toward market-determined exchange rate systems and exchange rate flexibility to reflect underlying fundamentals, avoid persistent exchange rate misalignments, and refrain from competitive devaluation of currencies." China also committed at the G-20 Los Cabos Summit to allow market forces to play a larger role in determining movements in the RMB, continue to reform its exchange rate regime, and increase the transparency of its exchange rate policy.

Chinese leaders have also acknowledged the need to shift to greater consumption-led growth. In discussions leading up the U.S. visit of Chinese Vice President Xi and in the 2012 S&ED, China

committed to reduce tariffs on consumer goods and intensify its efforts to reform taxation of the services sector. China cut import tariffs on certain consumer goods, and committed in the S&ED to another round of tariff cuts before the end of 2012. China also started a reform pilot in Shanghai – applying a value added tax (VAT) to the services sector – that lowered taxation on services industries to rates comparable to those paid by goods producing industries. In July 2012, Chinese authorities announced an expansion of the pilot to nine additional provinces and cities, including some of the largest population centers in China, such as Beijing and Guangdong, with plans to eventually extend the pilot nationwide. By fostering development of the services sector in China, these reforms would contribute to a rebalancing of China’s economy away from its reliance on manufacturing and investment, and support consumption as firms pass on tax savings to households.

From June 2010, when China moved off of its peg against the dollar (that it had reintroduced in 2008), through November 9, 2012, the RMB has appreciated by a total of 9.3 percent against the dollar. Because inflation in China has been higher than in the United States over this period, the RMB has appreciated more rapidly against the dollar on a real, inflation-adjusted, basis, appreciating 12.6 percent since June 2010 and 40 percent since China initiated currency reform in 2005. During 2012, the RMB has demonstrated periods of depreciation against the dollar, particularly in May and July, but for the year through November 9, the RMB has strengthened.

China’s real effective exchange rate (REER) – a measure of its overall cost-competitiveness relative to its trading partners – has appreciated since China initiated currency reform in mid-2005, after declining between 2001 and 2005. From July 2005 to October 2012, China’s real effective exchange rate appreciated by 27 percent. The REER appreciated particularly rapidly in the last several months of 2011, resulting in total REER appreciation of 6.2 percent over the course of 2011. Over the ten months of 2012, China’s REER has been unchanged. In the most recent IMF Article IV consultation with China, the IMF concluded that the RMB was moderately undervalued against a broad basket of currencies, and Table 5 in the IMF’s *Pilot External Sector Report* shows the RMB was undervalued by between 5 and 10 percent on a real effective basis, as of July 2012.

Reserve accumulation, an indicator of the degree of Chinese intervention in the currency market, has slowed markedly since the third quarter of 2011. According to China’s balance of payments data, reserve accumulation slowed to an average of \$18.7 billion per quarter in the four quarters ending September 30, 2012, compared to an average of \$140 billion per quarter during the four preceding quarters, and lower than for any four quarters since 2002. The slowdown has occurred as developments in Europe spurred an increase in global risk aversion, as capital flows to emerging economies fell or even reversed, as China’s own growth slowed, and as market expectations that Chinese authorities would continue to allow RMB appreciation under these circumstances declined substantially.

Even with the reduced pace of accumulation, China’s official foreign exchange reserves remain exceptionally high compared to those of other economies, and well beyond established benchmarks of reserve adequacy. As of end-September 2012, the PBOC held \$3.3 trillion in foreign reserves, equivalent to 42 percent of China’s GDP, or about \$2,440 for every Chinese

citizen.<sup>2</sup> China's stock of reserves is almost as large as the total amount of foreign exchange reserves held by all advanced economies combined, and accounts for nearly half of all of the foreign exchange reserves held by emerging and developing economies.

Although reserve accumulation provides some indication of the degree of intervention, China does not publish intervention data, in contrast to most large economies. Even when reported with a lag, such data provide valuable information to market participants and promote more transparent and effective functioning of international currency and financial markets. It is important that the Chinese government move toward greater disclosure of its activities in the currency market, which also would be consistent with China's commitment through the G-20 Los Cabos Summit to increase the transparency of its exchange rate policy. In addition, China should commit to participation in the IMF's COFER database and the SDDS befitting its status as a systemically important and the world's second-largest economy.

