

Report to Congress on International Economic and Exchange Rate Policies

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 (the “Act”).¹

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

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Key Findings

The Omnibus Trade and Competitiveness Act of 1988 (the “Act”) requires the Secretary of the Treasury to provide semiannual reports on the international economic and exchange rate policies of the major trading partners of the United States. Under Section 3004 of the Act, the Report must consider “whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade.”

This report covers developments in the second half of 2013, and where pertinent and available, data through end-March 2014. This report reviews the macroeconomic and exchange rate policies of economies accounting for 71 percent of U.S. foreign trade and of global economic developments more broadly in the second half of 2013. The Report concludes that although global growth prospects are improving, much more needs to be done to foster strong, sustainable and balanced growth, including through bolstering domestic demand growth in countries with external surpluses, and by making greater strides in allowing freely flexible exchange rates. Progress on rebalancing global demand continues to remain inadequate and may, in fact, have worsened in the second half of 2013. In addition, foreign exchange intervention and reserve accumulation in some countries increased notably in the second half of last year.

The Administration’s policies continue to promote growth and jobs. Real GDP grew at a 3.4 percent annual rate in the second half of 2013, accelerating notably from the 1.8 percent pace in the first half. A consensus of private forecasters is projecting a 2.7 percent increase in real GDP in 2014, and domestic demand is expected to accelerate. Export growth accelerated in late 2013, increasing at an annual rate of 6.6 percent, more than double the 3.2 percent gain posted in the first half. Nonfarm payrolls increased by 183,000 per month on average over the nine months through March 2014 and between December 2012 and December 2013, the unemployment rate fell by 1.2 percentage points to 6.7 percent. The federal deficit narrowed sharply in FY 2013 to 4.1 percent of GDP from 6.8 percent of GDP in FY 2012. The Administration’s proposed FY 2015 Budget would trim the deficit further and put publicly held debt on a declining path as a share of the economy.

Global growth is expected to strengthen in 2014, led by the advanced economies. But significant risks remain and global demand is inadequate. In the euro area, weak domestic demand growth, high output gaps and high unemployment have left inflation significantly below the ECB’s target. This has reinforced deflationary pressures on the periphery and made the needed adjustment in relative prices and costs in the euro area more painful. Domestic demand growth in Japan is likely to be muted by Japan’s shift to fiscal consolidation. The IMF projects that growth will strengthen in many emerging market economies compared to 2013 amid a mixture of weaker currencies, higher domestic interest rates, and stronger foreign demand; but decelerate in others where important policy adjustments are needed.

Given the changing global investment environment, with growth strengthening in the advanced economies and downshifting in emerging markets, there has been some re-pricing of global risk. The size of the adjustment has varied across countries according to domestic economic conditions and the strength of their respective policy frameworks (see Annex 1). Volatility has

been more severe and more frequent in those emerging markets whose current accounts deficits are wider and inflation is higher, while in many other markets prices rebounded from earlier declines as it became clear that domestic policy frameworks were more robust. Recent geopolitical tensions and certain one-off events in some emerging markets exacerbated volatility in the early months of 2014, following a period of general differentiation and relative calm over the fall, but conditions have since steadied.

The key global imperative is to foster strong, sustainable and balanced growth. Finance Ministers and Central Bank Governors of the G-20 agreed, in February 2014, to develop new growth strategies with the objective of increasing collective G-20 GDP by more than two percent above the trajectory implied by current policies over the coming five years. A key part of the agreement is that the policies must also contribute to more effective global rebalancing.

Two key ingredients have been missing or inadequate in the global adjustment process. The first is the need for the pace of domestic demand growth in the surplus economies to be faster than GDP growth. For example, in Germany, domestic demand has grown faster than GDP only three times in the past ten years. Most of the adjustment thus far has been by deficit economies increasing national saving which has held back global growth. Second, considerably more progress is still needed to at last achieve market-determined exchange rates and refrain from currency intervention and excessive reserve accumulation.

This report therefore highlights the need for concerted progress on global rebalancing, including boosting domestic demand in surplus countries and greater exchange rate flexibility, most notably in China. It also emphasizes the need for greater transparency on exchange rate management, much less official intervention in foreign exchange markets, and stronger restraints over actual and verbal intervention.

In Germany, the current account surplus remains well above 7 percent of GDP, increasing relative to GDP in the second half of last year. One sign of the subdued pace of German demand growth is that German goods imports were 1.0 percent weaker for the year. The euro-area's collective surplus expanded as well, as large current account deficits in peripheral countries continued to shrink and, in some cases, moved into surplus largely through demand compression.

In China, the RMB appreciated during 2013 on a trade-weighted basis, but not as fast or by as much as is needed, and large-scale intervention resumed. The RMB appreciated by 2.9 percent against the dollar in 2013. However, as a result of the depreciation of the yen and many emerging market currencies, the RMB strengthened more on a trade-weighted basis, with the RMB's nominal and real effective exchange rates rising 7.2 and 7.9 percent, respectively. For most of 2013 the RMB exchange rate was at, or very near, the most appreciated edge of the daily trading band, suggesting continuous pressure for greater RMB appreciation. During 2014, however, the exchange rate has reversed direction, depreciating by a marked 2.68 percent year to date.

There are a number of continuing signs that the exchange rate adjustment process remains incomplete and the currency has further to appreciate before reaching its equilibrium value. China continues to generate large current account surpluses and attracts large net inflows

of foreign direct investment; China's current account surplus plus inward foreign direct investment in 2013 exceeded \$446 billion. The reduction in the current account surplus as a share of China's GDP has largely been the reflection of the unsustainably rapid pace of investment growth. Finally, China has continued to see rapid productivity growth, which suggests that continuing appreciation is necessary over time to prevent the exchange rate from becoming more undervalued. All of these factors indicate a RMB exchange rate that remains significantly undervalued. Further exchange rate appreciation would help to smoothly rebalance the Chinese economy away from investment toward consumption.

The Chinese authorities have been unwilling to allow an appreciation large enough to bring the currency to market equilibrium, opting instead for a gradual adjustment which has now been partially reversed. The expectation that the RMB would continue to appreciate over time resulted in large and increasing capital inflows in 2013. The PBOC's policy of gradual adjustment triggered expectations of continued appreciation, and resulted in large-scale foreign exchange intervention. China's foreign exchange reserves increased sharply in 2013, by \$509.7 billion, which was a record for a single year. China has continued large-scale purchases of foreign exchange in the first quarter of this year, despite having accumulated \$3.8 trillion in reserves, which are excessive by any measure. This suggests continued actions to impede market determination.

On March 17, the PBOC widened the RMB's intra-day trading band to +/- 2.0 percent around its midpoint fixing against the dollar from the previous +/- 1.0 percent. In the month prior to the band widening, the PBOC took measures, including reported heavy intervention, to significantly weaken the RMB and push it away from the most appreciated edge of the previous band. The RMB has seen periods of depreciation before, such as mid-2012 when the RMB fell 1.5 percent against the dollar over a three-month period. However, the pace and the size of the recent decline was unprecedented. From February 17, 2014 to March 20, 2014, the RMB weakened 2.6 percent against the dollar.

The widening of the band gives China an opportunity to reduce intervention and allow the market to play a greater role in determining the exchange rate. To realize this opportunity, China should refrain from intervention within the band and should allow market forces to permit the reference rate to adjust if market pressures push the exchange rate to the edge of the band. Recent developments in the RMB exchange rate would raise particularly serious concerns if they presage renewed resistance to currency appreciation and a retreat from China's announced policy of reducing intervention and allowing the exchange rate to reflect market forces. We will continue to monitor these issues closely going forward. In line with the practice of most other G-20 nations, China should disclose foreign exchange market intervention regularly to increase the credibility of its monetary policy framework and to promote exchange rate and financial market transparency.

Japan has not intervened in the foreign exchange markets in almost two years. Japan's goods trade balance fell into deficit in 2011 for the first time since 1980, and reached a deficit of 2.6 percent of GDP in 2013. The current account surplus has narrowed substantially from almost 4.0 percent of GDP in 2010 to 0.7 percent in 2013. As Japan takes policy steps to bring about a durable recovery and escape deflation, it is imperative both for the success of those measures and

for the global economy that Japan's economic policies work primarily through an increase in domestic demand. In this respect, it is important that Japan carefully calibrate the pace of overall fiscal consolidation. Monetary policy cannot offset excessive fiscal consolidation nor can it substitute for necessary structural reforms that raise trend growth and domestic demand.

Korea's current account surplus further increased to 6.1 percent of GDP in 2013 – the highest since 1999 – compared to 4.2 percent in 2012. Korea is one of only a few surplus economies with a significantly larger external surplus now than before the crisis. Net exports accounted for over half of Korea's growth in 2013, highlighting the economy's continued dependence on external demand and the weakness of domestic demand. Although Korea does not publish data on its foreign exchange intervention, during the second half of 2013 the Korean authorities are believed to have intervened to limit the pace of won appreciation. Korea's foreign exchange reserves rose from \$315.6 billion at end-June 2013 to \$335.6 billion at end-December and \$341.0 billion at the end of February 2014. The Korean authorities also increased their net forward position by \$4.9 billion to \$50.5 billion over the second half of 2013. The magnitude of these changes is larger than can be reasonably expected from simple interest earnings on the existing stock of reserve assets or valuation changes. The Korean authorities should limit foreign exchange intervention to the exceptional circumstances of disorderly market conditions and increase the transparency of their interventions in foreign exchange. The Korean government has laid out ambitious plans to promote the development of the services sector and to reduce dependence on exports. Exchange rate appreciation is an important tool for supporting this rebalancing.

Based on the analysis in this report, Treasury has concluded that no major trading partner of the United States met the standard of manipulating the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade as identified in Section 3004 of the Act during the period covered in the Report. Nonetheless, Treasury is closely monitoring developments in economies where exchange rate adjustment is incomplete and pushing for comprehensive adherence to recent G-7 and G-20 commitments. Treasury will continue to monitor closely exchange rate developments in all the economies covered in this report, with particular attention to the need for greater RMB appreciation, and press for further policy changes that yield greater exchange rate flexibility, greater transparency on intervention, a more level playing field, and support for strong, sustainable and balanced global growth.

Introduction

This report focuses on international economic and foreign exchange developments in the second half of 2013. Where pertinent and when available, data and developments through end-March 2014 are included.

Exports and imports of goods to and from the ten economies analyzed in this report accounted for 71 percent of U.S. merchandise trade in 2013.

U.S. Macroeconomic Trends

U.S. Economic Growth Accelerated

The U.S. economic recovery strengthened in the second half of 2013, as private demand firmed. Real GDP grew at a 3.4 percent annual rate in the second half of 2013, accelerating notably from the 1.8 percent pace in the first half. Growth of private domestic demand – the sum of consumption, business fixed investment, and residential investment – accelerated to a 2.9 percent pace from 2.1 percent in the first half of 2013. Over the entire year, real GDP advanced 2.6 percent, faster than the 2.0 percent pace recorded during 2012. The economy is expected to strengthen further this year. A consensus of private forecasters is projecting a 2.7 percent increase in real GDP over the four quarters of 2014.

