DEPARTMENT OF THE TREASURY

SEVENTH ANNUAL

REPORT TO THE CONGRESS

ON

INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

DECEMBER 1994

Embargoed for release until
5:00 p.m., January 3, 1995

TABLE OF CONTENTS

			Page
Part I	Summary and Conclusions		1
Part II	Global Economic Developments		
	A.	Economic Situation in the G-7 Countries	3
	B.	Developments in the Foreign Exchange Markets	9
	C.	U.S. Balance of Payments Developments	13
Part III	Actions Under Section 3004		
	-	Korea	17
	-	Taiwan	22
	-	China	26

Appendix — Text of Sections 3004 - 3006 of the Omnibus Trade and Competitiveness Act of 1988

PART I: SUMMARY AND CONCLUSIONS

This seventh annual Report addresses recent developments in U.S. international economic policy, including exchange rate policy, since the interim Report to Congress submitted in July 1994. It is based on information available for the most part through November 1994. These reports are required under Sections 3004 and 3005 of the Omnibus Trade and Competitiveness Act of 1988 (Trade Act).

Global recovery is now well underway. Recovery is strengthening in continental Europe, and in Japan there are initial signs of recovery. The Managing Director of the International Monetary Fund has termed the 1995 outlook for the world economy the most favorable in seven years.

With the momentum now shifting from the United States, Canada and the UK, where growth first took hold, to the economies in continental Europe (and, more hesitantly, Japan), the prospects for a sustained and balanced recovery are much improved. G-7 growth in 1995 is expected to average at least 2.7 percent -- about the same as in 1994, and double the figure recorded in 1993.

Inflation in the G-7 has been held to levels achieved only once since the 1960s, despite gains in capacity utilization. The inflation outlook for 1995 is only slightly less favorable. Those that started earlier in the recovery cycle, the United States, Canada and the UK, will likely see a very modest increase in inflation, but the steady decline of inflation in Germany and continued progress in Italy will provide a counterbalance.

The growing sense of optimism about recovery and output growth in the industrial countries is not, however, without blemishes. Unemployment in Europe remains very high, and the upturn is not expected to be sufficient to bring about a substantial improvement. The large fiscal deficits in Europe are also troubling, although most European countries have embarked on strenuous efforts to reduce the underlying structural deficit.

Stronger growth in the United States than in many key trading partners led to a widening of the U.S. current account deficit in 1994. The current account deficit will likely continue to widen further during the remainder of 1994 and in 1995, although it will remain well below peaks recorded in the late-1980s as a percentage of GDP.

Japan's surpluses, though still high, have started to decline. For the first ten months of 1994, the current account surplus fell 9.2 percent in yen terms relative to the same period in 1993, and declined 1.6 percent in dollar terms on the same basis. A further modest reduction is expected in 1995 as domestic demand strengthens in Japan.

When measured on a trade-weighted basis, the dollar declined approximately 4 percent between October 1, 1993 and November 30, 1994. However, the peak-to-trough decline from early 1994 to the dollar's lows in October was 14.6 percent vs. the yen and 5 percent vs. the DM. The decline against the yen and mark during a period of robust growth and low inflation in the United States prompted the Administration to express concern about the decline on several occasions and to undertake several rounds of intervention. The Administration has made clear its desire for a strong dollar.

The main themes of the IMF's annual Article IV consultation with the United States Government, completed in August, were the U.S. fiscal outlook -- and its implications for the U.S. external position -- and the appropriate monetary policy at this stage of recovery in the United States.

In this Report, Treasury has re-examined the systems and policies of Korea, Taiwan and China, which have been identified in some previous reports as having manipulated the exchange rate between their currency and the U.S. dollar in order to prevent effective balance of payments adjustment or to gain an unfair advantage in international trade. It is Treasury's judgement that, at the current time, neither Korea nor Taiwan is manipulating the exchange rate between its currency and the U.S. dollar for such purposes. However, both Korea and Taiwan continue to maintain a number of troubling financial and foreign exchange policies, capital controls in particular, which discourage investment and hamper the full effect of market forces in exchange rate determination. Treasury will continue to seek removal of these impediments in the context of bilateral negotiations and/or discussions.

Treasury acknowledges that major strides in reforming China's foreign exchange system have been made this year. However, China maintains significant restrictions on foreign exchange transactions. Domestic firms are required to sell foreign exchange to designated banks, and while Foreign-funded enterprises (FFEs) may use the foreign exchange earned through exports, they must receive prior approval from the State Administration of Exchange Control (SAEC) for all purchases of foreign exchange in the interbank market. Moreover, China continues to require SAEC approval for certain current account transactions, including repatriation of profits.

At the moment, SAEC approval of foreign exchange purchases for foreign firms is not difficult to obtain. This liberal implementation stems from favorable market conditions -- ample foreign exchange availability and strong demand for the renminbi. However, as in the past, the SAEC could withhold approval. It is clear that the rationale for maintaining the approval system is to maintain the government's capability to ration foreign exchange.

Thus, Treasury has determined that China is not currently manipulating its exchange system to prevent effective balance of payments adjustment or gain unfair competitive advantage in international trade. However, it is essential that China commit to liberalizing access to foreign exchange for current account transactions, as is required under Article VIII of the IMF's Articles of Agreement. The United States continues to seek such commitments from China in bilateral negotiations and in multilateral negotiations regarding China's accession to the World Trade Organization (WTO).

PART II: GLOBAL ECONOMIC DEVELOPMENTS

A. Economic Situation in the G-7 Countries

Recovery of Growth is Taking Hold

The global recovery is on track. The overall outlook appears to be the most favorable in years, and the International Monetary Fund expects that global growth in 1995 will be the highest since 1988.

The recovery which began in the United States, Canada and the UK has now spread to continental Europe, and signs of an upturn are appearing in Japan. Aggregate G-7 growth for 1994 should reach close to 3 percent, and could exceed that rate in 1995. (The IMF growth forecasts published in October and noted below may now be somewhat conservative, especially regarding European growth, in light of recent indicators.)

Table 1

G-7: Real GDP Growth
(% change y/y)

	1993	1994F		1995F	
		IMF	Consensus	IMF	Consensus
United States	3.1	3.7	3.8	2.5	2.8
Japan	0.1	0.9	0.6	2.5	1.9
Germany*	-1.1	2.3	2.5	2.8	2.9
France	-1.0	1.9	2.2	3.0	3.8
Italy	-0.7	1.5	2.1	2.8	2.8
United Kingdom	2.0	3.3	3.5	3.0	2.9
Canada	2.2	4.1	4.1	3.8	3.8
Total G-7	1.4	2.8	2.8	2.7	2.7

* All Germany; F=Forecast

Sources: IMF, World Economic Outlook, October 1994, and Consensus Economics, Consensus Forecasts, November 1994.

The recovery in Europe began with the export sector. Domestic demand -- consumption, business investment and housing -- is now strengthening, and should carry the advance into 1995. In Japan, consumption rose sharply in the third quarter. Business investment -- though weak -- registered its first uptick in three years, suggesting that 1995 should see greater strength on the investment side and a gradually building acceleration in growth. The overall picture suggests that recovery will grow to encompass more and more countries in a broad, non-inflationary upturn. Economic conditions and policies are oriented to making the expansion sustainable.

Prospects for Low Inflation are Bright

The G-7 can look forward to a continuation of inflation rates that are among the lowest in nearly 30 years. On average, G-7 inflation is expected to be around 2.2 percent in 1994, and 2.5 percent in 1995.

Table 2

G-7: Consumer Price Inflation
(% change y/y)

	1993	1994F		1995F	
		IMF	Consensus	IMF	Consensus
United States	3.0	2.7	2.7	3.4	3.4
Japan	1.3	0.7	0.6	0.7	0.6
Germany*	4.6	3.1	3.0	2.2	2.4
France	2.1	1.8	1.8	1.8	2.1
Italy	4.2	3.8	3.9	3.1	3.8
United Kingdom	1.6	2.5	2.5	3.1	3.4
Canada	1.8	0.2	0.3	1.6	1.9
Total G-7	2.7	2.3	2.2	2.5	2.7

* All Germany for IMF; F=Forecast
Sources: IMF, World Economic Outlook, October 1994, and Consensus Economics, Consensus Forecasts, November 1994.

The optimistic outlook for inflation is well grounded. The moderate pace of the expansion and the shift of momentum from the countries recovering earlier to the Continent and Japan have helped to prevent undue pressure on supply in any one country, thereby containing inflation pressures. The normal rise in global commodity prices associated with an industrial country upturn has been moderate.

