DEPARTMENT OF THE TREASURY

INTERIM REPORT TO CONGRESS

ON

INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

JULY 1994

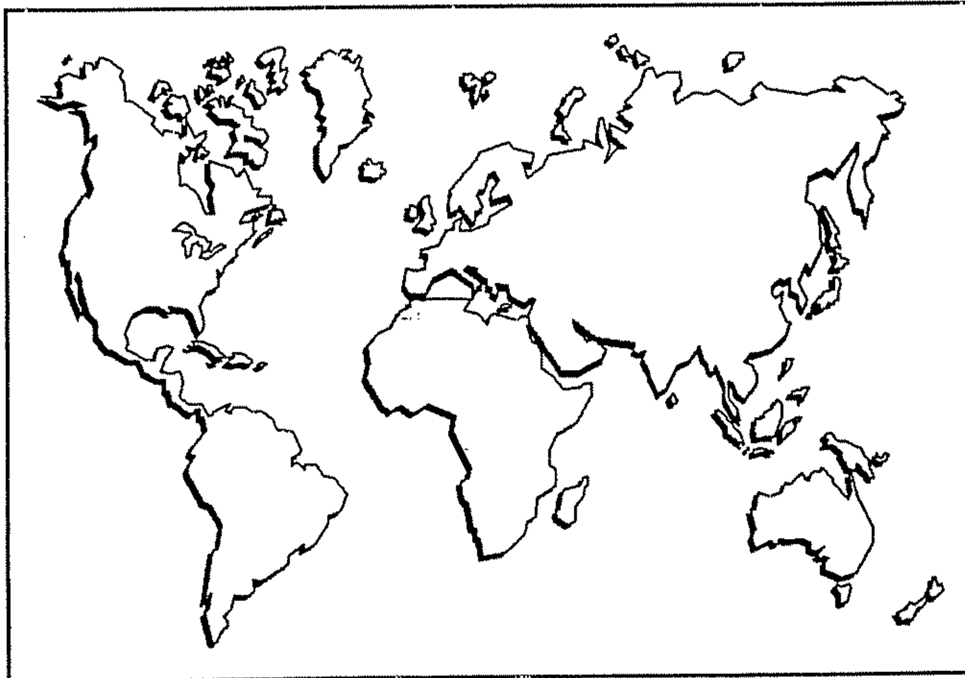

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TABLE OF CONTENTS

			Page
Part I	Summary and Conclusions		1
Part II	Global Economic Developments		
	A.	Economic Situation in the G-7 Countries	3
	B.	Developments in Foreign Exchange Markets	8
	C.	U.S. Balance of Payments Situation	15
Part III	Actions Under Section 3004		
	-	Korea and Taiwan	20
	-	China	21

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

PART I: SUMMARY AND CONCLUSIONS

This Report discusses recent developments in U.S. international economic policy, including exchange rate policy, since the sixth annual Report to Congress submitted in November 1993. It is based on information available through May 1994 except for foreign exchange developments, which are described through June. These reports are required under Sections 3004 and 3005 of the Omnibus Trade and Competitiveness Act of 1988 (Trade Act).

The outlook for the industrial economies has brightened considerably since the last report. Recovery is now firmly established in North America and the United Kingdom. The U.S. economy is flourishing, and Canada and the UK are expected to show satisfactory growth this year and next. In continental Europe and Japan, positive real growth is expected this year, though the pace of recovery remains comparatively weak.

Significant progress has been made on the inflation front. Inflation is under control throughout the G-7, even in those countries showing the greatest acceleration in growth. Inflation in the G-7 is expected to average 2.8 percent in 1994, the lowest level since the early 1960s. Particularly notable are essentially stable inflation in the United States; continued very low inflation in Japan and Canada; Italy's remarkable achievement in reducing inflation to very moderate levels; and the sharp decline forecast for German inflation. In countries where output remains well below potential, this progress towards price stability provides room for use of monetary policy to strengthen and sustain the expansion. In countries where the recovery has matured, policy has to be oriented to preventing acceleration of inflation that could threaten to curtail the expansion.

Despite the growing sense of optimism about recovery and output growth, unemployment remains alarmingly high and is still rising in much of Europe, particularly among the young, and people are staying unemployed longer. There are over 35 million unemployed in the OECD countries, 22 million of whom are in Europe alone. Over the past several business cycles, we have seen unemployment in Europe ratchet ever higher in the slumps and drop less during recoveries. With each iteration, part of the cyclical joblessness has become structural.

At the Naples Economic Summit, the G-7 reaffirmed their commitment to take action to sustain the expansion with low inflation. The European participants committed to further action on the fiscal front to create the conditions that would permit more flexibility on monetary policy. Japan committed to maintain the recent income tax cut and not put in place increases in other, offsetting taxes while the economy remained weak. And, building on the employment conference in Detroit, the G-7 leaders agreed on an action plan to reduce structural unemployment which focusses on investment in human capital, reduction of rigidities in labor markets, fostering innovation and spread of technology, removing barriers to competition and encouraging opportunities in new areas such as protection of the environment.

The pattern of recovery has been associated with some deterioration in the U.S. current account position, but virtually all the increase in the U.S. deficit during this period has been cyclical in nature -- the consequence of comparatively rapid growth in the United States relative to that of our major trading partners. Japan's external surplus appears to have peaked, and there is some evidence in recent volume numbers to suggest that further declines are likely.

Recent developments in the exchange markets have been a cause of considerable concern. By the end of June, the dollar had declined by 13 percent against the yen and 9 percent against the mark since the beginning of the year. Both the pace and the extent of these movements were unusual when set against the backdrop of a general improvement in the fundamental outlook for the U.S. economy. Given the rise of the dollar against the currencies of many of our other major trading partners the dollar has been relatively stable since the beginning of the year when measured on a trade-weighted basis. Nevertheless, the Administration has expressed concern over the dollar's recent movements against the major currencies, noting that they have not been in line with fundamental conditions and that a stronger dollar would be desirable.