Stronger growth in consumption, business fixed investment, as well as a marked build-up of private inventories, contributed to the faster pace of expansion in the third and fourth quarters of 2013, helping offset the negative effects of declining government spending. Consumer spending rose at a 2.6 percent annual rate over the final two quarters of 2013, faster than the 2.0 percent pace over the first two quarters. Business fixed investment rose 5.3 percent, a marked improvement following a 0.1 percent decline in the first half of 2013. Inventory accumulation picked up in the latter half of 2013, with a particularly large build-up in the third quarter. On average, the change in private inventories contributed 0.8 percentage point to real GDP growth in the second half of the year, slightly more than the 0.7 percentage point contribution averaged in the first two quarters of 2013.

Export growth also accelerated in late 2013, reflecting somewhat better global economic conditions. During the second half of the year, exports rose at an annual rate of 6.6 percent, more than double the 3.2 percent gain posted in the first half. At the same time, growth of imports slowed to a 1.9 percent pace from 3.7 percent in the first half of 2013. Accordingly, net exports contributed an average of 0.6 percentage point to real GDP growth in the third and fourth quarters of 2013, after subtracting nearly 0.2 percentage point on average from growth in the first two quarters of the year.

The recovery in the housing market moderated in the latter half of 2013, as higher mortgage rates weighed on housing demand. The benchmark interest rate for a 30-year fixed mortgage rose almost a full percentage point between May and December – from an average of 3.5 percent to an average of 4.5 percent, contributing to slower growth of both new and existing home sales. Altogether, single-family home sales declined 5.6 percent during the last six months of 2013

compared with growth of 6.5 percent during the first six months of the year on a seasonally adjusted basis. In addition to higher mortgage rates, a still restricted supply of mortgage credit, and relatively tepid income growth have also held down housing demand. Housing supply continued to expand through the end of 2013, but the pace of new home building has moderated recently. In the final quarter of the year, residential investment declined for the first time since the third quarter of 2010, and during the entire second half of 2013, residential investment rose just 0.8 percent at an annual rate, compared with growth of 13.4 percent during the first half of the year.

Fiscal consolidation weighed a bit more heavily on the economy during the latter half of 2013, as real federal government spending fell more rapidly, declining by 7.3 percent at an annual rate in the third and fourth quarters compared with a decline of 5.1 percent during the first two quarters of the year. The drop in real federal outlays was particularly pronounced in the fourth quarter, partly reflecting the effects of the partial government shutdown in October. Altogether, the drop in federal spending during the second half of 2013 reduced GDP growth by an average of 0.6 percentage point per quarter compared with an average quarterly subtraction of 0.4 percentage point in the first half of the year. In contrast, fiscal conditions at the state and local level generally improved in 2013. State and local government outlays rose by 0.8 percent at an annual rate in the second half of the year after declining 0.4 percent in the first half.

Labor Market Conditions Continued to Improve, and Inflation Remained Moderate

The economy continued to create jobs at a moderate pace in late 2013 and early 2014, and the unemployment rate moved lower. Nonfarm payrolls increased by 183,000 per month on average over the nine months through March 2014, somewhat slower than the 204,000 monthly average during the first half of last year. Nearly 8.3 million jobs have been created since February 2010, including 8.9 million in the private sector. As of March, the level of private employment had surpassed its pre-recession peak, but total payrolls remained more than 400,000 lower due to job losses in the public sector. Between December 2012 and December 2013, the unemployment rate fell by 1.2 percentage points to 6.7 percent and in March 2014 remained at 6.7 percent. The unemployment rate has fallen by 3.3 percentage points from its October 2009 peak but is still 1.7 percentage points higher than at the start of the recession in late 2007. The share of the unemployed out of work for 27 weeks or more, at 35.8 percent, is more than double the 17.5 percent share averaged in 2007, but it has declined from an all-time high of 45.3 percent in April 2010.

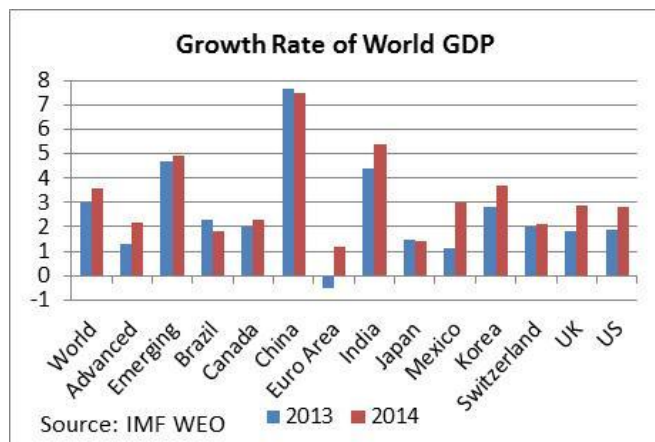
Headline and core inflation have generally remained low in recent months. The consumer price index rose 1.1 percent during the year ending in February 2014, down from 2.0 percent a year earlier. Core consumer inflation (which excludes the volatile food and energy categories) moderated to 1.6 percent over the year ending in February 2014 from 2.0 percent over the year-earlier period. Slower growth in medical care costs along with labor market slack and the low level of capacity utilization have helped contain inflationary pressures.

Putting Public Finances on a Sustainable Path Remains a Priority

The federal deficit narrowed sharply in FY 2013 to 4.1 percent of GDP from 6.8 percent of GDP in FY 2012. Since peaking in 2009, the deficit has fallen by 5.7 percentage points – the most rapid pace of fiscal consolidation for any four-year period since the demobilization following World War II. The Administration’s FY 2015 Budget would trim the deficit substantially further and put publicly held debt on a declining path as a share of the economy. By the end of the forecast horizon in FY 2024, the deficit is projected to fall to less than 2.0 percent of GDP. The primary deficit (non-interest outlays less receipts) is projected to become a primary surplus in FY 2018 and grow through the end of the forecast horizon. The debt-to-GDP ratio, as measured by debt held by the public, is projected to peak at 74.6 percent in FY 2015 and then begin to decline, falling to 69.0 percent of GDP by FY 2024.

The Global Economy

Global growth is expected to be stronger in 2014 than in 2013. The International Monetary Fund (IMF) projects an acceleration of 0.6 percent to 3.6 percent, mostly reflecting a pick-up in growth in the advanced economies as the United States strengthens further and the euro area continues to emerge from recession. In contrast, growth is projected to moderate in Japan, driven in large part due to planned fiscal consolidation. Despite a projected moderation of growth in China (from 7.7



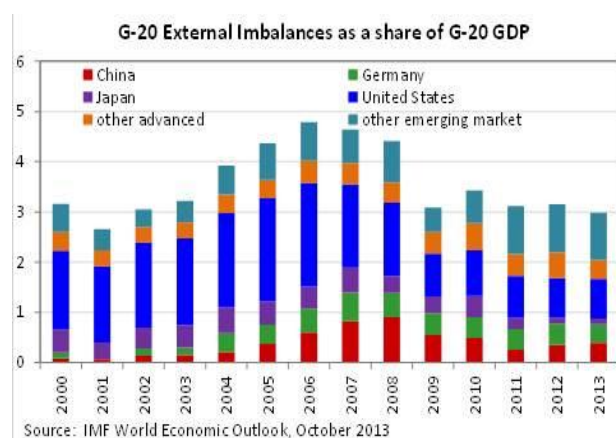
percent in 2013 to 7.5 percent in 2014) real GDP is projected to expand by 4.9 percent in the emerging market and developing economies, up from 4.7 percent in 2013 led by stronger growth in Mexico, the Middle East, Africa, and Asia. The strength of U.S. private demand growth has been a pillar of support to the global economy, and the expectation of increasing U.S. growth over the coming year is a major factor in the IMF’s more optimistic outlook for 2014.

Despite these recent improvements, the global economy still faces weaknesses in some areas of demand, and growth in many countries is still below the rates needed to foster strong job creation. With the intention of fostering strong, sustainable and balanced growth, G-20 Finance Ministers and Central Bank Governors agreed in February 2014 to develop policies to boost collective G-20 GDP by more than 2.0 percent above the trajectory implied by current policies over the coming five years. This would represent over \$2 trillion more in global economic activity and would lead to significant additional job creation.

The past year has seen periods of increased financial market volatility, especially in emerging markets. In some respects this has reflected a changing global investment environment in which the advanced economies, the United States in particular, have seen their growth rates increase relative to those of emerging markets with implications for the path of monetary policy and asset

prices. Volatility rose in the late spring months of 2013, with a strong initial correlation between the rise in the interest rate on longer-term U.S. Treasuries and a broad retrenchment in emerging market asset markets. But investors increasingly differentiated according to countries' economic fundamentals, the strength of countries' policy response, and signs of balance payments adjustment. A number of idiosyncratic factors, including disappointing data releases, renewed signs of slower growth in large emerging markets, and geo-political developments, prompted a new round of volatility in the early months of 2014. Those economies with stronger fiscal frameworks, more subdued inflation, and more robust external positions were less affected. By late March 2014 volatility had subsided, although risks to growth in certain economies still remained elevated.²

Progress to reduce global current account imbalances remains mixed. The euro area's overall current account, which was close to balance in 2009-2011, increased to a surplus of 2.2 percent of GDP in 2013, from 1.3 percent in 2012. The current account surplus of Germany widened to 7.4 percent of GDP in 2013 and widened further in the second half of 2013, rising to 8.1 percent of GDP by the fourth quarter. Essential to external adjustment and the rebalancing of global demand is that in surplus countries the pace of growth of domestic demand must exceed that of GDP, a condition that has been met in Germany only three times over the past ten years. For the year, German goods imports contracted slightly in 2013 relative to 2012, which was indicative of weak domestic demand.



China registered a moderate current account surplus at 2.1 percent of GDP in 2013 according to preliminary data. The appreciation of China's real effective exchange rate has been an important factor in reducing the current account surplus. At the same time, cyclical factors, such as weakness in demand from advanced economies, and shifts in terms of trade have also played a role. As discussed later in the report, the renminbi (RMB) remains significantly undervalued.

Notably, Korea's current account surplus rose significantly, reaching 6.1 percent of GDP in 2013, up from 4.2 percent of GDP in 2012. Taiwan's surplus was over 11 percent of its GDP in 2013, increasing from 10.6 percent of GDP in the first half of 2013 to 12.6 percent in the second half.

Achieving strong, sustainable, and balanced global growth will require a much more focused follow-through than achieved heretofore. Stronger commitments are needed to close current output gaps, increase jobs, rebalance global demand, and boost long-term growth potential. In this respect, economies with large external surpluses and sound fiscal positions have a key role to play in adding incrementally to global demand. In addition, a stronger follow-through is needed

² See Annex 1 for a fuller explanation of recent volatility developments in emerging markets.