In addition, the gap between actual and estimates of potential output remains sizeable in most countries. Hence, economies at a relatively early stage in their expansion can continue to grow for some time at above their long-run potential without experiencing inflationary pressures, and the recovery should not be cut short by the need to restrain inflation. Furthermore, G-7 policy measures are consistent with the goal of non-inflationary growth with higher employment.

Table 3

G-7: Output Gaps
% of potential GDP

	1993	1994	1995
United States	-0.9	+0.2	+0.2
Japan	-3.8	-5.6	-5.5
Germany*	-1.6	-1.7	-1.5
France	-3.0	-3.1	-2.3
Italy	-3.8	-4.2	-3.5
United Kingdom	-4.8	-3.7	-2.8
Canada	-4.3	-2.9	-1.9

Source : IMF, World Economic Outlook, October 1994
* All Germany

Judicious Monetary and Fiscal Policies

Monetary policy is being employed to bear on inflation risks in a timely fashion. Monetary tightening has been underway in the countries leading the recovery. Fiscal policy has also become more restrictive in all G-7 countries except (appropriately) Japan. This fiscal restraint will continue in 1995.

The restrictive movement in fiscal policy is indicated by the reduction in "structural" budget balances (i.e., the fiscal position estimated by abstracting from the normal cyclical movements in revenues and expenditures). Since the upturn will also reduce budget deficits by the revenue-increasing action of cyclical forces, the reduction in actual budget deficits will be even greater -- from 4.0 percent of G-7 GDP in 1993 to 3.2 percent in 1995, according to IMF projections. The tightening outside Japan will be even greater.

This generally optimistic picture should not obscure some very real problem areas. In addition to the continuing large high Japanese current account surpluses noted below, these problems include high fiscal deficits in many European countries, despite the reductions now in train. Both the IMF and the OECD estimate that the United States will have the lowest G-7 government sector budget deficit to GDP ratio again in 1995. Continuing efforts over the medium term will be needed to correct these deficits.

External Account Developments

While Japan's trade and current account surpluses remain high, they have started to come down. The current account surplus measured in yen peaked in 1992. Because of the rise of the yen against the dollar, however, the surplus in dollar terms continued to rise for some time, but may now be turning around. For the first ten months of 1994, the surplus in yen terms was down 9.2 percent relative to the same period in 1993, while the surplus in dollar terms fell 1.6 percent.

Trade volume figures show a substantial rise in imports, although exports have also risen somewhat. For 1994 as a whole, it is entirely possible that Japan's current account surplus measured in dollars could be the same as or slightly higher than its $131 billion level in 1993. But the cumulative impact of the past yen rise (which took place mainly in the first half of 1993) and the gradual strengthening of domestic demand in Japan should produce a small reduction in the 1995 surplus even in dollar terms.

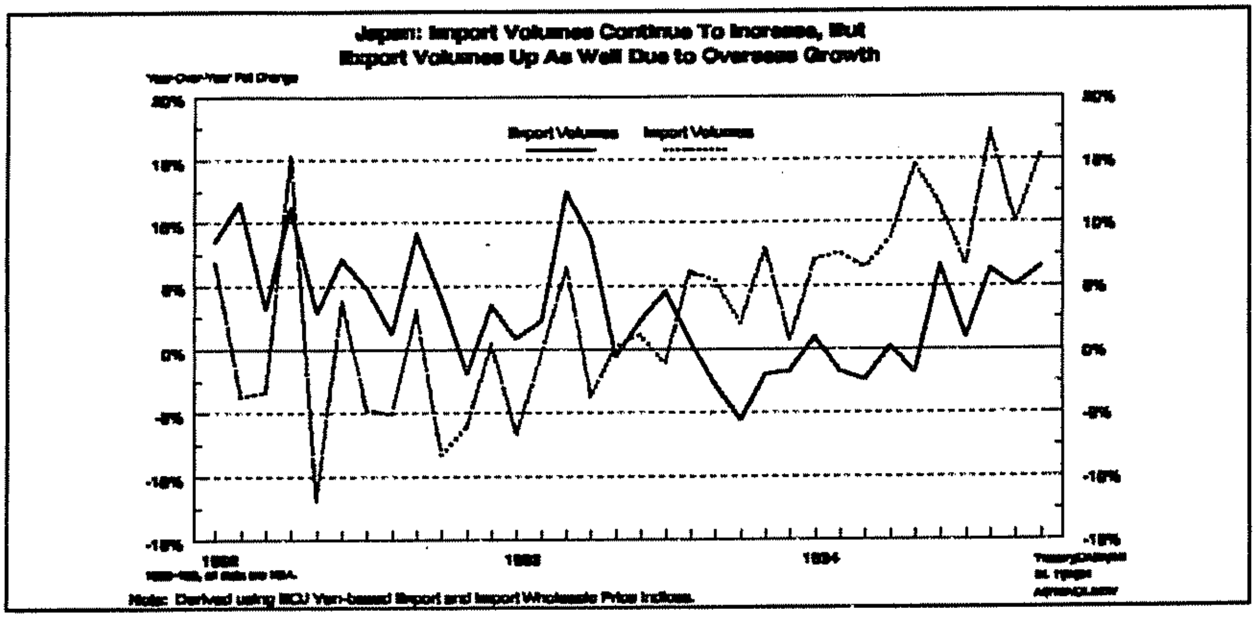

Chart 1

Even in 1995, however, Japan's external surpluses will remain sizeable, both in absolute terms and in proportion to GDP. It will therefore remain urgent that Japan continue to open its markets and avoid premature monetary and fiscal policy tightening, so that the recovery can gather strength and produce an expansion of domestic demand large enough to make a sizeable reduction in Japan's external imbalances. (For a discussion of U.S. trade and current account prospects, see section IIB.)

Table 4
G-7: Current Account Balances
($ billions; % of GDP in parentheses)

	1993		1994F IMF		1994F Consensus	1995F IMF		1995F Consensus
United States	-104	(-1.6)	-149	(-2.2)	-143	-167	(-2.4)	-141
Japan	+131	(+3.1)	+136	(+2.9)	+130	+129	(+2.6)	+115
Germany*	-20	(-1.0)	-16	(-0.8)	-25	-14	(-0.6)	-16
France	+10	(+0.8)	+10	(+0.7)	+8	+12	(+0.9)	+5
Italy	+11	(1.2)	+31	(+3.0)	+20	+38	(+3.4)	+23
United Kingdom	-16	(-1.6)	-13	(-1.3)	-8	-18	(-1.6)	-9
Canada	-24	(-4.3)	-21	(-3.9)	-22	-19	(-3.3)	-20
Total G-7	-11	(-0.1)	-23	(-0.1)	-39	-39	(-0.2)	-44

* All Germany for IMF; F=Forecast

Sources: IMF, World Economic Outlook, October 1994, and Consensus Economics, Consensus Forecasts, November 1994.

Unemployment and Structural Adjustment

The recovery has produced substantial employment gains in the United States. Since January 1993, 5.2 million new payroll jobs have been added, mostly in the private sector. The unemployment rate dropped to 5.6 percent in November. Job gains are now spreading to other countries, although unemployment remains high, particularly in Europe.

Reduction in unemployment rates normally lags upturns in production. The year 1995 should see a reduction in unemployment on the Continent, although the decline may be too small to reduce the aggregate European unemployment rate much below 10 percent before 1996. Thus, while it is likely that some gradual improvement in the unemployment rates will occur, and there is some evidence that G-7 labor markets are becoming more flexible, rates will remain at historically high levels in Europe even into the latter part of the decade. More progress in the structural policy area, supported by appropriate macroeconomic policies, is essential.

Other structural changes in the industrial economies have made product markets more competitive and reduced price-raising power. Among these changes is a more open international trade regime, which may reduce the power of capacity constraints in any one country to accelerate inflation.

Rise in Long-term Interest Rates

Long-term interest rates have risen substantially in all industrial countries over the past twelve months, although the size of the increase varies across countries. While the measurement of "real" (i.e., inflation-adjusted) interest rates is subject to a wide range of uncertainty, there appears to be a roughly one percentage point increase in the real ten-year bond rate which is common to all countries that have closely linked markets. This rise in real rates is due to the increasing strength of the global recovery, which has focussed attention on the large structural budget deficits in many countries. Increases in bond yields over and above the higher real rate reflect a mixture of concerns about future inflation and uncertainties about the future path of price increases that differs among countries. For example, the additional rise is lowest in Japan, where current and likely future inflation rates are lowest.

Policy Requirements

In the United States, where the expansion is now in its third year, monetary policy has been directed toward sustaining recovery with low inflation. The substantial increase in short-term rates since February 1994 (2-1/2 percentage points for Federal funds and over 3 percentage points for three month CDs) has begun to show some signs of slowing demand. The combined effects of the deficit reduction program and strong recovery brought the U.S. federal budget deficit down to only $203.4 billion (3.1 percent of GDP) in FY94, the lowest in five years. There will be another sizeable cut in the deficit in FY95, for the third consecutive year.