Chinese authorities have stated their intention to gradually move towards greater convertibility of the RMB under the capital account. This shift will require China to reduce the extensive capital controls that it currently has in place that restrict the free flow of cross-border capital and investment. China has been making some limited progress in this area recently. Under the framework of the S&ED, China more than doubled the total dollar amount that foreigners can invest in China's stock and bond markets under its Qualified Foreign Institutional Investor (QFII) program from \$30 billion to \$80 billion. China also has gradually permitted some offshore banks and financial institutions to invest RMB holdings into the domestic interbank bond market; allowed for the development of cross-border exchange traded funds (ETFs) between Hong Kong and Mainland China; made it easier for domestic Chinese firms to raise funds in the offshore market by issuing offshore RMB-denominated bonds; and announced plans to create a "Qianhai Bay" economic zone to pilot increased cross-border financial transactions. These policies represent steps in the direction of greater opening of China's financial sector, though significant restrictions still remain in place.

The decline in China's current account surplus over the past four years, together with the real appreciation of the RMB since June 2010, the apparent reduction in intervention, and China's steps to gradually open its capital account, indicate that China has gradually been allowing the necessary external adjustments and reducing its interventions. Because of these changes, estimates of the remaining degree of undervaluation have narrowed over the past two and a half years.

At the same time, this process of adjustment remains incomplete, and more progress is needed, particularly in shifting China towards sustainable growth based on household consumption. China's exceedingly high foreign exchange reserves relative to those of other economies, the persistence of its current account and trade surpluses, and the insufficient degree of appreciation of the RMB, especially given rapid productivity growth in the traded goods sector, suggest that

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<sup>2</sup> In addition, China has transferred (or swapped) some of its accumulated foreign exchange reserves to commercial banks, as well as capitalizing the China Investment Corporation (CIC), its sovereign wealth fund. China's state sector as a whole – including the PBOC, state-owned banks, and CIC – holds roughly \$4 trillion in foreign currency assets.

the real exchange rate of the RMB remains significantly undervalued and further appreciation of the RMB against the dollar and other major currencies is warranted. China's large foreign reserve accumulation has prolonged the misalignment in its real effective exchange rate and hampered progress toward global rebalancing, including among economies that compete with China for exports.

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

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

## **Japan**

The yen foreign exchange market is one of the largest and most liquid in the world, accounting for about 19 percent of the roughly \$4 trillion in daily global foreign exchange transactions, according to surveys by the Bank for International Settlements (BIS). Japan maintains a floating exchange rate regime.

The G-7 intervened jointly in March 2011 to steady disorderly market conditions following the Tohoku earthquake and tsunami. Japan intervened unilaterally in August 2011 (purchasing \$58 billion in foreign exchange) and again between October 31 and November 4, 2011 (purchasing \$116 billion). These interventions resulted in a sharp increase in Japan's reserves, although the interventions had only a temporary effect on the exchange rate. Japan has not intervened in the foreign exchange market this year, though the authorities publicly stated in several instances that they stand ready to "take decisive action" in response to "excessive" or "speculative" market movements

The yen has depreciated against the dollar in 2012, but there were significant swings in the exchange rate during this period. After reaching a high of ¥/\$ 76.2 on February 1, 2012, the yen depreciated by 10 percent against the dollar to ¥/\$ 83.7 on March 14. The sharp depreciation of the yen was driven in large part by the Bank of Japan (BOJ) announcement of the adoption of a 1 percent yearly inflation goal and the expansion of its domestic asset purchase program by \$123 billion on February 14, and by increasing market confidence in economic recovery in the U.S. From March 14 to June 4, yen appreciation resumed, due to market uncertainty regarding the



BOJ's ability to meet its 1 percent inflation target and increased safe-haven flows into Japan. Since reaching ¥/\$ 78 on June 1, to date the yen has traded within a band of ¥/\$ 77.4-80.6.