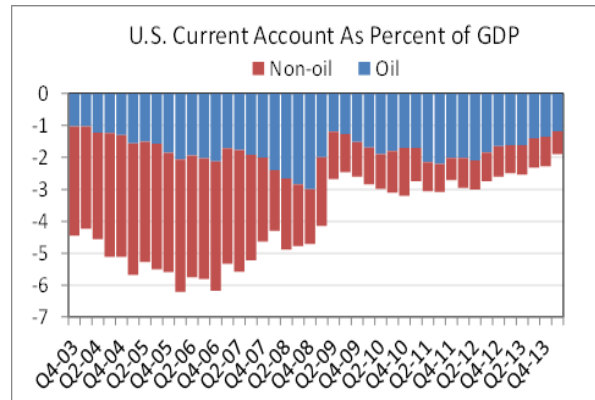
on past G- 20 commitments to move more rapidly to market-determined exchange rates, where such exchange rate regimes do not exist.

Global foreign-currency reserve accumulation continued to be large in 2013. China accounted for two-thirds of the increase, as shown in the table. Saudi Arabia saw its reserves rise at an average monthly pace of \$6.6 billion. However, many other countries reduced their pace of reserve accumulation in 2013 relative to previous years, as some engaged in defense of their currencies.

Foreign Currency Reserve Accumulation Major Holders			
	Jan 2014 Reserves \$ billions	Average Monthly increase, \$ billions	
		Jan 2009 to Dec 2012	Dec 2012 to Jan 2014
Global	11,684	75.1	62.4
China	3,821	28.4	40.3
Japan	1,211	4.0	1.2
Saudi Arabia	720	4.2	6.6
Switzerland	489	8.8	2.2
Russia	444	1.3	-1.3
Taiwan	417	2.3	1.1
Brazil	350	3.6	-1.3
Korea	338	2.4	1.5
Singapore	269	1.7	1.1
India	265	0.3	0.3
* data through Jan 2014			

U.S. International Accounts

The U.S. current account deficit was 1.9 percent of GDP in the fourth quarter of 2013, its lowest level since 1997. For the year, the deficit was 2.3 percent of GDP, a 3.5 percent of GDP decline from its peak in 2006 of 5.8 percent of GDP. Increased domestic oil production helped reduce the oil deficit from a peak of 3 percent of GDP in 2008 to 1.2 percent of GDP in 2013. Since the recession's trough in the June of 2009, the value of U.S. exports has increased by about 53 percent, while the value of imports has increased by almost 51 percent through the fourth quarter 2013. As of the fourth quarter of 2013, the U.S. net international investment position was -\$4.6 trillion, or -26.8 percent of GDP. The value of U.S.-owned foreign assets was \$22 trillion, and the value of foreign-owned U.S. assets was \$26.5 trillion.

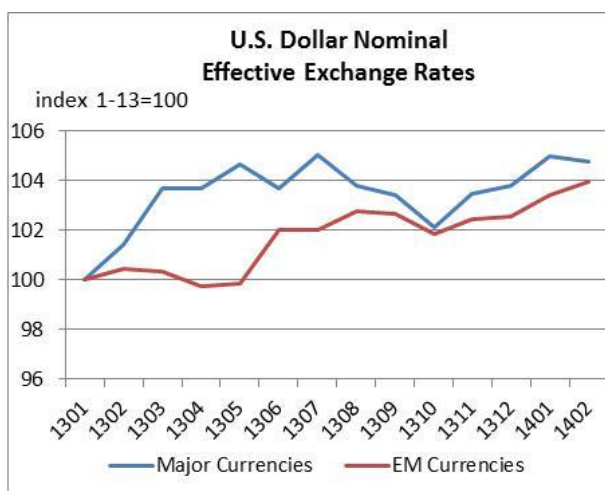


U.S. Balance of Payments and Trade							
(\$ billions, seasonally adjusted unless indicated)							
	2012	2013	Q4-12	Q1-13	Q2-13	Q3-13	Q4-13
Current Account							
Balance on goods (for details, see lower half of table)	-741.5	-703.9	-182.4	-178.7	-175.0	-178.4	-171.8
Balance on services	206.8	229.0	55.0	56.7	57.5	56.9	57.9
Balance on income (including employee compensation)	223.9	228.8	57.0	50.1	55.2	59.1	64.4
Net unilateral current transfers	-129.7	-133.2	-31.9	-33.1	-34.5	-34.0	-31.6
Balance on current account	-440.4	-379.3	-102.3	-105.0	-96.8	-96.4	-81.1
Balance on current account as % of GDP	-2.7	-2.3	-2.5	-2.5	-2.3	-2.28	-1.9
Capital and Financial Account (financial inflow = +)							
Net official assets	474.8	288.8	87.7	125.5	-3.3	66.9	99.6
Net bank flows	-6.9	461.8	-23.9	98.7	281.7	-55.4	136.6
Net direct investment flows	-221.9	-166.3	-53.1	-53.3	-55.2	-38.9	-18.8
Net sales of securities	208.5	-142.4	104.0	-94.0	-128.6	150.5	-70.2
Net liabilities to unaffiliated foreigners by nonbank concern	-65.2	-126.6	-4.1	-43.3	-40.9	-61.0	18.6
Other *	57.0	35.5	26.5	8.9	12.8	5.9	7.9
Balance on capital and financial account	446.3	350.8	137.1	42.6	66.5	68.2	173.7
Memo Items							
Statistical discrepancy**	-5.9	28.5	-34.7	62.5	30.3	28.3	-92.6
Change in foreign official assets in the United States	393.9	283.7	84.4	126.9	-6.6	66.1	97.4
Current Account Detail: Trade in Goods							
Exports of goods							
Agricultural products	132.8	135.9	33.3	34.1	30.8	33.3	37.8
Industrial supplies and materials (including petroleum)	518.9	525.3	128.6	130.9	128.8	132.1	133.4
Capital goods except autos	527.7	534.5	131.6	130.8	134.9	134.2	134.6
Automotive products	146.1	152.1	36.2	36.6	38.4	38.7	38.3
Consumer goods except autos and food	181.7	188.5	46.0	45.6	49.0	46.3	47.6
Other goods	54.0	53.3	14.7	13.2	13.2	13.3	13.7
Total exports of goods	1,561.2	1,589.7	390.3	391.3	395.2	397.8	405.4
Imports of goods							
Agricultural products	111.1	116.0	27.9	28.7	29.2	29.0	29.1
Industrial supplies and materials (including petroleum)	752.3	702.5	183.2	181.8	173.2	175.8	171.7
Capital goods except autos	551.7	557.3	137.7	137.1	137.3	139.6	143.2
Automotive products	298.5	309.7	75.3	72.9	76.9	80.0	79.8
Consumer goods except autos and food	519.6	535.8	131.7	131.8	134.4	133.7	135.9
Other goods	69.5	72.3	17.0	17.8	19.1	18.0	17.4
Total imports of goods	2,302.7	2,293.6	572.7	570.0	570.2	576.2	577.2
Balance of trade in goods	-741.5	-703.9	-182.4	-178.7	-175.0	-178.4	-171.8

Source: Bureau of Economic Analysis (BEA) via Haver Analytics.
Notes: *Latest quarter calculated by inference; this line contains items with a longer reporting lag than other lines.
**Amount needed to make the current account balance with the capital and financial account; by definition, current account + capital and financial account + statistical discrepancy = 0.

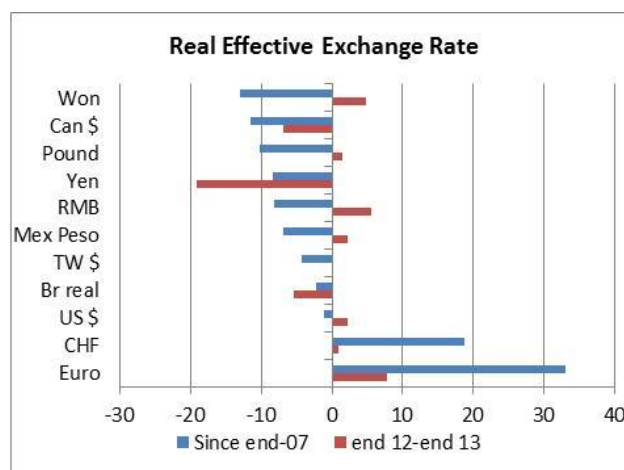
The Dollar in Foreign Exchange Markets

The nominal trade-weighted value of the U.S. dollar appreciated by 3.0 percent in 2013. The dollar rose by 4.5 percent against advanced economy currencies and by 2.0 percent against emerging market currencies. In the first three months of 2013, the dollar's path against the major and emerging market currencies diverged, as the dollar rose by 3.9 percent against major currencies, driven in large part by the yen's depreciation, while remaining generally stable against emerging market currencies. From May 2013 through October 2013, the dollar appreciated versus many emerging market currencies, particularly the Brazilian *real*, but depreciated against the currencies of major economies, particularly the



Australian dollar. Since October 2013, the dollar has appreciated against the currencies of both groups of countries, though more strongly against the majors – notably versus the yen and Canadian dollar.

On a real effective basis, which takes into account relative domestic price adjustments, the U.S. dollar appreciated 2.0 percent in 2013. The euro appreciated the most in 2013 in real terms among the currencies covered in this Report, followed by the RMB and the won. However, the won remains the most depreciated of the currencies in this report since end-2007. The yen weakened the most during 2013, after a sharp drop in the first half of the year following the Bank of Japan’s marked easing of monetary policy and the introduction of an explicit two percent inflation target in January 2013, and following a commitment in early April to aggressive monetary easing to support the inflation target. The Canadian dollar and Brazilian *real* weakened in 2013, with the Canadian dollar’s decline persisting into 2014.



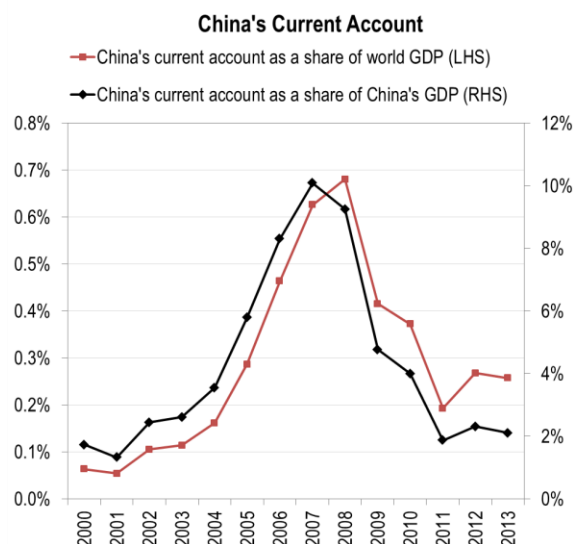
Analyses of Individual Economies

Asia

China

China’s GDP grew 7.7 percent in 2013, the same rate as 2012, although momentum decelerated in the second half of the year and into early 2014. Quarterly GDP growth fell from 2.2 percent in the third quarter to 1.8 percent in the fourth quarter, on a quarter over quarter seasonally adjusted basis. At the National People’s Congress in March 2014, China’s leaders announced a GDP growth target of 7.5 percent for 2014, unchanged from their 2013 target. Subsequent data on industrial production, fixed asset investment, and retail sales for the first two months of 2014 suggest a further slowdown in growth, posing a challenge to the Chinese Administration to maintain economic growth while pursuing reforms announced at November’s Third Party Plenum. However, growth supporting measures announced in early April 2014, including railway construction and social housing development, should help stabilize the economy in the near term.