In continental Europe, it will be important to continue the process of fiscal restraint. In addition to improving fiscal positions, this process will ensure continuing anti-inflation effects as the recovery accelerates. In this context of fiscal tightening -- and given declining inflation and substantial remaining gaps between actual and potential output -- there is no evident need for a tightening of monetary policy. Recovery also provides an opportunity to address structural obstacles to job creation more vigorously.

Japan needs to ensure that macroeconomic policy continues to support demand, so that the recovery which appears finally to be underway does not falter. In the fiscal policy area, it is essential to avoid a premature withdrawal of stimulus from the tax side, as well as expenditure cuts in the normal budget process that might undo the positive impact of the tax cuts on domestic demand and growth. In addition, the Bank of Japan should resist tightening monetary policy until the recovery is more assured. Real short-term interest rates are high, the financial system is still under strain, inflation is nil and the yen has been very strong. As the OECD remarks in its latest Economic Outlook, "the appropriate time for moving rates to an upward path appears to be some way off."

B. Developments in the Foreign Exchange Markets

Introduction

Between October 1, 1993 and November 30, 1994, the dollar experienced a moderate decline of approximately 4 percent on a nominal trade-weighted basis. The decline was widespread, including against many currencies which customarily follow dollar movements in the exchange markets. The dollar ended the period at a level 3.5 percent below its average over the past seven years in trade-weighted terms.

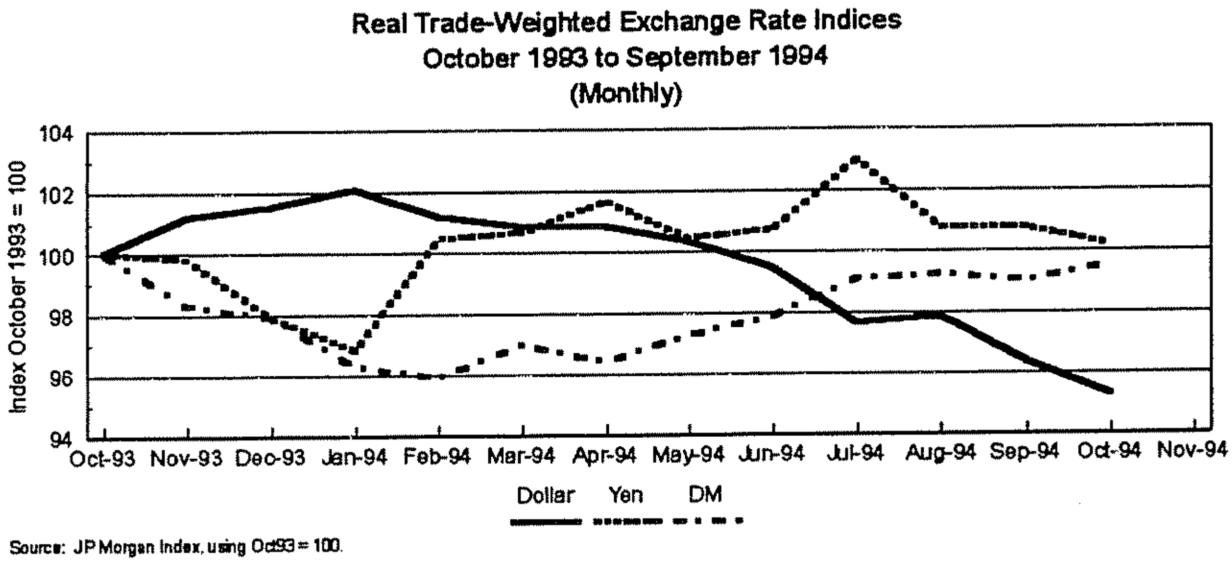

Chart 2

The downward movement in the dollar was first evidenced in January against the yen, reversing a trend of appreciation that had begun in August 1993. Over the next two months, the dollar also began to decline against the German mark and other European currencies. The following table shows the percent change in the dollar against various currencies from October 1, 1993 through November 30, 1994. The peak-to-trough decline from early 1994 to the dollar's lows in October was 14.6 percent vs. the yen and 5.0 percent vs. the DM.

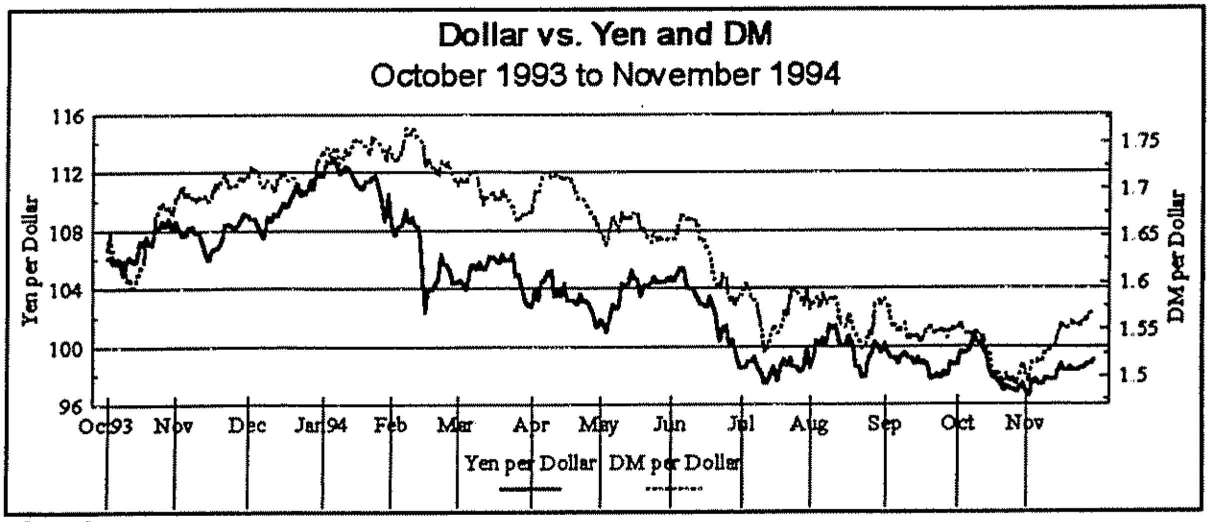

Chart 3

Table 5

Change in Dollar vs. Selected Currencies
(Percentage Change)

Currency	Change: October 1, 1993-November 30, 1994
Japanese Yen	-6.7%
German Mark	-3.9%
British Pound	-4.3%
French Franc	-5.4%
Italian Lira	1.6%
Canadian Dollar	3.4%
Swiss Franc	-6.8%
Mexican Peso	10.3%
Korean Won	-2.2%
Taiwanese Dollar	-2.3%

Factors Behind Recent Foreign Exchange Market Developments

The depreciation of the dollar over the period can be attributed to two sets of factors. First, there was a renewed focus in the market on external imbalances and the associated trade tensions between the United States and Japan. Second, there was a change in market expectations regarding the monetary policy response to the sustained strength of the economic expansion in the United States and a faster than expected recovery in Europe.

The widening of Japan's trade surplus in late 1993 and into early 1994 raised market caution about the need for further adjustment in imbalances. The market showed sensitivity at times to developments in US-Japan trade negotiations in subsequent months, given their importance to the adjustment process. Lack of progress in Japan on fiscal and other policy measures which influence domestic demand led the market to believe that external adjustment might come about mainly through the yen/dollar exchange rate.

In addition, the deterioration in the U.S. current account deficit that accompanied the recovery generated some concern in the market. Changes in capital flows, including the continued diversification of U.S. investors into foreign assets and a period of reduced demand by Japanese investors for foreign assets were perceived to have exerted pressure on the dollar.

Market expectations about growth, inflation, and the expected monetary policy response played a key role. At times, there was downward pressure on the dollar as the market participants gradually realized that U.S. economic growth was moving along faster than they had anticipated and became concerned whether the monetary response would be adequate to keep the economy from quickly reaching employment and capacity constraints.

Over the period, the pace of economic recovery in Germany and throughout Europe accelerated faster than many market participants had anticipated, raising expectations of strong relative investment returns in these markets and thereby leading to some adjustment out of dollar assets. Market perceptions in the summer that the monetary easing cycle in Europe was over implied that interest rate differentials would not widen sufficiently in the dollar's favor.

The dollar stabilized for a short period beginning in mid-July as some of these concerns receded. Optimism spread about the favorable resolution of the framework talks with Japan. There was a growing feeling in the market that the Japanese trade surplus had peaked. The August tightening by the Federal Reserve was well received in the markets. Later, the dollar was supported by encouraging signs that other steps, such as preliminary Japanese tax reform and other policies to stimulate domestic demand, were being taken to address external imbalances.

