



R E P O R T T O C O N G R E S S

# FOREIGN EXCHANGE POLICIES OF MAJOR TRADING PARTNERS OF THE UNITED STATES

U.S. DEPARTMENT OF THE TREASURY  
OFFICE OF INTERNATIONAL AFFAIRS

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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, and Section 701 of the Trade Facilitation and Trade Enforcement Act of 2015, 19 U.S.C. § 4421.<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.

## Executive Summary

**This Report is the second to implement the intensified evaluation provisions of the Trade Facilitation and Trade Enforcement Act of 2015 (the “2015 Act”).<sup>2</sup> The provisions of the 2015 Act provide the United States with valuable reporting and monitoring tools, as well as measures to address unfair currency practices. The 2015 Act establishes a process to monitor key indicators related to foreign exchange operations, engage economies that may be pursuing unfair practices, and impose meaningful penalties on economies that fail to adopt appropriate policies. The legislation accomplishes these important goals in a way that is consistent with our international obligations.**

The 2015 Act requires that Treasury undertake an enhanced analysis of exchange rates and externally-oriented policies for each major trading partner that has: (1) a significant bilateral trade surplus with the United States, (2) a material current account surplus, and (3) engaged in persistent one-sided intervention in the foreign exchange market. **Pursuant to the 2015 Act, Treasury has found in this Report that no economy satisfied all three criteria.**

As noted in the April 2016 Report, Treasury has created a “Monitoring List” of major trading partners that merit attention based on an analysis of the three criteria. Specifically, an economy is added to the Monitoring List when it meets two of the three criteria. Once added, an economy will remain on the Monitoring List for at least two consecutive Reports to help ensure that any improvements in performance versus the criteria are durable, not due to temporary one-off factors. **Six major trading partners of the United States are included on the Monitoring List in this Report: China, Japan, Korea, Taiwan, Germany, and Switzerland.**

China met two of the three criteria in the April 2016 Report – a large bilateral trade surplus with the United States and a current account surplus above 3 percent of GDP – and it met one of the three criteria in this Report – a large bilateral trade surplus with the United States. Japan, Korea, and Germany met two of the three criteria in both of the most recent reporting periods (April 2016 and October 2016), having material current account surpluses and significant bilateral trade surpluses with the United States. Taiwan also met two of the three

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<sup>2</sup> This Report is also responsive to the Omnibus Trade and Competitiveness Act of 1988 (the “1988 Act”).

criteria in both of the most recent reporting periods, having a material current account surplus and having engaged in persistent, one-sided intervention in foreign exchange markets. Switzerland has been added to this Report as its trade with the United States was sufficiently large as of June 2016 to be included as a “major trading partner.” Switzerland met two of the three criteria in this Report, having a material current account surplus and having engaged in persistent, one-sided intervention in foreign exchange markets.

### *The State of the Global Economy*

Global growth has been, and continues to be, soft relative to recent historical averages. Whereas the average pace of growth was 3.6 percent over the period 1990-2006, growth was a modest 3.2 percent in 2015, and the IMF is projecting growth of 3.1 percent in 2016. Growth is expected to increase modestly in 2017.

A variety of factors have been holding back growth: inadequate policy support, especially from fiscal policy; continuing high leverage in both the private and public sectors in many economies; demographic trends that are causing slower growth in labor forces; weak investment, which may have adversely affected productivity growth; and ongoing political uncertainty. The productivity slowdown is not yet well understood and may be protracted. The pass-through of lower oil prices to higher spending appears to have been smaller than initially anticipated, while the near-term adverse effects expected from the surprise Brexit vote have been muted thus far.

Monetary policy has been supportive in many economies, especially in Japan and the euro area, and remains supportive in the United States. Both nominal and real interest rates are exceptionally low, but inflation is below target in most major economies, reflecting to some extent weak demand in many parts of the global economy.

In February 2016, in Shanghai, G-20 Finance Ministers and Central Bank Governors for the first time committed to use all policy tools – fiscal, monetary, and structural – to energize the global economy. This is in contrast to the fiscal austerity many policymakers advocated following the early stages of recovery after the financial crisis in 2009. G-20 Leaders subsequently endorsed the use of all policy tools at their Summit in Hangzhou in September. Some economies – the United States, Japan, and Canada – have responded by either using, or planning

to use, available fiscal space to support demand. Other economies, especially those with substantial balances of excess saving over investment – Germany, Korea, and Taiwan – have substantial scope to support stronger national and global demand growth, but have yet to adopt forceful pro-growth programs. China can use consumption-friendly stimulus to support demand if growth slows more than expected as it implements its structural reform agenda.

Global trade continues to be surprisingly weak, expanding about 2.3 percent in 2016, according to the IMF's latest forecast. This may reflect the overall weak global growth environment, but other factors also seem to be at play, as not all of the slowdown is explained by slower GDP growth. The IMF projects that global trade will grow 3.7 percent in 2017, and 4.3 percent over the medium term.

Exchange rates have fluctuated in concert with shifting views about policy actions, growth prospects, and capital flows. The Japanese yen has appreciated sizably in 2016, while the Chinese RMB has depreciated. The British pound has depreciated significantly following the Brexit vote. The euro and the U.S. dollar have held generally steady, especially in nominal effective terms. Dollar foreign exchange markets have remained orderly even during periods of relatively rapid exchange rate moves and higher short-term spikes in volatility.

Global current account imbalances continue to be an issue. Though smaller in the aggregate than at their peak in 2007, current account imbalances expanded somewhat in 2015, and several economies – Germany, Korea, Switzerland, and Taiwan – have very large external surpluses. On the other side, the current account deficits of Mexico and Canada have also increased. While the current account deficit in the United States is notably smaller than in 2007, it has expanded from its level in 2013-14.

More support is needed to bolster global demand and help improve growth expectations. The Administration has strongly advocated that economies should use all available policy space and all policy tools. Faster nominal GDP growth is essential to facilitate faster global debt adjustment, in turn leading to more sustainable growth paths. The Administration also has been a vocal advocate of pursuing global policies that lead to more inclusive growth and rising incomes for lower income individuals and families.

## *Treasury Assessments of Major Trading Partners*

As noted in Treasury's April 2016 Report, Treasury has determined the following thresholds for the three criteria for enhanced analysis specified in the 2015 Act: (1) a significant bilateral trade surplus with the United States is larger than \$20 billion; (2) a material current account surplus is larger than 3.0 percent of GDP; and (3) persistent, one-sided intervention includes net purchases of foreign currency, conducted repeatedly, totaling in excess of 2 percent of an economy's GDP over a 12 month period.<sup>3</sup> No economy satisfied all three criteria in this Report.

Treasury has created a "Monitoring List" of economies that have met two of the three criteria specified in the 2015 Act. In the April Report, the Monitoring List included China, Japan, Korea, Taiwan, and Germany. In this Report, the Monitoring List includes China, Japan, Korea, Taiwan, Germany, and Switzerland.

With regard to the six economies on the Monitoring List:

- China has a significant bilateral trade surplus with the United States. The country's current account surplus fell from 3.0 percent of GDP over the full year 2015 to 2.4 percent for the four quarters through June 2016, moving below the established threshold for that criterion. China's intervention in foreign exchange markets has sought to prevent a rapid RMB depreciation that would have negative consequences for the Chinese and global economies. Treasury estimates that from August 2015 through August 2016, China sold more than \$570 billion in foreign currency assets to prevent more rapid RMB depreciation. More transparency over exchange rate management and goals, and strong adherence to G-20 commitments to refrain from competitive devaluation and not to target exchange rates for competitive purposes, will enhance the credibility of China's exchange rate regime. At the same time, China has a very large bilateral goods trade surplus with the United States. This underscores the need for further implementation of reforms to rebalance the Chinese economy to household consumption. Fiscal policy can support structural reform and provide consumption-friendly stimulus to support demand if growth slows more than expected.

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<sup>3</sup> See Section 3 for a discussion of the factors used to assess the three criteria which, taken together, would require enhanced analysis.

- Japan has a significant bilateral trade surplus with the United States, and its current account surplus for the last four quarters through June 2016 reached the highest level since 2011, at about 3.7 percent. Japan has not intervened in the foreign exchange market in almost five years, but upward pressure on the yen in 2016 has been accompanied by persistent public comments by Japanese authorities aimed at restraining yen appreciation. Treasury assesses that the dollar-yen foreign exchange market has been functioning smoothly, and reiterates the importance of all countries adhering to their G-20 and G-7 commitments regarding exchange rate policies. For Japan, it remains important that the authorities use all policy levers, including a flexible fiscal policy and an ambitious structural reform agenda, to lift near-term growth and inflation and improve the medium-term economic outlook.
- Korea has a significant bilateral trade surplus with the United States and a current account surplus well above the material threshold. Treasury estimates that over the 12 months ending June 2016, Korea sold nearly \$24 billion in foreign exchange, representing a shift from several years of asymmetric intervention to resist appreciation. The IMF assesses the won to be undervalued. Over the medium term, appreciation of the won would help Korea reorient its economy away from its reliance on exports by encouraging the reallocation of resources to the non-tradables sector. Treasury has urged Korea to limit its foreign exchange intervention to only circumstances of disorderly market conditions. In addition, Treasury continues to encourage the Korean authorities to increase the transparency of their foreign exchange operations and to take further steps to support domestic demand, including more robust use of fiscal policy tools.
- Taiwan has a current account surplus well above the material threshold and, per Treasury estimates, has engaged in persistent net foreign currency purchases in the 12 months through June 2016. Such interventions limit currency appreciation that would generally reduce Taiwan's large and growing current account surplus. However, Taiwan's bilateral trade surplus with the United States was below the threshold, and thus Taiwan does not meet all three criteria for enhanced analysis. Taiwan's authorities should limit foreign exchange interventions to the exceptional circumstances of disorderly market conditions, as well as increase the transparency of reserve holdings and foreign exchange market intervention.

- Germany has both a significant bilateral trade surplus with the United States and a current account surplus well above the material threshold. The European Central Bank (ECB) has not intervened in foreign currency markets since 2011, and did so then as part of a G-7 concerted intervention to stabilize the yen following Japan’s earthquake and tsunami.<sup>4</sup> In nominal dollar terms, Germany has the largest current account surplus globally. This surplus represents substantial excess saving – with the current account surplus sitting at just over 9 percent of GDP in the second quarter of 2016. Some of this saving could, at least in part, be used to support German domestic demand while also reducing the current account surplus and contributing markedly to euro area and global rebalancing. In Treasury’s view, Germany continues to have substantial fiscal policy space to provide additional support to demand. It could also take steps to encourage private investment, which would support demand.
- Switzerland has been added to this Report as its trade with the United States was sufficiently large as of June 2016 to be included as a major trading partner. The country has a current account surplus well above the material threshold and, per Treasury estimates, has engaged in significant foreign currency purchases over the last year. However, Switzerland’s bilateral trade surplus with the United States was below the threshold, and thus Switzerland did not meet all three criteria for enhanced analysis. Moreover, Switzerland’s economic policy situation is distinctive given its relatively small stock of domestic assets, which limits monetary policy options to address persistent deflation in the context of significant safe haven capital inflows.

While no economy met all three of the criteria for the current reporting period, this result remains a reflection, in part, of the dynamics of the global economy during the past year, in which capital outflows from emerging markets have led a number of economies to engage in foreign exchange intervention to resist further *depreciation* (rather than appreciation) of their currency. The extent of these flows has been high by historical standards, underscoring the possibility that more economies may trigger the threshold going forward.

