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THE POLITICAL ECONOMY OF THE WON: U.S.-KOREAN BILATERAL NEGOTIATIONS ON EXCHANGE RATES

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ABSTRACT

This paper traces the development of U.S.-Korean negotiations on exchange rates in the second half of the 1980s. Background on Korea's foreign exchange control system is provided, including the evolution of its exchange rate determination mechanisms from 1945 to the current period. The U.S. Congress' rationale for including exchange rates in the Omnibus Trade and Competitiveness Act, the U.S. Treasury's Reports to Congress, and the results of the U.S. Treasury's negotiations with Korea on exchange rate "manipulation" are examined.

Korea's current account surpluses emerged at a time when the United States was experiencing record current account deficits, in part due to the rapid appreciation of the dollar in the first half of the 1980s. The fact that the dollar subsequently depreciated against the United States' industrial-country trading partners but moved little against the currencies of the NIEs prompted the U.S. Congress to examine the exchange rate policies of those economies. Under the Omnibus Trade and Competitiveness Act, Korea and Taiwan were cited in 1988 as "manipulating" their currencies for "unfair" trade gain. With the implementation of the market average-rate system in March 1990, Korea was removed from Treasury's list of exchange rate manipulators. However, the Treasury has complained that even though Korea does not directly manipulate the won within the meaning of the Exchange Rates Act, pervasive capital controls limit potential exchange rate movements and may be used to "manipulate" the value of the won indirectly.

The Political Economy of the Won: U.S.-Korean Bilateral Negotiations on Exchange Rates

Deborah J. Lindner[1]

I. Introduction

South Korea's GDP has grown at an annual rate of more than 8.5 percent on average since 1960. With exports over the same period having grown nearly 30 percent per annum, much of Korea's development success has been attributed to its export orientation. An important feature of this export orientation has been the maintenance of a competitive exchange rate. Korea's exchange rate policies and U.S. interest in those policies are the focus of this paper.

The evolution of exchange rate determination in Korea has been influenced by many factors in the last 30 years. The Korean authorities have sought to control the use of scarce foreign exchange during Korea's development by establishing an exchange control system that prohibits all external transactions unless otherwise approved. While there are exceptions, Koreans have not generally been permitted to hold foreign currency assets; foreign exchange is concentrated at Korea's central bank. In the 1980s, some of these controls were relaxed as Korea's external balances improved and as its external debt burden fell. In addition, in the second half of the 1980s, external pressure, primarily from the United States, encouraged the appreciation of the won and eventually the introduction of a more flexible exchange rate mechanism in Korea.

In 1988, the United States enacted the Omnibus Trade and Competitiveness Act that, in part, required the U.S. Treasury to identify trading partners that "manipulate" their exchange rates to gain "unfair competitive advantage in international trade" and to negotiate with those trading partners to eliminate that "manipulation." The Treasury determined in its October 1988, April 1989, and October 1989 *Reports to Congress on International Economic and Exchange Rate Policy* that Korea's exchange rate was "manipulated" by the Korean authorities for "unfair" trade advantage. In March 1990, a new exchange rate system was implemented in Korea. Since the implementation of the new exchange rate system, the Treasury has concluded that Korea is not manipulating its exchange rate within the meaning of the legislation.

This paper traces the development of U.S.-Korean negotiations on exchange rates in the second half of the 1980s. In the next section, some background on Korea's foreign exchange control system is provided, including the evolution of its exchange rate determination mechanisms from 1945 to the current period. In subsequent sections, the U.S. Congress' rationale for including exchange rates in the Omnibus Trade and Competitiveness Act, the U.S. Treasury's Reports to Congress, and the results of the U.S. Treasury's negotiations with Korea on exchange rate "manipulation" are examined. In the final section, I present some concluding remarks.

II. Brief History of Korea's Foreign Exchange Systems

The Foreign Exchange Control Act (FECA), enacted in 1961, is the backbone of Korea's foreign exchange control system. This system has been in place through most of Korea's exchange rate regimes, including the current market-average exchange rate system. The FECA provides the framework for governmental control over all foreign exchange transactions, short-term capital inflows, and all capital outflows.[2] The FECA prohibits all external transactions in principle; allowable transactions are defined in regulations issued by the Minister of Finance or its delegate, usually the Bank of Korea, Korea's central bank.

The Korean won was pegged to the U.S. dollar from Korea's liberation from Japan in 1945 until 1964.[3] There was essentially no foreign exchange market in Korea during this time. In the period prior to 1962, Koreans were required to surrender all foreign exchange to the Bank of Korea, or to its precursor, the Chosun Exchange Bank, for domestic currency. In 1962, five nationwide commercial banks were permitted to act essentially as intermediaries for the Bank of Korea in foreign exchange transactions. Interbank transactions in foreign exchange were not permitted.