Rebalancing the Chinese economy to rely more on household consumption, and less on exports and investment for growth is a longstanding goal of the Chinese leadership. However, China has made only

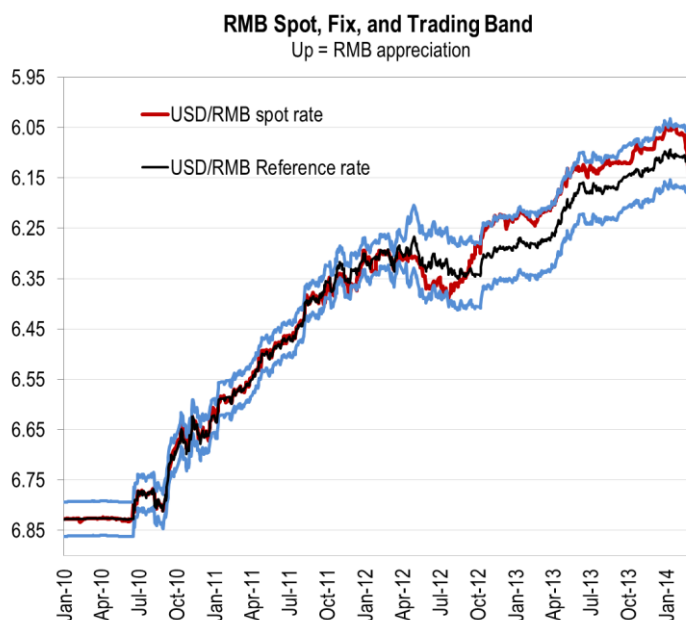


limited progress to date. According to preliminary 2013 data, investment's contribution to GDP growth rose and consumption's contribution declined. With investment accounting for about 50 percent of GDP, and consumption still too weak to drive overall growth, China's economy remains highly vulnerable to a slowdown in investment.

China has reduced its reliance on net exports subsequent to the global crisis. China's current account surplus declined to 2.1 percent of GDP in 2013, according to preliminary data, down from 2.3 percent of GDP in 2012 and from a peak of over 10 percent in 2007. China's current account surplus has also declined as a share of global GDP, but not as dramatically, since China now makes up a larger share of the world economy. According to IMF projections, assuming no further real effective appreciation of the RMB and a moderate pace of reform implementation, China's current account surplus would begin to expand this year as a share of China's GDP and nearly double in size as a share of global GDP in five years.

RMB appreciation continues to be critical if China is to meet its goals of rebalancing the Chinese economy and ensuring stable growth. A stronger RMB would support domestic consumption by increasing the purchasing power of households, and encourage a shift from tradable goods production to production of domestically-oriented goods and services. A market-determined exchange rate would allow China to reduce its intervention in the foreign exchange market and give Chinese authorities greater control over liquidity creation and domestic monetary policy.

China's new leadership has expressed a strong desire for exchange rate reform. China's November 2013 Third Plenum decision document underlines the goal to "perfect the market-based renminbi exchange rate formation mechanism." In an article explaining the Third Plenum reforms, People's Bank of China (PBOC) Governor Zhou said that China will "basically exit from normal foreign-exchange market intervention." China has also made a number of bilateral and multilateral commitments to reform its exchange rate. At the July 2013 Strategic & Economic Dialogue (S&ED) in Washington, DC, China pledged to "continue exchange rate reform, increase flexibility of the RMB exchange rate, and let [the] market play a more fundamental role in exchange rate formation."



The RMB appreciated 2.9 percent against the dollar in 2013. This modest strengthening stood in contrast to the large depreciations in the yen and many emerging market currencies. As a result, the RMB strengthened more significantly on a trade-weighted basis, but not as fast or by as much as is needed. While the RMB nominal effective exchange rate (NEER) and real effective

exchange rate (REER) rose 7.2 and 7.9 percent, respectively, for most of this period the RMB exchange rate was at or very near the most appreciated edge of the daily trading band, suggesting continuous pressure for RMB appreciation (see graph). During 2014, however, the exchange rate has reversed direction, depreciating by a marked 2.68 percent year to date.

China faced increasingly large capital inflows in 2013 and, given the PBOC's policy of gradual adjustment, resumed large-scale foreign exchange intervention. Foreign exchange inflows were particularly sizeable in the first quarter of 2013, but slowed in the second quarter after the government clamped down on false trade invoicing used to channel "hot money" onshore for speculation, and introduced stricter requirements for managing the net open foreign exchange positions of domestic banks. Foreign exchange accumulation resumed again in the second half of the year, increasing to \$98 billion and \$131 billion in the third and fourth quarters of 2013, respectively.

For more than a year, market participants – particularly Chinese firms operating in both the onshore and offshore markets – had been able to profit from the combination of high domestic RMB interest rates, low dollar borrowing rates, and a steady and predictable pattern of RMB appreciation.³ In fact, China's exchange rate volatility declined last year, with inter-day and intra-day movements of the RMB getting significantly smaller during the third and fourth quarters of 2013. Expectations of continued low volatility created a clear incentive for firms to borrow dollars at low interest rates and invest the funds in China, which fueled the large capital inflows.

The Recent China Carry Trade:

During 2013 and into early 2014, market participants—particularly firms with onshore and offshore operations—sought to profit from the combination of relatively high domestic RMB interest rates, relatively low dollar borrowing rates, and a steady, predictable appreciation of the RMB. Even the modest positive carry available to offshore investors through the non-deliverable forward (NDF) market was highly profitable on a volatility-adjusted basis, especially if currency positions were highly leveraged. The RMB's attractiveness as a carry trade currency has been partly a function of the PBOC's unwillingness to allow the exchange rate to adjust to appreciation pressures stemming from China's large current account surplus and foreign direct investment inflows. Limited movements in the daily reference rate and persistent foreign exchange intervention to keep the spot rate within the trading band allowed market participants to be reasonably confident that appreciation would continue in a predictable way. The introduction of RMB volatility in February 2014 has led to an unwinding of carry trade positions in the short-term.

As noted above, mounting inflows in 2013 increased the amount of foreign exchange intervention necessary to keep the RMB within the trading band. China's headline foreign exchange reserves increased \$509.7 billion during 2013, a record for a single year. China's

³ One result of Chinese efforts to encourage greater use of the RMB in settling trade transactions is that firms that operate in both the Chinese domestic market and Hong Kong have considerable flexibility to move funds on- and off-shore, despite Chinese capital controls.

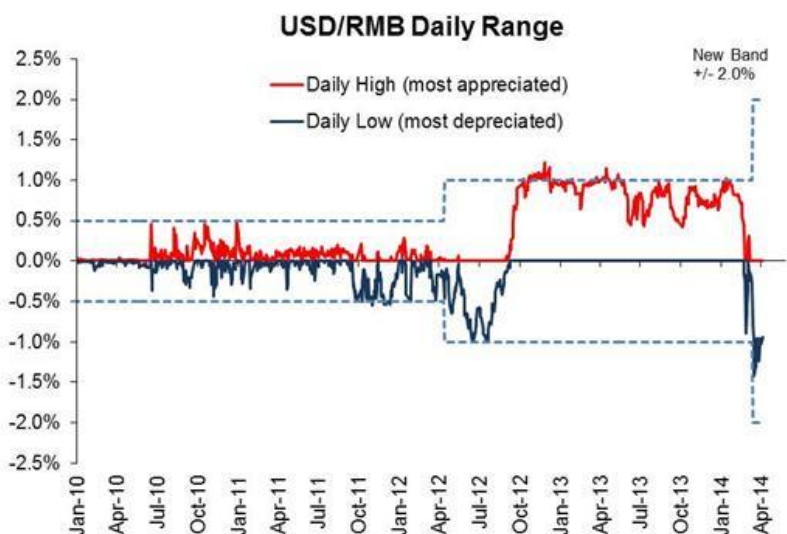
balance of payments data, which removes the impact of valuation changes from China's reserves, indicates \$433 billion in underlying reserve growth. The central bank's "other foreign assets" increased by \$56 billion, for a combined increase of \$489 billion.

At the end of 2013, China's total holdings of foreign exchange reserves came to \$3.8 trillion, equivalent to 41 percent of China's GDP, or \$2,808 for every Chinese citizen. This is an exceptionally large amount compared to other economies, and well beyond established benchmarks of reserve adequacy. China's stock of reserves is more than the total amount of foreign exchange reserves held by all advanced economies combined, and accounts for nearly half of all of foreign exchange reserves held by emerging and developing economies. Evidence that China continued large-scale purchases of foreign exchange during the first quarter of this year as well, despite having accumulated \$3.8 trillion in reserves, which are substantial by any measure, is suggestive of continued actions to impede market determination.

The events of the past year highlight a fundamental problem that China's policy makers have faced since the end of the dollar exchange rate peg in 2005. In the recent past the authorities have been unwilling to allow an appreciation large enough to bring the currency to market equilibrium, opting instead for a gradual adjustment. The expectation that the RMB would continue to appreciate over time resulted in capital inflows in 2013. The PBOC's policy of gradual adjustment triggered expectations of continued appreciation, and resulted in large-scale foreign exchange intervention. China's capital controls have provided a degree of insulation, but these have weakened as a result of increasing opportunities to move capital created by China's large trade volumes and greater opportunities for RMB settlement through on- or off-shore affiliates.

In what was initially interpreted as an effort to introduce two-way volatility and discourage carry trade inflows after large inflows over the past 15 months, China appears to have recently taken measures to weaken the RMB. After 18 months of sustained appreciation, the RMB depreciated significantly from late-February 2014 through March. Over the course of 30 trading days, the onshore spot rate fell 2.5 percent against the dollar, and the PBOC lowered the daily "reference rate" – the exchange rate that defines the center of the RMB's permitted trading band – by 0.7 percent. The RMB has seen periods of depreciation before, such as mid-2012 when the RMB fell 1.5 percent against the dollar over a three-month period, but the pace and the size of the recent decline was unprecedented.

According to market analysts, the immediate trigger for the depreciation in late February was the PBOC's decision to set sequentially lower reference rates, combined with PBOC intervention in the spot market to weaken the RMB. These actions pushed the spot price below the reference rate for the first time since May 2012 on



February 25, 2014. On March 17, 2014, the PBOC widened the RMB's trading band with the dollar from +/- 1 percent to +/- 2 percent, and RMB depreciation extended into the newly-widened weak side. The widening of the band gives China an opportunity to reduce intervention and allow the market to play a greater role in determining the exchange rate. To realize this opportunity, China should refrain from intervention within the band and should allow market forces to permit the reference rate to adjust if market pressures push the exchange rate to the edge of the band.

Although the RMB exchange rate may be more volatile than it has been in the recent past, the core factors that have long driven RMB appreciation remain. There are a number of signs that the exchange rate adjustment process remains incomplete and the currency has further to appreciate before reaching its equilibrium value. China continues to generate large current account surpluses and attracts large net inflows of foreign direct investment; China's current account surplus plus inward foreign direct investment in 2013 exceeded \$446 billion, or 4.8 percent of China's GDP. The reduction in the current account surplus as a share of China's GDP over the past few years has largely been the reflection of the unsustainably rapid pace of investment growth. Finally, China has continued to see rapid productivity growth, which suggests that continuing appreciation is necessary over time to prevent the exchange rate from becoming more undervalued. All of these factors indicate a RMB exchange rate that remains significantly undervalued. Rebalancing the Chinese economy will require further exchange rate appreciation so that consumption rather than investment drives domestic demand.