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<sup>4</sup> For the purposes of Section 701 of the 2015 Act, policies of the ECB, which holds responsibility for monetary policy for the euro area, will be assessed as the monetary authority of individual euro area countries.



Based on the analysis in this Report, Treasury has also concluded that no major trading partner of the United States met the standard of manipulating the rate of exchange between its currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade during the period covered in the Report.

The Administration will continue to take effective actions to help ensure a level playing field for our workers and companies. The President has been clear that no economy should grow its exports based on a persistently undervalued exchange rate, and Treasury has been working aggressively to address exchange rate issues bilaterally, including through the U.S.-China Strategic and Economic Dialogue, and multilaterally, including through the G-7, G-20, and the International Monetary Fund (IMF).

As noted in the April Report, this strategy has produced results. The United States has secured important commitments in recent years regarding exchange rate policy from G-7 and G-20 members. In particular, the G-7 has committed to orient fiscal and monetary policies towards domestic objectives using domestic instruments and to not target exchange rates. The G-20 has committed to refrain from competitive devaluations and to not target exchange rates for competitive purposes. This year, G-20 members also agreed to consult closely on exchange markets – an important component of G-7 communiqués in the past, but never before included as a G-20 commitment.

Further, the IMF has improved the exchange rate analysis in its bilateral and multilateral reports, and Treasury is working with the IMF to further strengthen this analysis. Treasury will continue to closely monitor adherence to all G-7, G-20, and IMF exchange rate commitments.

The Trans-Pacific Partnership (TPP) countries have adopted – for the first time in the context of a trade agreement – provisions that address unfair currency practices. When TPP comes into force, Treasury will be better able to monitor the exchange rate commitments made by partner countries due to the transparency and accountability provisions of the Joint Declaration of the Macroeconomic Policy Authorities of TPP Countries.

Going forward, Treasury will benefit from the formation of an Advisory Committee on International Exchange Rate Policy, established by the 2015 Act, to provide advice to the Secretary of the Treasury with respect to the impact of international exchange rates and financial policies on the economy of the United States. Pursuant to the 2015 Act, the Advisory Committee will be comprised of nine members, with three appointed by the President, three by the President pro tempore of the Senate, and three by the Speaker of the House of Representatives. Treasury has filed a charter for the Advisory Committee, in accordance with the Federal Advisory Committee Act, and will work closely with the relevant members of Congress to form the Advisory Committee as quickly as possible.

## **Section 1: Global Economic and External Developments**

This Report covers economic, trade, and exchange rate developments for the first six months of 2016 and, where data are available, developments through end September 2016. The countries covered in this Report are the 12 largest trading partners of the United States. Their total goods trade with the United States amounts to nearly \$2.6 trillion over the last 12 months, or around 70 percent of all U.S. goods trade. For some parts of the analysis, especially those parts having to do with Section 701 of the 2015 Act, data over the most recent four quarters are considered.

### ***U.S. Domestic Economic Trends***

In the second quarter of 2016, consumer spending growth strengthened in the United States. Net exports and business fixed investment also gave a small boost to growth, but continued inventory adjustment, as well as declines in residential investment and government spending, all subtracted from growth. Economic growth can be variable from quarter to quarter, and most projections point to an acceleration of growth in the second half of 2016. Although the pace of GDP growth in the first half of 2016 has been relatively slow, the underlying strength of the U.S. economy remains intact and features strong job creation, employment close to the full-employment level, and rising wages and incomes.

Real GDP expanded at a 1.1 percent annual rate over the first two quarters of this year after rising 1.4 percent in the latter half of 2015. A further pullback in inventory accumulation accounted for part of the slowdown in the first half of 2016, subtracting a quarterly average of 0.8 percentage point compared with a

drag of 0.5 percentage point during the latter half of 2015. On net, weaker business fixed investment, as well as softer residential investment, (after double-digit growth throughout 2015) played a role. Net exports provided a small boost to growth during the first half of 2016, after posing a drag in the latter half of last year. Consumer spending, which accounts for just over two-thirds of all economic activity in the United States, accelerated to a solid 3 percent pace during the first half of this year, up from the 2.5 percent pace recorded during the latter half of 2015.

### *Favorable Near-Term Outlook for the U.S. Economy*

Domestic demand remains solid, consumer sentiment is around pre-recession norms, and the period of inventory adjustment appears to be drawing to a close. The current outlook suggests that real GDP will expand at a solid pace through the end of 2016, led by healthy growth of consumer spending, further recovery in the housing sector, and a small boost from government spending. A consensus of private forecasters predicts that, after average growth of about 1.1 percent in real GDP during the first half of 2016, growth will pick up to around 2.5 percent in the second half of 2016 and 2.2 percent in 2017.

### *Fiscal Headwinds Have Diminished*

The rapid pace of fiscal consolidation in recent years has weighed on economic activity in the United States, but it has moderated in the last six months. During the first half of 2016, federal government spending subtracted 0.1 percentage point per quarter from real GDP growth, after a 0.15 percentage point contribution during the latter half of 2015. State and local outlays added slightly to growth in the first half of 2016, after adding 0.1 percentage point in the latter half of last year. Looking ahead, federal government spending is expected to make a positive contribution to GDP in 2016 overall, and continued improvement in state and local government finances has laid the groundwork for that sector to be a small net positive for growth once again this year.

### *Healthy Labor Market Conditions*

The pace of job creation remained robust during the first nine months of 2016, and the unemployment rate remained at low levels. Nonfarm payroll employment increased 178,000 per month on average during the nine months

ending September 2016, compared with average monthly gains of 229,000 in 2015. The unemployment rate currently stands at 5.0 percent, half its 2009 peak of 10 percent. Other indicators of labor utilization, including the rate of involuntary part-time employment, have improved thus far in 2016 but are still elevated compared with pre-recession levels, suggesting some slack remains in labor markets.

Headline and core (excluding energy and food prices) inflation rates have picked up from year-ago levels, but remain relatively low. The consumer price index rose 1.1 percent during the year ending August 2016, compared with a 0.2 percent rise during the year ending August 2015. Core consumer inflation was 2.3 percent over the year ending August 2016, up from 1.8 percent during the same period a year earlier. Compensation growth started to strengthen in late 2015, but remains below its pre-recession norms. Average hourly earnings rose 2.4 percent over the 12 months ending August 2016, stepping up from gains averaging 2.1 percent from 2011 through 2014. The Employment Cost Index for private-industry workers showed compensation rising 2.4 percent over the 12 months ending June 2016, up from a gain of 1.9 percent in the year-earlier period.

### *Public Finances on a Sustainable Medium-Term Path*

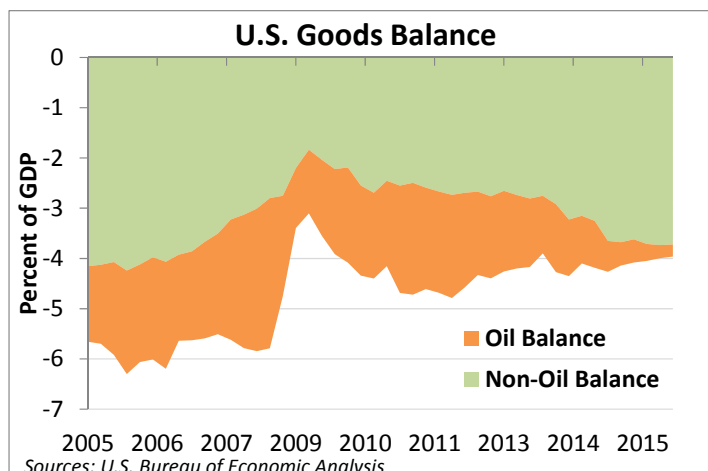
The federal budget deficit continued to narrow in FY 2015, declining to 2.5 percent of GDP from 2.8 percent of GDP in FY 2014. Since peaking in 2009, the deficit has fallen by 7.3 percentage points – the most rapid pace of fiscal consolidation for any six-year period since the demobilization following World War II. The Administration’s Mid-Session Review of the FY 2017 Budget projects the budget deficit will increase to 3.3 percent of GDP in FY 2016, then decline to 2.3 percent in FY 2018 and stabilize at 2.4 percent of GDP from FY 2022 to FY 2026 – well below the 40-year average of 3.2 percent of GDP. The primary deficit (non-interest outlays less receipts) will be eliminated by FY 2018, and will be roughly neutral thereafter and not add to the federal debt. Publicly-held debt as a share of the economy declined to 73.7 percent of GDP at the end of FY 2015; it is projected to stabilize at 77.1 percent of GDP in FY 2017 and then decline gradually to 75.0 percent by FY 2025.

### ***U.S. External Trends***

#### *Developments in the U.S. Current Account and Trade Balances*

The U.S. current account was in deficit by 2.7 percent of GDP in the first half of 2016, up marginally over the 2.6 percent deficit in the second half of 2015.

Low oil prices have helped shrink the U.S. petroleum deficit – it is at its lowest level since 1998 at just 0.3 percent of GDP. But the gains from lower oil prices have been offset by a decline in the services trade surplus and a decline in investment income (by \$40 billion over the past year) as earnings on U.S. assets held abroad decreased. The non-oil trade balance has remained largely unchanged, as both exports and imports declined in the year ending June 2016.

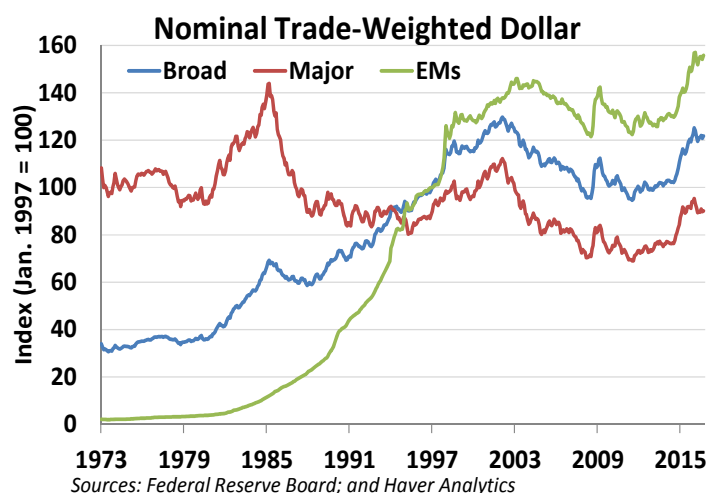


At the end of the second quarter of 2016, the U.S. net international investment position stood at a deficit of \$8.0 trillion (43.6 percent of GDP), an increase of roughly \$1.3 trillion over the period in 2015. The value of U.S.-owned foreign assets was \$24.5 trillion, while value of foreign-owned U.S. assets stood at \$32.5 trillion. Much of the recent deterioration over the past year has been driven by valuation effects that lowered the dollar value of U.S. assets held abroad.

### *The Dollar in Foreign Exchange Markets*

The dollar depreciated on a nominal trade-weighted basis by 1.1 percent during the first half of 2016, following a 6.5 percent nominal trade-weighted appreciation in the second half of 2015.