In 1964, the foreign exchange certificate (FEC) system--essentially a crawling peg against the dollar--was introduced. In the FEC system, a market for foreign exchange was developed. Koreans were required to surrender their foreign exchange for won at posted rates or exchange it for FECs at licensed foreign exchange banks; the FEC was a negotiable claim on foreign exchange valid for a short period.[4] Individuals who needed foreign exchange for approved payments were required to purchase FECs on the certificate market (from foreign exchange banks or other traders) and exchange them at an approved bank for foreign exchange. The Bank of Korea set its buying and selling rates for foreign exchange with foreign exchange banks daily within a few percentage points of the banks' customer rates on the previous day. The Bank of Korea's rates were maintained by providing an elastic supply of foreign exchange at those rates. The spread between the central bank's rates and foreign exchange banks' customer rates provided the Bank of Korea with an indication of market pressures on the won.[5]

In 1967, the Bank of Korea allowed foreign exchange banks to engage in additional foreign exchange transactions, and an interbank foreign exchange market was established. The Foreign Exchange Dealers' Office was established in 1970 to handle interbank transactions, and, in 1976, an over-the-counter market was allowed to operate. Foreign exchange banks were allowed to maintain limited long (overbought) foreign exchange positions but not short (oversold) positions. Banks could issue additional FECs within the limit of their long positions.

Although the FEC system remained in place, the Bank of Korea's rate for won-dollar transactions was again essentially fixed to the dollar in mid-1972. The won was devalued against the dollar in December 1974 and then remained unchanged until the end of 1979. Bank-customer rates were allowed to vary within a band around the fixed central bank rate. In 1979, Koreans were allowed to open foreign currency accounts and hold foreign currency deposits with foreign exchange banks rather than surrender foreign earnings for won or FECs, and in early 1980, the FEC system was abolished.

In January 1980, the central bank rate for won-dollar transactions was devalued nearly 17 percent and, in March 1980, a new exchange rate system--essentially a managed float--was implemented in which the Bank of Korea (under guidance from the Ministry of Finance) set the mid-rate for the won against the dollar based on the SDR basket and an unspecified trade-weighted basket of major foreign currencies, as well as other unspecified factors.[6] Some of the factors considered were domestic and foreign price trends and the balance of payments position.[7] The won mid-rate was used only for official transactions.[8] However, its importance stemmed from the fact that all other rates were set within a small band around the mid-rate. Buying (selling) rates for the dollar used for official intervention in the interbank market were set by subtracting (adding) a small spread from the mid-rate.[9] Interbank foreign exchange rates were freely set. However, in practice, of course, the rates remained within the Bank of Korea's intervention rates. Customer rates offered by foreign exchange banks were also set at a given percentage from the mid-rate. The spread for telegraphic-transfer (non-cash) rates for the dollar was slightly larger than the spread for the Bank of Korea's intervention rates; the spread for non-dollar transactions was slightly larger than for dollar transactions.[10] The spread for customer cash rates was much larger, about 1.5 percent.

In July 1980, forward contracts between the won and foreign currencies were introduced.[11] Except for interbank transactions, it was required that the amount and term of any contract be based on a bona-fide trade transaction.[12] Ceilings on the foreign exchange positions of foreign exchange banks were set by the Bank of Korea; the Bank of Korea acted as the bank of last resort in settling the residual open foreign exchange positions.

On November 1, 1988, South Korea formally accepted the obligations of Article VIII, Sections 2-4 of the International Monetary Fund's Articles of Agreement. This obligated Korea to eliminate its remaining restriction on payments and transfers for current account transactions.[13]

In September 1989, the Bank of Korea no longer set its intervention rates at a fixed margin from the mid-rate, but allowed the margin for the intervention rates to be reduced at times when interbank spreads were small. In addition, foreign exchange banks were allowed at that time to set telegraphic-transfer rates for the dollar for customers within (no longer necessarily at) a 0.4 percent band around the mid-rate. The band for non-dollar transactions was expanded to 0.8 percent. The band for cash rates was removed; these rates were liberalized.

In March 1990, a new exchange rate system, called the market-average exchange rate (MAR) system, was introduced in Korea. Under the MAR system, the won-dollar mid-rate is calculated as the weighted average of the previous day's interbank rates for spot dollar transactions. Exchange rates are allowed to float daily within relatively narrow margins of the mid-rate and, therefore, to move slowly in line with market pressures. In the previous system, interbank rates had been liberalized in principle, but, in practice, they remained within the central bank's intervention limits. In the MAR system, daily fluctuations in interbank rates for the dollar are currently limited by regulation; interbank rates for non-dollar currencies remain freely determined. Interbank dollar rates and rates offered by foreign exchange banks to customers for large dollar transactions ($100,000 or more) were determined within a 0.4 percent band around the official mid-rate until September 1, 1991, when the band was extended to 0.6 percent. The band for small dollar telegraphic-transfer transactions with customers remained at 0.4 percent, and the band for non-dollar transactions remained at 0.8 percent. Customer rates for cash transactions continued to be set freely by foreign exchange banks.

Consistent with the FECA, foreign exchange and other foreign currency assets generally must still be surrendered to a domestic foreign exchange bank at its posted customer rate or be deposited in foreign currency accounts or placed in the custody of those banks.[14] In addition, daily ceilings on the foreign exchange positions of banks encourage the concentration of foreign exchange at the Bank of Korea.[15] Customer foreign exchange transactions must be based on bona-fide trade transactions or approved capital flows. In general, foreign exchange banks have the responsibility of ensuring that underlying documentation exists prior to engaging in a customer transaction. This requirement is considered by the U.S. Treasury to be an important impediment to the development of Korea's foreign exchange market.