Although incentives for capital inflows may have been blunted in the near term by the PBOC's recent actions, the fundamental problem referred to above – that the authorities have only allowed a part of the necessary appreciation to take place – will continue to drive expected-appreciation-based capital inflows in the future. Therefore it is very much in China's interest to fulfill its own commitment to move more rapidly to a market-determined exchange rate, with intervention only in the case of disorderly market conditions.

While the desire to introduce two-way volatility in the RMB foreign exchange market is clear, recent developments in the RMB exchange rate raise particularly serious concerns, if they presage a retreat from China's announced policy of allowing the exchange rate to reflect market forces, reducing exchange market intervention, and moving toward a market-determined exchange rate. We will continue to monitor this issue closely going forward.

The RMB's recent depreciation underlines the importance of a significant increase in the transparency of China's actions in the foreign exchange market. Because China still does not provide transparent disclosure of its activity in the currency market, market participants and other observers must resort to estimating China's intervention using published reserve levels and changes in the central bank balance sheet. In line with the practice of most other G-20 nations, China should disclose foreign exchange market intervention regularly to increase the credibility of its monetary policy framework and to promote exchange rate and financial market transparency. Other large emerging market countries – including India, Russia, and Brazil – disclose their monthly intervention in the foreign exchange market, with several publishing daily intervention data.

China is currently one of only two G-20 members that do not report reserves under the IMF's Special Data Dissemination Standard (SDDS) template, the international standard for public reporting of reserves data. Participation in the SDDS and the IMF's aggregate Currency Composition of Foreign Exchange Reserves (COFER) database would be consistent with China's commitment at the 2012 G-20 Los Cabos Summit to increase the transparency of its exchange rate policy. China stated at the 2013 S&ED that it is "actively considering" subscription to the SDDS.

Japan

Japan maintains a floating exchange rate regime. As of February 2014, Japan's foreign exchange reserves were \$1.2 trillion, the second-largest in the world. The yen foreign exchange market accounts for about 23 percent of the roughly \$5 trillion in daily global foreign exchange transactions, according to surveys by the Bank for International Settlements (BIS).⁴

Japan has not intervened in the foreign exchange markets in over two years, although the authorities did issue numerous public statements regarding their desire to "correct the excessively strong yen" in the weeks following Prime Minister Abe's election on December 16, 2012. Shortly thereafter, in the G-7 statement of February 2013, Japan joined the other G-7 countries in pledging to base its economic policies on domestic objectives using domestic instruments, and to avoid targeting exchange rates. Japan was also part of the subsequent G-20 consensus and statement at the February 2013 Finance Ministers and Central Bank Governors Meeting in Moscow that countries would not target exchange rates for competitive purposes. These statements were affirmed by G-20 Leaders in September 2013 at the St. Petersburg Summit. Since the February 2013, G-7 and G-20 statements, Japanese officials have clearly ruled out purchases of foreign assets as a monetary policy tool, and public comments by Japanese officials on the exchange rate have notably diminished.

The yen started to depreciate against the dollar in October 2012 as market expectations built for more aggressive monetary easing by the Bank of Japan (BOJ). After the April 4, 2013, announcement of "Quantitative and Qualitative Easing" in which the Bank of Japan committed to double the monetary base to achieve a 2.0 percent inflation target, the yen depreciated as far as ¥103.2 per dollar on May 17, 2013, representing a 32 percent depreciation from the beginning of October 2012. The yen depreciated again between October and December 2013, reaching ¥105.3 per dollar, on widening interest rate differentials between the United States and Japan and growing market expectations of additional monetary easing by the BOJ in early 2014. Since December 2013, the yen has appreciated against the background of renewed emerging market volatility, trading in a range of ¥101-105 per dollar in the first quarter of 2014. On a real trade-weighted basis, the yen has depreciated by 25 percent since the beginning of October 2012 through February 2014. In its last Article IV Consultation Report for Japan (August 2013), the IMF assessed the yen's real effective exchange rate to be moderately undervalued, while noting

⁴ The 2013 BIS Triennial Central Bank Survey, released in September, showed that a significant expansion in yen trading between October 2012 and April 2013 was driven by expectation of a regime shift in Japanese monetary policy. In the last triennial BIS Central Bank Survey of Foreign Exchange Turnover, the yen foreign exchange market accounted for 19 percent of the roughly \$4 trillion in daily global foreign exchange transactions.

the very large uncertainty about its assessment given the major changes to Japan's economic fundamentals.

Japan's nominal goods trade balance fell into deficit in 2011 for the first time since 1980 as exports slowed following production disruptions stemming from the tsunami, while imports increased due to higher commodity prices and rising demand for reconstruction materials. The deficit continued to rise in 2012 and 2013, due in large part to the rise in import prices driven by the weaker yen and increased demand for fossil fuel imports following the shutdown of most of Japan's nuclear power generators. The trade deficit reached 2.6 percent of GDP in 2013. The current account has remained in surplus due to positive net income flows, but narrowed substantially from almost 4.0 percent in 2010 to 0.7 percent in 2013 and posted a deficit on a monthly basis from October 2013. Japan's bilateral trade surplus with the United States totaled \$73.4 billion in 2013, down slightly from \$76.4 billion in 2012. The IMF is projecting that Japan's current account surplus will rise in 2014 and 2015, to 1.2 and 1.3 percent of GDP, respectively, as growth in Japan slows, foreign demand growth increases, and past yen depreciation begins to have an effect.

For over a decade and a half, Japan has struggled to establish sustained economic growth and to escape from persistent price deflation. The "three arrows" of Prime Minister Abe's economic program are the most forceful attempt to meet these challenges. Aggressive monetary policy and initially-stimulative fiscal policy have contributed to the recovery in the Japanese economy in the short term, and GDP grew by 2.5 percent year-on-year as of the fourth quarter 2013. Over the four quarters of 2013, domestic demand has contributed 3.0 percentage points to growth on a cumulative basis, compared to a negative 0.2 percent point contribution from net exports.

Fiscal policy will turn contractionary in 2014, as Japanese authorities seek to put their public finances on a more sustainable footing, with net debt of 140 percent of GDP and gross public debt of 250 percent of GDP. An increase in Japan's consumption tax, with an initial stage from 5 to 8 percent on April 1, 2014, and a second stage to 10 percent scheduled for October 2015, is a large part of the authorities' deficit-reduction strategy. However, Japan also needs to take care that the *overall* fiscal position, inclusive of expiring fiscal stimulus and reconstruction spending, does not result in too rapid a consolidation that prevents escape from deflation, stalls Japan's growth, and undermines the success of its reform program. The short-term, negative impact of consumption tax increases should be moderated through temporary fiscal measures calibrated to support domestic demand. In December 2013, the Japanese government approved a ¥5.5 trillion (\$54 billion) supplemental budget to help offset the drag on growth from the consumption tax. The government plans to front-load this spending to support growth at the time the consumption tax hike takes effect. The authorities also plan to accelerate regular budgetary spending, but should be prepared to provide additional fiscal support if growth slows more than authorities forecast. As fiscal consolidation sets in, and support from the weaker yen abates, the IMF projects GDP growth will slow to 1.5 percent in 2014 with a further slowdown to 1.0 percent in 2015.

As Japan takes policy steps to bring about a durable recovery and escape deflation, it is imperative both for the success of those measures and for the global economy that Japan's economic policies work primarily through an increase in domestic demand. Sustaining domestic

demand growth will depend on sustained rises in business and residential investment, household consumption, and wage increases that exceed inflation. In this respect, it is important that Japan carefully calibrate the pace of overall fiscal consolidation. Monetary policy cannot offset excessive fiscal consolidation nor can it substitute for structural reforms needed to raise trend growth and domestic demand.

Ambitious and effective structural reforms to durably increase domestic demand would include measures to raise household income through greater labor force participation and higher earnings. They would also include measures to facilitate new domestic opportunities for activity and investment, by opening up domestic sectors – particularly services – to new products and new competition through deregulation, as well as measures to encourage more effective use of land, especially land now classified as agricultural. In March 2013, Prime Minister Abe announced Japan's intention to join the Trans-Pacific Partnership (TPP) trade negotiations, and Japan joined the negotiations in July 2013. The TPP could also lead to internal reforms such as deregulation in areas like agriculture and medical services that support growth.

South Korea

South Korea officially maintains a market-determined exchange rate, and its authorities intervene with the stated objective of smoothing won volatility. In February 2013, Korea joined the rest of the G-20 in committing to refrain from competitive devaluation and resolving not to target its exchange rate for competitive purposes. Korean authorities appear to intervene on both sides of the market but, on net, they have intervened more aggressively to resist won appreciation.

Korea's current account surplus further increased to 6.1 percent of GDP in 2013 – the highest since 1999 – compared to a surplus of 4.2 percent in 2012. Korea is one of only a few surplus economies with a significantly larger external surplus now than before the crisis. Net exports accounted for 1.6 percentage points of Korea's 3.0 percent growth in 2013, highlighting the economy's continued dependence on external demand. Korea's goods and services trade surplus was 5.6 percent of GDP in 2013, and Korea's bilateral trade surplus in goods with the United States totaled \$20.7 billion, around 2 percent of Korean GDP, up from \$16.6 billion in 2012.

The rise in the current account and trade surpluses can be only partly explained by an improvement in Korea's terms of trade due to falling commodity prices, as energy imports constitute around 40 percent of total imports. Domestic demand growth remains sluggish, although supported somewhat last year by incremental fiscal stimulus of 0.4 percent of GDP and a pick-up in business investment. Personal consumption growth lagged overall GDP growth. Korea's elevated household debt – currently at 136 percent of disposable income – and general government fiscal surplus have weighed on domestic demand and consumer spending.

In February 2014, President Park announced a sweeping economic reform agenda that targets a potential growth rate of 4.0 percent, an employment rate of 70 percent of the population, and per capita income of \$40,000 (compared with approximately \$24,000 at present). This ambitious reform plan seeks to reduce Korea's dependence on exports and largely targets for improvement the services sector, where productivity growth has lagged the export sector. Exchange rate appreciation is an important tool for supporting this rebalancing, as it would encourage reallocation of production resources to the non-tradables sector, which includes most services.

The won's real effective exchange rate remains about 11 percent weaker than its 2007 level. The won appreciated 1.4 percent against the dollar during 2013. Although Korea was less affected than other emerging markets by financial turbulence, the won depreciated by 9.1 percent in the first half of 2013, from 1064 won per dollar on December 31, 2012 to 1161 on June 24, 2013. Thereafter, the won appreciated 9.6 percent by year-end to 1050 won per dollar as market participants took stock of the relative strength of Korean fundamentals.