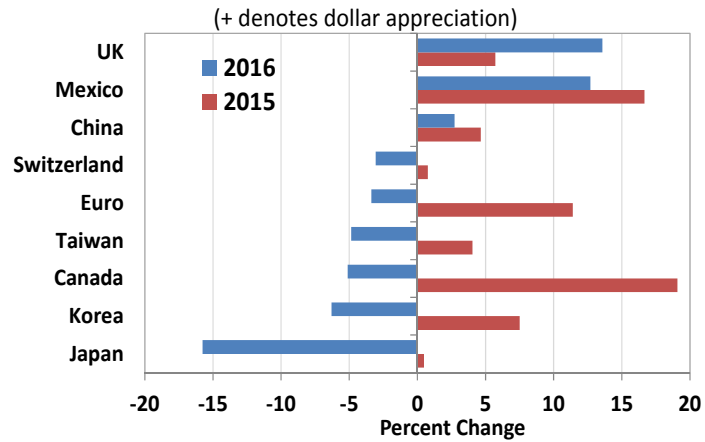
The dollar depreciated by about 4 percent against the currencies of advanced economies in the



first half of 2016. This reflects the 14 percent depreciation of the dollar against the Japanese yen, partially offset by the 10 percent appreciation against the British pound. The dollar/euro relationship was mostly stable through the first half of 2016. Since June, through end-September, the dollar has seen slight further depreciation against the yen, moving within the 100-106 yen/dollar band; and remained unchanged against the euro. Over that same period, the dollar was relatively stable against the British pound, but in the first half of October, the British pound depreciated by more than 5 percent.

Against the currencies of emerging market economies, the dollar appreciated 0.8 percent in the first half of 2016. Since June, through end-September, the dollar was unchanged on a nominal effective basis against emerging market currencies.

### U.S. Dollar vs. Major Trading Partner Currencies



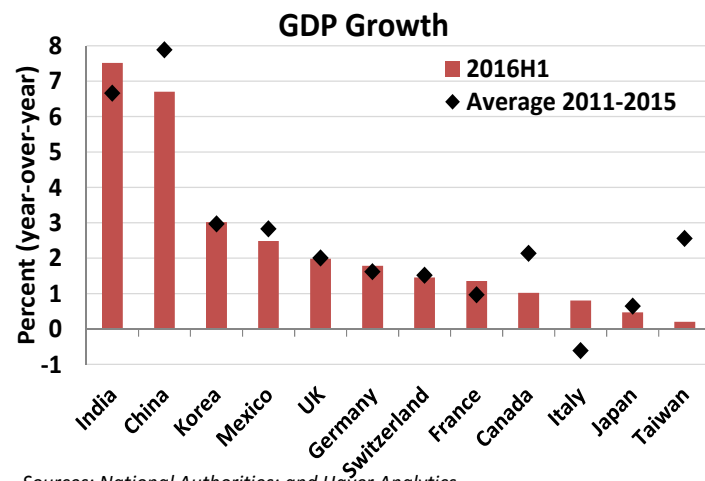
Sources: FRB; and Haver Analytics.

Bilaterally, year-to-date as of September, the dollar has appreciated against the British pound, the Mexican peso, and the Chinese renminbi. It has depreciated against the euro, the Japanese yen, the Korean won, the Swiss franc, the Canadian dollar, and the new Taiwan dollar. Some of the 2016 currency movements are reversals, to varying degrees, of currency movements in 2015.

Dollar exchange markets have functioned smoothly and with low levels of volatility notwithstanding periodic concerns over disappointing global growth outcomes, a surprise Brexit vote in the United Kingdom, the unprecedented use of negative interest rates in some economies to boost credit flows, and shifting views on potential monetary policy adjustments by central banks in the major currencies. The U.S. dollar continues to be the world's principal currency in international trade, with it being bought or sold in 88 percent of all currency trades according to the most recent (2016) BIS Triennial Survey of foreign exchange activity.

## International Economic Trends

The growth trajectory of the global economy continues to be tepid and markedly weaker than the 3.6 percent average pace of growth over the period 1990 to 2006. Global growth since 2011 has averaged a modest 3.3 percent, leaving many economies with overly high unemployment and underutilization of productive capacity. Global GDP growth in the first half of 2016 was 2.9 percent, based on estimates from the IMF's World Economic Outlook. Additionally, the distribution of global demand is highly imbalanced, with large and sustained external surpluses in a handful of countries, which have the effect of absorbing demand from the rest of the world and dampening global aggregate demand.



Sources: National Authorities; and Haver Analytics.

Growth in the euro area averaged 1.6 percent in the first half of 2016, 0.4 percentage point less than 2015 growth. The average contribution of domestic demand to growth was just 0.8 percent annualized, far less than the 1.8 percent contribution posted in 2015, mostly due to weak investment. Germany, the euro area's largest economy, grew a solid 2.3 percent on average during the first half of 2016, but domestic demand's contribution to growth was only an average of 0.6 percentage points, again due to slumping fixed investment.

Growth in Japan was 1.4 percent in the first half of 2016, with domestic demand adding an average of 1.7 percentage points per quarter, but declining real exports reduced the pace of growth. In part reflecting the weak growth outlook, Japan has chosen to once again postpone a planned hike in the consumption tax and is commencing implementation of a package of fiscal stimulus measures that will include social spending to encourage greater labor force participation and direct payouts to low-income earners.

The IMF, in its October 2016 forecast, projects that advanced economies will grow 1.6 percent in 2016, the same weak pace they have averaged since 2011, picking

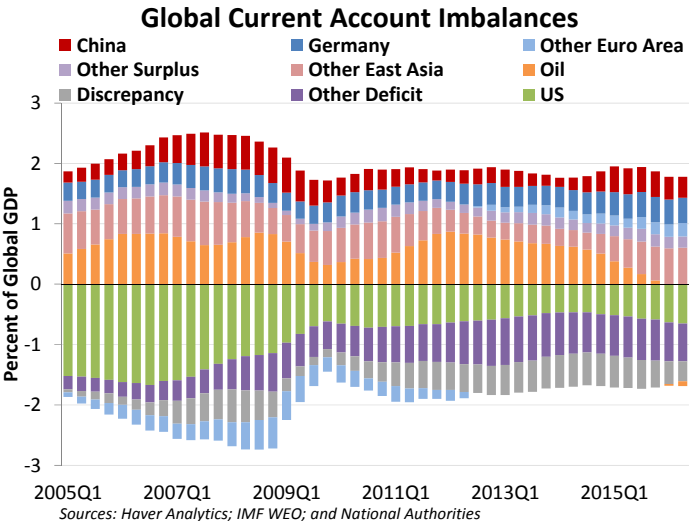
up to 1.8 percent in 2017. Japan is expected to grow 0.5 percent, the United States 1.6 percent, and the euro area 1.7 percent. The United States is expected to accelerate to 2.2 percent in 2017, while Japan is expected to grow 0.6 percent in 2017, and the euro area 1.5 percent.

Emerging market economy growth is expected to be 4.2 percent in 2016, well below their 5 percent pace since 2011, but consistent with the steady downshift in the growth rate of emerging markets over the past five years. The IMF expects growth in emerging markets to pick up to 4.6 percent in 2017, largely reflecting reversals in Russia and Brazil from recession to growth. Emerging Asia is projected to slow in 2017, as is emerging Europe.

Overall global growth is being held back by (1) inadequate macroeconomic policy support, (2) still high private sector leverage in some economies, and (3) sluggish lending growth in some economies. Weak investment is often cited as a contributing factor to subdued global growth, but investment tends to follow GDP growth. Still, as noted, some countries could take steps to lift both private and public investment. More policy action is needed globally to strengthen domestic demand. Monetary policy responses have been forceful in general, but they need to be supported with additional fiscal actions to deliver a stronger boost to domestic demand. Policy space exists as exceptionally low long-term interest rates provide governments with more fiscal breathing room than under historically normal circumstances. And there are a number of advanced and emerging market economies with large external surpluses – including Germany, Korea, and Taiwan – that could improve domestic demand growth in their own economies and contribute both to stronger global growth and to a more balanced global economy.

Global current account imbalances diminished in the aftermath of the global financial crisis, mainly because of compressed imports by deficit economies rather than because of stronger demand in surplus economies.

Imbalances began widening



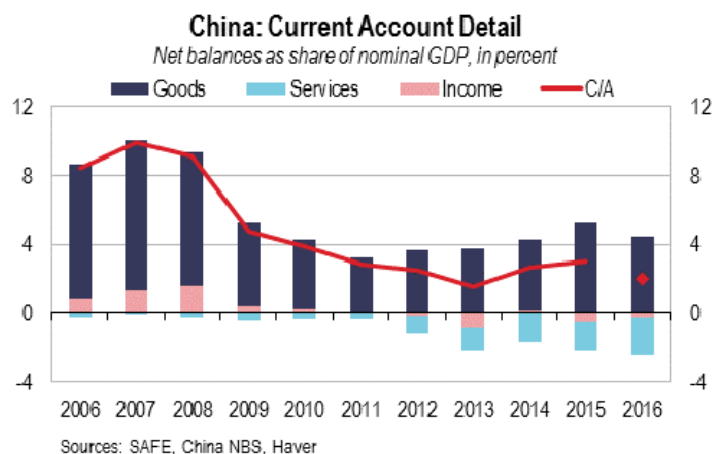


again in late 2014 and early 2015, but have eased in recent quarters. Some surpluses, however, still remain exceptionally large and indicate that these countries are absorbing demand from the rest of the world to sustain stronger growth at home than would otherwise be the case. As such, large surpluses depress global aggregate demand, highlighting the urgency of deploying all policy levers to boost strong, sustainable, balanced, and inclusive growth. The very large surpluses of Taiwan, Switzerland, Germany, and Korea have each remained significant in the first half of 2016. Adding in Japan, the surpluses (excess of saving over investment) of these economies totaled around \$720 billion over the four quarters ending June 2016. China's surplus of around 3 percent of GDP in 2015 has since declined to 2 percent of GDP in the first half of 2016.

The decline in the price of oil has been a key factor in redistributing income from oil exporting to oil importing economies, and that is one reason for the expanding surpluses of some economies. But even if the price of oil were to have stayed around \$80 per barrel, Taiwan, Germany, and Korea would still have large surpluses, at around 12.8, 8.5, and 6.2 percent of GDP, respectively.