On a real trade-weighted basis, the yen depreciated by 2.8 percent during the first three quarters of 2012. In its latest Article IV Report for Japan (July 2012), the IMF assessed the yen's real effective exchange rate to be moderately overvalued. In the first ten months of 2012, Japan's foreign currency reserves decreased by \$23.9 billion on valuation changes. Reserves are \$1.2 trillion, the second-largest stock of reserves in the world behind China's \$3.3 trillion.

The Japanese economy continues to struggle to recover from the earthquake, tsunami, and nuclear power plant disasters of March 2011. Real GDP expanded 5.3 percent at an annualized rate in the first quarter of 2012 – boosted by strong personal consumption supported by temporary auto subsidies and reconstruction spending. Real GDP growth decelerated to an annualized rate of 0.3 percent in the second quarter of 2012 and output contracted by 3.5 percent in the third quarter. Falling exports, resulting from the global slowdown was a key factor, but private consumption and investment also declined. Prior to the release of the third quarter data, the IMF projected growth of about 2.2 percent in 2012 and 1.2 percent in 2013.

Japan's fiscal outlook is challenging. Japan's fiscal deficit is projected by the IMF to reach 10 percent of GDP in 2012 and 2013. Reconstruction spending, which is earmarked at 1.5 percent of GDP in 2012 and a moderate uptick in social security spending have placed additional pressure on the fiscal deficit in 2012. To reduce the deficit Prime Minister Noda championed and passed consumption tax legislation in August 2012; the IMF estimates that the increase in the consumption tax and other reforms amount to about half of the adjustment necessary to put the debt to GDP ratio on a downward path. The IMF projects that the government's gross debt will reach 240 percent of GDP in 2013.

On the monetary side, deflation remains a serious concern. Core consumer prices (excluding food and energy) are down 0.1 percent since the beginning of the year as of September 2012. Headline consumer prices increased during the first quarter of 2012, driven in part by an increase in energy costs – global oil prices have risen at the same time as Japan has shut down all of its nuclear reactors, which had previously provided 30 percent of Japan's electricity. The price level resumed its 3-year declining trend in May. Year to date, overall consumer prices have declined 0.3 percent. To combat entrenched deflation, in February the BOJ committed to monetary easing to meet a newly announced 1 percent inflation goal. Additionally, on five separate occasions in 2012, the BOJ announced the expansion of its existing asset purchasing program by \$589 billion (from ¥20 trillion to ¥66 trillion) on a cumulative basis, and as well as the extension of the maturity of its government bond purchases.

In 2011, Japan's goods trade balance fell into deficit for the first time since 1980 as exports slowed following production disruptions while imports increased on higher commodity prices and demand for reconstruction materials. The deficit in Japan's trade balance rose sharply in the first three quarters of 2012 due to deteriorating in consumer sentiment in the euro area, slowing demand from China, and growing demand for external energy sources in Japan. Japan's current account balance remained in surplus during the first half of 2012, at 1.3 percent of GDP, due to relatively stable income from overseas investments. However, for the first time on record, the

current account fell into deficit during the third quarter due to a continued decline in the trade balance compared to the previous quarter. Japan's bilateral trade surplus with the United States totaled \$52.6 billion in the first half of 2012, up significantly from \$38.4 billion in the first half of 2011, but in line with pre-crisis levels.

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

### **South Korea**

South Korea officially maintains a market-determined exchange rate, and its authorities intervene with the stated objective of smoothing won volatility. For the year 2011, Korea's foreign exchange reserves grew by \$11.3 billion (4 percent) to \$298 billion. In 2012, through October, Korea had accumulated an additional \$16 billion in reserves to reach a total of \$314 billion. In its 2012 Article IV Consultation with Korea, the IMF noted that reserves are adequate and that "there is no need for further reserve accumulation beyond what would be needed to keep pace with rising foreign liabilities over time."