Treasury has reviewed the foreign exchange systems and exchange rate policies of China, Taiwan and Korea -- countries with an important role to play in promoting a healthy, open global economy and adjustment in external imbalances. This assessment examines whether these countries are manipulating their exchange rates within the meaning of Section 3004 of the Trade Act, to prevent effective balance of payments adjustment or gain unfair competitive advantage in international trade.

It remains Treasury's judgment that neither Korea nor Taiwan is manipulating its exchange rate within the meaning of this provision. Nevertheless, Treasury remains concerned about certain financial and foreign exchange policies in both countries, particularly capital controls, which discourage investment and impede the operation of market forces in exchange rate determination.

Treasury welcomes China's decision to unify its dual exchange rates as of January 1, 1994. Nonetheless, further reforms implemented on April 1, 1994 segmented the foreign exchange market and imposed restrictions that limit foreign-funded enterprises' access to foreign exchange. Based on China's continued reliance on foreign exchange restrictions, it is Treasury's judgment that China manipulates its exchange system to prevent balance of payments adjustment and gain unfair competitive advantage. Treasury urges the Chinese authorities to eliminate the segmentation of the foreign exchange market and restrictions on access to foreign exchange. Such steps would facilitate imports and promote adjustment in China's large bilateral trade surplus with the United States.

PART II: GLOBAL ECONOMIC DEVELOPMENTS

A. ECONOMIC SITUATION IN THE G-7 COUNTRIES

Growth

Real GDP growth in the G-7 countries continues to show a clear distinction among patterns of solid expansion in North America and the UK, some signs of slow recovery in continental Europe, and continued weakness in Japan.

The **U.S.** recovery is flourishing, led by investment which will expand capacity and extend the duration of that expansion. **Canada** continues firmly on an expansionary path. The International Monetary Fund (IMF) now projects (see Table 1 below, which also shows the broadly similar average forecast by the June edition of *Consensus Forecasts*) U.S. real GDP growth for 1994 of 3.9 percent on a year-over-year basis (3.2 percent over the year to the fourth quarter of 1994), slowing to 2.6 percent in 1995. Canada's growth is expected to accelerate to 3.5 percent this year and 4.1 percent in 1995.

Table 1
G-7 Real GDP Growth
(% change y/y)

	1993	1994F		1995F	
		IMF	Consensus	IMF	Consensus
United States	3.0%	3.9%	3.7%	2.6%	2.9%
Japan	0.1	0.7	0.7	2.3	1.9
Germany*	-1.2	0.9	1.6	2.1	2.5
France	-1.0	1.2	1.8	2.6	2.7
United Kingdom	1.9	2.5	2.8	2.8	2.8
Italy	-0.7	1.1	1.6	2.5	2.4
Canada	2.2	3.5	3.5	4.1	3.8
Total G-7	1.5	2.5	2.6	2.5	2.7

* All Germany

F=Forecast; source:IMF, World Economic Outlook, April 1994; Consensus Economics, Consensus Forecasts June 1994

Growth in **Japan** has been very weak, although there have recently been some signs of recovery. The current slowdown is the worst since the end of postwar reconstruction, taking into account the very low growth also recorded in 1992 (1.1 percent) and projected for this year. Even the 1995 projections would suggest a very weak recovery, and may be on the optimistic side.

The sharp rise in public sector investment in 1992 and 1993 under the fiscal expansion programs has compensated only in part for the weakness in private consumption and the two-year decline in private plant and equipment investment. The February fiscal package -- which includes income tax cuts as well as additional public infrastructure spending -- will be helpful, but will not fully compensate for other sources of weak domestic demand.

The outlook for **continental Europe** is slightly more encouraging, but the recovery forecast for this year is still quite modest for this stage of the business cycle and too weak to prevent further increases in unemployment. For the European Union (EU) countries other than the UK, the IMF projects only 1.0 percent aggregate growth this year, after an 0.8 percent decline in GDP in 1993.

Output Gap

The gap between actual and potential output has been growing in Japan, France, Germany and Italy, and declining in the United States, Canada and the UK. Table 2 below shows IMF estimates of this gap for the major countries. While these calculations are crude and the precise numbers somewhat questionable, the relationships and directions are indicative. These gaps are expected to remain sizeable outside the United States, despite narrowing in 1995.

Table 2
G-7: Output Gaps
% of potential GDP

	1993	1994	1995
Canada	-5.2%	-4.6%	-3.6%
France	-3.5	-4.5	-4.4
Germany	-1.8	-3.1	-3.2
Italy	-3.9	-4.7	-4.2
Japan	-3.5	-5.3	-5.6
UK	-5.3	-4.9	-4.2
US	-0.9	+0.1	+0.2

Source: IMF

Inflation

Inflation has been declining in most G-7 countries, and low inflation for the G-7 group is likely to continue. IMF and *Consensus* projections for consumer price increases (see Table 3 below) show inflation at the lowest aggregate rates since the early 1960s, excepting only the year 1986, when world petroleum prices were cut in half.

Particularly notable in these projections are essentially stable U.S. inflation rates; continued very low inflation in Japan and Canada; Italy's remarkable achievement in reducing inflation to very moderate levels; and the sharp decline forecast for German inflation. Measures of German inflation have been distorted by the impact of some increases in value added and other consumption taxes that enter the consumer price index. As the impact passes from the index, and as tight German monetary policy achieves success in reducing the rate of wage and price increases, German inflation has declined. Consumer prices in western Germany were up only 3.0 percent in the year to June; the IMF projections indicate a significant decline in the rate of increase over the course of this year and into 1995.