Korea has intervened in the market to resist appreciation within the context of a widening current account surplus. During the second half of 2013 the Korean authorities are believed to have intervened to limit the pace of won appreciation, with market speculation of intervention increasing as the won approached key levels. Unfortunately, Korea does not publicly report foreign exchange market intervention, unlike many other major emerging markets and industrialized economies.⁵ Instead, market participants derive estimated intervention from changes in Korean foreign exchange reserves and forward positions. Korea's foreign exchange reserves rose from \$315.6 billion at end-June 2013 to \$335.6 billion at end-December and \$341.0 billion at the end of February 2014. The Korean authorities also increased their net forward position by \$4.9 billion to \$50.5 billion over the second half of 2013. The magnitude of these changes is larger than could be reasonably expected from simple interest earnings on the existing stock of reserve assets or valuation changes, leaving little doubt that Korea has been active in the market.

Notably in the last published Article IV Consultation Report on Korea, released in September 2012, the IMF noted that foreign exchange reserves were adequate and that there was "no need for further reserve accumulation beyond what would be needed to keep pace with rising foreign liabilities over time." The Korean authorities have not yet authorized publication of their latest IMF Article IV review, which the IMF Executive Board concluded in January 2014.

Prior to the global crisis, the Korean banking system relied heavily on wholesale funding, much of it external. The Korean government has subsequently taken a number of useful steps to reduce short term external liabilities. However, it is important that Korea's macroprudential measures continue to target financial vulnerability and not the level of the exchange rate. Throughout 2013 and early this year, in periods of won appreciation, the Korean authorities have publicly warned they were contemplating further tightening of macroprudential measures on the foreign exchange exposure of the banking system in periods of won appreciation. During periods of won depreciation, no additional macroprudential measures were signaled.

The Korean authorities should limit foreign exchange intervention to the exceptional circumstances of disorderly market conditions, increase transparency of foreign exchange intervention, approve the timely publication of the IMF's recent Article IV surveillance report, and ensure that macroprudential measures clearly focus on reducing financial sector risks – in design, timing, and description – rather than alleviating upward pressure on the exchange rate.

Taiwan

Taiwan has a large and rising current account surplus, which reached a record level of \$57.4 billion in 2013. The surplus was 11.7 percent of GDP, the highest since 1988. Taiwan's goods and services trade surplus totaled \$46.3 billion in 2013, up 22 percent from 2012. The current account and trade surpluses reflect both the recovery of the global economy and sluggish domestic demand. Weak private consumption and business investment held overall GDP growth to 2.2 percent in 2013, below the 2001-2008 average of 3.8 percent. The IMF currently projects overall GDP growth of 3.1 percent in 2014 and 3.9 percent in 2015. Policies to stimulate consumption and investment, further liberalize the services sector, and remove trade and investment barriers would help rebalance the Taiwanese economy.

Taiwan has a largely open capital account, but maintains some restrictions to avoid large inflows or outflows of capital, including measures to discourage foreign investors from holding local currency deposits. Taiwan was less affected by capital outflows than other emerging markets in 2013. While the financial account showed a net outflow of \$41 billion in 2013, this largely reflected greater investment abroad by Taiwanese insurance companies.

Taiwan's foreign exchange reserves grew by \$13.6 billion (3.4 percent) in the second half of 2013, and stood at \$418 billion as of end-February 2014. Taiwan's foreign exchange reserves are well in excess of adequate levels by any metric. They are equivalent to 85 percent of GDP, 19 months of imports, and 2.8 times the economy's short-term external debt.

Taiwan maintains a managed float exchange rate regime, and the central bank states that the New Taiwan Dollar (NTD) exchange rate is determined by the market, except when the market is disrupted by seasonal or irregular factors.⁶ The NTD appreciated 1.1 percent against the dollar in the second half of 2013, and has depreciated 1.9 percent against the dollar in the first three months of 2014. The real effective exchange rate, as calculated by the Bank for International Settlements (BIS), was unchanged over the course of the year, while the BIS nominal effective exchange rate appreciated 0.2 percent during 2013.

Taiwan does not disclose its foreign exchange market intervention. However, looking at publicly available statistics, Taiwan appears to intervene on both sides of the market but, on net, much more to resist appreciation than depreciation. On a balance of payments basis, reserve assets increased every quarter since 2008 except one. The change in foreign assets on the central bank's table "Factors Responsible for Changes in Reserve Money" (which excludes valuation changes resulting from foreign exchange fluctuations) also has been positive since 2011 every month but two. The magnitude of these changes is larger than could be reasonably expected from simple interest earnings on the existing stock of reserve assets, leaving little doubt that Taiwan intervened in the market.

⁶ In December, Central Bank Governor Perng issued a report to the legislature as well as an open letter to the public stressing the limits on the ability of the central bank to influence the exchange rate, the need for the central bank to balance competing domestic interests (including those of importers and consumers) in its monetary and foreign exchange policy, and the need for structural reforms to promote investment, increase competitiveness, and move Taiwan up the value-added product ladder.

Taiwan uses the IMF's Special Data Dissemination Standard (SDDS) framework to provide data on many aspects of its economy, including the real sector, and fiscal, financial and many external accounts. But Taiwan does not publish data on international reserves that conforms to the SDDS reserves template, nor does it publish intervention data. Taiwan is the only major emerging market in Asia not to be either currently subscribing, or publicly considering subscription, to the SDDS reserves template.

Given the size of Taiwan's economy and its importance in international trade flows, Taiwan should move toward a more fully market-determined exchange rate, Taiwanese authorities should limit their foreign exchange interventions to the exceptional circumstances of disorderly market conditions, and increase the transparency of reserve holdings and foreign exchange market intervention.

Europe

Euro Area

The euro area has a freely floating exchange rate. The euro has experienced large fluctuations since the financial crisis resulting from ebbs and flows in risk aversion associated with financial stresses in the euro area. In the second half of 2013, the euro appreciated by 5.3 percent against the dollar and has been relatively stable through the first three months of 2014. On a real effective basis, the euro depreciated by 0.7 percent in the second half of 2013.

The euro area's recovery has substantially lagged other developed countries, leaving economic activity at a low level. Euro area GDP is 2.7 percent below its peak in the first quarter of 2008. Private demand is more than five percent below pre-crisis levels, and unemployment is running at a near-record high of 12 percent. Following six consecutive quarters of contraction, the euro area economy returned to growth in the second quarter of 2013, with GDP expanding by 1.0 percent, on a seasonally adjusted, annualized basis, over the last three quarters of 2013.

However, significant macroeconomic and financial headwinds persist. While the pace of fiscal consolidation has eased, the region's fiscal stance remains contractionary, and bank deleveraging, low real wage growth, and weak investment continue to weigh on economic activity. Moreover, growth was driven primarily by net exports in 2013. With inflation in the euro area dropping to new record lows in recent months and the risk of further financial volatility in emerging markets having an adverse impact on global demand, Europe faces the risk of a prolonged period of substantially below-target inflation or outright deflation. This would slow Europe's return to growth, further hinder the internal rebalancing that is still needed between the core and periphery, and increase the real burden of public and private debts. The European Commission forecasts that the euro area economy will grow by around 1.0 percent in 2014.

The euro-area's collective current account surplus expanded to 2.2 percent of GDP in 2013, as large current account deficits in peripheral countries continued to shrink, in some cases moving into surplus largely through demand compression, while surplus countries have not reduced their current account surpluses. Both in dollar terms and as a share of GDP the euro area's surplus now exceeds China's surplus. Previous current account deficits in Italy, Spain, and the smaller economies in the periphery have turned into small surpluses in recent quarters, primarily as a

result of a collapse of domestic demand and falling wages. The Netherlands and Germany, meanwhile, have continued to run substantial current account surpluses since 2011, with Germany's surplus rising to 7.4 percent of GDP in 2013.

To ease the adjustment process within the euro area, countries with large and persistent surpluses need to take action to boost domestic demand growth and shrink their surpluses. For example, in Germany, domestic demand has grown faster than GDP only three times in the past ten years. German domestic demand picked up in the third quarter of 2013, but weakened in the fourth quarter, leaving domestic demand just 0.4 percent larger in the second half of 2013 than in the first half. One sign of the subdued pace of German demand growth is that German goods imports were 1.0 percent weaker for the year. Stronger domestic demand growth in all surplus European economies is needed to help facilitate a durable rebalancing of imbalances in the euro area.

The European Union's (EU) annual Macroeconomic Imbalances Procedure, developed as part of the EU's increased focus on surveillance, recently identified Germany's current account surplus as an imbalance which requires monitoring and policy action. Notably, the EU stated that, given the size of the German economy, action was particularly important to reduce the risk of adverse effects on the functioning of the euro area. While identification of Germany is a welcome step, as are the EC's recommendations for measures to bolster investment and demand growth, it remains to be seen whether the procedure can produce robust recommendations or policies aimed at the euro area aggregate fiscal stance and symmetric rebalancing.

A key priority for the euro area moving forward is to solidify and accelerate the recovery in growth, which will support a reduction of heavy debt burdens, lower high unemployment rates, and help maintain political support for the adjustment process within the core and periphery. While structural reforms are a necessary part of the European policy mix, a more balanced approach that couples such reforms with measures to boost investment, job creation, and demand is needed. Continued flexibility with respect to fiscal targets will allow countries with more fiscal space to support growth and better align the euro area's aggregate fiscal stance with the economic cycle. Measures to increase domestic demand, particularly in surplus countries like Germany, can help further European and global rebalancing. Germany's recent agreement to implement the country's first economy-wide minimum wage represents incremental progress towards this goal. Appropriate monetary accommodation to move inflation back toward target could accelerate healing in Europe's labor markets and also support rebalancing, as higher domestic inflation in strong economies like Germany would provide more headroom for periphery countries to improve their competitiveness without outright deflation. Finally, deepening euro area financial, economic, and fiscal integration – more centralized risk sharing, greater resource pooling, enhanced cost sharing – would facilitate the ongoing adjustment and make the monetary union more resilient to future shocks.

Switzerland

Switzerland is a small open economy surrounded by the euro area, and has been disproportionately affected by the financial stresses in Europe, resulting in disorderly movements

in the exchange rate. The Swiss authorities faced a constrained policy environment as external forces pushed the economy into deflation in the summer of 2011. In September 2011, after a number of alternate policy measures failed to achieve the Swiss National Bank's (SNB) monetary policy objectives, it established a minimum exchange rate ("floor") of 1.20 Swiss francs per euro, temporarily changing the exchange rate regime from a floating to a managed rate. Through 2012 the SNB intervened repeatedly to prevent the franc from appreciating. However, as European authorities implemented measures to reestablish financial stability, and concerns about tail risks subsided, pressures on the Swiss franc subsided and SNB interventions ceased. The SNB continues to reaffirm its commitment to a managed rate, noting that it is prepared to buy foreign currency in unlimited quantities to enforce the 1.20 exchange rate floor.

Since establishing the exchange rate floor, the SNB's foreign reserve assets have increased by \$172 billion on a headline basis, and now total \$492 billion as of February 2014. In 2013, foreign reserve assets increased \$20.6 billion to \$488.6 billion (72 percent of GDP). Given the lack of foreign exchange intervention in 2013, the change is attributable to valuation effects. While the currency composition of reserves fluctuates on a monthly basis as a result of interventions and valuation changes, the SNB rebalances its portfolio over time to keep the euro share around 50 percent of reserves and the U.S. dollar share between 25 and 30 percent.