In July 1991, the Korean Ministry of Finance announced a proposed revision to the FECA. In contrast to the current version of the Act, foreign exchange transactions would be permitted in principle under the proposed plan, with exceptions explicitly listed in regulations. The plan has been submitted to the National Assembly for consideration. The proposed date of enforcement is September 1992.

III. U.S. Legislation: The Omnibus Trade and Competitiveness Act

Between 1980 and the dollar's peak in February 1985, the dollar appreciated in nominal terms about 85 percent on a weighted-average basis against the G-10 currencies. In part due to this rapid appreciation, the U.S. current account worsened to a deficit of $122 billion in 1985 from near balance in 1980.[16] Lagged effects of the dollar's appreciation on the current account, as well as possible J-curve effects, pushed it further into deficit in subsequent years; the U.S. current account deficit peaked in 1987 at $160 billion. In response to the large current account deficit of the United States and surpluses in Japan and Germany and the protectionist pressures associated with those imbalances, the G-5 decided in September 1985 in the Plaza Agreement to bring about an orderly depreciation of the dollar.[17] By February 22, 1987, when the G-7 in the Louvre Accord agreed to stabilize exchange rates at around then current levels, the dollar had depreciated about 42 percent against the yen and 47 percent against the mark from its peak.

The fluctuations of the won against the dollar during the 1980s were significant but less extreme than that of the weighted-average dollar.[18] Under Korea's managed float implemented in March 1980, the won depreciated 35 percent in nominal terms against the dollar by the end of 1985. In addition, the appreciation of the G-10 currencies against the dollar in the next two years was not matched by the appreciation of the won; during that period, the won rose about 12 percent against the dollar. Consequently, the won depreciated over 60 percent against the yen by the end of 1987 under its managed float exchange rate system.

Partly as a result of these exchange rate changes, Korea's current account shifted from deficit to surplus over the 1980s. Korea's global current account balance improved from a deficit of $5.3 billion, a historical high at 8.5 percent of GDP, in 1980 to $0.9 billion in 1985. In 1986, Korea recorded its first substantive current account surplus at $4.6 billion, and in 1987, the surplus grew to $9.9 billion. Furthermore, Korea's bilateral trade balance with the United States shifted to surplus in the early 1980s and more than doubled from 1985 to 1987, to $9.3 billion.

Against the background of these developments, according to U.S. Treasury Under Secretary David Mulford, the Treasury began ". . . discussions with Korea on the matter of currency in the latter part of 1986 when it became obvious after the Plaza Agreement that the currency adjustments that were taking place among the major currencies were not being followed by certain other countries, including Korea. Our efforts met with little success."[19] In addition, in the Louvre Accord, the G-7 called for the newly industrializing economies (NIEs) to observe their responsibilities as major trading nations "by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals." In April 1987, the Korean government agreed to allow the International Monetary Fund (IMF) to arbitrate the currency dispute with the United States during its consultations with the IMF in June. The IMF team advised the government to increase the rate of appreciation of the won and to relax foreign exchange controls in order to prevent Korea's current account surplus from exceeding the $5 billion target set by the government in 1987.[20] Under increasing external pressure, the won appreciated against the dollar nearly 9 percent in 1987; however, Korea's current account surplus was nearly twice the government's target.

In February 1988, when President Roh was inaugurated, U.S. Treasury Secretary Baker urged Korea to appreciate the won more rapidly against the dollar to help avert protectionist legislation in the United States. According to press reports, in March 1988 the IMF reiterated its advice that Korea continue revaluing the won. Despite increasing domestic pressure to slow the rise of the won, the won was allowed to appreciate against the dollar nearly 16 percent in 1988. However, the current account surplus rose to $14.2 billion, 7.8 percent of GDP, and international reserves increased by $8.8 billion.[21] In addition, the U.S. bilateral trade deficit with Korea totalled $9.5 billion in 1988. According to the U.S. International Trade Commission, "U.S.

dissatisfaction with the pace of change continued, making currency revaluation one of the most contentious issues between the two countries . . ." in 1987 and 1988.[22]

In August 1988, the U.S. Congress passed legislation designed to deal with these and related external imbalances--the Omnibus Trade and Competitiveness Act of 1988 (OTCA), providing the United States with the threat of retaliation for a broader range of "unfair" trade practices. The OTCA represented a move away from multilateralism in trade relations by the U.S. government (as represented by GATT) to unilateral action. Frustration with the growing U.S. external deficits and the failure to correct (and perhaps recognize) the underlying policy configuration that contributed to those deficits led to Congressional focus on "unfair" trade practices by U.S. trading partners and the value of the U.S. dollar as fundamental causes of the U.S. deficits.

Sections 3001-3006 of the OTCA,[23] hereafter referred to as the Exchange Rates Act, mandated that the Secretary of the Treasury determine whether countries with "material" global current account surpluses and "significant" bilateral trade surpluses with the United States "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." If such a determination is made, the Secretary, in general, is required to initiate negotiations with those countries to adjust their exchange rate and to "eliminate the unfair advantage." The Secretary, after consulting with the Chairman of the Federal Reserve Board, is also required to report to Congress semiannually on the progress of those negotiations.