### China

China's reported current account surplus for the first half of 2016 was \$103 billion (2.0 percent of GDP), compared with \$157 billion (2.7 percent of GDP) in the second half of 2015. China's current account surplus was 2.4 percent of GDP for the 12 months ending June 2016, narrowing from 3.2 percent of GDP for the 12 months ending

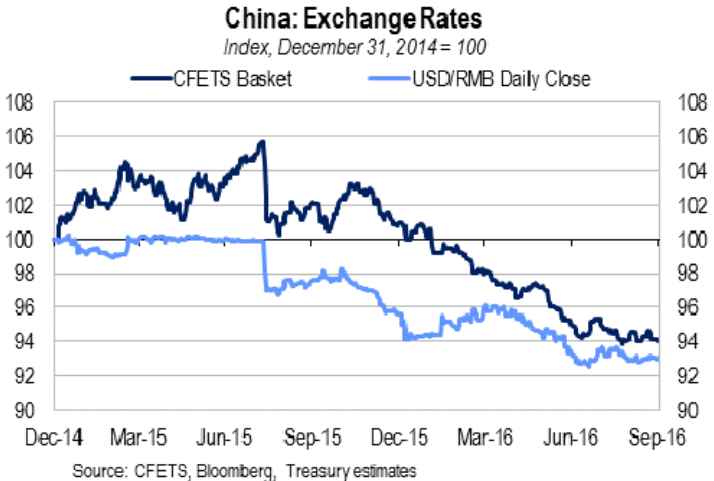
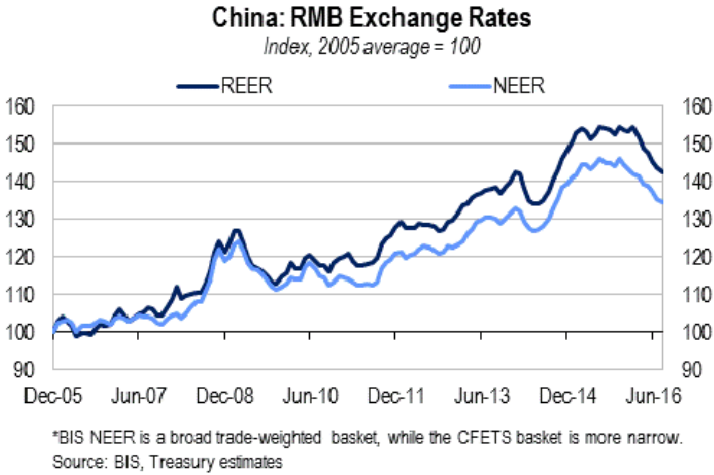


June 2015. The current account surplus declined, owing to a larger services trade deficit and a modest decline in the merchandise trade surplus. From July 2015 to June 2016, merchandise export volumes and values contracted by 0.4 percent and 6.9 percent, respectively. During the same period, merchandise import volumes grew 2.5 percent, but nominal value fell 11.8 percent, reflecting still-depressed commodity prices. Tourism imports continued to drive China's services trade deficit, which grew from 1.7 percent of GDP in the four quarters ending June 2015

to 2 percent of GDP in the four quarters ending June 2016. Treasury analysis of partner tourism trade data suggests that tourism imports have partially masked capital outflows in late 2014 and 2015, and that the current account surplus is likely larger than reported, possibly approaching 3 percent of GDP. While data are uncertain, recent data suggest that outflows through this channel have fallen.

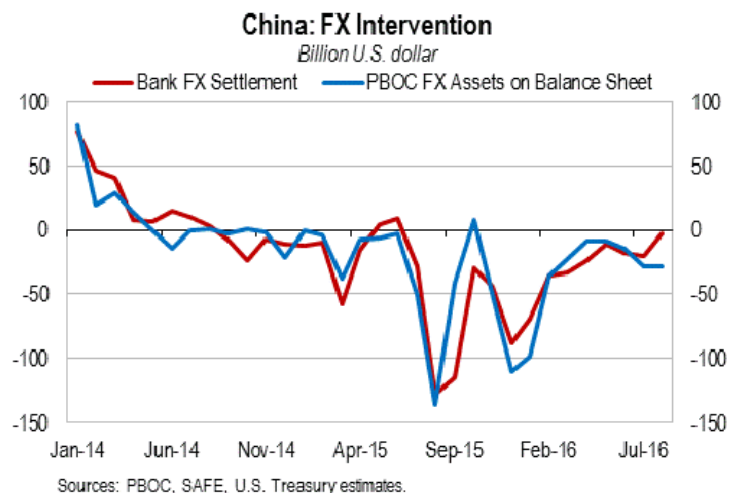
China runs a merchandise trade surplus and a services deficit with the United States. For the 12 months ending June 2016, China’s merchandise trade surplus with the United States was \$356 billion, as compared with \$363 billion for the 12 months ending June 2015, according to U.S. Census data. The United States has a surplus of roughly \$35 billion in trade in services with China, making China’s bilateral trade in goods and services balance with the United States a bit lower.

Since February 2016, China’s central bank, the People’s Bank of China (PBOC), has sought to improve communications on its exchange-rate policy with the market, after its unanticipated change in the midpoint fixing mechanism in August 2015 and weaker-than-expected reference rates in early January 2016 triggered large capital outflows. The PBOC has clarified its intention to manage the RMB flexibly, stating that it sets the daily reference rate based on overnight movements in key currencies, the previous day’s closing rate, and expected demand for foreign currencies during the day. In addition, the PBOC has communicated that it references three baskets, including a basket that the China Foreign Exchange Trading System (CFETS) – a unit under the PBOC – introduced last December. The CFETS



basket – the most commonly cited basket – has weakened 6.8 percent year-to-date as of September and 10.8 percent from its peak August 2015. Consistent with the decline in the CFETS basket, the real effective exchange rate has weakened 7.2 percent year-to-date. Meanwhile, the RMB has depreciated 2.7 percent against the dollar year-to-date and 6.9 percent since August 2015. Notwithstanding these changes, market participants remain highly sensitive to signals from the Chinese authorities on the exchange rate, highlighting the importance of the clear communication of policy actions and greater transparency.

While China does not publish its foreign exchange intervention, it is possible to construct estimates of foreign exchange market intervention using data that China does publish. China has intervened heavily in the foreign exchange markets to *prevent* even faster RMB depreciation after strong downward market pressure



triggered by the surprise change in China’s foreign exchange policy in August 2015. The pace of net foreign exchange sales has slowed in recent months to \$20-30 billion on strengthened enforcement of capital controls, a favorable external environment, and improved market communication. This underscores that additional Chinese efforts to clarify its exchange rate goals, and to underscore that devaluation will not be used to support growth, would help stabilize the foreign exchange market. Treasury estimates that from August 2015 through August 2016, China sold more than \$570 billion in foreign currency assets to prevent faster RMB depreciation. Despite recent sales, China maintains ample reserves of roughly \$3.2 trillion as of end-September 2016.

At the 2016 U.S.-China Strategic and Economic Dialogue, China committed to continue market-oriented exchange rate reform, allowing for two-way flexibility. China also stressed that there is no basis for persistent RMB depreciation based on economic fundamentals. China reaffirmed these statements publicly as part of President Xi’s meeting with President Obama in September. Core factors that have been supportive of the RMB remain in place, including high net savings, a

sizeable current account surplus, GDP growth above the global average, and still-strong terms of trade reflecting lower commodity prices.

Despite the recent downward pressure on the RMB, the Chinese currency is still 21 percent stronger than the dollar since December 2005, and 38 percent stronger on a real, trade-weighted basis. Chinese authorities have stressed that the RMB will continue to be a strong currency, given China's current account surplus, relatively high economic growth, large foreign exchange reserves, and stable fiscal and financial conditions. Overall, the balance of evidence suggests that the RMB is likely to continue to trend stronger over the medium to long term.

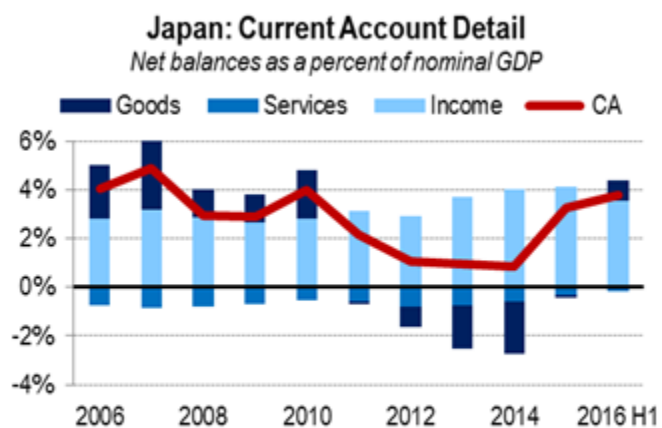
Expectations that the Chinese currency would depreciate in the short term have contributed to capital flows through a number of different channels. Net private outflows from China have stemmed in large part from a rebalancing in Chinese corporate balance sheets and outbound Chinese foreign direct investment (FDI). As a result, the net foreign assets of Chinese firms have risen to a historical high of roughly \$450 billion as of the second quarter of 2016. In the first six months of 2016, China recorded net FDI outflows of \$47 billion. Separately, Treasury analysis of tourist spending – which rose sharply and abruptly in late 2015 – suggests that tourism spending abroad masked capital outflows.

China has the policy tools – monetary, fiscal, and structural – to foster confidence and create the conditions for an orderly transition to a market-determined exchange rate. Fiscal policy should be used flexibly to strengthen growth, job creation, and household demand, and can complement and support the implementation of China's structural reform agenda. China has laid out an ambitious structural reform agenda, which includes measures to stem the rise of corporate leverage, allow for a market-determined allocation of credit, open the services sector to competition, and strengthen the social safety net. Full implementation of this agenda will facilitate a shift in the economy away from a dependence on investment toward household consumption. Structural problems, including excess capacity in some industries, exacerbated by a weak global economic recovery and depressed market demand, have caused a negative impact on trade and workers globally. China has committed to undertake further steps to resolve its domestic excess capacity, including in the steel and aluminum sectors, and has outlined a package of structural reform policies that would enable its industries to be more responsive to market forces.

## Japan

Prime Minister Abe continues to pursue his economic revitalization plan known as “Abenomics,” and recent announcements have focused on fiscal policy actions. In May, the Prime Minister decided to postpone the consumption tax increase planned for 2017, and in August he announced the largest stimulus package of his administration at nearly 6 percent of GDP, although new spending will only account for roughly a quarter of the headline number. As for monetary policy, the Bank of Japan (BOJ) surprised markets in January 2016 by introducing negative interest rates on a portion of excess bank reserves. In September, the BOJ fundamentally shifted its policy focus from targeting monetary base expansion to “yield curve control,” or targeting short-term interest rates and long-dated yields, accompanied by an “inflation-overshooting commitment” in order to further support inflation expectations. Analysts have interpreted the regime change as providing the BOJ greater flexibility to execute its monetary policy, including by giving it more room to further lower negative rates if necessary. Structural reform has seen progress in select areas such as corporate governance, but parliamentary ratification of TPP and Prime Minister Abe’s ability to enact challenging reforms in the labor market and the services sector remain essential.

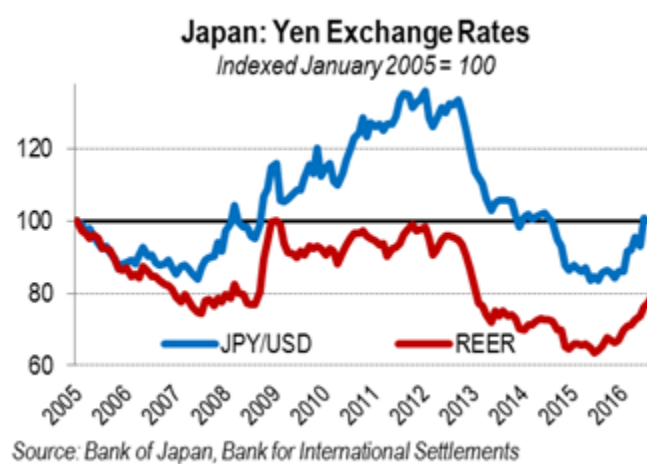
Japan’s current account continued to widen in the first half of 2016, reaching a surplus of \$86 billion (3.8 percent of GDP), compared with \$63 billion (3.0 percent of GDP) in the first half of 2015. For the 12 months ending June 2016, the current account registered a surplus of 3.7 percent of GDP, a substantial increase from 2.4 percent for the 12 months ending June 2015, and the highest 12-month surplus since 2011. The widening current account has been driven by strong net foreign income as well as an improvement in the trade balance due to (1) the re-emergence of a goods surplus for the first time in six years, (2) lower oil prices that reduce the import bill, and (3) a lower services deficit underpinned by



Source: Bank of Japan, Japan Ministry of Finance, Japan Cabinet Office. Figures are seasonally-adjusted and "Income" is primary income only

increased tourism from China. Japan’s seasonally adjusted trade balance (goods and services) turned to a surplus in late-2015 and continued to widen in 2016 on contracting imports, , climbing in August to the largest level since 2010. Export volumes fell by 2.3 percent in the first half of 2016 as compared with the first half of 2015. For the 12 months ending June 2016, Japan’s merchandise trade surplus with the United States was \$67.6 billion, as compared with \$69.0 billion for the 12 months ending June 2015. Including services, Japan’s overall trade surplus (merchandise *plus* services, seasonally adjusted) with the United States was \$55.2 billion for the same period.