The won has continued to fluctuate in value, reflecting in part changing developments in global market conditions. After depreciating by 11 percent against the dollar in September 2011 as risk aversion among international investors increased, the won strengthened in late 2011 and early 2012 as global markets stabilized. The won began to weaken in the second quarter of 2012 before shifting directions again in the third quarter. In 2012, through early November, the won has appreciated by 6.1 percent against the dollar. Although the Korean government does not publish intervention data, market participants indicate that Korean authorities intervened on both sides of the market during the course of the year. According to estimates from the IMF's July 2012 *External Sector Report* and the IMF's Article IV Consultation with Korea, the real effective exchange rate of the won was moderately undervalued by between 0 and 10 percent and the won REER was about 7 percent below its historical average.

Korea's economy grew by 3.5 percent in the first quarter of 2012 on an annualized basis, but growth has slowed since then. Second and third quarter annualized growth rates were 1.1 and 0.6 percent, respectively. The IMF forecasts growth of 2.7 percent in 2012 and 3.6 percent in 2013.

Inflation has increased in recent months, rising to 2.1 percent in October on a year-over-year basis from its low of 1.2 percent in August, but remains near the bottom of the Bank of Korea's 2 to 4 percent inflation target range. The policy rate remained at 3.25 percent from June 2011 to June 2012, after having been ratcheted up from a low of 2.0 percent in June 2010. The rate has been lowered twice since June, to 2.75 percent as of October.

Korea's goods and services exports totaled \$497 billion in the first three quarters of 2012, an increase of 2.9 percent from the same period in 2011. Korean imports have totaled \$469 billion in the year to date, up 0.6 percent from the same period last year. Korea's current account surplus rose to 2.9 percent of GDP during the second quarter of 2012, up from 1.0 percent in the

second quarter of 2011. Korea's current account has remained in surplus even as the rise in commodity prices have resulted in a large shift in Korea's terms of trade over the past several years.

Korea maintains a series of measures aimed at reducing short-term external debt and the exposure of the financial system to foreign exchange risk. Short-term external debt has come down from \$190 billion at the peak of the financial crisis in 2008 to \$141 billion at the June 2012. Korea's reserves, however, are now more than twice short-term external debt.

We will continue to press the Korean authorities to limit their foreign exchange interventions to the exceptional circumstances of disorderly market conditions and to commit to greater foreign exchange market transparency including through the publication of intervention data.

## *Europe*

### **Euro Area**

The exchange rate of the euro is determined freely in the foreign exchange market. The euro has experienced large fluctuations since the financial crisis resulting from ebbs and flows in risk aversion associated with financial stresses in the euro area. In the first half of 2012, the euro depreciated by 2.4 percent against the dollar but has appreciated by 0.4 percent since then. On a real effective basis, the euro depreciated by 3.5 percent in the first half of 2012 but remained steady in the third quarter of 2012.

Growth momentum in the euro area turned negative in late 2011 as output contracted by 1.3 percent on an annualized basis in the fourth quarter. Declining domestic demand, particularly inventory destocking and private consumption, was the main contributor to the drop in output, but exports also fell, reflecting weaker global demand.

These trends continued in the first half of 2012, as real GDP stagnated in the first quarter and contracted 0.7 percent at an annualized rate in the second quarter. The divergence between countries in the core and periphery also has worsened, with countries such as Germany and the Netherlands returning to positive growth in 2012, while Italy and Spain remained in recession and economic growth in France stagnated. During the first half of 2012, the German economy grew by 1.6 percent on an annualized basis, relying on rising net exports as domestic demand weakened. Output contracted in Italy by 3.3 percent, by 1.5 percent in Spain, and was little changed in France. High-frequency business surveys, such as the Purchasing Managers Index suggested further deterioration in the third quarter.