The requirement for exchange rate negotiations was included in the OTCA by Congress because members believed that ". . . the benefit of trade concession can be adversely affected by misalignments in currency, and misalignments in currency caused by government policies intended to maintain an unfair trade advantage tend to nullify and impair trade concessions."[24] In addition, undervaluation of exchange rates was considered by some supporters of the Exchange Rates Act to be analogous to an export subsidy that should be subject to countervailing duties or dumping charges.[25]

Exchange rate "manipulation" was viewed by the U.S. Congress as an unfair trade practice by foreign governments and was included in the OTCA with other "unfair" trade practices that are not considered such under the GATT. Unlike unfair trade practices under GATT, exchange rate "manipulation" under the OTCA was not even relevant unless a foreign trading partner registered both a global trade surplus and a bilateral trade surplus with the United States;[26] the exchange rate practices of countries with trade deficits were not considered relevant. Not unlike other unfair trade practices under GATT, the definition of the practice, exchange rate "manipulation", is unclear, but perhaps more so, because exchange rate policies have generally been considered the sovereign domain of foreign governments.

Early versions of the Exchange Rates Act were introduced in the Senate and House of Representatives in 1985.[27] According to Senator Sarbanes, ". . . the provision in the 1988 trade bill requiring a semiannual report and testimony by the Treasury on the conduct of international economic and exchange rate policy was, in large part, a response to the experience of the early 1980s, when the dollar was permitted to rise steadily to very high levels for an extended period of time without any effect to bring it into line with other currencies."[28] Initial versions focussed on the appreciation of the dollar against the currencies of industrial countries in the first half of the 1980s and the resulting trade deficit of the United States. Early versions of the Act required multilateral discussions essentially to determine the appropriate value of the dollar against a basket of currencies and to effect the depreciation of the dollar to that point. Because by the Louvre Accord in February 1987, the dollar had depreciated 40 percent against the G-10 currencies from its peak in February 1985,[29] concern about the value of the dollar against the currencies of its industrial-country trading partners had been reduced. However, concerns about exchange rate movements in other important trading partners, specifically Korea and Taiwan, surfaced repeatedly in Congress.[30] These concerns reflected pressure by private interest groups such as the National Association of Manufactures (NAM).[31]

In early 1987, a number of individuals testifying before Congressional committees were asked about exchange rate changes in non-G-7 currencies, including Korea. In February, Secretary Baker argued that public pressure on Korea's exchange rate was not appropriate--Korea was a major debtor country and had only recently recorded a trade surplus. In addition, the United States has important national security interest in Korea. According to Secretary Baker, the U.S. Treasury planned to continue negotiating with Korea, but the Secretary did not support Congress' attempt to "mandate legislative solutions to the questions of exchange rates."[32] Economists C. Fred Bergsten and Ronald McKinnon argued in March that the focus of exchange rate realignment should be on Japan and Europe, not on developing countries, including Korea.[33] In April, Lawrence Fox, representative of the NAM, urged the U.S. government to pressure Korea and Taiwan to substantially appreciate their currencies.[34]

Although multilateral negotiations continued to be part of the Exchange Rates Act, in amended form, requirements for bilateral exchange rate negotiations were added to versions of the Act in early 1987. This portion of the law was passed with Korea as one of the countries in mind. The 1987 versions of the Exchange Rates Act mentioned Korea, as well as Taiwan, explicitly.[35] These references were removed from the final version of the Exchange Rates Act, but the countries that were targeted by the Act were clear.

IV. U.S Treasury Reports to Congress and Negotiations with Korea

On October 24, 1988, the U.S. Treasury issued its first *Report to Congress on International Economic and Exchange Rate Policy*. The Report concluded that Korea and Taiwan had been pursuing exchange rate policies that prevented effective balance of payments adjustment and provided an "unfair" competitive advantage. "Given Korea's strong underlying economic fundamentals, further exchange rate appreciation within a framework of liberalized trade, exchange, and capital controls, is clearly required."[36] "In the cases of Taiwan and Korea, this undervaluation is a direct result of central bank currency intervention, capital controls, and administrative guidance designed to prevent their exchange rates from reflecting market forces and to achieve a competitive advantage." [37]

Countries with external surpluses and floating exchange rates (Japan, Germany, and Singapore) or true fixed exchange rates (Hong Kong) were not cited as "manipulating" their exchange rates.[38] Economies with external surpluses and a managed float with restrictive capital controls (Korea and Taiwan) were identified. As long as their (global and bilateral) external surpluses remained, both of these economies were required to cease their exchange rate "manipulation" or face retaliation by the United States. The Treasury negotiations focused first on appreciation of their respective currencies and then later on a change in their exchange rate determination mechanisms. Although neither freely floating nor fixed exchange rate systems were adopted by Korea and Taiwan, both economies eventually instituted changes that allowed more influence by market forces and less by the government in the determination of their exchange rates.

The won continued to appreciate somewhat in 1989 until April 24, four days before the April 1989 Treasury Report was released; at its peak, the won was 2.7 percent higher than at the end of 1988 and 33.7 percent higher than the end of 1985, when it was close to its low against the dollar. In part due to cumulative won appreciation, Korea's current account surplus fell in the first quarter of 1989 for the first time in over three years, by over two-thirds from the previous quarter. In addition, real GDP growth fell by two-thirds from the same period in 1988. Korea's current account surplus declined further in the second quarter of 1989, leading Korea's Deputy Prime Minister Cho Soon to announce in May that the current value of the won was appropriate and he saw no reason to revalue the won further. In fact, the won was allowed to depreciate in the second half of the year, and by the end of 1989, the value of the won was only slightly higher than at the end of the previous year. In 1989, Korea's current account surplus declined to $5.1 billion, about one third the level in 1988. International reserves continued to increase over most of 1989--by $2.9 billion on balance--but at a slower pace than in 1988.