Year-to-date, the yen has appreciated 18.7 percent against the dollar as of end-September and 18.0 percent on a real effective basis as of end-August. Yen appreciation has been reinforced throughout the year by (1) the yen’s safe haven appeal amid a retreat in global risk assets, particularly following the Brexit referendum; and (2) a slower-



than-anticipated interest rate hike cycle in the United States, resulting in a narrower interest-rate differential between Japan and the United States. In addition, the BOJ’s decision to adopt a negative interest rate policy in January led to market speculation that the unconventional policy raised concern that the BOJ was running out of tools to achieve its two percent inflation target. Japan has not intervened in the foreign exchange market in almost five years, but authorities have made persistent public statements to restrain appreciation in 2016, characterizing yen/dollar movements as “rough” and warning that they “will take firm action” if necessary.

Treasury assesses that the dollar-yen foreign exchange market has been functioning smoothly, and reiterates the importance of all countries adhering to their G-20 and G-7 commitments regarding exchange rate policies. In the context of the G-7 and G-20, Japan has committed to use all policy tools – monetary, fiscal, and structural – to foster confidence and strengthen the recovery, and affirmed that monetary policy alone cannot lead to balanced growth. The IMF in 2015 evaluated Japan’s real effective exchange rate to be moderately weaker

than a level consistent with fundamentals, but as of mid-2016, the IMF estimated that the yen had moved to a level consistent with medium-term fundamentals.

Given Japan's weak growth outlook and continuing weakness in global demand, it is increasingly important that the authorities use all policy levers, including implementation of a flexible fiscal policy in the near-term, to avoid a contractionary fiscal impulse. Japan's fiscal plan unveiled in August – particularly measures to improve workforce participation and direct payouts to low-income earners – appears consistent with this. Authorities must also complement monetary and fiscal support with structural reform policies that prioritize near-term growth (such as policies to raise wages and revitalize local economies) while continuing to push for reforms with longer-term benefits (such as a stronger R&D infrastructure). Ratification of TPP by Japan's parliament would be an important first step toward much needed reform in protected sectors such as agriculture and automobiles.

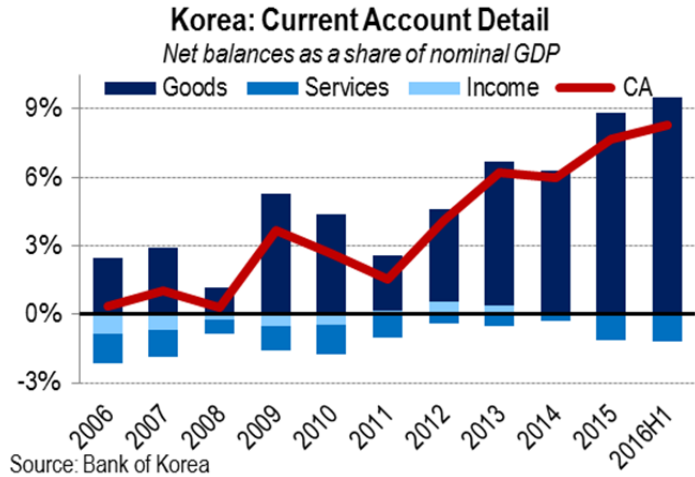
### *Korea*

Exports continue to play a dominant role in the Korean economy (greater than 50 percent of GDP), which highlights the need for Korea to continue rebalancing toward domestic demand. Historically, Korea has intervened at times on both sides of the foreign exchange market, but on net has resisted appreciation, including strongly so when the won was subject to sustained appreciation pressure. Over the 12 months ending June 2016, Korea experienced capital outflows, and the Korean authorities have intervened on net to limit won depreciation.

In June, the Korean authorities announced a fiscal package to help industrial sectors undergoing restructuring. The package focused on measures to facilitate corporate restructuring, invest in infrastructure, provide financial support to small- and medium-sized enterprises, and provide larger unemployment benefits. While the announced measures will be complemented by tax benefits for replacing older cars and rebates for home appliances to support domestic demand, the overall impact on growth will likely be quite limited as the package was entirely funded by government revenue over-performance and is being used partially to retire government debt. Furthermore, the proposed 2017 budget will represent consolidation of 0.5 percent of GDP.



Korea's current account surplus for the first half of 2016 reached 8.3 percent of GDP (\$57 billion), the second largest as a percent of GDP among G-20 countries, just after Germany, and up slightly from 7.9 percent of GDP in the first half of 2015. For the 12 months ending June 2016, the current account surplus rose to 7.9 percent of GDP, from 7.0 percent of GDP for the 12 months ending June 2015. The



larger current account surplus owed to a growing goods surplus – a function of lower import prices, particularly for energy and other commodity imports – and real merchandise export growth, which, at 3.8 percent, outpaced real merchandise import growth of 2.3 percent from July 2015 to June 2016. Korea's merchandise trade surplus with the United States totaled \$30 billion over the same 12 month time period, while the combined trade and services surplus was lower, at \$21 billion. In the first six months of 2016, Korea's merchandise trade surplus with the United States totaled \$16.5 billion; the combined trade and services surplus was lower, at \$11.4 billion, over the same period.

From July 2015 to June 2016, the won depreciated 3.5 percent against the dollar and 3.5 percent on a real effective basis. Year-to-date through September, the won has appreciated 6.5 percent against the dollar and 3.0 percent on a real effective basis. Korea officially maintains a market-determined exchange rate, and the authorities intervene with the stated objective of smoothing

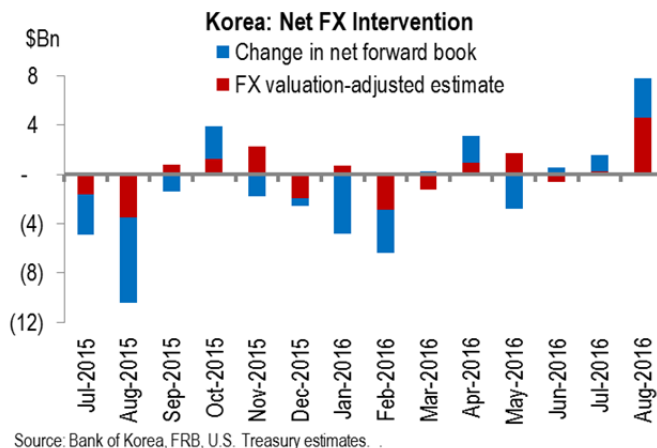


won volatility. Korea has committed in the G-20 to refrain from competitive devaluation and not target its exchange rate for competitive purposes. The IMF's 2016 External Sector Report assessed that Korea's real effective exchange rate was 4 to 12 percent weaker than the level consistent with fundamentals and



desired policies, and Korea’s external position was judged substantially stronger than that implied by medium-term fundamentals and desirable policies.

Unlike many other major emerging markets and industrialized economies, Korea does not publish foreign exchange market intervention. Treasury estimates that in the first half of 2016, the Korean authorities intervened both to resist appreciation and to resist depreciation of the won, and on net sold an estimated \$9.5 billion



Source: Bank of Korea, FRB, U.S. Treasury estimates.

in foreign exchange. For the 12 months ending June 2016, Treasury assesses that on net the authorities intervened to support the won, selling an estimated \$24 billion (1.8 percent of GDP) in foreign exchange, including activity in the forward market. More recently, Treasury estimates Korea has, on net, purchased \$9.3 billion in foreign exchange in July and August to limit won appreciation. Korea maintains ample reserves at \$369 billion as of September 2016, equal to roughly 350 percent of short-term external debt and 27 percent of GDP.

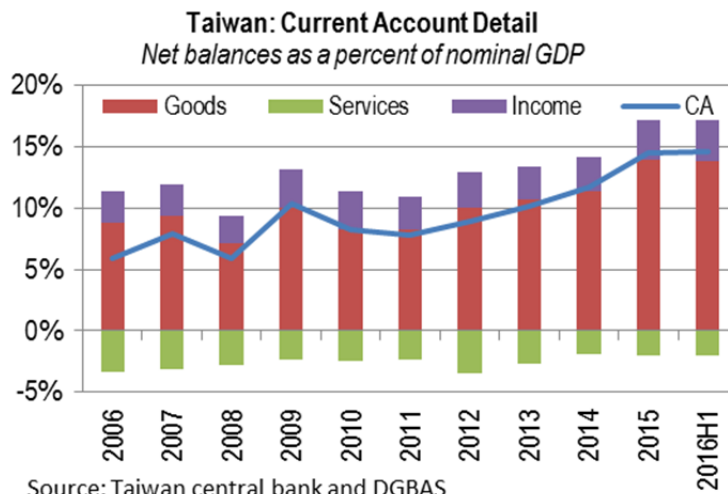
Given Korea’s growth slowdown, external headwinds, and fiscal space, it is important that Korea use all policy levers, including near-term fiscal support, to avoid a contractionary fiscal impulse. While the Bank of Korea has cut its policy rate five times since August 2014, and most recently in June 2016 to 1.25 percent, fiscal support has been more limited. Appreciation of the won over the medium term would help to narrow Korea’s large and growing current account surplus, and reorient its economy away from its heavy reliance on exports by encouraging the reallocation of resources to the non-tradables sector. Treasury has urged Korea to limit its foreign exchange intervention to only circumstances of disorderly market conditions, and to increase the transparency of its foreign exchange operations.

### Taiwan

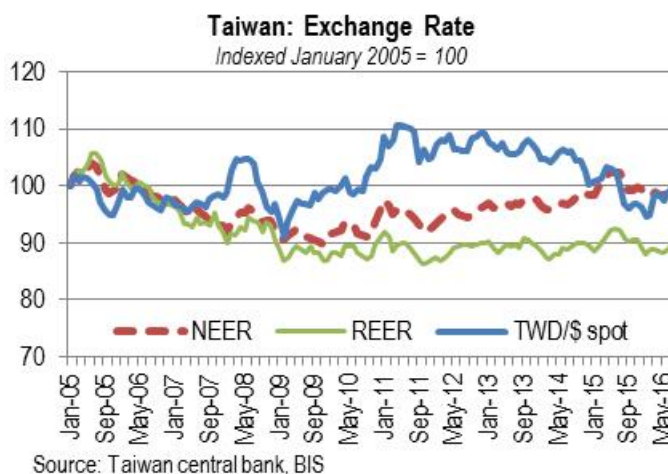
Taiwan’s economy recovered moderately after falling into recession in 2015, with GDP growth of 3.4 percent and 0.2 percent annualized in the first and second

quarters of 2016, respectively. Investment growth rebounded moderately in the second quarter, while private consumption growth slowed and the contribution of net exports to overall growth was negative.