The euro area's current account has been close to balance since early 2009. In 2011 the euro area had a current account deficit averaging 0.3 percent of GDP. In the first half of 2012, the current account moved into a surplus of 1 percent of GDP. The euro area current account, however, masks substantial imbalances among euro area countries. The Netherlands and Germany continued to run substantial current account surpluses through mid-2012, averaging 9.5 and 6.3 percent of GDP, respectively. The current accounts of the other major euro area economies (France, Italy, and Spain) remained in deficit. Stronger domestic demand growth in

European economies with current account surpluses would help to reduce imbalances in the euro area. The Macroeconomic Imbalances Procedure, developed as part of the EU's increased focus on surveillance, should help increase the amount of attention paid to building external and internal imbalances; however, the procedure is somewhat asymmetric and does not appear to give sufficient attention to countries with large and sustained external surpluses like Germany.

In 2012, the euro area, in aggregate, is undertaking the most aggressive fiscal consolidation of the advanced economies despite having the smallest cyclically-adjusted fiscal deficit and the lowest growth prospects. Most of the major euro area economies have committed to reducing their general government budget deficits to less than 3.0 percent of GDP by 2013; Germany achieved this target in 2011. However, concerns are mounting about the aggregate pace of consolidation in the euro area amid signs that the euro area remains in recession. Several euro area countries have the capacity to take advantage of available room for countercyclical policy responses while still ensuring credible paths to fiscal consolidation. Euro area leaders have noted they must develop proposals to balance austerity with growth; however, they have not yet made any concrete proposals capable of yielding meaningful near term results. In its October 2012 *World Economic Outlook*, the IMF presented analysis that suggests that the impact of large-scale fiscal adjustment may have a larger detrimental impact on growth than previously thought.

The ECB alleviated funding pressures in the banking sector through the provision of over €1 trillion in three-year funding via longer-term refinancing operations (LTRO) in December 2011 and February 2012. The ECB continues to provide full allotments of liquidity against eligible collateral to euro area financial institutions. The Federal Reserve's U.S. dollar swap lines with the ECB also have played a critical role alongside the ECB's direct efforts by making it possible for Europe's banks to borrow dollars from the ECB and avoid a more rapid reduction in credit. Still, bank access to market funding continues to be heavily impacted by sovereign funding pressures, with many banks located in the most vulnerable euro area economies having little or no access.

On September 6, 2012, ECB President Draghi announced a new framework for the ECB's intervention in sovereign bond markets – Outright Monetary Transactions (OMT) – whereby the ECB will stand ready to buy sovereign bonds, potentially in unlimited amounts, of countries that request support from the European Financial Stability Fund (EFSF) or the European Stabilization Mechanism (ESM) and adhere to agreed conditions. Meanwhile, as part of the effort to enhance financial integration and to break the link between bank and sovereign balance sheets, the European Commission has put forth a proposal to establish a single bank supervisory mechanism for the euro area, which will comprise the ECB and national supervisory authorities. The Euro group has agreed that this mechanism should enable the ESM to recapitalize banks directly without adding further to a country's debt, although uncertainty remains over the timing and the treatment of legacy interventions.

These actions are in addition to prior measures undertaken by European leaders, including stronger economic governance, increased economic surveillance, and a temporary increase in the size of the euro area crisis response firewall to provide a more effective backstop for large, vulnerable countries and the financial sector. In recent months, European leaders and the ECB

have taken important steps forward that have helped reduce financial stress and lay the foundations for greater stability. The ECB's proposal to undertake Outright Monetary Transactions in certain circumstances, the launch of the ESM, country-level reforms, and the broader commitment by European leaders to banking union were very significant steps. The success of the next phase of the crisis response will hinge on rapid implementation of institutions that strengthen the euro and continued progress on economic reforms that support growth.

## **Switzerland**

In September 2011, the Swiss National Bank (SNB) established a minimum exchange rate of 1.20 Swiss francs per euro, moving the exchange rate from floating to a managed rate. Since then the SNB has intervened repeatedly to prevent the exchange rate from moving beyond this bound. On September 13, 2012, it reaffirmed its commitment stating, "The SNB is leaving the minimum exchange rate unchanged at CHF 1.20 per euro, and will continue to enforce it with the utmost determination."<sup>3</sup>

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

The SNB had expressed concerns last year that the appreciation of the franc was stoking deflation risks. Consumer prices fell in September 2011 on a year-over-year basis, and have continued to decline. Nevertheless, deflation has eased since mid-2012. Consumer prices fell by 0.2 percent on a year-over-year basis in October 2012, compared to a 1.1 percent decline in June. The SNB expects deflation of 0.6 percent in 2012 and inflation of 0.2 percent in 2013.