Against these developments, the finding that Korea had manipulated its exchange rate within the meaning of the Exchange Rates Act was repeated in the April 1989 and October 1989 Treasury Reports to Congress.[39] However, as Korea's global and bilateral surpluses began to fall in 1989, the emphasis of the Reports shifted somewhat from won appreciation to pressure for a market-based exchange rate system and for broader discussions on financial market liberalization.[40] According to the Treasury's Report in April 1989, the upcoming negotiations between the United States and the Korean authorities ". . . will be aimed at obtaining assurances that exchange rate policy during the period ahead will reinforce the direction of recent trade developments"[41] and encouraging ". . . the Korean authorities to dismantle the comprehensive capital and exchange controls that prevent market forces from asserting themselves in exchange rate determination."[42] "It is not just a question of asking the Korean authorities to move the exchange rate. Obviously that's part of it and we will continue on that front as well because they do control the exchange rate today. But we will seek to have them alter their exchange rate mechanism . . . so that the exchange rate can more freely reflect the economic fundamentals."[43]

In July 1989, the IMF concluded that further appreciation of the won was not necessary, but Korea should accelerate the pace of liberalization of its financial and foreign exchange markets.[44] In late August, Trade Minister Han publicly called for a devaluation of the won, but in early September, Finance Minister Lee reported that the government would not artificially depreciate (or appreciate) the won against the dollar. In addition, the Minister of Finance announced plans to liberalize Korea's foreign exchange system, including the implementation of a more market-determined mid-rate system in 1990, similar to Taiwan's previous system, and full convertibility of the won after 1992.

The October 1989 U.S. Treasury Report criticized the won's depreciation against the dollar since the April Report and stated that ". . . further appreciation of the won may prove necessary if the reduction of Korea's imbalances does not continue next year. . . . The absence of a role for market forces in exchange rate determination remains a fundamental problem in Korea and adds to our concern about the won's movements over the past six months."[45] The Report concluded that Korea continued to "manipulate" the won due, in part, to the won's depreciation but primarily due to the absence of a significant role for market forces in exchange rate determination.

In the October 1989 Report, the Treasury announced that the Korean Ministry of Finance had agreed to formal high-level talks on financial policy with the Treasury.[46] Under Secretary Mulford reported that in the upcoming negotiations with Korea, the Treasury planned to ". . . continue to press for exchange rate policy to support further, lasting external adjustment and urge liberalization of the exchange rate system."[47] At Under Secretary Mulford's November 1989 testimony before the U.S. Senate, some senators contended that Korea had not made much progress towards eliminating its currency "manipulation," and warned that if the Treasury was not successful in getting countries, in particular Korea, to adjust their exchange rates, Congress would feel the need to address the exchange rate issue in trade negotiations led by the USTR, i.e., treat exchange rate "manipulation" similarly to an export subsidy and threaten countervailing duties as a remedy.[48]

In February 1990, the Korean Ministry of Finance and the U.S. Treasury conducted a series of financial policy talks. These talks covered the liberalization of Korea's financial markets, including the exchange market, as well as specific market access problems of U.S. financial firms in Korea. In part as a result of these meetings, Korea implemented the MAR system of exchange rate determination in March 1990. As discussed above, under this system the official mid-rate became the weighted average of the previous day's spot rate for interbank transactions, rather than being based loosely on a trade-weighted basket of major foreign currencies.[49] In addition, the Korean government eased some controls on capital flows.[50]

In the April 1990 Report to Congress, the Treasury expressed concern about the won's depreciation over the previous year but concluded that Korea was no longer manipulating the won within the meaning of the Exchange Rates Act. The introduction of the MAR system, as well as the continued decline in Korea's external balances, led to this conclusion. According to the Report, "The real significance of this step [the introduction of the MAR system], however, will depend on the government's willingness to ease the pervasive control on capital flows and the types and amounts of permissible foreign currency transactions that give it effective tools for indirectly 'manipulating' supply and demand in the currency market, and, thus, the exchange rate itself."[51]

In December 1990, the Treasury's Report to Congress concluded that "Although there are no indications at this time that Korea directly 'manipulates' the won, the continued existence of . . . exchange and capital controls and their aggressive implementation render less relevant the determination that there is no direct 'manipulation.'"[52]

In 1990, Korea's current account shifted to deficit and that deficit continued in 1991. In addition, Korea's bilateral surplus with the United States fell considerably further over the same period. In the May 1991 Report to Congress, the Treasury added to its conclusion of no direct "manipulation" of the won, ". . . there is no basis for concluding that Korea . . . is using the array of exchange and capital controls at its disposal to 'manipulate' the rate indirectly. . . . Nonetheless, we remain seriously concerned that pervasive Korean exchange and capital controls significantly constrain supply and demand in the currency market. The exchange rate system in place, while an improvement over the previous regime, is far from a truly market-determined exchange rate system."[53] In addition, the Treasury criticized Korea for postponing earlier plans to liberalize its financial markets, for refusing to implement broader liberalization, such as the deregulation of interest rates and elimination of credit allocation schemes, and for refusing to provide national treatment for foreign financial firms in Korea. In Under Secretary Mulford's testimony before Congress in May 1991, he complained, ". . . we have had the least level of cooperation consistently from Korea of all countries that we've worked with. We are in the middle of financial negotiations with them. They haven't gone very well; they're not producing good results. I'm concerned about that."[54]