However, starting in September, renewed indications of stronger than anticipated U.S. economic activity kept U.S. bond prices under pressure. Increases in various indicators of capacity utilization, of prices of inputs, and of employment pointed to sustained growth at faster than anticipated rates, which raised the market's concern about inflation risks. The dollar temporarily traded lower during the second half of October.

Subsequently, the dollar recovered following foreign exchange market intervention by the U.S. monetary authorities in early November and an increase by the FOMC in short term interest rates on November 15. Over the course of this period, short-term interest differentials favoring dollar placements widened further. Also, recent months' data have provided evidence that the Japanese trade surplus has probably peaked and is on a declining trend.

Exchange Rate Policy

The Administration supports a strong dollar. A strong dollar is good for the U.S. and world economies:

- it supports confidence in the financial markets;
- it enhances the attractiveness of U.S. assets;
- it gives an incentive for longer-term investment in the United States; and
- it helps to keep inflation low.

In early November, Secretary Bentsen stated that a decline in the dollar would be inconsistent with the fundamentals of a strong, investment-led recovery in the United States and with the greatly enhanced ability of U.S. firms to compete around the world, and that a continuation would be counterproductive for the U.S. and world economies. The U.S. position is shared generally among the G-7 authorities, who agree that, in prevailing economic conditions, a decline of the dollar is neither justified nor desirable.

As we have emphasized since early 1993, the Administration's position on exchange rate policy rests on two basic points. First, exchange rates should reflect economic fundamentals, as they evolve, and the policies that help shape the fundamentals. Second, the U.S. monetary authorities are prepared to cooperate with other G-7 authorities in the foreign exchange market when appropriate. As we have demonstrated in the past year, we believe that intervention can be a valuable policy instrument in the right circumstances.

Foreign Exchange Market Intervention

During the period under review, the Administration intervened in the foreign exchange market on five days. The first three episodes, occurring on April 29, May 4, and June 24, are detailed in the July report. On November 2 and 3, the U.S. monetary authorities intervened in the foreign exchange market, purchasing dollars against sales of Japanese yen and German marks.

C. U.S. Balance-of-Payments Developments

Goods and Services Trade

The U.S. deficit on Goods and Services (G&S) trade continued to widen in 1994, running at an annual rate of $109.3 billion for the first 9 months, compared with $74.1 billion for the same period in 1993, and a recent low point of $28 billion for the year 1991. This widening was entirely due to an increased deficit on goods trade. The surplus on trade in services so far this year is roughly unchanged from the 1993 level.

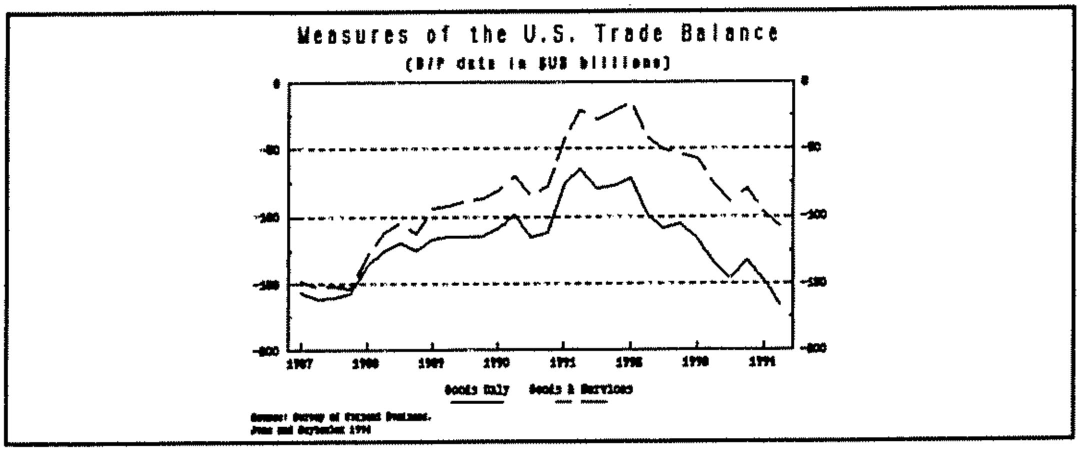

Chart 4

The goods trade balance was heavily influenced by cyclical factors.

- o The robust U.S. expansion, now in its third year, continues to draw in imports, which are up 12.6 percent in value terms for first 9 months of 1994 over the same period in 1993. Strong import growth is characteristic of such a robust expansion. However, 40 percent of the increase has been accounted for by capital goods, including computers. Such imports have a positive impact on the U.S. economy, since they support the strong capital investment expenditures by U.S. firms, which in turn contribute to the continued strong competitive performance by U.S. exporters in the face of weak demand in several major export markets.

- o Exports are up 9.3 percent in value terms over the first 9 months, despite having been hampered by sluggish growth in Europe and Japan. The drag of sluggish growth in major industrial country markets has been partly offset by strong growth in emerging country markets, and continued improvement in the foreign market share of U.S. exports, reflecting a robust U.S. competitive position as measured, e.g., by relative unit labor costs.

Table 6

Goods Exports and Imports by End-Use 1993-4
($ billion; Jan-Sept at annual rates)

End-Use Category	Exports		Imports	
	1993	1994	1993	1994
Foods, Feeds, & Beverages	39.9	39.6	27.5	30.6
Industrial Materials	110.0	118.3	145.4	159.1
Capital Equipment	178.0	201.5	148.4	178.7
Automobiles & Parts	51.4	56.0	101.0	115.7
Misc. Manufactures	77.3	84.2	150.2	164.0
TOTAL, CENSUS BASIS	456.6	499.6	572.4	648.0
TOTAL, BOP BASIS	448.5	490.1	580.7	654.0

The surplus on services, though large, has remained in the $55 billion range for several years, after rapid growth in the latter 1980s. The factors behind this apparent levelling-off are not clear, but may in part reflect the same cyclical factors influencing the goods trade balance, since U.S. competitiveness is as marked in services as in goods. Recovery abroad should contribute to a renewed widening in the services surplus.

However, renewed growth in the services surplus may well be offset by a widening deficit on investment income, as a decade of current account deficits has built-up a large net debt which has to be serviced. In 1994, for the first time, the United States will run a deficit on net investment income.

Table 7

U.S. Current Account: 1987; 1991*; 1994
($ billion; data from SCB)

Balance	1987	1991*	1994#
Goods	-160	-74	-164
Services	+8	+46	+57
Investment Income	+8	+15	-10
Transfers	-23	-35*	-32
Current Account	-167	-49*	-149

*excludes $42 billion in one-time transfers from allies to support Desert Storm. Totals may not add due to rounding.
#Jan-Sept at annual rate

Changing Capital Account Patterns

The pattern of financing of the U.S. current account has changed somewhat in recent years. Direct investment recorded net inflows during much of the decade of the 1980s, but has shifted to net outflows so far during the 1990s. At the same time, there has been a substantial decline in the net inflow from securities transactions, though changes in the net have masked much larger swings in gross inflows and outflows. (In particular, there was a very large surge in U.S. purchases of foreign securities during 1993, which rose to $142 billion annual rate during the second half of the year but dropped back sharply in 1994, to an annual rate of $42 billion in the second and third quarters.) Banking transactions have accounted for increased inflows. There have been substantial official inflows in recent years, in part relating to foreign official intervention in exchange markets by major industrial countries and in part to the accumulation of dollar reserves by dynamic developing countries, which are a counterpart of their increased ability to attract private capital.

Table 8

Annual Capital Flows: 1981-85; 1986-90; 1991-93; 1994
($billion; annual averages, selected transactions)

	1981-85	1986-90	1991-93	1994*
Direct Invest, net	+11	+28	-24	-15
Securities, net	+23	+31	+5	+18
Corporate (non-d.i.)	+1	+3	+12	+14
Banks, net	-1	+15	+32	+119
Official, net	-5	+28	+5	+52

* Jan-Sept at annual rate

Outlook for the Trade and Current Account

Relative growth performance by the United States and its major trading partners will continue to be a major factor driving the U.S. trade and current account during 1995 and beyond. The U.S. economy should continue to expand, though at a more moderate pace, and thus imports will continue to grow as well. Renewed expansion in Europe and Japan will give a boost to U.S. exports, but the improvement will be gradual.

We expect the U.S. trade and current account deficit to continue to widen in 1995, albeit at a declining rate, reflecting this growth pattern. (A range of recent private and public sector forecasts is shown below.) However, the deficit in 1995 should not exceed 2-1/2 percent of GDP, well short of the peak deficit of 3.7 percent of GDP recorded in 1987. Recent data confirm that a recovery is underway in Europe -- though the likely vigor of the expansion remains uncertain -- and prospects for a revival of economic activity in Japan have improved. And various indicators of U.S. competitiveness, notably data on unit labor costs and export market shares, show that U.S. goods are highly competitive in world markets.