After remaining close to the 1.20 exchange rate floor through the end of 2012, the franc depreciated by 1.3 percent against the euro in 2013. Against the U.S. dollar the franc appreciated by 1.8 percent in 2013 and on a real trade weighted basis the franc has appreciated 0.9 percent in 2013 (based on BIS data).

Preliminary data indicates that the 2013 the current account surplus was 13.0 percent of GDP. The large current account surpluses traditionally run by Switzerland must be interpreted with caution. The IMF's 2013 Article IV staff report notes that (a) the activities of international commodity trading companies could add up to 4.0 percent of GDP to the surplus even though some have limited operations in Switzerland; (b) Swiss multinationals partly owned by foreigners artificially raise the surplus and are estimated to have added 2.0 percent of GDP to the surplus in 2011; and (c) cross-border shopping direct purchases and deliveries may not be reflected in import statistics and overstate the current account by non-trivial amounts. Finally, Switzerland's role as an international banking center generates fee and investment income that contribute to the overall current account surplus but cannot be attributed to Swiss citizens.

In the IMF's 2013 *Pilot External Sector Report*, the Swiss external position is assessed to be "moderately stronger than the level consistent with medium-term fundamentals and desirable policy settings." The real effective exchange rate is assessed to be "moderately overvalued because of safe-haven capital inflows, but the overvaluation is eroding over time given negative inflation differentials with trading partners."

Economic growth in Switzerland is slowly reviving and deflationary pressures appear to be subsiding. Switzerland's economy expanded by 1.9 percent in 2013, up from 1.2 percent in 2012; and the SNB forecasts 2.0 percent growth for 2014. Consumer prices increased 0.1 percent year-on-year in December 2013, but have subsequently fallen back into deflation – declining 0.1 percent year-on-year in February 2014. With low unemployment (3.2 percent) and

high capacity utilization (around 81 percent in the third quarter 2013) there appears to be little “slack” in the economy. The SNB estimates the negative output gap in the fourth quarter of 2013 at around 1.0 percent of potential GDP.

The exchange rate floor has contributed to the reduction of deflation and overall economic stability. Once economic conditions normalize, a return to a freely floating currency would be desirable.

United Kingdom

The UK economy expanded by 1.8 percent in 2013, its highest rate of annual growth since 2007. Growth was driven by household consumption growth of 2.6 percent, which makes up 62 percent of economic output. Gross fixed capital investment decreased by 0.5 percent in 2013 and real net exports increased by 0.1 percent.

The fiscal deficit fell from its post-war peak of 11.0 percent of GDP in fiscal year 2009-10 to 7.3 percent of GDP in 2012-13, excluding one-off factors. On a cyclically-adjusted basis, the fiscal deficit decreased from 8.7 percent of GDP in 2009-10 to 5.3 percent of GDP in 2012-13. As of March 2014, the Office of Budget Responsibility projects that the headline fiscal deficit will fall further in 2013-14, to 5.0 percent of GDP.

Monetary policy remains accommodative. The Bank of England (BOE) has maintained its historically low policy rate at 0.5 percent and, since October 2011, increased the size of its quantitative easing program three times – each time by £50 billion – to reach £375 billion at its July 2012 meeting. In July 2012, BOE launched its Funding for Lending Scheme (FLS), which is designed to incentivize banks to increase their lending by reducing the cost of BOE funding in response to commercial banks’ lending performance. In November 2013, BOE reoriented FLS toward business lending. Consumer price inflation peaked at 5.2 percent in September 2011 on year-on-year basis, but has fallen to 1.8 percent as of February 2014.

The United Kingdom (UK) has a freely floating exchange rate. The pound appreciated by 1.9 percent against the U.S. dollar on a nominal basis in 2013, and continued to appreciate by 0.4 percent through end-March of 2014. On a real effective basis, the pound appreciated by 1.5 percent in 2013. The UK real effective exchange rate has appreciated 13.3 percent from its trough in early 2009, but remains 19 percent below its pre-crisis peak. However, in July 2013, as part of the UK’s Article IV consultation, the IMF assessed the pound to be moderately overvalued.

The current account deficit in 2013 widened to 4.4 percent of GDP – the largest deficit since 1989 – reflecting a widening of the income and transfers deficits. The goods and services trade deficit remained more modest at 1.6 percent of GDP in 2013, narrowing from 2.1 percent of GDP in 2012. In the IMF’s 2013 *Pilot External Sector Report*, the UK’s external position is assessed to be “moderately weaker than implied by medium-term fundamentals and desirable policy settings.”

Western Hemisphere

Brazil

Brazil's economy expanded by 0.7 percent quarter-on-quarter on a seasonally adjusted basis in the fourth quarter of 2013 after contracting by 0.5 percent in the previous quarter. The fourth quarter expansion helped Brazil's real GDP increase 2.3 percent for the year in 2013. The IMF projects a moderation of growth to 1.8 percent in 2014. Annual inflation reached 6.5 percent year-on-year in the first half of 2013, at the upper limit of the central bank's target band of 4.5 percent \pm 2 percent, and decelerated to 5.7 percent year-on-year by February 2014. Market participants surveyed in the Brazilian central bank's weekly market survey expect inflation to remain in the upper end of the central bank's target band through 2015.

Brazil maintains a floating exchange rate regime, although over the past few years there have been, at times, increased official efforts to manage the *real*. The authorities have used foreign exchange market intervention – primarily through foreign exchange derivatives markets – as well as verbal guidance and capital flow management measures to dampen directional movements of the currency. Brazil's real effective exchange rate depreciated substantially over the past year, weakening 7.6 percent year-on-year as of March 2014. In nominal terms, the *real* depreciated by 17.3 percent against the dollar over that period. In Brazil's July 2013 Article IV review, IMF staff assessed the *real* to be 10-15 percent overvalued.

In response to sharp depreciation pressures on the *real*, in August 2013, the Brazilian Central Bank (BCB) announced a formal intervention program, with a stated objective of providing hedging and liquidity to the foreign exchange market. From August through December 2013, the BCB sold a minimum of \$2 billion in swap contracts per week, along with \$1 billion in USD in the spot market through repurchase contracts. The repurchase operations will cause a temporary fall in foreign exchange reserves until the operations are reversed, whereas dollar swaps are settled in local currency. As a result of this activity, the BCB has built up a short dollar position in the foreign exchange forward market, which reached \$86 billion as of end-March 2014. In addition, on net, the BCB has sold \$14.5 billion in the spot market using repurchase contracts through end of February. The BCB announced a reduction in the size of the intervention program starting in January 2014, but stated that the program will continue at least through June 2014. Brazil's headline foreign exchange reserves totaled \$363 billion as of end-February 2014, equivalent to 14 months of import cover.

Brazil's current account deficit increased to 3.7 percent of GDP in 2013, up from 2.4 percent in 2012, reaching its largest deficit since 2001. Brazilian export growth was flat in 2013, while imports increased about 7 percent.

Canada

Canada saw growth of 2.0 percent in 2013, underpinned by private consumption and a marginal pickup in exports. The IMF projects growth to increase to 2.3 percent in 2014, driven by stronger external demand. Canada's current account deficit narrowed slightly from 3.4 percent

in 2012 to 3.3 percent in 2013, and the IMF forecasts it will continue to narrow, albeit slightly, over the next few years as external demand for Canada's exports, particularly from the United States, recovers.

Canada maintains a flexible exchange rate and employs an inflation-targeting monetary policy regime. The Canadian dollar fluctuated against the dollar throughout 2013 but was on a depreciating trend for the year. In nominal terms, the Canadian dollar depreciated by 8.4 percent against the U.S. dollar from March 2013 through March of this year. On a real effective basis, the Canadian dollar depreciated 9.0 percent over the course of 2013. Inflation remained low at just above 1.0 percent for the year.

Canada had foreign exchange reserves of \$63.7 billion as of the beginning of March 2014, representing 3.5 percent of GDP and about 1.6 months of imports. Canada recently took steps to diversify its foreign exchange reserves, and will begin to add pound sterling-denominated assets to its Exchange Fund Account (EFA). The EFA also holds U.S. dollar-, euro-, and yen-denominated assets.

Mexico

After rebounding strongly following the financial crisis, the Mexican economy lost momentum in 2013, growing by just 1.1 percent. Government spending was weak in 2013 as the new government took time to execute its spending priorities, and softness in the residential housing sector also contributed to low overall growth. Continued soft global demand throughout 2013 also contributed to a challenging external environment, weakening Mexican exports and manufacturing, with negative second-order effects on consumption. The IMF forecasts growth increasing to 3.0 percent in 2014, as government spending and investment rebound and stronger growth in the United States boosts Mexican manufacturing and exports. Mexico's current account deficit was 1.8 percent of GDP in 2013 and the IMF forecasts it to remain relatively stable at 2.0 percent of GDP in 2014, reflecting higher imports associated with stronger economic activity offset by higher exports due to the strengthening global economy.

Mexico has a flexible exchange rate and employs an inflation-targeting monetary policy regime. After strengthening steadily during the first four months of 2013, the peso began to reverse course in May 2013. In nominal terms, the Mexican peso depreciated by 5.5 percent against the U.S. dollar from March 2013 through March 2014, and 7.6 percent from the end of April 2013 through March 2014. On a real effective basis, the peso, on net, was nearly unchanged over the course of 2013, appreciating 0.1 percent.

Mexico has a comfortable level of foreign exchange reserves at \$168.2 billion as of the end of 2013 (equivalent to five months of import cover). Mexico's reserves continue to be backed by the availability of an additional \$72 billion from a two-year Flexible Credit Line (FCL) with the IMF, which was most recently renewed in November 2012. As of March 2014, Mexico had not drawn on this line.

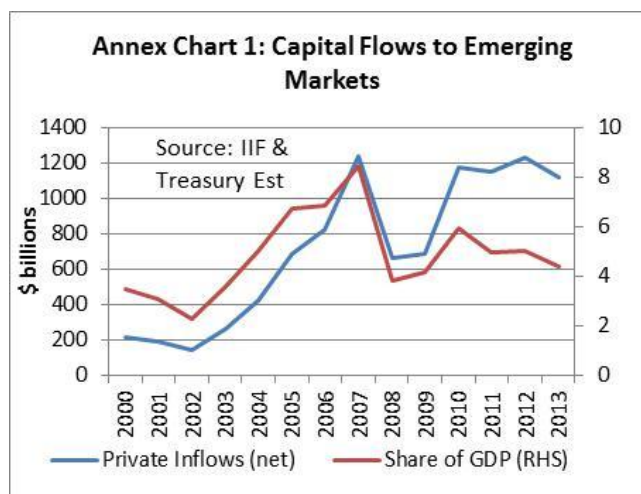
Annex 1: Financial Volatility in Emerging Market Economies⁷

Over the past year there have been periodic bouts of increased financial market volatility in emerging market economies (EMEs). Increased volatility has been manifest in increased capital flows (mostly outflows), depreciating currencies, rising domestic interest rates, and declining prices of equity assets. Not all periods over the past year have been unusually volatile, in fact May and June 2013 and January 2014 account for the bulk of the rapid price adjustments. Nor have all emerging market economies experienced the same intensity of volatility; there has been considerable differentiation by international investors across emerging markets according to the strengths or weaknesses underlying economic activity in the various economies. Idiosyncratic factors appear to have played a substantial role in the most recent January episode of volatility. With the exception of May 2013, actions by the Federal Reserve do not appear to bear a strong correlation with the occasional spikes in volatility in certain emerging market economies. The backdrop appears to be that the U.S. economy is gaining economic strength in comparison to emerging markets in general and this has had implications for the portfolio decisions of international investors.