Taiwan’s current account surplus for the first half of 2016 reached \$37.6 billion (14.6 percent of GDP), broadly unchanged from first half of 2015. For the 12 months ending June 2016, the current account surplus reached \$76 billion (14.8 percent of GDP) compared to \$71 billion (13.2 percent of GDP) in the previous 12 months ending June 2015. Both imports and exports showed year-on-year declines in the July 2015 to June 2016 period, with a larger decline in imports. The decline in exports was driven by a fall in export prices as export volumes increased slightly. The fall in imports was due to declines in both volumes and values. For the 12 months ending June 2016, Taiwan’s merchandise trade surplus with the United States was \$13.6 billion, as compared with \$15.3 billion for the 12 months ending June 2015.

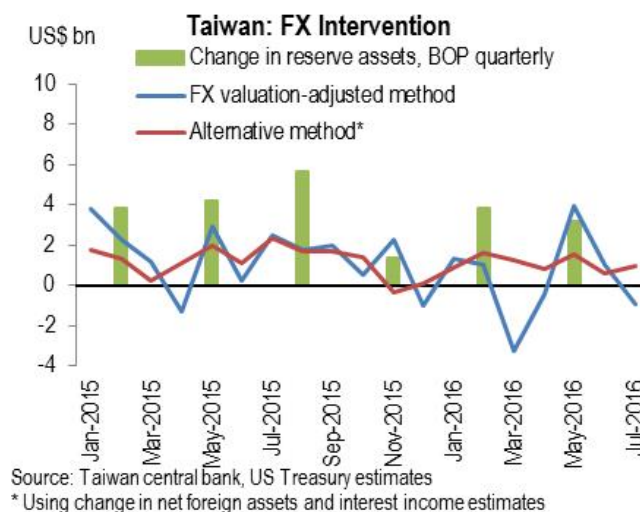


Year-to-date, as of September, the new Taiwan dollar has appreciated 4.9 percent against the dollar, after depreciating 6.1 percent in the second half of 2015, and 1.1 percent on a real effective basis. Taiwan officially maintains a managed peg exchange rate, and its stated currency policy is to smooth volatility and intervene only when



the market is “disrupted by seasonal or irregular factors.” The Peterson Institute for International Economics estimated in May 2016 that Taiwan’s real effective exchange rate was undervalued, and would need to appreciate by 25 percent to bring Taiwan’s current account surplus down to 3 percent of GDP.

Treasury estimates that Taiwan’s authorities continued to make net foreign currency purchases through the first half of 2016, with net foreign exchange purchases averaging \$1 billion per month in the second half of 2015 and the first half of 2016. Treasury estimates Taiwan continued net foreign exchange purchases of \$1 billion in July. As Taiwan does not publicize its foreign currency intervention, Treasury estimates



Taiwan’s intervention by taking the change in the central bank’s net foreign assets and subtracting estimated income on its reserves; intervention estimates are therefore sensitive to the rate of return assumed to be earned on reserves. Beginning in April, intraday foreign exchange activity suggests that the central bank reduced the frequency and volume of its intervention at the end of the trading day, which many market participants had viewed as a preference for currency depreciation. Foreign exchange reserves totaled \$437 billion (85 percent of GDP and 290 percent of short-term external liabilities) at the end of September 2016, an increase of \$11 billion from the end of 2015.

Taiwan should increase the transparency of its reserve holdings and foreign exchange market intervention, which would limit the need for outside estimates. 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 of the external sector accounts. Taiwan does not, however, publish data on the full details of its international reserves in accordance to the SDDS reserves template. Taiwan is the only major emerging market economy in Asia not to report reserves data based on the SDDS template.

### *The Euro Area*

The euro area economy strengthened moderately in the first half of 2016, supported by low commodity prices and monetary stimulus. Growth, however, decelerated in the second quarter, declining to 1.2 percent annualized, down

from 2.0 percent in the first quarter. Whereas real GDP growth was driven by domestic demand throughout 2015 and into the first quarter of 2016, domestic demand stagnated in the second quarter of 2016. Private consumption contributed only mildly to growth and investment declined in the second quarter, while net export growth improved. For the year, the IMF projects growth of 1.7 percent, down from 2.0 percent in 2015. Uncertainty stemming from the Brexit vote may weigh on investment and growth in the second half of the year. Inflation also remains well below the European Central Bank's target, while banking sector weaknesses in several countries pose an additional risk.

The euro area current account surplus expanded significantly in 2015, to 3.2 percent of GDP, driven in large part by an increase in the German current account, which increased to 8.5 percent of GDP. The euro area current account surplus rose further in the first half of 2016 to 3.4 percent. Although the pace of expansion has moderated compared to last year, the increase in the German current account surplus (to 9.4 percent of GDP in the first half of 2016) remains a large driver of growth. Much of the increase continues to reflect lower commodity prices and weak investment spending. In particular, investment spending declined in the first half of 2016 and remains 14 percent below its pre-crisis peak. Additionally, most euro area periphery economies continue to run small current account surpluses due to policy adjustments affecting internal demand following years of sustained current account deficits.

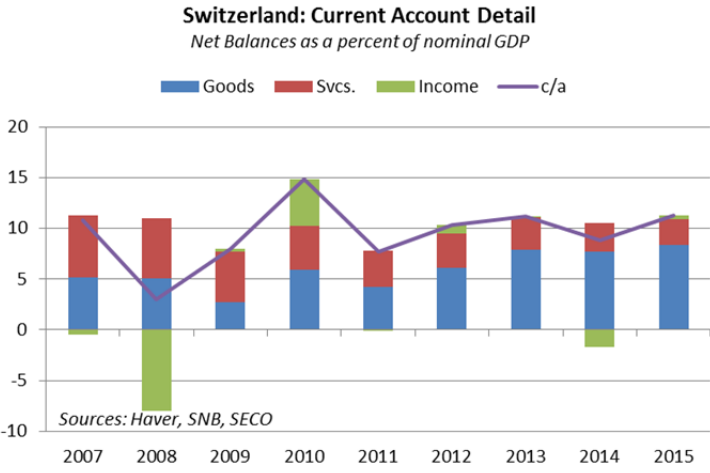
After weakening by over 12 percent against the dollar in 2015, the euro has appreciated slightly against the dollar in 2016, by 2.7 percent through end-September. In nominal and real effective terms, the euro has appreciated by about 1.8 and 1.6 percent, respectively, in 2016 through end-September.

It is critical for euro area economies to deploy a more balanced set of tools, including fiscal and structural policies, to provide support to domestic demand, particularly investment. Several countries – including Germany – have the fiscal space to provide more support for domestic demand. Boosting demand growth through increased fiscal support for infrastructure investment and greater private consumption is essential to sustaining the euro area recovery. The adjustment process, both within the euro area and globally, would function better if countries with large current account surpluses took strong action to boost investment and domestic demand so as to exceed GDP growth.

Euro area authorities should also take additional steps to accelerate the balance sheet adjustment of banks, with many burdened by a large portion of non-performing loans. A faster pace of balance sheet adjustment could improve the ECB’s monetary policy transmission channel to the real economy and improve productivity growth.

*Switzerland*

The Swiss current account surplus expanded from 8.8 percent of GDP in 2014 to 11.4 percent in 2015. The increase in the current account was driven by a 7 percent decline in nominal goods imports resulting from lower domestic demand, lower commodity prices, and a more appreciated Swiss franc.

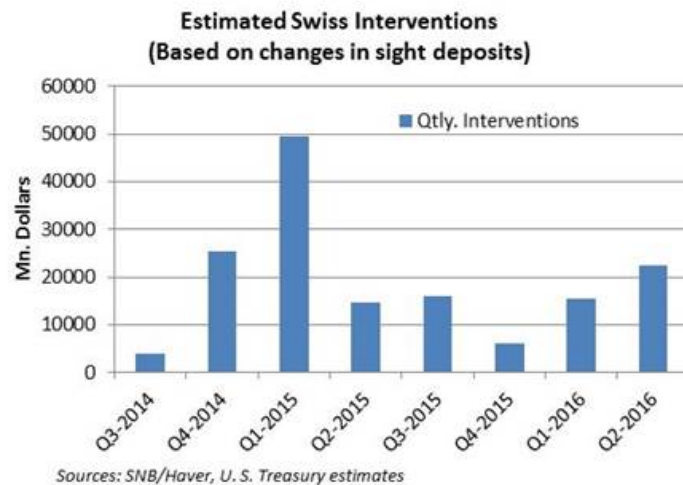


For the 12 months ending June 2016, the current account surplus decreased slightly to 10.0 percent of GDP. The IMF assesses that Switzerland’s persistently large current account surpluses are driven to some extent by non-traditional factors such as commodity trading, financial and insurance services, and net FDI earnings “whose savings may not be fundamentally Swiss.” The IMF also finds that the association between the Swiss real effective exchange rate and current account is “mild.” In 2016, through August, the Swiss franc has been roughly flat on a real and nominal effective basis, after appreciating 5.4 percent and 7.9 percent, respectively, in 2015, following the January 2015 removal of the exchange rate floor. Since end-2014, through end-September 2016, the Swiss franc has appreciated 2.1 percent against the dollar and 9.9 percent against the euro.

During the first and second quarters of 2016, Switzerland posted 1.4 percent and 2.5 percent growth (quarter-on-quarter, annualized). The Swiss National Bank (SNB) projects that economic growth will be 1.5 percent in 2016, up from 0.8 percent in 2015. Unemployment is rising, but still remains low at 3.3 percent. Deflation continues to dominate the price landscape with the central bank forecasting -0.4 percent in 2016 and 0.3 percent in 2017. The latest inflation print in August 2016 was -0.1 percent year-on-year. Switzerland continues to rely

on an expansionary monetary policy as its main tool to spur growth and inflation, with negative interest rates and intervention in the foreign exchange market to contain appreciation pressure on the franc. Fiscal policy is constrained by Switzerland’s fiscal rules despite very low borrowing costs.

The SNB has consistently been a net buyer of foreign assets after it abandoned the 1.20 Swiss francs per euro floor in mid-January 2015. These foreign asset purchases follow the SNB’s stated policy to “remain active in the foreign exchange market, as necessary,” and its assessment that “the Swiss



franc is still significantly overvalued.” The IMF agrees that the Swiss franc is overvalued, though classifies it as *moderately* overvalued. A relatively small stock of domestic assets limits the SNB’s ability to conduct a domestic asset purchase program similar to other central banks in the post-crisis period. The SNB’s recent foreign asset purchases are primarily a monetary tool to try to stem safe haven inflows and meet its inflation target, as further appreciation of the franc would add to deflationary pressures. Switzerland has experienced persistent deflation since 2012 despite full utilization of traditional monetary policy tools as well as negative interest rates. Treasury estimates that the SNB’s net foreign currency purchases totaled \$60 billion over the last 12 months ending June 2016. Reserves increased by \$70 billion during the same period and stood at \$624 billion as of end-June 2016 (95 percent of GDP). Treasury encourages the Swiss authorities to publish all intervention data.

### *United Kingdom and Brexit*

Global financial markets reacted sharply and swiftly to the outcome of the United Kingdom (UK) vote on June 23 in favor of exiting the European Union. Equity markets, particularly financial sector indices, came under significant pressure, euro area sovereign periphery yields increased, and the sterling and euro weakened against the dollar by over 11 percent and 3 percent, respectively, in the two trading sessions after the vote. Since then, equities have largely retraced

their losses and periphery yields have tightened. The pound had stabilized until the beginning of October, and since then it has depreciated by more than 5 percent against the dollar. Improving investor sentiment has been supported by the faster-than-expected formation of the UK government, accommodative monetary policy by the Bank of England (BoE), a weaker exchange rate, and better-than-expected economic data in the UK and euro area in July and August. Importantly, signals from UK authorities that they are prepared to use fiscal policy to support growth have also improved sentiment.