Switzerland's foreign exchange reserves declined by \$21 billion in January 2012, reflecting the unwinding of currency swaps and valuation changes. Between January and September reserves increased by \$207.6 billion as the currency came under pressure. The SNB confirmed that it conducted "extensive foreign exchange transactions in the spot market."<sup>4</sup> Reserves declined by \$1.6 billion in October, bringing Switzerland's total reserve holdings to \$456.1 billion. After hovering around the 1.20 Swiss franc/euro threshold between April and early September, the franc has weakened and now stands around 1.21 francs per euro.

The current account surplus increased from 10.5 percent of GDP in 2011 to 12.9 percent of GDP in the first half of 2012. The increase resulted from a rise in investment income. Investment income rose from 5.4 percent of GDP in 2011 to 7.8 percent of GDP in the first half of 2012. The surplus on services trade also increased, rising from 7.7 percent of GDP to 8.1 percent.

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<sup>3</sup> Swiss National Bank *Quarterly Bulletin* (September 3/2012) Volume 30, p. 7

<sup>4</sup> Swiss National Bank *Quarterly Bulletin* (September 3/2012) Volume 30, p. 24

Slower global growth and events in the euro area continued to affect growth in 2012. Output grew by 1.2 percent during the first quarter of 2012 on an annualized basis but declined by 0.2 percent in the second quarter largely due to a drag from net exports and machinery and equipment investment. With the weaker international outlook, the SNB forecasts growth of about 1 percent for 2012.

The SNB was armed with new prudential tools in June to dampen an overheated property market but, so far, has not used them. Safe haven capital inflows have improved Switzerland's already good fiscal outlook: record low yields (under 0.5 percent for 10-year and under -0.3 percent on 2-year issuances) have led to savings on interest payments, enlarging budget surpluses and lowering public debt. For 2012 and 2013, general government surpluses of 0.7 percent of GDP and 0.4 percent of GDP, respectively, are expected, while the corresponding debt-to-GDP ratios are 35 percent and 33 percent, respectively.

### **United Kingdom**

The United Kingdom (UK) has a freely floating exchange rate. The pound appreciated by 1.0 percent against the dollar in the first half of 2012, and another 1.2 percent in the second half through early November. On a real effective basis, the pound appreciated by 1.8 percent in the first half of 2012, reflecting its nominal appreciation against other currencies, notably the euro. In the third quarter, the pound appreciated by a further 2.0 percent on a real effective basis.

The UK economy contracted in the first half of the year, with output falling by 1.2 percent and 1.5 percent on an annualized basis in the first and second quarters of 2012, respectively, marking three consecutive quarters of contraction. The economy, however, expanded by 4.0 percent in the third quarter on an annualized basis, the fastest pace of growth since 2007.

First quarter growth was weighed down by the depletion of inventories and a plunge in exports. Consumption – both public and private – and investment posed an additional drag on activity in the second quarter, as did the decline in working days related to the Queen's Jubilee. A drop in construction activity, subdued services activity, and the flagging manufacturing sector were major contributors to the decline in output in the first half. Part of the rise in output in the third quarter reflects the boost from hosting the Olympics and the reversal of the working day effect in the second quarter.

The government is committed to a fiscal mandate that requires it to balance the cyclically adjusted current budget at the end of a rolling, five-year period, as well as a supplementary target, which requires public sector net debt to fall as a share of GDP between 2014-15 and 2015-16. In November 2011, the Office of Budgetary Responsibility made significant updates to its economic forecasts, which resulted in upward revisions to its targets, and extended the timeframe to meet the fiscal mandate to 2016-17.