Table 3
G-7 Consumer Price Inflation
(% change y/y)

	1993	1994		1995	
		IMF	Consensus	IMF	Consensus
United States	3.0%	2.8%	2.7%	3.2%	3.3%
Japan	1.3	0.9	0.7	0.9	0.8
Germany*	4.7	3.0	2.9	2.2	2.2
France	2.1	1.9	1.8	2.1	2.1
United Kingdom**	3.0	3.2	2.6	3.0	3.5
Italy	4.3	3.8	3.9	3.1	3.7
Canada	1.9	0.5	0.7	1.7	1.8
Total G-7	2.8	2.4	2.3	2.5	2.7

* All Germany for IMF; western Germany for Consensus
** For UK , consumer prices excluding mortgage interest in IMF projections

Global Rise in Long-term Interest Rates

Yields on long-term government bonds increased during the first half of 1994. For the United States, the rise was about 150 basis points. Increases of between 100 to 200 basis points were recorded on ten-year benchmark issues in Japan, France, Germany and Italy, and by over 200 percent in Canada and the United Kingdom. During the first part of this period, the rise was largely synchronized across national markets. In the latter part, movements were more divergent.

A number of factors underlay the rise in long-term rates. Expectations regarding future developments in real economic growth and inflation were affected

by adjustments of monetary policy in the United States and Europe and by new economic data. Also, the willingness of market participants to hold long positions in bonds decreased as yields rose, prompting additional sales that augmented the rise. It is generally thought that the substantial decline in yields during 1993, reflecting the build-up of long positions by a variety of market participants, created the potential for a substantial correction.

It is not possible to specify with precision the relative importance of the various factors; however, the generalized rise in yields is consistent with the improved outlook for economic growth in the United States and in most other major countries. Stronger growth is associated with greater demand for credit, and thus with higher interest rates in real terms. Although faster growth also tends to be associated with rising inflationary expectations, there is no evidence to date of accelerating price increases in the United States, and inflation also remains under control in other countries.

External Account Developments

The pattern of recovery in the industrial world has been accompanied by some deterioration in the U.S. external deficit and by pressures that have limited the extent of adjustment of Japan's external surplus. **Japan's** trade and current account surpluses have remained high as a result of the continued stagnation of demand in Japan combined with strength in Japan's export markets in North America and Asia. **U.S.** external deficits are rising once again, as the U.S. expansion continues to pull in imports while growth in our export markets in Europe and Japan remains slack. IMF and *Consensus* projections for the G-7 are shown in Table 4.

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

	1993		1994F			1995F		
			IMF		Consensus	IMF		Consensus
United States	-104	(-1.6)	-140	(-2.1)	-130	-166	(-2.3)	-135
Japan	+131	(+3.1)	+133	(+3.0)	+123	+126	(+2.7)	+103
Germany*	-21	(-1.2)	-13	(-0.7)	-15	-11	(-0.5)	-7
France	+17	(+1.0)	+10	(+0.8)	+9	+13	(+1.0)	+7
United Kingdom	-16	(-1.7)	-19	(-2.0)	-17	-20	(-1.9)	-19
Italy	+8	(+1.1)	+26	(+2.7)	+15	+31	(+3.1)	+17
Canada	-24	(-3.5)	-15	(-2.6)	-19	-14	(-2.4)	-16
Total G-7	-9	(-0.1)	-17	(-0.1)	-34	-40	(-0.2)	-50

* All Germany
F=forecast; source: IMF, World Economic Outlook, April 1994
Consensus Economics, Consensus Forecast

Relative national growth rates are a key to understanding these changes in current account balances. For **Japan**, the IMF currently is projecting (see Table 1) real GDP growth of only 0.7 percent for 1994, after 0.1 percent in 1993. In contrast, growth in important export markets for Japan is projected to be far above these rates: 3.9 percent in the United States (after 3.0 percent in 1993); 3.5 percent in Canada (vs. 2.4 percent in 1993); and 7.5 percent in Asian developing countries (vs. 8.4 percent in 1993). It should not be surprising that, under these conditions, the volume of Japan's imports grew only 1.4 percent in 1993, while export volume grew 1.6 percent despite the sharp rise of the yen (12 percent in real trade-weighted terms over the course of 1993).

In the **United States**, strong growth in imports in the face of relatively weak export performance, especially to Europe and Japan, contributed to rising trade and current account deficits. Strong export growth to Japan and Western Europe had been a major factor in the 1987-91 decline in our deficits. Despite a continued solid U.S. competitive position, the weak outlook for growth in Europe and Japan will hamper U.S. export growth until recovery strengthens, and the U.S. recovery will continue to pull in imports.

The developments in external imbalances, however, are not by themselves a significant cause of concern. Indeed, the large capital inflows associated with the external deficit enable the United States to maintain a higher level of investment than it could do if solely dependent on domestic saving, helping to strengthen our recovery. The U.S. current account deficit is expected to stabilize as the negative forces associated with growth differentials recede. Moreover, given the strength of U.S. investment, the buildup of debt associated with our current account deficits should not pose a problem.

B. DEVELOPMENTS IN THE FOREIGN EXCHANGE MARKET

Fluctuations of the Dollar against Individual Currencies

The dollar appreciated against the German mark and Japanese yen in the first half of the period covered in this report. From mid-October until end-December, the dollar rose in nominal terms by six percent against the mark and by four percent against the yen. Meanwhile, the mark depreciated by two percent against the yen. Against other currencies, the results were mixed. The dollar depreciated very slightly against the Canadian dollar and the Mexican peso. Latin American currencies generally tracked dollar movements, with some exceptions such as Brazil. Key Asian currencies also followed the dollar, although the floating Singapore dollar depreciated.

Flows out of yen were attributed to continued economic weakness in Japan and political uncertainty related to the new coalition government. Demand for dollars vs. marks was related to expectations that interest rate differentials would move in favor of dollar assets. During the final quarter of 1993 and first quarter of 1994, acceleration of the U.S. economic recovery contrasted sharply with continued weakness in the real economy in Europe.

In the early months of 1994, however, these exchange rate trends reversed course. Over the period from end-1993 until end-June the dollar declined in nominal terms by nine percent against the mark and by 13 percent against the yen. Over this same period, the mark depreciated by 4 percent against the yen.