According to the Treasury in its November 1991 Report to Congress, "Progress in the Financial Policy Talks has been limited. The Ministry of Finance has taken some concrete measures over the past two years to improve the treatment of foreign financial institutions in

Korea. . . . However, significant denials of national treatment for foreign financial institutions in Korea remain. . . . More troubling at this stage is that the Korean government appears to lack a 'vision' and well-defined strategy for broader liberalization of its tightly controlled financial markets."[55]

V. Concluding Remarks

Korea's foreign exchange control system, governed by the FECA, is aimed at controlling all external transactions and uses of foreign exchange earnings. In Korea's developing years, even up until the mid-1980s, the focus of the system was to maintain Korea's external competitiveness and manage its foreign debt. The determination of exchange rates from regime to regime has differed with respect to the amount of variability allowed for the won. However, all of these regimes, to some extent, have been implemented to achieve the above goals. As Korea's foreign debt situation stabilized and current account surpluses emerged in the mid-1980s, the Korean government began to relax some of the constraints placed on foreign exchange and capital transactions. However, even under the current MAR system, existing foreign exchange and capital controls limit the extent to which exchange rates can reflect market pressures.

Korea's current account surpluses emerged at a time when the United States was experiencing record current account deficits, in part due to the rapid appreciation of the dollar in the first half of the 1980s. The fact that the dollar subsequently depreciated against the United States' industrial-country trading partners but moved little against the currencies of the NIEs prompted the U.S. Congress to examine the exchange rate policies of those economies. Under the OTCA, Korea and Taiwan were cited in 1988 as "manipulating" their currencies for "unfair" trade gain. With the implementation of the MAR system in March 1990, Korea was removed from Treasury's list of exchange rate manipulators. However, the Treasury has complained that even though Korea does not directly manipulate the won within the meaning of the Exchange Rates Act, pervasive capital controls significantly constrain supply and demand in the foreign exchange market and limit potential exchange rate movements. The proposed change in the FECA has the potential for allowing a true market-oriented foreign exchange system in Korea. However, it will depend on how it is implemented. If a long list of restricted transactions accompanies that new FECA, exchange rates will be market influenced but not truly market determined.

Endnotes

1. This is a version of a paper that was written for a conference on U.S.-Korean Economic Relations held at the Hoover Institute on December 5-7, 1991. The author is a staff economist in the Division of International Finance. This paper represents the views of the author and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or other members of the staff. I would like to thank Robert F. Emery, Dale W. Henderson, Steven B. Kamin, Michael P. Leahy, Yves Maroni, Ellen E. Meade, Larry J. Promisel, Patrice T. Robitaille, Charles J. Siegman, Ralph W. Smith, Jr., and Charles P. Thomas for their valuable comments and suggestions and Neil M. Yekell for excellent research assistance.

2. The Foreign Capital Inducement Act regulates longer-term capital inflows: foreign direct investment and large loans with maturities over three years.

3. Korea's exchange rate was devalued significantly over this period, however. In 1945, the exchange rate was set at 0.015 won per dollar. In 1964 prior to the introduction of a new exchange rate system, the rate stood at 130 won per dollar.

4. For example, the maturity was 45 days in 1970-74 and 30 days in 1978 and 1979.

5. The Bank of Korea stood ready to purchase foreign exchange from banks at its posted buying rate. However, the Bank of Korea was not committed to sell foreign exchange to banks and normally did not do so.

6. According to Kim (1989), the currencies in the trade-weighted basket included the yen, U.S. dollar, Deutsche mark, pound sterling, and Canadian dollar (the only currency not in the SDR).

7. See Bank of Korea, *Annual Report*; 1981, page 36; 1983, page 26; 1984, page 23; 1985, page 28, 30-31. For example, according to the Bank of Korea, in 1985, ". . . foreign exchange policies focused on improving further the current account and reducing significantly the growth of the external debt. . . . To support export competitiveness, exchange rates were managed flexibly, in response to the changes in the price differentials between at home and abroad and movements in the exchange rate of our major export competing countries."

8. Official rates for transactions between the won and other currencies were determined by the cross-rate of the won-dollar mid-rate and dollar-nondollar rates in international markets.

9. The dollar remained the intervention currency. Between 1980 and 1989, the spread for intervention rates was set between 0.2-0.4 percent.

10. Between 1980 and 1989, the spread for telegraphic-transfer rates varied between 0.25-0.45 percent for dollar transactions and between 0.5-0.6 percent for non-dollar transactions.

11. In July 1980, only forward contracts between the won and the dollar were approved; in October, the list of approved foreign currencies for forward transactions expanded to pound sterling, Deutsche mark, and yen. Prior to July 1980, only forward contracts between foreign currencies were allowed.

12. In July 1980, approved transactions included only those related to export and import. In October, some capital transactions, such as the payments on long-term foreign currency loans, were approved for forward contracts.