Table 9

FORECASTS OF CURRENT ACCOUNT BALANCE

	1994		1995	
Source	$billion	%GDP	$billion	%GDP
L. Meyer & Assoc (12/94)	-155	(-2.3)	-172	(-2.4)
DRI (12/94)	-158	(-2.3)	-200	(-2.8)
Consensus Econ, London (11/94)	-143	(-2.1)	-141	(-2.0)
OECD (12/94)	-154	(-2.3)	-173	(-2.4)
IMF (10/94)	-149	(-2.2)	-168	(-2.4)

The timing of a possible turn-around is very difficult to predict, but, if activity in the U.S. moderates as expected and there is robust recovery in Europe and Japan, at some point during the course of 1995 or 1996 the U.S. current account deficit should stabilize or begin to decline -- at least as a share of GDP, and probably in absolute terms as well.

The degree, and longevity, of such a turn-around will depend on improvements in the U.S. saving performance. At current levels of private saving, even if the progress made to date in reducing the budget deficit can be sustained, domestic saving will continue to be inadequate to finance desired levels of investment, and the United States will continue to need to borrow abroad to finance the difference -- or cut investment and future growth. Substantial further progress in improving U.S. saving performance will be needed to produce long-term reductions in the current account deficit.

PART III: ACTIONS UNDER SECTION 3004

Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 requires the Secretary of the Treasury to consider whether countries manipulate the rate of exchange between their currencies and the U.S. dollar for the purposes of preventing effective balance of payments adjustment or gaining competitive advantage in international trade. Section 3004 also requires the Secretary to undertake negotiations with those manipulating countries that have material global current account surpluses and significant bilateral trade surpluses with the United States. This section summarizes the current status of Korea, Taiwan and China, which in some past reports have been designated as manipulating the rates of exchange between their currencies and the U.S. dollar.

KOREA

Korea currently has a global current account deficit, but maintains a small bilateral trade surplus with the United States. It is the judgement of the Treasury Department that Korea is not at this time manipulating the rate of exchange between the won and the U.S. dollar to prevent effective balance of payments adjustment or to gain unfair competitive advantage in international trade.

Notwithstanding this determination, the Treasury Department remains concerned that Korea's continued use of foreign exchange and capital controls reduces market demand for the won and thereby tends to deter upward pressure on the won.

Trade and Economic Developments

Korea's external accounts continued to shift in 1994. Korea's current account was nearly balanced in 1993, recording a small surplus of $500 million compared to a deficit of $4.5 billion in 1992. Korea's trade balance registered a surplus of $1.9 billion in 1993.

This year, according to statistics provided by the Bank of Korea, the current account balance in January-June registered a deficit of roughly $2.7 billion. A small second-half surplus is expected to lower the annual deficit to $2.5 billion. Trade flows accounted for most of the increased deficit. Imports, reflecting the recovery in aggregate demand as Korea pulled out of last year's recession, jumped roughly 14.5 percent in the first half of 1994 compared to the same period in 1993. Korea's exports, on the other hand, grew by 11.9 percent during January-June 1994, compared to 5.9 percent during the same period in 1993. Overall, Korea registered a trade deficit of $1.6 billion during the first six months of this year. Korea ended 1993 with $20.7 billion in gross reserves (excluding gold), equivalent to over two months of imports. By May 1994, this figure had risen to an estimated $21.4 billion.

While Korea's economic recovery has been the driving force in widening the overall deficit in dollar terms, exchange rate developments may also be playing a role. Won depreciation with respect to the yen and EU currencies has increased the dollar value of imports but will only gradually slow the growth of import volumes ("the J-curve effect"). According to Korean statistics, the value of imports from the EU and Japan grew at 22.8 and 21.9 percent, respectively, during the first half of 1994. This is more rapid than the rate of growth reported for imports from the United States, whose currency remained comparatively stable relative to the won. Despite government promotion of 1994 as "Visit Korea" year, the deficit in the tourism account during January-June more than tripled to $655 million compared to the same period in 1993.

Korea's trade with the United States has also undergone significant adjustment. During January-September 1994, Korea's trade surplus with the United States amounted to $1.4 billion, down from the $1.9 billion surplus recorded in the first nine months of 1993 according to U.S. statistics. The decline in Korea's surplus with the United States is attributable to the surge in Korea's economic growth and the consequent increase in aggregate demand for imports. Korea's imports from the United States during January-September 1994 grew by roughly 18 percent over the same period in 1993. By comparison, the value of Korean exports to the United States grew by 11.5 percent.

Overall, the Korean economy surged ahead in the first two quarters of this year. Real GNP grew by an estimated 8.5 percent, with average growth for the entire year predicted to be around 8 percent. Facility investment and exports led the second quarter growth, as in the first quarter, but the second quarter also saw an acceleration in private consumption spending, which rose 7.6 percent over 1993 levels. Korea seems destined to overshoot its target of 6 percent inflation for 1994. The government has focused its 1995 budget on price stabilization, however, and the Bank of Korea will attempt to keep monetary growth in the 14-15 percent range.

Despite the depreciation of the won relative to the yen, Korea's trade deficit with Japan has widened. While Korean exports to Japan have risen 13.2 percent, the value of Korean imports from Japan have grown even more rapidly -- possibly due to the J-curve effect mentioned earlier and inelastic demand for imported capital equipment and inputs from Japan. The chronic trade deficit with Japan is a concern for Korean officials, with the gap widening 32 percent from $4.4 billion during the first half of 1993 to roughly $5.9 billion during the same period in 1994.

At the same time, the decline of the won relative to the yen has apparently also made Korea more competitive in some export markets in which it competes with Japan. Exports to the developing nations, for example, grew by 16.4 percent during the first half of 1994, while exports to the developed nations (the United States, Japan, and the European Union) grew by only 8.9 percent during the same period.

Exchange Rate Developments

The value of the Korean won relative to the U.S. dollar has not changed significantly since the last report in July 1994. Between December 31, 1993 and November 18, 1994, the won appreciated 1.9 percent relative to the dollar.

Korea's exchange rate system has acted to keep the won's value against the dollar virtually steady while the dollar has declined against most other major currencies. As a result, the won has captured the competitive benefits of the dollar's depreciation against the yen, declining from 629 won per 100 yen in early 1993 to a record low of 818 won per 100 yen at the end of June.

Exchange Rate and Financial System

Korea's exchange rate system is characterized by thin trading and an extensive set of capital controls. Treasury believes that the maintenance of foreign exchange and capital controls, rather than direct intervention by the Bank of Korea, is the more important factor in deterring upward pressure on the won.

Under the present system, the won's exchange rate is determined by a weighted average of the interbank won-dollar exchange rates applied in spot transactions on the previous day. The won is allowed to fluctuate ±1 percent relative to the dollar on a daily basis. In July, the Minister of Finance stated that the government intends to widen the exchange rate fluctuation band to ±1.2 - 1.5 percent sometime before year-end 1994. In October, the new Minister of Finance announced that the limit would be increased to ±1.5 percent effective November 1.

Korea continues to maintain a broad array of controls on foreign exchange and capital account transactions. These controls inhibit market forces from fully determining the exchange rate, prevent the free flow of capital both into and out of Korea, and constitute a potential means by which Korean authorities may influence the exchange rate. Foreign exchange banks, for example, have been required to obtain and review documentation of underlying commercial transactions for most foreign exchange transactions. Effective November 1, 1994, the MoF relaxed these regulations to some degree by increasing the minimum value of forward foreign exchange contracts subject to underlying documentation requirements to $10 million, up from $3 million. Despite this recent move, however, these restrictions remain an impediment to foreign exchange transactions. Korea's restrictive terms for deferred import payment, although recently eased by means of expanding the payback period to 150 days, still lag far behind international norms and continue to be a key concern. Offshore financing is also restricted. Some progress was made in this area during the summer, but the easing of access to offshore financing was selectively focused to maximize the importation of high-tech or capital equipment while leaving other sectors untouched.

Regarding inward capital controls, foreigners have been subject to a 10 percent general and 3 percent specific limit on investment in Korean stocks. Newly appointed Finance Minister Park Jae Yoon announced October 5 that, effective December 1, the 10 percent ceiling on aggregate foreign purchases in a listed stock will be increased to 12 percent, with the ceiling going to 15 percent sometime in 1995. The 3 percent limit on purchases by an individual will remain unchanged. Soon after the announcement, however, the Stock Market Stabilization Fund reportedly sold its equity holdings to slow the rise in stock prices. The Fund's decision to sell equity holdings was viewed by some as unnecessary intervention in the market. Treasury will closely monitor this issue and continue to press Korea for more rapid liberalization.