However, the dollar appreciated by 4 percent against the Canadian dollar and by almost 10 percent against the Mexican peso. Other Latin American currencies were steady, with the exception of Brazil's and Venezuela's. After the Venezuelan Government introduced exchange rate and price controls on June 27, the Venezuelan bolivar took a third large step in its depreciation since mid-April. On July 1, Brazil introduced a new currency linked to the dollar as part of a broader price stabilization policy. The dollar depreciated by 4 percent against the Singapore dollar, but showed little change against other Asian currencies. Table 5 shows the percent change in the dollar against various currencies since October 15, 1993.

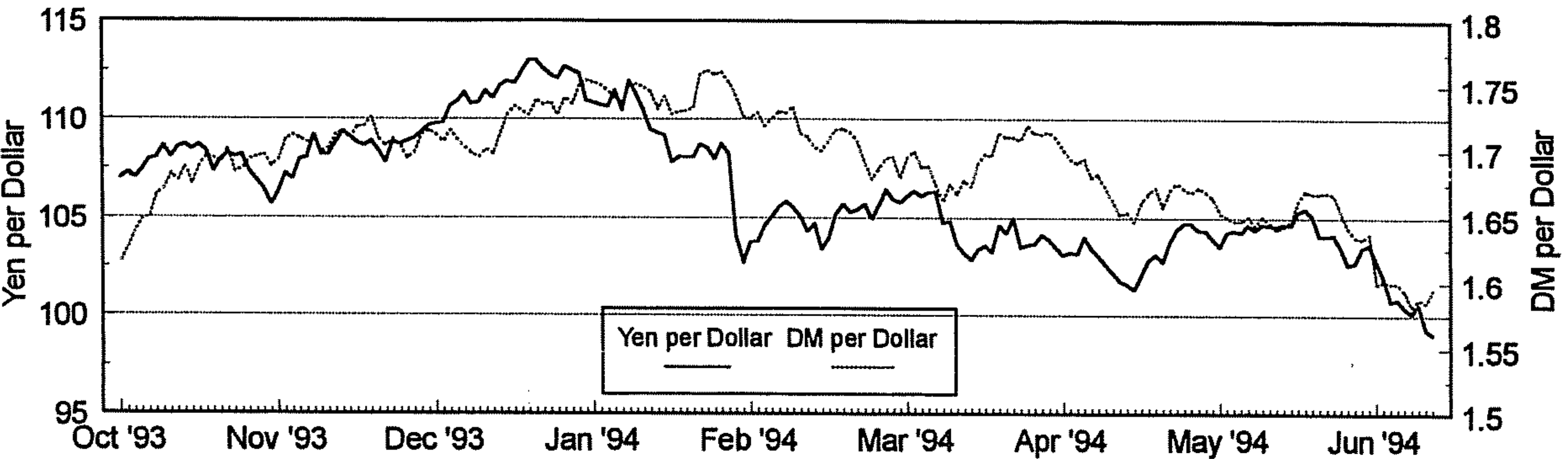
Table 5
Change in Dollar vs. Selected Currencies
(Percentage Change)

	Change from 10/15/93 to 12/31/93	Change From 10/15/93 to 6/30/94
Japanese Yen	4.4%	-7.4%
German Mark	6.5	-1.3
British Sterling	2.1	-1.8
French Franc	2.5	-4.5
Italian Lira	6.7	-0.4
Canadian Dollar	0.7	4.1
Swiss Franc	3.3	-5.9
Mexican Peso	-0.2	9.0
Korean Won	-0.6	-0.7
Taiwan Dollar	0.3	-0.2

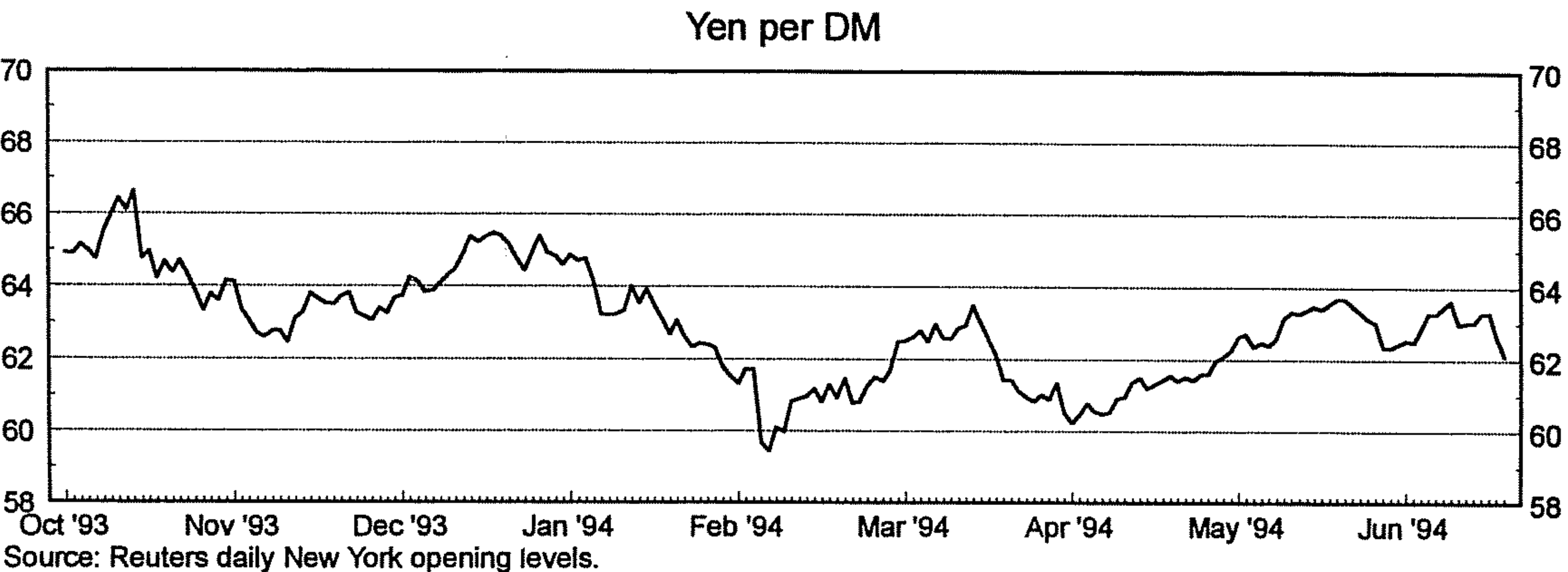
The most important factors behind the rise of the yen and the mark this year were a reassessment of the pace of economic activity in Europe and a renewed focus on the external imbalances of the United States and Japan. Emerging indications of economic recovery in Germany dampened market expectations about the extent of monetary easing there and about prospects for declines in German yields relative to U.S. yields. Japanese political uncertainties raised questions as to whether Japan's external surplus would be addressed. The widening of the U.S. current account deficit and continued diversification by U.S. investors into foreign assets raised questions about prospects for financing the deficit.