Monetary policy remains accommodative. The Bank of England (BOE) has maintained its historically low policy rate at 0.5 percent and, since October 2011, has increased the size of its quantitative easing program three times – each time by £50 billion – to reach £375 billion at its

July 2012 meeting, and introduced a new program to support bank lending. The rationale for all decisions was similar: the weaker global environment (particularly slower euro area growth), tight credit conditions, weak real household incomes, and fiscal tightening. After peaking at 5.2 percent in September 2011, inflation has fallen and is converging towards the BOE's 2.0 percent target.

After narrowing to 0.8 percent of GDP in the second quarter of 2011, the UK's current account deficit rose sharply in 2012, reaching 5.4 percent of GDP in the second quarter. Exports declined in the first half of 2012 and investment income turned negative for the first times since 2000.

## *Western Hemisphere*

### **Brazil**

Brazil typically operates under a floating exchange rate regime, although the authorities have used foreign exchange market intervention, as well as verbal guidance, in addition to capital flow measures, to dampen volatility of the *real*. Recently, the currency has fluctuated in a tight range against the dollar. In early 2012, the *real* appreciated against the dollar, strengthening by nearly 10 percent. From February to late May, it reversed course and depreciated sharply against the dollar, falling by 23.3 percent. Since early July, the *real* has fluctuated within a narrow band between 2.00 and 2.05 to the dollar. Overall, the *real* has depreciated by 9.7 percent against the dollar in 2012 through early November. On a real effective exchange rate basis, the *real* depreciated by 7.8 percent in the first half of 2012, but rose by 0.2 in the third quarter.

The Banco Central do Brasil (BCB) has regularly intervened in foreign exchange markets since February. The central bank purchased \$11.2 billion in dollars in spot markets from February through May. At the end of September, the central bank also had a modest \$2.6 billion long dollar position in the forward market and a \$3.9 billion long dollar position in local currency swaps, a position that commits the central bank to buying dollars in the derivatives market. Between July and September there was a significant swing in the central banks' net position in the swaps market. Foreign exchange reserves have grown by \$26 billion in 2012 to \$369 billion at the end of September.

Brazil has implemented a series of measures to limit capital inflows and upward pressures on the *real* over the past two years. Most notably, in early 2012, the authorities broadened the scope of the 6 percent financial operations tax (IOF) on capital inflows to include medium duration external borrowing (between two and five years), but reversed this measure in June as capital inflows slowed. Net financial inflows year-to-date have been \$58.6 billion, led by foreign direct investment inflows.

In an effort to stimulate economic growth, the BCB has pursued a 14-month monetary easing cycle, with a cumulative 525 basis points in cuts, bringing the official policy rate (SELIC) to an all-time low of 7.25 percent. The authorities have also implemented a number of fiscal stimulus measures, targeting durable consumer goods to boost flagging industrial production. After nearly flat growth in the first two quarters, the economy is expected to accelerate to 4 percent

annualized growth in the second half as the stimulative measures take hold. The IMF projects the economy will grow by 1.5 in 2012 and 4 percent in 2013.

After reaching 7.4 percent on a year-over-year basis in September 2011 (above the upper limit of the central bank's target band of 4.5 percent  $\pm$  2 percent) inflation has declined, falling to 4.9 percent in September 2012. Persistent high core and services inflation (5.7 percent and 8.2 percent, respectively as of September 2012) indicate that latent inflation pressures remain. Inflation expectations for 2012 and 2013 are around 5.4 percent. Brazil's current account deficit averaged 2.2 percent of GDP in the first half of 2012, remaining around this level since 2010.

## **Canada**

Canada maintains a flexible exchange rate and employs an inflation-targeting monetary policy regime. The Canadian dollar appreciated against the U.S. dollar early in 2012 but declined in May to end the first half 0.4 percent stronger. In the third quarter, the currency appreciated by an additional 3.3 percent but has fallen by 1.6 percent against the dollar in October and early November. On a real effective basis, the Canadian dollar appreciated by 0.1 percent in the first half of 2012 and an additional 3.7 percent in the third quarter. The appreciation of the Canadian dollar has occurred amid rising prices for its commodities exports, combined with a relatively stable domestic economic outlook.