With regard to capital outflows, Koreans and Korean companies are permitted, effective July 1, 1994, to purchase foreign stocks and bonds, but individual Koreans are limited to investments of up to \$125,000 and companies up to \$375,000. However, new capital controls were introduced early this year in response to a surge in capital inflows. Foreign investors were required to obtain special identification cards prior to purchasing Korean shares. Foreign investors were also required to deposit 40 percent of the purchase price prior to entering the order -- a practice prohibited in the United States -- thereby cutting U.S. institutional investors out of Korea's securities market. Although these regulations were eased during the course of the year, their imposition had the effect of slowing capital inflows during the early months of 1994.

The limits on capital inflows and outflows, while they were eased on an incremental basis, reflect the cautious approach taken by the Korean government and the desire to insulate the won from the effects of market-determined capital flows. The imposition of new capital controls earlier this year and more recent actions to depress activity on the Korean stock exchange are evidence that Korean authorities are still far from the goal of allowing market forces to determine exchange rates. Moreover, such actions undermine foreign confidence in Korea's financial liberalization commitments, and in the longer run can complicate monetary management.

Financial Negotiations

Treasury has continued to engage Korean authorities in discussions related to accelerating its financial market and capital account liberalization and will continue to do so under extended Uruguay Round negotiations and further bilateral contacts. Most recently, Treasury has focused on the need for the exchange rate to reflect the influence of global capital markets. Treasury has expressed concern to Korean officials about the consequences of maintaining an undervalued exchange rate. Of particular note since the last report, the Ministry of Finance announced on December 7 its *Foreign Exchange System Reform Plan* -- a package of measures based on the recommendations of a study committee set up earlier this year. The reforms will loosen some controls on Korea's foreign exchange and capital markets, and will be introduced in three stages: 1995; 1996-97; and 1998-99. Specific areas which will be affected by the reform plan include selected current and capital account transactions, import/export payments and the foreign exchange market structure -- including transition to a floating rate system for the won in 1996-97.

This latest package of reforms will, when fully implemented, represent an important liberalization of Korea's foreign exchange system. However, the plan delays many of the more important reform measures until the end of the reform schedule. Treasury will closely monitor implementation of the plan and encourage Korean authorities to accelerate its pace.

Assessment

The present determination, like the assessment contained in the July 1994 report, is that Korea is not at this time engaging in practices which constitute manipulation of the exchange rate between its currency and the U.S. dollar. Two factors support this conclusion. First, the won/dollar exchange rate has remained relatively unchanged since the July report. Second, Korea's current account and trade balance are now in deficit.

However, Treasury will continue to urge Korean authorities to make greater progress in lifting exchange and capital controls in the context of bilateral financial policy talks and in the extended Uruguay Round financial services negotiations. Removal of these controls is essential to promote the freer flow of goods, services, and capital, to facilitate Korea's integration with global financial markets, and to permit the won to respond to market forces.

TAIWAN (figures in U.S. dollars)

Taiwan continues to register an overall current account surplus and a bilateral trade surplus with the United States. However, it is the judgement of the Treasury Department that Taiwan is not at this time manipulating the rate of exchange between the New Taiwan (NT) dollar and the U.S. dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade.

Notwithstanding this determination, the Treasury Department remains concerned that restrictions maintained by Taiwan on foreign exchange transactions and capital flows continue to reduce market demand for the NT dollar and thereby deter market generated appreciation.

During several rounds of negotiations during 1994 concerning a draft Special Exchange Agreement as part of Taiwan's accession to the World Trade Organization (WTO), Taiwan showed a willingness to undertake that it will not impose exchange restrictions on current account transactions. Despite this progress, however, Taiwan has been unwilling to remove key restrictions that can constrain demand for the NT dollar for capital account transactions. Permitting the full range of market forces to determine the level of demand for the NT dollar would likely contribute to further adjustment of the existing bilateral trade imbalance.

Trade and Economic Developments

Taiwan's current account surplus fell from $8.2 billion (3.9 percent of GDP) in 1992 to $6.7 billion (3 percent of GDP) in 1993. This decline was mainly attributable to a smaller overall merchandise trade surplus, which declined $1.4 billion from $12.8 billion in 1992 to $11.5 billion in 1993 -- the lowest surplus since 1983. A slightly larger deficit in services and income ($4.6 billion in 1993 compared to $4.4 billion in 1992) and an increase in the deficit in private unrequited transfers from $168 million in 1992 to $957 million in 1993 also contributed to the reduction of the current account surplus.

According to recent estimates, Taiwan registered a current account surplus of $2.4 billion in the first six months of 1994. Taiwan's trade surpluses continued to shrink in 1994. The continuing decline in Taiwan's trade surpluses stems from the slow recovery in Taiwan's export markets and from increasing competition posed by nations such as the PRC and Thailand. Taiwan's global trade surplus for the first eight months of 1994 was $3.9 billion, compared to $5.1 billion in the corresponding period in 1993.

Taiwan's bilateral trade surplus with the United States was $8.8 billion in 1993, down from $9.4 billion in 1992. Adjustment in Taiwan's bilateral trade surplus with the United States, has stalled so far this year. Taiwan's surplus with the United States during January-September 1994 registered roughly $7 billion, a small increase over the $6.8 billion seen in the same period in 1993. As the New Taiwan dollar/U.S. dollar exchange rate has remained relatively steady, the small increase in the bilateral trade deficit with Taiwan is probably attributable to increased economic growth in the U.S.

In 1992, Taiwan ran its first overall balance of payments deficit in twelve years. Since that time, however, Taiwan's position has improved, despite a steady decline in the current account surplus. Taiwan registered an overall surplus of $1.5 billion in 1993, which grew to $3.8 billion in the first six months of 1994. The principal reasons for this improvement in the balance of payments are: 1) a substantial increase in the inflow of foreign direct and portfolio investment; 2) a steady fall in Taiwan's direct and portfolio investment abroad; 3) a drop in Taiwan's purchases of foreign real estate; and 4) a net inflow of short-term capital in 1994. Because of these factors, Taiwan's long- and short-term capital accounts together ran a surplus of $2.1 billion in the first half of 1994, compared to a deficit of $4.8 billion for all of 1993. Taiwan ended 1993 with $83.6 billion in foreign exchange reserves, equivalent to over one year of imports. By August 1994, this figure had climbed to $91 billion.

Taiwan's real GDP grew 6.2 percent during 1993, continuing the pattern set in recent years of more moderate growth. Annual growth rates below the seven percent rate which prevailed over the last several decades reflect both Taiwan's economic maturation and weakness in the world economy. Economic growth in the first half of 1994 registered only 5.7 percent, but an increase in exports and private sector investment has led to an upward adjustment of Taiwan's economic forecast to 6.2 percent growth for all of 1994.

Inflation in Taiwan ran at roughly 2.9 percent for 1993, but indicators for 1994 are mixed. The consumer price index jumped to 7.1 percent in August and 6.7 percent in September over previous year levels. These rates are far above the Central Bank's target of 3.8 percent for the full year. Inflation may have been distorted, however, by poor weather, which has significantly increased prices for basic commodities. The growth of broad money (M2) during the first eight months of 1994 slightly surpassed the Central Bank's target of 15 percent.

Foreign direct investment in Taiwan, measured on an approval basis, has declined steadily in recent years. The most likely causes for this drop include the earlier appreciation of the NT dollar against the U.S. dollar, an increase in labor costs and an increase in land costs. Inward foreign investment showed a surprising increase during the first six months of 1994, however, totalling $465 million during January-June of this year, an increase of 72 percent over the same period in 1993. Further, it is estimated that Taiwan received $1.5 billion of portfolio investment in the first half of 1994, compared to $433 million during the same period in 1993.

Exchange Rate Developments

The NT dollar depreciated nearly 5 percent against the US dollar in 1993, largely due to strong capital outflows from the island during the first three quarters of that year.

However, between December 31, 1993 and November 18, 1994, the NT dollar has strengthened moderately, appreciating by roughly 1.2 percent relative to the U.S. dollar.

Exchange Rate and Financial System

Taiwan continues to maintain controls and regulations on foreign exchange transactions and capital flows. Together, these limit the size of Taiwan's foreign exchange market. Principally through negotiations held on accession to the WTO, Taiwan has made some progress in liberalizing its financial sector during the past year. Certain key ceilings and restrictions on foreign exchange remain in place, however, and authorities on Taiwan are reluctant to abolish them in favor of indirect controls.