In addition to these underlying fundamental factors, market participants remained sensitive to progress in discussion of trade issues between the United States and Japan and to the reception of U.S. officials to the stimulus measures announced by Japan in early February. Dollar movements also were affected at times by market dynamics and volatility in other asset markets.

Nominal Exchange Rates
October 15, 1993 through June 30, 1994
Dollar vs. Yen and DM



Yen per DM



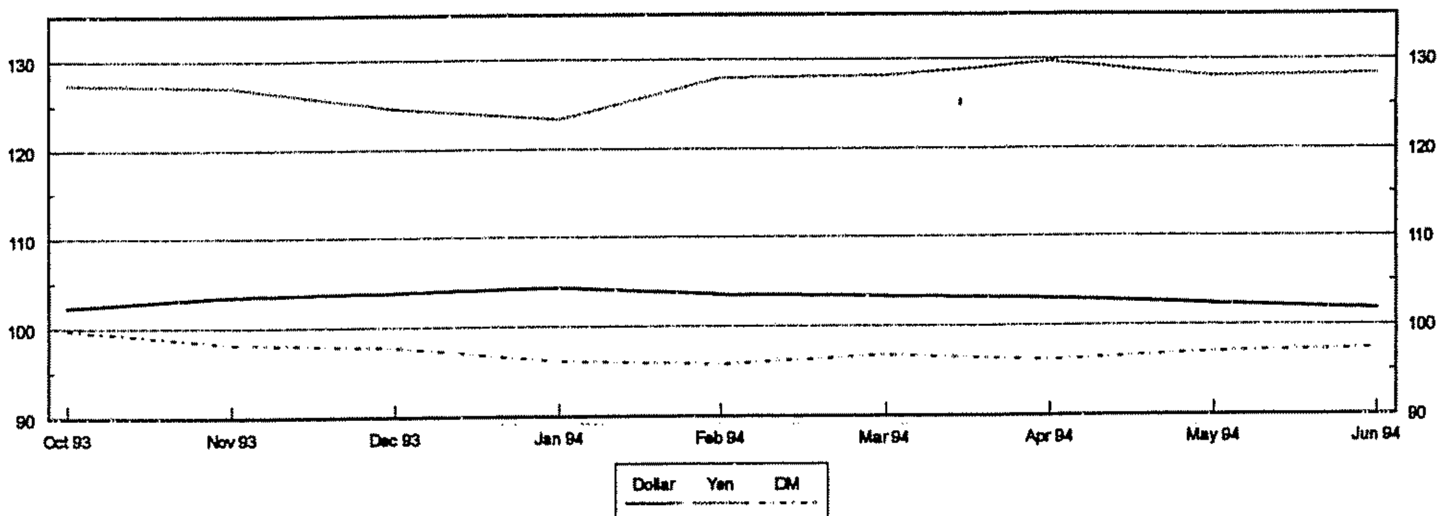
Source: Reuters daily New York opening levels.

The dollar's depreciation accelerated in April and spread beyond the yen to encompass European currencies as well. Political uncertainty in U.S.-Japan trade relations increased following Prime Minister Hosokawa's resignation. Meanwhile, the narrowing of interest rate differentials between the United States and Germany seemed to have run its course after the Bundesbank made an unexpected cut in interest rates on April 14 and the Federal Reserve hiked rates on April 18.

Fluctuations of Major Currencies on a Trade-weighted Basis

Taken over a time period of two to three years, the dollar and the German mark have fluctuated moderately on a trade-weighted basis, while the Japanese yen has greatly appreciated. However, from mid-October 1993 through June 1994 the dollar has registered a decline of some 2 percent, while the mark has remained little changed and the yen has appreciated by 3.0 percent.

Real Trade Weighted Index
(Monthly)
October 93 - June 94



Morgan Real Trade Weighted Index

North American Financial Group

Following the March 23 assassination of Mexican presidential candidate Colosio, the U.S. monetary authorities announced on March 24 the establishment of a temporary bilateral swap facility at the request of the Mexican authorities. The assassination had prompted the closing of Mexican financial markets on March 24, giving rise to concern that the reopening of the market on March 25 would be accompanied by market disorders that could spill over into U.S. financial markets. However, no drawings on this facility proved necessary.

On April 26, the U.S., Canadian, and Mexican monetary authorities announced the creation of the North American Financial Group, a forum for regular consultation on economic and financial developments and policies in the three countries. These arrangements had been planned earlier in recognition of the three countries' increasingly interdependent economic relationships, particularly NAFTA.

In connection with the creation of the North American Financial Group, the monetary authorities also announced the establishment of a trilateral swap facility to expand the pool of potential resources available to each to maintain orderly exchange markets. The United States and Mexico put in place swap agreements for up to $6.0 billion. The Bank of Canada and the Bank of Mexico expanded an existing swap agreement to Canadian $1.0 billion. The Federal Reserve and the Bank of Canada reaffirmed their existing $2.0 billion swap agreement. Each party has reciprocal privileges to make drawings of the others' currencies under this facility.