Emerging Market Economies and Capital Flows

EMEs have long benefitted from, but also faced certain challenges posed by, cross-border capital flows. Strong growth prospects, financial market development, and improved macroeconomic and institutional frameworks have made investing in EMEs considerably more attractive over time, especially as global investors have sought both yield and diversification. The period following the 2008/09 financial crisis saw a resumption of significant capital flows to EMEs, on the order of flows just prior to the crisis.

These flows helped fuel economic growth in EMEs, but also raised concerns about upward pressures on exchange rates. Over this period expansionary macroeconomic policies in some EMEs resulted in rapid credit growth, widening of external deficits, and inflation rates moving above target. Other economies pursued stronger fundamentals and built up larger policy toolkits than in years past, including having more scope for implementing countercyclical fiscal and monetary policies as needed, and more flexible exchange rate regimes.



⁷ Prepared by Leslie Hull

Volatility

Beginning in May 2013, with the first suggestions of eventual Fed tapering as the U.S. economy strengthened, assets in EMEs began to re-price. Although the market selloff was triggered by global factors, markets differentiated among EMEs according to the strength of their policy frameworks and their current account positions (see Annex Table 1). This differentiation persisted through the remainder of 2013, especially with respect to exchange rates and credit default swaps. On January 22, 2014, a new round of volatility occurred amid several events, including a disappointing flash Chinese purchasing manager index data release, weakening EM growth prospects, Argentina's peso devaluation, ongoing civil unrest in Ukraine and concerns about the sustainability of foreign exchange intervention in Turkey, rattled investors, highlighting some of the broader economic and political challenges that many EMEs face. The market response included a decline in emerging market equities, increases in benchmark bond yields, and further depreciation of EME currencies.

Annex Table 1				
Equities	end April - end-June	July - December	since Jan 22	YTD
EM	-11.1%	8.2%	5.0%	1.2%
Argentina	-22.6%	78.5%	9.8%	20.1%
Brazil	-15.1%	9.1%	3.8%	-0.6%
Mexico	-3.9%	3.8%	-2.7%	-4.2%
China	-9.1%	6.1%	2.6%	-0.5%
Korea	-5.1%	8.4%	1.4%	-0.6%
India	-1.5%	6.9%	7.2%	7.8%
Indonesia	-4.3%	-10.5%	9.9%	15.1%
Russia	-4.7%	8.0%	-9.7%	-9.6%
Turkey	-11.3%	-11.6%	7.5%	6.8%
S. Africa	2.9%	17.3%	2.8%	4.7%
Equity Flows (\$ Mil)	end April - end-June	July - December	since Jan 22	YTD
Argentina	-35.4	21.6	-28.1	-33.1
Brazil	-3354.2	-4490.8	-2582.0	-3035.4
Mexico	-1102.1	-1391.2	-1702.0	-2295.6
China	-6107.1	-2555.8	-7657.0	-7041.6
Korea	-1447.1	1943.6	-3699.3	-4538.1
India	-1684.2	-1558.1	-2160.7	-2595.3
Indonesia	-518.8	-162.2	-372.4	-434.3
Russia	-1713.9	-2106.2	-1732.8	-2131.4
Turkey	-552.6	-462.5	-227.9	-145.2
S. Africa	-602.2	-202.3	-996.1	-1114.1
Bond Flows (\$ Mil)	end April - end-June	July - December	since Jan 22	YTD
Argentina	-46.4	-146.7	-67.8	-78.4
Brazil	-1456.0	-4895.2	-1772.6	-2098.3
Mexico	-380.6	-2076.8	-538.4	-656.5
China	265.1	-658.3	-914.1	-924.2
Korea	-149.8	-953.4	-126.9	-107.0
India	-145.3	-436.0	-164.0	-199.4
Indonesia	-390.2	-1272.3	-464.4	-547.3
Russia	-470.4	-2303.7	-792.9	-905.3
Turkey	115.8	-1375.6	-498.0	-586.9
S. Africa	-267.6	-869.3	-306.2	-358.6
FX	end-June	December	Jan 22	YTD
EM	-5.9%	-2.0%	2.5%	-0.2%
Argentina	-3.7%	-17.3%	-13.0%	-18.5%
Brazil	-10.3%	-5.6%	8.5%	8.0%
Mexico	-6.2%	-0.6%	2.5%	0.4%
China	0.4%	1.3%	-2.4%	-2.4%
Korea	-3.6%	7.9%	2.5%	0.8%
India	-10.4%	-4.0%	3.1%	3.0%
Indonesia	-4.1%	-17.6%	6.4%	7.8%
Russia	-5.4%	0.3%	-4.8%	-7.8%
Turkey	-7.0%	-10.5%	7.3%	2.1%
S. Africa	-9.2%	-5.3%	4.8%	1.1%
Bond Yields	end June	December	Jan 22	YTD
EM	120	47	-9	-6
Brazil	219	129	-24	-3
Mexico	113	-8	-31	-15
China	27	99	-15	-29
Korea	58	-2	-14	-9
India	15	119	42	15
Indonesia	150	160	-32	-42
Russia	121	14	106	132
Turkey	211	198	63	83
S. Africa	155	20	14	31

*YTD and Since 1-22-2014 Data is dated from 4-9-2014

Potential Drivers of Market Differentiation

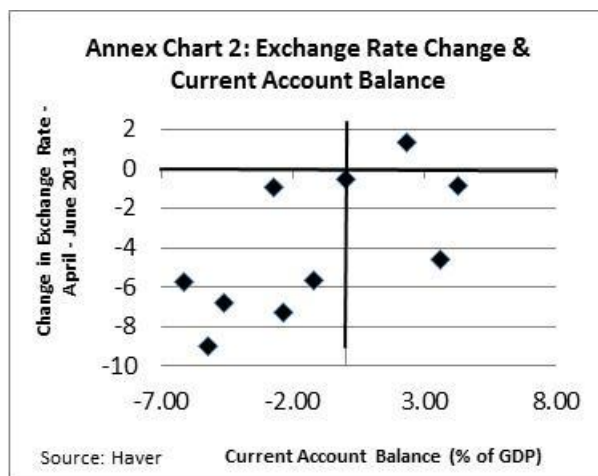
Following the initial market sell-off last May, financial markets began differentiating pricing on the basis of various countries' fundamentals.

Traditional fundamentals can be grouped into three broad categories: (1) external vulnerabilities; (2) domestic fundamentals; and (3) policy space. No single data point can explain fully the market reaction

in any particular country. Instead, a broad picture of growth prospects, financial stability and policy settings is taken into account by market participants (Annex Table 2).

	Current Account (% of GDP), 4q sum	ST External Debt, All currencies (% of FX Reserves)	Domestic Credit - GDP Growth (yoy %)	Inflation (YoY%)	Budget Balance (% of GDP)
	Q3-13	Q3-13	Dec-13	Jan-14	Q3-13
Turkey	-7.2	115	22.7	7.7	-1.8
South Africa	-6.2	61	-1.1	5.8	-8.0
India	-4.3	35	3.4	5.2	-6.0
Indonesia	-3.6	50	8.9	8.3	-2.4
Brazil	-3.6	10	3.1	5.6	-3.8
Mexico	-2.0	42	6.6	4.5	-3.0
Argentina	-0.7	153	8.9	--	-1.2
Russia	1.8	18	9.6	6.1	1.6
Korea	5.4	33	-1.3	1.1	7.9

While investors search for strong returns, they also take into account a country's economic and financial stability. Crises can arise from fiscal, banking or external vulnerabilities. The initial volatility seen last summer seemingly correlated with indicators of external vulnerability. The most basic indicators of external vulnerability include current account balance, external debt, and foreign exchange reserves. Annex Chart 2 shows the strong correlation between current account balances and exchange rate changes between April and June of last year. Larger current account deficits have larger financing requirements and at some point can drive market skepticism about sustainability.



Strong growth in EMEs has attracted capital inflows over the past few years as growth prospects in advanced economies remained tepid. Weakening growth prospects in EMEs, which were seen in the second half of 2013 in emerging markets as a whole, coupled with stronger growth prospects in advanced economies, can create an environment of repositioning. Indicators of domestic fundamentals such as retail sales, purchasing manager indices (PMI), and industrial production can therefore drive a market reaction. Indeed, as noted above, weaker than expected growth in China, as proxied by its January PMI release, triggered a strong market reaction.

In the event of a local or global shock, market participants will look to the ability of country authorities to take measures to support growth and financial stability. In the context of slowing growth, markets will look to the ability of policymakers to implement supportive monetary and/or fiscal policies. Indicators of fiscal space typically include budget balances (overall and

primary) and the level of public debt. Indicators of monetary policy space can include the level of the policy rate, whether medium and long-run inflation expectations are well-anchored, and whether expectations are close to the target. In addition to policy space, sound and credible policy frameworks, with demonstrated implementation of appropriate policy settings, support sound domestic and external fundamentals, and foster market confidence.

Monetary Policy Response

EME central bankers face a balancing act with respect to raising interest rates to support their currencies: higher interest rates lend support to currencies while withdrawing support to the real economy. In some cases, the prolonged period of low interest rates has fuelled a rapid build-up of debt which, in the context of a weakening economic outlook, could precipitate a disorderly unwinding of financial imbalances as interest rates rise. Balancing these considerations, a number of central banks responded with strong policy rate hikes in late January and early February with positive results as currencies have stabilized and some have appreciated since early February. Specifically, the Central Bank of Turkey hiked rates by a de facto 225 basis points, and the South African Reserve Bank hiked rates by 50 basis points. The hikes followed a 50 basis point rate increase by Brazil on January 15, which was part of a sustained tightening cycle in Brazil that began last year. Similarly, the Reserve Bank of India hiked rates by 25 basis points between December and February as part of a tightening cycle that began in September.

Conclusion

Volatility in emerging markets reflects a complex interplay between factors local to EMEs and concerns about global growth, structural challenges, and potential shifts in policy. Strong growth prospects, financial market development, and improved macroeconomic and institutional frameworks have strengthened the fundamentals of a number of EMEs. Accordingly, there has been considerable differentiation by international investors across EMEs according to the strengths or weaknesses underlying economic activity in the various economies. EMEs can best manage potential spillovers through policies that support strong economic fundamentals, including flexible exchange rates.

Glossary of Key Terms in the Report

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

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

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

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

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

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

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

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

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

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

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

Trade Weighted Exchange Rate – see Nominal Effective Exchange Rate

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