Taiwan's ceilings on banks' foreign exchange liabilities limit the ability of banks to engage in forward trading in the NT dollar, to offer foreign currency loans in Taiwan, and to use swap funding in order to obtain NT dollars with which to make local currency loans. In January, the Taiwan authorities again raised the foreign exchange liabilities ceiling for commercial banks, and the industry as a whole does not appear to be operating up against the ceilings at present. Nevertheless, the existence of these ceilings may act to restrict the activities of individual foreign banks. The existing limits force banks to be more selective in the types of business that they do and have the effect of restricting long-term lending. Also, although some banks still have excess capacity on their limits, the Gross Business Revenue Tax on domestic interbank loans makes interbank lending too expensive. Further, while there currently is excess foreign liability capacity in the market, there is no guarantee that this will not change. The use of foreign currency borrowing is generally influenced by interest rate differentials and exchange rate movements. The current limits hinder the ability of banks to react to market movements and thus raise their costs. Taiwan authorities have pledged to replace these limits with reserve requirements after passage of a new Central Bank law.

Limits on foreign banks' short and long foreign exchange positions are also a concern. Under current regulations, foreign banks are subject to the same ceiling as "small" domestic banks. That is, foreign banks are limited to a $20 million "long" position compared to $50 million for large domestic banks; and a $6 million "short" position, compared to $10 million for large domestic banks. As New Taiwan dollar funding and liquidity remain areas of concern for foreign banks, raising the long and short ceilings for foreign banks to a level comparable to that for large domestic banks would be a positive development.

Non-trade-related capital inflows and outflows by an individual continue to be subject to a limit of $5 million per year without prior approval. The limit for firms, however, has been raised to $10 million per year. Foreign individual investors are prohibited from investing on Taiwan's stock exchange (the Taiex). The Taiex was opened to foreign institutional investors in January 1991, but these investors continue to face restrictions on repatriation of capital and earnings. On the positive side, however, the Central Bank of

China has raised the ceiling for aggregate foreign institutional investment from $5 billion to $10 billion, and increased the limit for a single institutional investor from $100 million to $200 million.

Financial Policy Negotiations

While not citing Taiwan as an exchange rate manipulator, Treasury nonetheless continues to urge Taiwan to move more rapidly to reduce restrictions on foreign exchange transactions and capital flows. Taiwan's aim of achieving the status of a regional financial center will require significant liberalization of these restrictions, as well as further movement toward opening its financial markets. Progress has been made in this regard during WTO accession negotiations, but foreign exchange restrictions remain a particularly troublesome area.

Of particular note since the last report, bilateral negotiations conducted in July resulted in a draft Special Exchange Agreement for use by the GATT Working Party in its discussions on Taiwan's accession to the WTO. The Special Exchange Agreement outlines disciplines on the use of foreign exchange restrictions once Taiwan joins the WTO. The draft agreement has strong commitments prohibiting exchange restrictions on the current account, and also requires Taiwan to seek to avoid capital controls.

Assessment

The present determination maintains the assessment contained in the July 1994 report that Taiwan is not at this time engaging in practices which constitute manipulation of the exchange rate between its currency and the U.S. dollar. Two factors support this conclusion. First, there has been no significant change in the value of the New Taiwan dollar relative to the U.S. dollar since the last report. Second, adjustment continues to occur in Taiwan's current account and trade surpluses.

Treasury will continue to use bilateral and multilateral discussions to press for further elimination of restrictions on foreign exchange transactions and capital movements which constrain demand for the NT dollar.

CHINA

As noted in the July report, China has taken important steps to reform its foreign exchange system this year, unifying exchange rates and liberalizing domestic firms' access to foreign exchange. Yet, government approval of foreign exchange purchases by foreign-funded enterprises, which account for a large share of China's imports, is still required. Documentation requirements for domestic enterprises wishing to acquire foreign exchange for current transactions are also burdensome and give authorities the scope to prohibit foreign exchange transactions. While approval is readily given at the moment, the arrangements can only be viewed as intended to provide the means to limit imports of goods and services if government officials wish to do so. The non-transparency of the process and the criteria for approval allow scope for discrimination in imports.

It is therefore Treasury's determination that China is not currently manipulating its exchange system to prevent effective balance of payments adjustment and gain unfair competitive advantage in international trade, but that it retains the capacity and bureaucratic means to do so in the future. In the context of bilateral negotiations as well as multilateral negotiations on China's entry into the WTO, Treasury continues to urge China to complete market-oriented reform of its foreign exchange system, give foreign and domestic firms equal access to the new interbank foreign exchange market, and eliminate all government approval systems aimed at regulating the level and composition of imports of goods and services.

Indeed, foreign exchange controls are but a part of a multiplicity of formal and informal trade controls. Restrictions include foreign exchange balancing requirements, limitations on the trading rights of foreign and domestic firms, and import licenses that restrict and distort the composition of China's imports.

Trade and Economic Developments

After deteriorating to a deficit of $12.2 billion in 1993, China's overall trade balance returned to surplus in the first nine months of 1994 as exports benefitted from stronger growth in China's markets. China's data indicate that exports were up 30 percent in the first three quarters of 1994 to $79.4 billion while imports, driven by China's continued rapid growth, rose 15 percent to $78.0 billion. China thus reported a trade surplus of $1.4 billion for January-September 1994. Current account information is not yet available for this year, but the improvement in China's trade account should give China a small current account surplus in 1994.

In this context, it is important to reiterate the caveat noted in previous reports that China's trade data are not consistent with those of its trading partners. Specifically, China's data significantly understate exports because of the incentives that China's foreign exchange surrender requirements generate to underreport export earnings and hold foreign exchange offshore. For example, while China reported a trade deficit of $12.2 billion for 1993, trading partner data adjusted for differences in valuation and transshipment through Hong

Table 10

Chinese Balance of Payments Figures
($ Billions)

	1990	1991	1992	1993	Jan-Sept 1994
Current Account	11.9	13.3	6.4	-11.9	na
Of which:					
Trade Balance*	8.7	8.2	4.4	-12.2	1.4
Capital Account	3.3	8.1	-0.2	23.5	na
Net Errors & Omissions	- 3.1	-6.8	-8.3	-9.8	na
Increase in Reserves	-12.0	-14.5	2.1	- 1.8	-18.6
(- = increase)					

Sources: Chinese and IMF Statistics
* Trade Figures on Customs Basis; Other Figures on a Balance-of-Payments Basis

Kong suggest that China's 1993 trade balance was instead in surplus by approximately $20 billion.

China's large bilateral trade surplus with the United States will likely continue to increase this year. Extrapolating from January-September 1994 data, the bilateral surplus is projected to be $28.7 billion, compared with $22.8 billion in 1993 and $18.3 billion in 1992. Growth in U.S. exports, largely capital goods, to China rose 15 percent for this period over last year (compared with 1993 growth of 17 percent), while imports, dominated by consumer goods, rose at a 23 percent rate (the same rate as 1993).

All sources agree that China's foreign exchange reserves have increased sharply this year. Chinese authorities reported that reserves of the People's Bank of China rose $18.6 billion in the first nine months of 1994, from $21.1 billion at the end of 1993 to $39.8 billion at the end of September 1994, i.e., about five months of imports. This excludes foreign exchange holdings of the Bank of China that until 1992 were counted as part of official reserves.

The large increase in China's reserves and the selective easing of credit to unprofitable state enterprises in 1994 contributed to rapid growth of China's money supply. M1 and M2 expanded by 33 and 37 percent, respectively, in the year ending September 1994. This monetary expansion helped to sustain China's rapid growth in 1994. Real GDP growth remains very high -- 11.4 percent for the first 9 months of this year. This pace represents some moderation of last year's 13.4 percent growth and is in line with official forecasts of 11-12 percent growth in 1994. However, indicators suggest that growth is accelerating in the second half of this year. Industrial sector value added grew 18.1 percent in the third quarter, 2.3 percentage points higher than in the first half.

China's inflation figures reflect this acceleration in demand and monetary growth. Urban prices were 27.5 percent higher in September 1994 compared to September 1993. Inflation rates have shown an upward trend in recent months, rising from an average of 25 percent in the first quarter. China's authorities blame the upward trend on rising food prices resulting from price decontrol and supply problems. Nevertheless, consumer demand is also likely playing an important role as urban wages have risen 30-40 percent in the first three quarters of the year. Under these circumstances, the need for renewed emphasis on monetary restraint is evident.

Foreign Exchange System

China's current foreign exchange system operates as a highly managed float. The daily exchange rate is set according to the median price for foreign exchange on the preceding day. An interbank market for foreign exchange, the foreign exchange trading center (FETC), was established in April 1994. The headquarters are located in Shanghai with additional, satellite-linked centers in 19 cities.