13. In addition, Korean traders were allowed to enter into export and import contracts denominated in won as long as settlement was in designated foreign currency. Settlement currencies are comprised of the Hong Kong dollar, Swiss franc, and the currencies of member countries of the IMF that have accepted the obligations of Article VIII. In September 1991, all current account transactions, not just export and import contracts, were allowed to be denominated in won; settlement must still be made in designated foreign currencies.

14. In March 1990, Korean residents were allowed to purchase and hold up to $5,000 in foreign exchange for any reason. In addition, large trading firms were allowed to deposit up to $10 million in foreign exchange deposits with domestic foreign exchange banks without documentation (expanded to a maximum of $100,000 in July 1991), and Korea's eight major trading companies were allowed to retain up to $5 million in foreign exchange earnings abroad.

15. As of July 1991, foreign exchange banks are required to hold foreign exchange balances (maintain a long foreign exchange position) of at least 1 percent of the value of the preceding month's average foreign exchange transactions (reduced from 2 percent). The ceiling on the long foreign exchange position for an individual bank is twice its previous month's total foreign exchange transactions or $20 million, whichever is larger. (This ceiling on long positions was put in place in August 1977. For some period prior to 1989 the ceiling was 20 percent to 150 percent depending on the type of foreign exchange bank.) The short foreign exchange position ceiling is $5 million and must be limited to forward transactions.

16. The effect of the dollar's appreciation on the U.S. current account was even larger than the observed change over this period. However, other factors reduced the exchange rate's effect.

17. Destler-Henning (1989) provides an interesting discussion of Congressional pressure (Chapter 6) and private sector pressure (Chapter 7) on the administration to adjust the value of the dollar prior to the Plaza Agreement. Pauls (1990) also mentions the desire to deflect protectionist legislation as one motivation for the Plaza Agreement.

18. From 1960 to the end of 1979, the won was devalued periodically to keep Korea's real exchange rate from becoming uncompetitive on balance. During that period, the won was devalued against the dollar on average 10 percent per year, a rate sufficient to offset the average (CPI or WPI) inflation differential between Korea and the United States. Over the

same period, the won depreciated against the yen on average over 12 percent per annum, a rate more than sufficient to offset the average inflation differential between Korea and Japan. (Despite Korea's long-standing bilateral trade deficit with Japan, trade equations estimated for Korea suggest that depreciation of the won against the yen results in a higher nominal global trade balance for Korea due to third-country effects.)

19. Under Secretary Mulford's response to questions by Senator Sarbanes. U.S. Senate, Committee on Banking, Housing, and Urban Affairs, *First Annual Hearing on International Economic and Exchange Rate Policy*, May 5, 1989, pages 39-40.

20. U.S. International Trade Commission, *Operation of the Trade Agreements Program* 1987, [one] page 4-49.

21. The effect of Korea's foreign exchange intervention in the second half of the 1980s on its ability to control its money aggregates and the subsequent inflationary pressure is discussed in Lindner (1992).

22. U.S. International Trade Commission, *Operation of the Trade Agreements Program* 1987, [one] page 4-49; and 1988, page 129.

23. OTCA, Title III--International Financial Policy, Subtitle A--Exchange Rates and International Economic Policy Coordination.

24. OTCA, Title I--Trade, Customs, and Tariff Laws, Subtitle A--U.S. Trade Agreements, Section 1124--Negotiations on Currency Exchange Rates.

25. For example, see Senator Heinz's line of questioning Under Secretary Mulford before the Senate Banking Committee on May 5, 1989, page 49-50. The export subsidy analogy is straightforward and, in some cases--such as in multiple exchange rate regimes--has been the focus of countervailing duty investigations. An example is textiles, apparel, and related products from China (PRC) in 1983 (*Federal Register*) and china tableware from Germany (F.W. Woolworth Co. v. United States). With respect to the dumping issue, assume a Korean export sells at the same price in both Korea and the United States when evaluated at an undervalued (won) exchange rate. If instead the dollar export price is evaluated at a market-determined exchange rate (an appreciated won), the export is sold in the United States at a price less than in Korea (dumping).

26. Global external imbalances need not be evidence of unfair trade practices, but rather may reflect differences in tastes over intertemporal consumption decisions between a country and the rest of the world. Moreover, the focus of the OTCA on bilateral trade balances seems particularly misguided; bilateral imbalances primarily reflect the comparative advantages of a country and its trading partners.

27. For a discussion of early versions of the Exchange Rates Act see Destler-Henning (1989), pages 107-113.

28. U.S. Senate, Committee on Banking, Housing, and Urban Affairs, Subcommittee on International Finance and Monetary Policy, *Treasury Department's Report on International Economic and Exchange Rate Policy*,

May 16, 1991, page 1. Senator Sarbanes is the chairman of this subcommittee.

29. The dollar depreciated 41.5 percent against the yen over this same period.

30. For example, ". . . it is clear our trade deficit is due to currency misalignments. . . . But I think the Administration is to be commended. They have done a great job in getting the G-5 and the G-7 together to bring the dollar down in comparison with the yen and the mark. Unfortunately, there are many other countries whose currencies are not in line. . . . I am thinking of Taiwan, Korea, Brazil, and to some degree, Canada." Senator Baucus, *Mastering the World Economy*, January 13, 1987, page 21.