Prior to and through the referendum, UK economic growth was solid – second quarter GDP growth came in at 2.2 percent year-on-year, up from 2.0 percent in the first quarter. Since the vote, high frequency indicators have been mixed, though still point to growth moderation. The composite PMI fell by 5 points to 47.5 in July, the lowest level since April 2009, but then more than retraced in August to 53.6. July manufacturing production (a component of industrial production), however, indicated a contraction in British manufacturing of 0.9 percent over the previous month. The IMF estimates that Brexit uncertainty could reduce UK growth by around 1.2 percent – relative to baseline forecasts – through 2017. To help support growth, the BoE eased monetary policy in July by cutting interest rates and augmenting and broadening its quantitative easing program. The BoE also signaled a willingness to cut rates further, stopping short of negative interest rates.

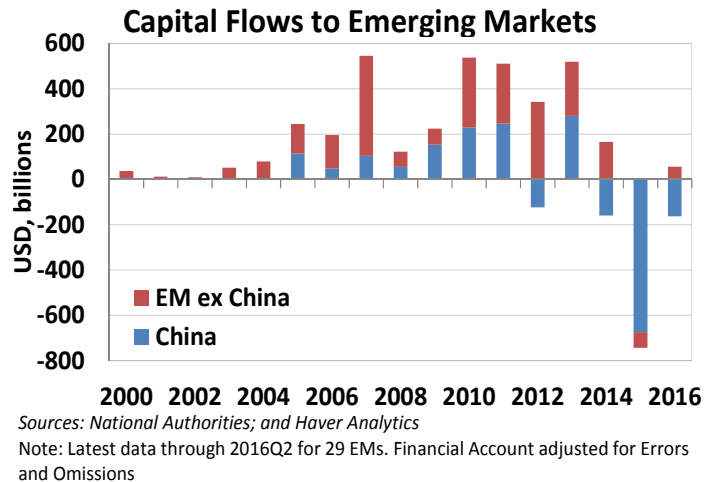
The UK continues to run a large current account deficit, which was 5.4 percent of GDP in 2015, driven by wide goods and primary income deficits. In the fourth quarter of 2015, the current account deficit came in at 7.0 percent of GDP, the largest ever quarterly peace time deficit, before narrowing slightly to 5.8 percent in the first half of 2016. The recent depreciation of the pound may improve the current account deficit by increasing the value of income from investments abroad, boosting goods exports, and suppressing imports.

The UK authorities announced plans to begin formal exit talks with the EU starting in the first quarter of 2017. Treasury encourages both sides to engage in a smooth, transparent, and pragmatic manner. Maintaining a highly integrated economic relationship would support global growth, trade, and financial stability.



## International Capital Flows

Global private capital has generally flowed to emerging markets. That reversed in a large way in 2015, as diminished growth prospects due to a sharp fall in commodity prices, as well as increased risk aversion by investors, sales of foreign assets by foreign central banks to defend against currency depreciation, and expectations of monetary policy adjustments, particularly in the United States, induced capital outflows from emerging markets.



Private outflows continued in the early part of 2016, the vast majority of which were from China, as other emerging market economies were again experiencing net inflows in the first part of 2016.

Net private outflows from China have been driven largely by a rebalancing in Chinese corporate balance sheets and outward Chinese FDI rather than a broader flight of resident investment in domestic assets. Recent high frequency data indicate that net outflows from China continued in the second and third quarters, but at a more moderate pace.

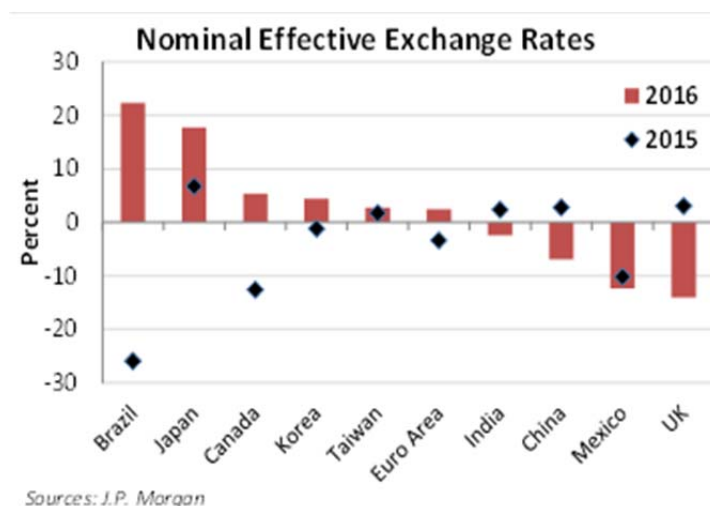
Net capital flows to other emerging markets recovered slightly during the first quarter of 2016 relative to last year. Preliminary data for the second quarter, along with high frequency data from the third quarter, indicate a stronger pace of capital inflows to emerging markets during the middle part of 2016. Portfolio inflows, both in debt and equity assets, recovered substantially during the second quarter. The flows appear to be broad based across emerging market economies.

The extent to which countries have robust and healthy financial sectors – including deep capital markets and adequate capital buffers – will likely improve financial intermediation, contribute to real-sector growth, and dampen the volatility of capital flows in response to shocks.



## Global Currency Markets

Global currency markets have experienced periodic bouts of volatility over the last year, in part reflecting policy and political surprises, including the Bank of Japan's announcement in January of negative interest rates on a portion of bank reserve assets, and the outcome of the UK vote on exiting the European Union.

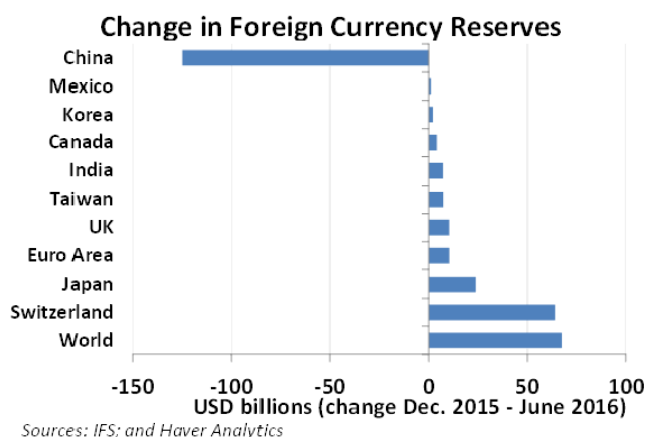


On a nominal, trade weighted basis, emerging market currencies have followed different paths in 2016, just as they did in 2015. Brazil's currency has appreciated 22 percent year-to-date as of end-September, reflecting renewed investor confidence in Brazil's economic prospects. Mexico's currency continued to depreciate and is down nearly 12 percent. China's currency, through September, depreciated 7 percent on a nominal effective basis, while India's currency is down 2 percent.

Most of the advanced economy currencies covered in this Report have appreciated on a nominal trade-weighted basis; the main exception being the British pound. The Canadian dollar has increased 5 percent year-to-date as of end-September, following a commodity-related decline in the currency in 2015, and the Japanese yen has advanced 18 percent over the same period. The British pound began depreciating in late-2015 amid weak economic data and uncertainty over the UK's continued membership in the European Union. As of end-September, the pound had depreciated by over 14 percent in trade-weighted terms so far this year.

## Foreign Exchange Reserves

Through the first six months of 2016, world foreign currency reserves have increased by about \$66 billion, and



now total just under \$11 trillion worldwide. This is in contrast to the decline in reserves in 2015 of around \$660 billion, as many economies engaged in the selling of dollar and other foreign reserve assets to stem or slow the depreciation of their currencies.

Switzerland accounts for a sizable share of the increase in reserves, but reserve holdings in Korea, Taiwan, and India also increased. A large reduction in China’s reserves offset these increases. China held reserves of roughly \$3.2 trillion as of end-September.

	FX reserves as % of short term debt	FX reserves as % of GDP
India	403.7%	16.1%
China	377.5%	29.1%
Korea	351.0%	26.5%
Taiwan	288.6%	84.5%
Mexico	283.2%	16.5%
Switzerland	68.6%	94.6%
Japan	49.8%	27.9%
Canada	13.3%	4.9%
Italy	5.0%	1.9%
UK	2.1%	4.0%
Germany	2.0%	1.1%
France	1.8%	1.5%

Sources: National Authorities, IFS, and Haver Analytics  
 Note: Data as of 2016Q2

As noted, China, Korea, Taiwan, and Switzerland do not publish their foreign exchange intervention activities so it is not possible to separate precisely transactions from valuation adjustments.<sup>5</sup> These countries each have more than ample amounts of foreign currency reserves, expressed either as a share of their short-term liabilities or as a percent of their GDPs.

## Section 2: Intensified Evaluation of Major Trading Partners

### Key Criteria

Pursuant to Section 701 of the Trade Facilitation and Trade Enforcement Act of 2015, this section seeks to identify any major trading partner of the United States that has: (1) a significant bilateral trade surplus with the United States, (2) a material current account surplus, and (3) engaged in persistent one-sided intervention in the foreign exchange market. Section 701 requires data on each major trading partner’s bilateral trade balance with the United States, its current account balance as a percentage of GDP, the three-year change in the current account balance as a percentage of GDP, foreign exchange reserves as a

<sup>5</sup> In addition, Taiwan does not currently release foreign exchange reserves information according to the IMF’s Special Data Dissemination Standard (SDDS). Taiwan is not a member of the IMF but does use SDDS templates for the release of other macroeconomic and financial data.

percentage of short-term debt, and foreign exchange reserves as a percentage of GDP. Data for the most recent four-quarter period July 2015 to June 2016 are provided in the preceding and following tables.

Treasury has chosen to focus on the 12 largest trading partners of the United States, which account for around 70 percent of U.S. trade in goods. Below the top 12 trading partners, the amounts of trade fall off sharply. Treasury’s goal is to focus attention on the currency practices of those economies whose bilateral trade is the most significant to the U.S. economy, and whose policies are the most material for the global economy.<sup>6</sup>

**Table 1. Major Foreign Trading Partners Evaluation Criteria**

	Bilateral Goods Deficit (USD Bil., Trailing 4Q) (1)	Current Account			FX Intervention		
		Balance (% of GDP, Trailing 4Q) (2a)	3 Year Change in Balance (% of GDP) (2b)	Balance (USD, Billion; Trailing 4Q) (2c)	Net FX Purchases (% of GDP) (3a)	Net FX Purchases (\$ Bil.) (3b)	Persistent Net FX Purchases? (3c)
China	356.1	2.4	0.0	260.9	-5.1%	-566	No
Germany	71.1	9.1	2.3	312.3	-	-	No
Japan	67.6	3.7	2.6	158.3	0.0%	0	No
Mexico	62.6	-2.9	-0.8	-31.7	-2.2%	-24	No
Korea	30.2	7.9	2.0	107.1	-1.8%	-24	No
Italy	28.3	2.3	1.9	42.5	-	-	No
India	24.0	-0.8	4.2	-16.0	0.3%	5	No
France	18.0	-0.5	0.4	-12.8	-	-	No
Taiwan	13.6	14.8	5.2	75.8	2.5%	13	Yes
Switzerland	12.9	10.0	-1.6	66.2	9.1%	60	Yes
Canada	11.2	-3.4	0.1	-51.1	0.0%	0	No
United Kingdom	-0.3	-5.7	-2.0	-161.2	0.0%	0	No
<b>Memo : Euro Area</b>	<b>130.5</b>	<b>3.2</b>	<b>1.3</b>	<b>380.4</b>	<b>0.0%</b>	<b>0</b>	<b>No</b>

Sources: Haver Analytics; National Authorities; U.S. Bureau of Economic Analysis; and U.S. Department of the Treasury Staff Estimates

### Criterion (1) – Significant bilateral trade surplus with the United States:

Column 1 in Table 1 provides the bilateral goods trade balances for the United States’ 12 largest trading partners for the four quarters ending June 2016.<sup>7</sup> China has the largest trade surplus with the United States by far, after which the size of bilateral trade surpluses declines very quickly. Treasury assesses that economies

<sup>6</sup> See Section 3 for a discussion of the factors used to assess the three criteria which, taken together, would require enhanced analysis.