Foreign-funded enterprises (FFEs) may, with the approval of the State Administration of Exchange Control (SAEC), buy and sell foreign exchange in the interbank market using a member institution as agent. (Member institutions currently comprise 278 domestic banks and non-bank financial institutions and designated foreign banks.) A FFE agent bank must submit the purchase request to the SAEC for approval. With SAEC approval, the agent bank executes the transaction at the FETC. FFEs, unlike domestic firms, can retain their foreign exchange earnings.

Domestic enterprises may not trade foreign exchange in the interbank market. However, those domestic companies that have trading rights are allowed to purchase foreign exchange automatically from designated members of the interbank market upon presentation of: (1) an import contract; (2) a request for payment from a foreign institution; and (3) an import license (if required). The spreads applicable to domestic firms are reportedly slightly wider than those in the interbank market, providing a small profit margin for the banks. Domestic firms are required by the government to sell their foreign exchange earnings to a designated bank at the prevailing exchange rate.

The important distinction between the treatment of FFEs and domestic firms is that FFEs cannot purchase foreign exchange without the approval of the SAEC, whereas domestic firms may purchase foreign exchange automatically for permitted transactions. (Domestic firms must still obtain SAEC approval for capital account transactions and some invisible current account transactions.) In this context, it is important to note that China continues to impose requirements on FFEs to balance foreign exchange receipts and expenditures. The

SAEC approval system can be used as a means to enforce foreign exchange balancing requirements.

If a domestic firm wishes to purchase foreign exchange for permitted current account transactions, the request is not submitted to the SAEC. The firm needs only the required documentation cited above. With such documentation, the domestic firm can buy the foreign exchange directly from a designated bank.

Exchange rate management in the interbank market comes in two forms: (1) limiting trading to within a particular range of the daily determined rate ($\pm$0.25 percent); and (2) intervention through buying or selling foreign exchange by the People's Bank of China (PBOC) to stabilize rates.

Outside the 19 cities linked to the interbank market in Shanghai, foreign firms must trade foreign exchange in the previously existing swap centers. These swap centers are not part of the integrated foreign exchange market in Shanghai but still must balance the local supply and demand for foreign exchange according to the exchange rate set in Shanghai. Local authorities often have been unwilling to allow foreign-funded enterprises to trade foreign exchange outside the local swap center.

Exchange Rate Developments

On November 4, 1994 China's exchange rate (unified in January of this year) stood at 8.53 yuan/dollar, a nominal appreciation of 2 percent from its end-1993 value of 8.71 yuan/dollar. Most of this appreciation has come in recent months and is likely the result of increased demand for renminbi stemming from domestic credit controls and the increased availability of foreign exchange resulting from large investment inflows and China's improved trade balance. Large accumulation of foreign currency by the People's Bank of China, as evidenced by the large increase in official foreign exchange reserves, prevented greater nominal appreciation of the exchange rate.

Nonetheless, China's inflation rate greatly exceeded that of the United States. As a result, China's yuan/dollar exchange rate appreciated an estimated 12 percent in real terms over the period end-1993 to end-September 1994.

Exchange Rate Negotiations

In the context of bilateral negotiations between Treasury and Chinese authorities, as well as in China's WTO accession negotiations, Treasury and other U.S. Government agencies have pressed China to: (1) give domestic and foreign firms equal access to a unified foreign exchange market; (2) eliminate all requirements for government approval of foreign exchange purchases for goods and services transactions (i.e., move to current account convertibility); and (3) eliminate foreign exchange balancing requirements.

While accepting these objectives as long-term goals, China's position in these negotiations is that reforms undertaken this year are very significant; that access to foreign exchange is already nearly unrestricted; and that China needs to maintain a system which provides the capability of regulating foreign exchange availability.

Table 11

China: Nominal Bilateral Exchange Rate Indices
(End of Period)

	1990	1991	1992	1993	Sept 1994
United States	100	96.4	80.2	68.9	65.5
Japan	100	88.7	73.7	56.7	47.8
EU	100	98.9	91.1	84.8	72.7

China: Real Bilateral Exchange Rate Indices
(End of Period)

	1990	1991	1992	1993	Sept 1994
United States	100	97.2	83.9	82.4	92.2
Japan	100	89.9	78.8	70.5	70.2
EU	100	98.6	93.8	101.3	102.6

Sources: IMF and Treasury Department Data

Decline of Index = Depreciation of Chinese Currency
September Real Exchange Rate Indices Are Based on Estimated Inflation Rates for China, Japan, and the European Union

Assessment

Treasury acknowledges that major strides in reforming China's foreign exchange system have been made this year. However, China maintains significant restrictions on foreign exchange transactions. Domestic firms are required to sell foreign exchange to designated banks, and, while FFEs may use the foreign exchange earned through exports, they must receive prior approval from the SAEC for all purchases of foreign exchange in the interbank market. Moreover, China continues to require SAEC approval for certain current account transactions, including repatriation of profits.

At the moment, SAEC approval of foreign exchange purchases for foreign firms is not difficult to obtain. This liberal implementation stems from favorable market conditions -- ample foreign exchange availability and strong demand for the renminbi. However, as in the past, the SAEC could withhold approval. It is clear that the rationale for maintaining the approval system is to maintain the government's capability to ration foreign exchange.

Thus, Treasury has determined that China is not currently manipulating its exchange system to prevent effective balance of payments adjustment or gain unfair competitive advantage in international trade. However, it is essential that China commit to liberalizing access to foreign exchange for current account transactions, as is required under Article VIII of the IMF's Articles of Agreement. The United States continues to seek such commitments from China in bilateral negotiations and in multilateral negotiations regarding China's accession to the WTO.

APPENDIX 1: **OMNIBUS TRADE AND COMPETITIVENESS ACT OF 1988 (H.R. 3)**

SEC. 3004. INTERNATIONAL NEGOTIATIONS ON EXCHANGE RATE AND ECONOMIC POLICIES.

(a) Multilateral Negotiations.--The President shall seek to confer and negotiate with other countries--

(1) to achieve--

(A) better coordination of macroeconomic policies of the major industrialized nations; and

(B) more appropriate and sustainable levels of trade and current account balances, and exchange rates of the dollar and other currencies consistent with such balances; and

(2) to develop a program for improving existing mechanisms for coordination and improving the functioning of the exchange rate system to provide for long-term exchange rate stability consistent with more appropriate and sustainable current account balances.

(b) Bilateral Negotiations.--The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate 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. If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses; and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payments adjustments and to eliminate the unfair advantage. The Secretary shall not be required to initiate negotiations in cases where such negotiations would have a serious detrimental impact on vital national economic and security interests; in such cases, the Secretary shall inform the chairman and the ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and of the Committee on Banking, Finance and Urban Affairs of Representatives of his determination.

SEC. 3005. REPORTING REQUIREMENTS.

(a) Reports Required.--In furtherance of the purpose of this title, the Secretary, after consultation with the Chairman of the Board, shall submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, on or before October 15 of each year, a written report on international economic policy, including exchange rate policy. The Secretary shall provide a written update of developments six months after the initial report. In addition, the Secretary shall appear, if requested, before both committees to provide testimony on these reports.

(b) Contents of Report.-- Each report submitted under subsection (a) shall contain--

(1) an analysis of currency market developments and the relationship between the United States dollar and the currencies of our major trade competitors;

(2) an evaluation of the factors in the United States and other economies that underlie conditions in the currency markets, including developments in bilateral trade and capital flows;

(3) a description of currency intervention or other actions undertaken to adjust the actual exchange rate of the dollar;

(4) an assessment of the impact of the exchange rate of the United States dollar on--

(A) the ability of the United States to maintain a more appropriate and sustainable balance in its current account and merchandise trade account;
(B) production, employment, and noninflationary growth in the United States;
(C) the international competitive performance of United States industries and the external indebtedness of the United States;

(5) recommendations for any changes necessary in United States economic policy to attain a more appropriate and sustainable balance in the current account;

(6) the results of negotiations conducted pursuant to section 3004;

(7) key issues in United States policies arising from the most recent consultation requested by the International Monetary Fund under article IV of the Fund's Articles of Agreement; and

(8) a report on the size and composition of international capital flows, and the factors contributing to such flows, including, where possible, an assessment of the impact of such flows on exchange rates and trade flows.

(c) Report by Board of Governors.--Section 2A(1) of the Federal Reserve Act (12 U.S.C. 225a(1)) is amended by inserting after "the Nation" the following: ", including an analysis of the impact of the exchange rate of the dollar on those trends".

SEC. 3006. DEFINITIONS.

As used in this subtitle:

(1) Secretary.--The term "Secretary" means the Secretary of the Treasury.

(2) Board.--The term "Board" means the Board of Governors of the Federal Reserve System.