Operations in the Foreign Exchange Market and U.S. Policy

In response to the currency movements in the spring and to market perceptions about U.S. exchange rate policy, the U.S. monetary authorities, in cooperation with other major countries, intervened on Friday, April 29 in support of the dollar. Secretary Bentsen also issued the following statement:

> The U.S. monetary authorities intervened today in foreign exchange markets to counter disorderly market conditions. This is in line with our previously articulated policy, which recognizes that excessive volatility is counterproductive to growth. We stand ready to continue to cooperate in foreign exchange markets.

The U.S. authorities sold $500 million equivalent of marks and $200 million equivalent of yen on that morning.

On Sunday, May 1, Secretary Bentsen said in a television interview that "what we're concerned about is volatility in the market" and that the U.S. authorities intervene "when we see the market move away from what we think are the underlying economic realities."

The April 29 intervention operation was followed on May 4 by a concerted intervention operation involving the U.S. monetary authorities and the authorities of 18 other countries. The U.S. monetary authorities sold $750 million equivalent of marks and $500 million equivalent of yen. These operations were accompanied by a further statement from Secretary Bentsen:

"I am concerned by recent developments in the exchange markets. This Administration sees no advantage in an undervalued currency. The monetary authorities of the major countries are joining this morning in concerted intervention. These operations reflect our view that recent movements in exchange markets have gone beyond what is justified by economic fundamentals."

These operations demonstrated that the G-7 are prepared to act quickly, and in concert, in response to deteriorating conditions in foreign exchange markets.

Subsequently, the Bank of Japan accommodated a decline in market interest rates to record low levels; the Bundesbank lowered its discount and Lombard rates by 50 basis points each; and the Federal Reserve raised its presumed Fed funds rate target and discount rate by 50 basis points each. These actions were followed by a short period of relative stability of exchange rates.

However, in early June, the dollar's decline resumed. Political uncertainties in Japan were growing. The market was increasingly cautious about the end of the monetary easing cycle in Europe and about upside risk to European growth forecasts. With market participants' views growing more bearish, the U.S. authorities responded with a series of statements reiterating the Administration's concern, and on June 24 the U.S. monetary authorities and the authorities of 16 other countries made coordinated intervention purchases of dollars. The U.S. authorities sold $610 million equivalent of yen and $950 million equivalent of marks, and Secretary Bentsen said

"Our actions today in cooperation with our G-7 partners and other monetary authorities reflect a shared concern about recent developments in financial markets. We look forward to continued cooperation to maintain the conditions necessary for sustained economic expansion with low inflation."

On June 28, Secretary Bentsen stated

"We believe a stronger dollar is better for our economy and better for the world's economy. The dollar is not a tool of our trade policy. No country can be indifferent to a fall in its currency."

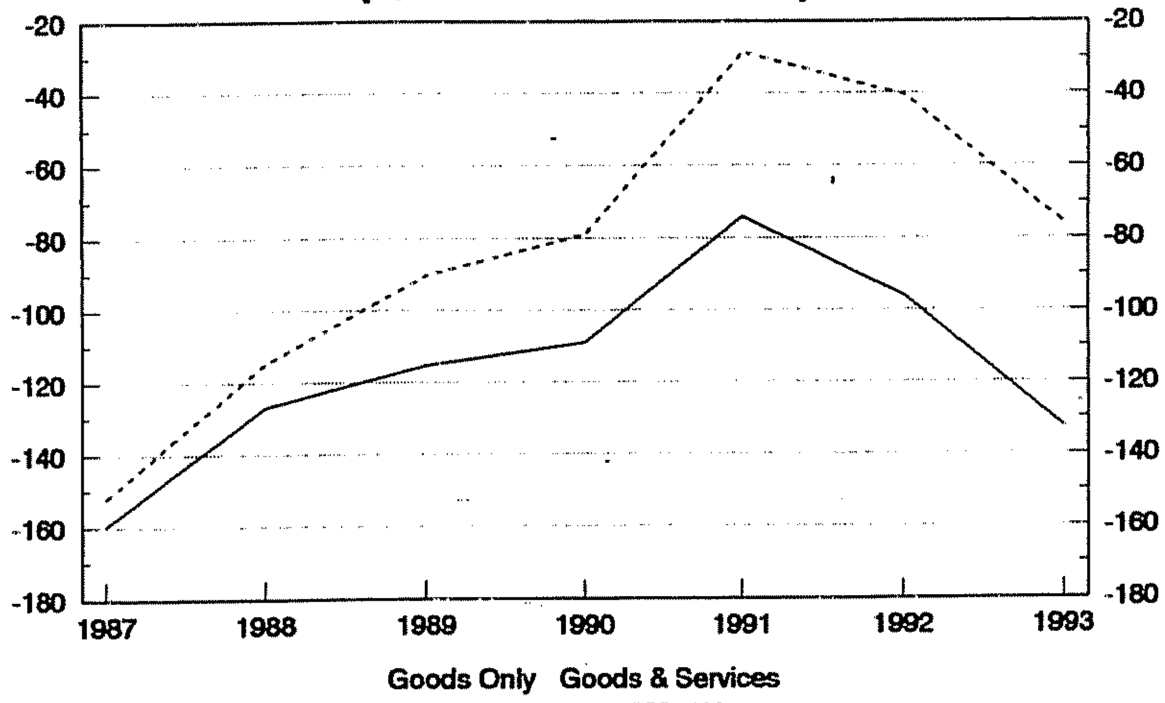
The Administration believes that a stronger dollar would have important economic benefits for the United States. It would restore the confidence in financial markets that is important to sustaining recovery. It would boost the attractiveness of U.S. assets and the incentive for longer-term investment in the economy, and help to keep inflation low. In addition, we believe -- and this view is shared by other G-7 countries -- that a continuation of recent movements in exchange markets would be counterproductive to global recovery.