<sup>7</sup> Although this Report does not treat the euro area itself as a major trading partner for the purposes of the 2015 Act – this Report assesses euro area countries individually – data for the euro area are presented in Table 1 and elsewhere in this Report both for comparative and contextual purposes, and because policies of the ECB, which holds responsibility for monetary policy for the euro area, will be assessed as the monetary authority of individual euro area countries.

with a bilateral goods surplus of at least \$20 billion (roughly 0.1 percent of U.S. GDP) have a “significant” surplus. Highlighted in red are the major trading partners that have a bilateral surplus that meets this threshold over the most recent four quarters. In the aggregate, this threshold captures around 75 percent of the value of all trade surpluses with the United States.

### **Criterion (2) – Material current account surplus:**

Treasury assesses current account surpluses in excess of 3 percent of GDP to be “material” for the purposes of enhanced analysis. Highlighted in red in column 2a are the five economies that had a current account surplus in excess of 3 percent of GDP for the four quarters ending June 2016. Column 2b shows the change in the current account surplus over the last three years, although this is not a criterion for enhanced analysis.

### **Criterion (3) – Persistent, one-sided intervention:**

Treasury assesses net purchases of foreign currency, conducted repeatedly, totaling in excess of 2 percent of an economy’s GDP over a period of 12 months to be persistent, one-sided intervention.<sup>8</sup> Column 3a in Table 1 provides Treasury’s assessment of this criterion. In economies where foreign exchange interventions are not published, Treasury uses estimates of net purchases of foreign currency to proxy for intervention. Taiwan and Switzerland meet this criterion the last four quarters available, per Treasury estimates.

### ***Summary of Findings***

Pursuant to the 2015 Act,<sup>9</sup> Treasury finds that no economy currently meets all three criteria. Six major trading partners of the United States, however, have met two of the three criteria for enhanced analysis in this Report or the previous Report. These six economies – China, Japan, Korea, Taiwan, Germany, and Switzerland – constitute Treasury’s Monitoring List. China met two of the three criteria in the April 2016 Report – a large bilateral trade surplus with the United States and a current account surplus above 3 percent of GDP – and it met one of

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<sup>8</sup> Notably, this quantitative threshold is sufficient to meet the criterion. Other patterns of intervention, with lesser amounts and/or less frequent interventions, might also meet the criterion depending on the circumstances of the intervention.

<sup>9</sup> Section 701 of the Trade Facilitation and Trade Enforcement Act of 2015, 19 U.S.C. § 4421.

the three criteria in this Report – a large bilateral trade surplus with the United States. Japan, Germany, and Korea met two of the three criteria in both Reports, having material current account surpluses combined with significant bilateral trade surpluses with the United States. Taiwan met two of the three criteria in both Reports, having a material current account surplus and persistent, one-sided intervention in foreign exchange markets. Switzerland met two of the three criteria in this Report, having a material current account surplus and having engaged in persistent, one-sided intervention in foreign exchange markets. Treasury will closely monitor and assess the economic trends and foreign exchange policies of these economies.

The fact that no major trading partner met all three criteria during this period is a reflection, in part, of the dynamics of the global economy during the past year, in which capital outflows from emerging markets have led a number of economies to engage in foreign exchange intervention to resist further *depreciation* of their currency (rather than appreciation). The extent of these flows was unusually high by historical standards, which underscores the possibility that more economies may trigger these thresholds going forward.

Treasury will continue to review the factors it uses to assess whether an economy has: (1) a significant bilateral trade surplus with the United States, (2) a material current account surplus, and (3) engaged in persistent one-sided intervention in the foreign exchange market, to ensure these reporting and monitoring tools meet their objective of indicating where unfair currency practices may be emerging.

Based on the analysis in this Report, Treasury has also concluded that no major trading partner of the United States met the standard of manipulating the rate of exchange between its currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade during the period covered in the Report.

### **Section 3: Assessment Factors for Enhanced Analysis<sup>10</sup>**

This Section describes the factors Treasury used to assess, under Section 701(a)(2)(A)(ii) of the Trade Facilitation and Trade Enforcement Act of 2015, whether an economy that is a major trading partner of the United States has: (1) a significant bilateral trade surplus with the United States, (2) a material current account surplus, and (3) engaged in persistent one-sided intervention in the foreign exchange market.

In determining the appropriate factors to assess these criteria, Treasury analyzed data spanning 15 years across dozens of economies including all economies that have had a trade surplus with the United States during that period, and a group of economies that collectively represent 80 percent of global GDP. The discussion below presents the findings of this analysis through the first half of 2016.

This is the second Report to formally implement this framework. To help prepare this Report, Treasury has consulted with external analysts regarding the thresholds described below and their implications. Going forward, Treasury will benefit from the formation of an Advisory Committee on International Exchange Rate Policy, as called for in the 2015 Act, to provide advice to the Secretary of the Treasury with respect to the impact of international exchange rates and financial policies on the economy of the United States. Treasury will continue to review the factors it uses to assess these criteria to ensure that the new reporting and monitoring tools provided under the 2015 Act meet their objective of indicating where unfair currency practices may be emerging.

#### **A. (a)(2)(A)(ii)(I) a significant bilateral trade surplus with the United States**

Trade patterns are driven by a host of different factors including production costs, geographic location, geological endowments, and consumer and producer demand patterns among many other things. Accordingly, it is rare for any given economy to have balanced trade overall, or with its bilateral trading partners. In assessing what constitutes a “significant” trade surplus, Treasury analyzed the size

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<sup>10</sup> This Section is submitted pursuant to Section 701(a)(3) of the Trade Facilitation and Trade Enforcement Act of 2015, 19 U.S.C. § 4421.

of bilateral trade surpluses with the United States over the past 15 years.<sup>11</sup> The ordering of economies by the size of their bilateral surpluses with the United States is relatively stable, and there is a rapid drop off from the largest to smaller bilateral surpluses.

The distribution of bilateral trade surpluses points to a significance threshold of about \$20 billion. This threshold would generally include a group of economies representing around 75 percent of the value of all trade surpluses with the United States, and corresponds closely to the top decile of trade surplus countries. Over time, as global trade expands, this nominal figure will be reassessed to ensure it remains current and relevant.

### **B. (a)(2)(A)(ii)(II) a material current account surplus**

An economy's current account balance reflects its trade position and its income on assets abroad, less income it pays on foreign investment within its borders. There are several factors that influence an economy's current account balance, including its policies, level of development, and structure of the economy. As with trade balances, economies rarely have a balanced current account.

Treasury took an approach in assessing what is a "material" current account surplus similar to the approach it took in assessing what constitutes a "significant" bilateral trade surplus. Based on an examination of global current account balances since 2000, and taking into account a variety of studies in the economics literature that examine the impact of current accounts as well as with the work done by other policy institutions, a surplus of 3 percent of GDP is considered material. Looking at 2015 data (the last full year for which data are available on global current account surpluses), a threshold of 3 percent of GDP captures economies that account for more than half of total global current account surpluses.

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<sup>11</sup> Given data limitations, we focus on trade in goods, not including services. The United States has a surplus in services trade with many countries in this Report including Canada, China, Japan, Korea, Mexico, and the UK. Taking into account services trade would reduce the bilateral trade surplus of these countries with the United States.

This threshold is broadly consistent with a variety of studies in the economics literature that examine the impact of current accounts as well as with the work done by other policy institutions.<sup>12</sup>

**C. (a)(2)(A)(ii)(III) engaged in persistent one-sided intervention in the foreign exchange market:**

Governments accumulate reserves for a range of reasons. Foreign currency reserves may be needed for day-to-day transactions including debt repayments, payments to international organizations, and payments for imports. Economies with pegged exchange rates hold reserves to counter downward pressure on their currencies. Economies with flexible exchange rates hold reserves in order to intervene in foreign exchange markets to prevent a disorderly depreciation of their currencies. Reserve holdings also can provide a defense against substantial and rapid capital outflows that could cause a loss of investor confidence and a currency crisis. At the same time, excess reserve accumulation by one or a subset of economies runs counter to the effective rebalancing of global demand, can distort the international monetary system and, by bidding up the cost of reserve assets, also makes it more expensive for vulnerable economies to build up their own precautionary buffers.

In defining what constitutes persistent, one-sided intervention, it is important to acknowledge that there are only limited precedents in the economics literature or policy practice. There is also no single metric by which to assess reserve accumulation. Treasury has set a threshold for this criterion of net purchases of foreign currency, conducted repeatedly, totaling at least 2 percent of an economy's GDP over a period of 12 months ending either June or December. Notably, this quantitative threshold is *sufficient* to meet the criterion. Other patterns of intervention, with lesser amounts and/or less frequent interventions, might also meet the criterion depending on the circumstances of the intervention.

This quantitative threshold captures all of the major periods of foreign exchange intervention by important emerging markets since 2000. For example, based on Treasury estimates, both China and Taiwan would have met this threshold for 12

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<sup>12</sup> External work that bears on this topic includes: (1) BIS working paper #169: Current Account Adjustment and Capital Flows, 2005; (2) the IMF's World Economic Outlook, October 2014, Chapter 4: Are Global Imbalances at a Turning Point?; and (3) the EU's Occasional Paper #92, Scoreboard for the surveillance of macroeconomic imbalances, 2012.



of the past 15 years, and Korea would have met the threshold for several of those years. In assessing the persistence of intervention, Treasury will consider an economy that is judged to have purchased foreign exchange on net for 8 of the 12 months to have met the threshold, although other patterns of intervention may also meet the persistence threshold.

Treasury used publicly available data for intervention on foreign asset purchases by country authorities, or as estimated by Treasury staff using valuation-adjusted foreign exchange reserves. This methodology requires assumptions about both the currency and asset composition of reserves in order to isolate returns on assets held in reserves and currency valuation moves from actual purchases and sales, including estimations of transactions in foreign exchange derivatives markets. Treasury also uses alternative data series when they provide a more accurate picture of foreign exchange balances, such as China's monthly reporting of net foreign assets on the PBOC's balance sheet and Taiwan's reporting of net foreign assets at its central bank. To the extent the assumptions made are not reflective of the true composition of reserves, estimates may over or under state intervention. Treasury strongly encourages those economies in this Report that do not currently release data on foreign exchange intervention to do so.

## Glossary of Key Terms in the Report

**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** – An exchange rate 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.

**Foreign Exchange 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 own currency for a foreign currency, increasing its foreign currency reserves. Sales involve the exchange of an economy’s foreign currency reserves for its own currency, reducing foreign currency reserves. Interventions may be sterilized or unsterilized.

**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** – An exchange rate 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)** – A weighted average of bilateral exchange rates, expressed in price-adjusted terms.

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