31. Private interest group support for dollar depreciation in the 1980s is described in Chapter 7 of Destler-Henning (1989), pages 117-141.

32. Senator Bentsen, chairman of the Senate Committee on Finance, replied to Secretary Baker, ". . . talking to them [Korea and Taiwan] is fine, but in all candor I don't expect them to do anything, unless you find a way to really pressure them. . . . I want to understand that you are in there pushing, and pushing hard." *Mastering the World Economy*, February 19, 1987, page 35.

33. *Banking Committee Provisions of the Trade Bill*, March 3, 1987, pages 99-100.

34. *Exchange Rates and Third World Debt*, April 7, 1987, pages 318, 324, and 331-332.

35. H.R. 3, Title IV, Subtitle A, The Competitive Exchange Rate Act of 1987; and S. 1409, Title IV, Exchange Rates and Economic Policy.

36. U.S. Department of the Treasury, *Report to the Congress on International Economic and Exchange Rate Policy: October 1988*, page 19.

37. U.S. Department of the Treasury, *Report to the Congress on International Economic and Exchange Rate Policy: October 1988*, page 37.

38. In addition, the global surpluses of both Hong Kong and Singapore were relatively small and both were considered free traders in other respects as well.

39. In the October 1989 Report, the Treasury concluded that Taiwan was no longer manipulating its exchange rate, largely because Taiwan had introduced a new exchange rate system in April and had raised the ceiling on capital inflows by ten times its value at the time of the April Report. In addition, Taiwan's central bank had ceased its practice of substantial intervention.

40. The declines in Korea's surpluses were viewed as temporary by the U.S. Treasury. "In our judgement, these trade data are too limited and preliminary to indicate a clear irreversible trend towards a structural reduction in Korea's surpluses." (April 1989 Report, page 21.) ". . . it

has yet to be demonstrated clearly that a lasting, structural decline in Korea's external surpluses is underway. Caution should be exercised against imposing trends on data for recent months." (October 1989 Report, page 25.)

41. It should be noted that during this time the so-called "Super-301" provisions of the OTCA were being used to pressure Korea to change aspects of its trade policy. Korea was widely expected to be named a "priority country" under this provision by the USTR in May 1989. Despite strong industry pressure for the naming of Korea, advance concessions by Korea in April and May (reforms in investment, import barriers, and agriculture) removed Korea from the list. Japan, Brazil, and India were named. Korea was placed on the "Priority Watch List" under the "Special-301" provisions in May 1989, but was moved down to the "Watch List" in November 1989 after increasing protection for intellectual property rights.

42. U.S. Department of the Treasury, *Report to the Congress on International Economic and Exchange Rate Policy: April 1989*, page 17.

43. Under Secretary Mulford's response to a question by Senator Pressler. *First Annual Hearing on International Economic and Exchange Rate Policy*, Senate Banking Committee on May 5, 1989, page 42.

44. According to press reports and a statement by Finance Minister Lee.

45. U.S. Department of the Treasury, *Report to the Congress on International Economic and Exchange Rate Policy: October 1989*, page 25.

46. According to Korean press reports on the October 1989 Treasury Report, an unnamed Ministry of Finance official said that even though Korea would likely be named a priority country by the USTR, the Korean officials hoped to avoid U.S. trade retaliation through negotiations.

47. Prepared statement before the Subcommittee on International Finance and Monetary Policy of the Senate Banking Committee on November 16, 1989, *Review of the Department of the Treasury's Second Annual Report on International Economic and Exchange Rate Policy*, page 10.

48. Subcommittee on International Finance and Monetary Policy of the Senate Banking Committee, *Review of the Department of the Treasury's Second Annual Report on International Economic and Exchange Rate Policy*, November 16, 1989, pages 11-14 (Sarbanes) and page 21 (Heinz).

49. The MAR system is similar to Taiwan's foreign exchange system prior to April 1989. Under that system, Taiwan's central bank and government-controlled commercial banks transacted heavily in the interbank market to control changes in the mid-rate. The U.S. government determined that Taiwan was manipulating its exchange rate under that system. However, the Treasury in its *Reports to Congress* has concluded that there is no evidence that the Bank of Korea or government-owned banks have intervened heavily under the MAR exchange rate system.

50. In addition to the changes described in footnote 14, the limits on overseas investment by Korean securities firms and insurance and

investment trust companies were raised. Korean banks were allowed to borrow up to $2 billion from foreign banks or issue bonds in international markets.

51. U.S. Department of the Treasury, *Report to the Congress on International Economic and Exchange Rate Policy: April 1990*, page 25.

52. U.S. Department of the Treasury, *Report to the Congress on International Economic and Exchange Rate Policy: November 1990*, December 3, 1990 release page.

53. U.S. Department of the Treasury, *Report to the Congress on International Economic and Exchange Rate Policy: May 1991*, page 18.

54. Under Secretary Mulford's response to question by Senator Sarbanes, Chairman, in Subcommittee on International Finance and Monetary Policy of the Senate Banking Committee, *Treasury Department's Report on International Economic and Exchange Rate Policy*, May 16, 1991, page 68.

55. U.S. Department of the Treasury, *Report to the Congress on International Economic and Exchange Rate Policy: November 1991*, page 20.

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