The Canadian economy grew by 1.8 percent on an annualized basis in the first quarter of 2012 and by 1.9 percent in the second quarter. Private consumption expenditure growth has moderated considerably, slowing to 0.8 percent in the second quarter, while investment has maintained a relatively high rate of growth, rising 5.8 and 4.9 percent in the first and second quarters, respectively. The Bank of Canada has reduced its 2012 GDP growth forecast to 2.1 percent.

Canada's current account deficit widened to 4.0 percent of GDP in the first half of 2012. Exports slowed due largely to moderating demand in the United States, Canada's largest trading partner. Imports continued to rise as a result of capital goods and vehicles imports.

The government has continued fiscal consolidation but late in 2011 pushed back by one year the goal of returning to fiscal balance, which is now forecast to occur by the end of FY2015. The Bank of Canada has maintained its policy rate at 1.0 percent since September 2010, citing subdued core inflation and concerns about the external outlook. The Bank of Canada's target for inflation is 2 percent. Headline inflation decelerated to 2.0 percent in the first half of 2012, down from 2.9 percent in the second half of 2011 on a year-over-year basis, with core inflation of 2.0 percent. Core inflation slowed further in the third quarter of 2012, down to 1.3 percent on a year over year basis in September.

## **Mexico**

Mexico has a flexible exchange rate and employs an inflation-targeting monetary policy regime. The peso rose by 4.1 percent against the dollar in the first half of 2012 and an additional 3.8 percent in the third quarter of 2012. The peso reversed course in October and early November,



depreciating by 2.6 percent against the dollar. On a real effective basis, the peso depreciated by 0.8 percent in the first half of 2012. In the third quarter of 2012, however, the peso appreciated by 7.4 percent on a real effective basis.

Mexico's foreign exchange reserves increased \$12.3 billion in the first half of 2012, reaching a total of \$149 billion. Virtually all of this increase was driven by foreign exchange inflows from the state-owned oil company, Pemex. The Bank of Mexico discontinued its monthly auctions of options to purchase foreign exchange, in November 2011, which had previously allowed Mexico to gradually purchase foreign exchange when the peso was on an appreciating trend. In conjunction with this announcement and as a measure to support liquidity in the foreign exchange market, the Bank of Mexico indicated that it would auction up to \$400 million in foreign exchange on any day in which the peso depreciated against the dollar by more than 2 percent. The Bank sold \$365 million dollars during May 2012 in response to sharp depreciations in the exchange rate. In December 2010, Mexico obtained an augmented precautionary Flexible Credit Line (FCL) from the IMF equivalent to \$72 billion, up from \$48 billion previously. As of the early November 2012, Mexico had not drawn on this line.

Real GDP growth strengthened in the first half of 2012, expanding 4.9 percent and 3.6 percent (annualized) in the first and second quarters, respectively. Private consumption continues to drive the gains in the rate of economic growth. While there are indications of an export-led slowdown in the second and third quarters, domestic demand appears to be holding firm.

The Bank of Mexico has maintained an accommodative monetary policy stance, keeping its target interest rate at 4.5 percent since July 2009. Headline inflation accelerated significantly in mid-2012, reaching 4.8 percent as of September (on a year-over-year basis). However, core inflation and inflation expectations remain contained. The Bank of Mexico maintains an inflation target of 3 percent, with a band of plus or minus 1 percent.

Mexico's current account posted a modest 0.6 percent of GDP surplus in the first quarter, but returned to deficit (0.7 percent of GDP) in the second quarter. A decline in exports accounted for most of the deterioration, offset to some degree by a decline in imports.

## Glossary of Key Terms in the Report

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

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

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

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

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

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

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

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

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

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

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

**Trade Weighted Exchange Rate** – see Nominal Effective Exchange Rate

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