The prospects for sustained noninflationary growth in the United States are more favorable than they have been at any time in a generation, and should be reflected in a strong and stable U.S. dollar.

C. Balance-of-Payments Developments

Trade Developments in 1993

Services have become a major component of international trade in recent years, in terms of both size and rapid growth. This development has been particularly important for the United States, as services are an area where the United States is a world leader, and trade in services has recorded large and rising surpluses in recent years while goods trade -- which has received much more attention -- has recorded large deficits. Thus any complete discussion of U.S. trade performance has to take account of developments in services as well as goods.



Source: Survey of Current Business, June 1994

The 1993 deficit on goods and services (G&S) trade was $75.7 billion, up from $40.4 billion in 1992. The widening of the deficit was entirely due to a larger deficit on goods trade; there was a slight increase in the already large surplus on services transactions.

Cyclical Influences.

The 1993 goods trade balance reflected a continuation of the primarily cyclical factors noted in the November 1993 Report. The U.S. goods deficit for the full year (balance-of-payments basis) was $132.6 billion, up from $96.1 billion for 1992. Exports totalled $456.9 billion, up $16.5 billion (under 4 percent) as weak demand in Europe and Japan was only partially offset by strong export growth to Latin America and East Asia, which avoided recession. Reflecting the solid U.S. expansion during 1993, imports rose $53 billion (nearly 10 percent) to $589.4 billion. Import growth was broadly based across a range of manufactures and industrial materials. Capital goods, including computers, accounted for roughly one-third of the increase.

Growing Role of Developing Countries.

Table 6 shows shifts in the geographic pattern of goods trade since 1991, when the United States had its lowest annual trade deficit since 1983. The solid competitive position of U.S. goods meant that exports could keep pace as long as the market itself was growing. In developing economies where growth was strong -- notably in Asia and certain countries in Latin America -- the goods trade deficit was flat or declining. In those industrial regions where growth was weakest, notably in Europe and Japan, the deficit widened. The notable exception to this pattern, of course, was China, where exports rose substantially (albeit from a low base) but imports rose by nearly two-thirds.

Table 6
U.S. Goods Trade with Selected Areas: 1991, 1993
($billion; data from Survey of Current Business)

Country or Region	Exports to 1991	Exports to 1993	Imports from 1991	Imports from 1993	Balance 1991	Balance 1993
W. Europe	116.8	111.3	102.0	121.0	+14.8	-9.7
Japan	47.2	46.9	92.3	107.3	-45.1	-60.5
China	6.3	8.7	19.0	31.5	-12.7	-22.8
Asian NIEs	44.4	50.1	59.2	64.5	-14.9	-14.5
L. America	63.3	78.2	63.0	75.2	+0.3	+3.0
Canada	85.9	101.2	93.0	113.0	-7.1	-12.1
OPEC*	13.8	14.2	25.3	24.2	-11.4	-10.1
Rest of Wld	39.2	46.3	37.1	52.8	-1.9	-5.9
TOTAL	416.9	456.9	491.0	589.4	-74.1	-132.6

*excl. Venezuela, which is included in Latin America

Current Account Follows Trade Deficit

The widening trade deficit was reflected in the current account balance, as trade is by far the largest and most volatile component. Table 7 shows data for the peak deficit year of 1987, for 1991 (post-1987 low point) and for 1993.

Table 7
U.S. Current Account: 1987; 1991; 1993
($billion; data from SCB)

Balance	1987	1991	1993
Goods and Services	-152	-28	-76
Investment Income	+8	+15	+4
Transfers	-23	-35*	-32
Current Account	-167	-49*	-104

* Excludes $42 billion in one-time transfers from allies to support Desert Storm. Totals do not add due to rounding.

The succession of large current account deficits -- which began in the early 1980s and is not expected to be broken in the near future -- has eroded the U.S. net investment position abroad and, inevitably, our net investment earnings. In consequence, the surplus on net investment income which has been characteristic of the U.S. balance of payments throughout the post-WWII period has disappeared, leaving services as the only offset to adverse swings in the goods deficit.

Turning to the capital account, U.S. investors substantially increased their purchases of foreign assets in 1993, in the form of both portfolio and direct investments. U.S. purchases of foreign securities were about 2-1/2 times total equivalent purchases for 1992; direct investment outflows were about 40 percent above 1992 levels. Net flows of U.S. official capital were negligible.

Foreign purchases of U.S. securities also rose substantially -- over 50 percent -- compared with 1992. Foreign direct investment inflows, which declined substantially in 1992, recovered somewhat in 1993, though they remain well below the very high annual levels of 1987-90.

Table 8
Capital Flows, 1992-93
Selected Transactions, $billion

	1992	1993
Direct Investment	-31.1	-36.5
(Inflows)	(+9.9)	+21.4)
(Outflows)	(-41.0)	(-57.9)
Securities	+21.6	-15.1
(Inflows)	(+66.7)	(+104.9)
(Outflows)	(-45.1)	(-120.0)
Official	+44.8	+70.2
Foreign	(+40.9)	(+71.6)
U.S.	(+3.9)	(-1.4)
Banks, net	+38.9	+46.9
Other	-6.3	+38.4
TOTAL	+67.9	+103.9

Source: Survey of Current Business

Prospects for 1994.

As in 1993, relative growth performance in the U.S. and major foreign economies will continue to dominate the trade and current account outlook for 1994. The U.S. economy will continue to expand, albeit at a more sustainable pace, while the prospect is for only modest recovery in Europe, and the timing of a recovery in Japan remains a question mark. In consequence, the U.S. trade and current account deficits should continue to widen at least through the remainder of 1994. Data through April are consistent with this outlook. The deficit could widen further in 1995, though at a slower pace as import growth moderates with the slower pace of U.S. growth, and exports pick up with stronger demand in Europe and, perhaps, Japan.

The evidence from data on costs and export performance indicates that the competitive position of U.S. goods remains solid, so that U.S. exports should respond well to stronger growth abroad. There has been substantial progress made in reducing the federal budget deficit, which should be reflected in improved national saving performance and a smaller external deficit than would otherwise be the case. However, sustained declines in the external deficit, beyond the reversal of cyclical effects in prospect, will require further improvements in U.S. saving performance.

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, countries that have in past reports been designated as manipulating the rates of exchange between their currencies and the U.S. dollar.

Korea and Taiwan

It remains Treasury's judgement that neither Korea nor Taiwan is manipulating its exchange rate within the meaning of Section 3004 of the Omnibus Trade Act of 1988. Nevertheless, Treasury remains concerned about certain financial and foreign exchange policies in both countries, particularly capital controls, which discourage investment and impede the operation of market forces in exchange rate determination.

Korea

The Korean won remains roughly unchanged since Treasury's last report in November 1993. Korea's trade surplus with the United States rose slightly from $2.0 billion in 1992 to $2.3 billion in 1993, while the country's overall current account balance moved into a small surplus of $500 million.

Korea's strong economic performance and initial stock market-opening steps resulted in large capital inflows in 1993 and early 1994. Concern about the effect of these inflows on monetary growth and inflation prompted authorities to seek to stem the capital inflows by imposing exchange controls early in 1994 which placed onerous requirements on foreign investors and succeeded in dampening these inflows.

Treasury continues to engage the Korean government as it implements its five year financial sector liberalization plan. Having set its sights on achieving OECD membership by 1996, the Korean Government has recently announced that financial sector liberalization will be accelerated to accomplish that goal. This plan includes projected steps to liberalize controls on capital flows and current account payments, including regulations that limit payback periods to only a fraction of international norms, and access of foreign financial institutions to Korea's financial

markets. Treasury will continue to engage in negotiations with the Korean Government to achieve satisfactory results in these areas.

Taiwan

The New Taiwan dollar also remained roughly constant against the U.S. dollar since Treasury's November report. Adjustment in Taiwan's external surpluses continued. Taiwan's overall current account surplus fell to $5.8 billion in 1993 from $8.2 billion in 1992. The shrinkage stems from slow recovery in Taiwan's export markets as well as increasing competition from other exporting economies in the region. Taiwan's trade surplus with the United States declined slightly from $9.4 billion in 1992 to $8.9 billion in 1993.

While Taiwan has incrementally relaxed certain limitations on foreign exchange transactions and capital flows, the pace of reform has been very slow. Key restrictions on Taiwan's financial markets, which constrain pressure for NT dollar appreciation, remain in place. Of particular concern in recent months has been the ceiling on foreign institutional investment inflows. By December 1993, foreign institutional investment was nearing the $5 billion ceiling. Taiwan's authorities waited until March 5 before raising the ceiling to $7.5 billion, but, at the same time, they set a new limit of $2.5 billion for capital raised on foreign stock markets by local securities investment trust companies (these funds were not previously subject to any limit).

Building on its existing bilateral talks with Taiwan, Treasury has raised these issues in the context of Taiwan's current GATT accession negotiations. In particular, Treasury is engaging in negotiations with Taiwan's authorities regarding liberalization of Taiwan's financial markets. Treasury will participate in GATT negotiations regarding a special exchange agreement, which is aimed at ensuring that Taiwan's foreign exchange regime does not impede trade and investment. Treasury hopes that these issues can be addressed expeditiously in the GATT accession process.

China

Treasury welcomes China's decision to unify its dual exchange rates as of January 1, 1994. Nonetheless, further reforms implemented on April 1, 1994 excluded foreign enterprises from the interbank foreign exchange market and imposed restrictions that limit their access to foreign exchange. Based on China's continued reliance on foreign exchange restrictions that could limit imports, it is Treasury's judgement that China manipulates its exchange system to prevent effective balance of payments adjustment and gain unfair competitive advantage in international trade. Treasury urges the Chinese authorities to eliminate the segmentation of the foreign exchange market and restrictions on access to foreign

exchange. Such steps would facilitate imports and promote adjustment in China's large bilateral surplus with the United States.

Trade and Economic Developments

According to Chinese customs figures, China's trade balance deteriorated from a surplus of $4.4 billion in 1992 to a deficit of $12.2 billion in 1993 while China's current account deficit was approximately $9.6 billion in 1993. However, China's reported current account deficit was more than offset by a net capital inflow of $20.5 billion. As a result, at end-December 1993, China's foreign exchange reserves stood at $49.9 billion (equivalent to 6 months of imports), up from $38.2 billion at end-June 1993.[1] China's external debt remains modest. Total external debt stood at $77 billion at the end of 1993 while China's debt-service ratio was 12 percent. Chinese trade figures suggest that China's external position has improved somewhat in 1994. For January-March 1994, China's exports increased faster than imports, resulting in a trade deficit of $1.3 billion.

Table 9
Chinese Balance of Payments Figures
($ Billions)

	1990	1991	1992	1993	Q I 1994
Trade Balance	8.7	8.2	4.4	-12.2	-1.3
Current Account	12.0	13.3	6.4	- 9.6	na
Capital Account	3.3	8.1	-0.2	20.5	na
Net Errors & Omissions	-3.1	-6.8	-8.3	- 9.1	na
Increase in Reserves (- = increase)	-12.0	-14.5	2.1	- 1.8	na

Source: Chinese and IMF Statistics

However, China's trade data are inconsistent with those of its trading partners. Chinese figures probably significantly underestimate exports as the requirement that exporters sell foreign exchange to designated banks creates incentives for exporters to hold foreign exchange offshore. In 1992, for example, China reported total exports of $85 billion while partner countries reported imports from China of $134 billion. Some of this discrepancy arises from: 1) valuation differences (China reports f.o.b. exports while partners report c.i.f. imports); and 2) goods transshipped through Hong Kong and counted as imports by both Hong Kong and China's other trading partners. However, even after adjusting for these

[1] This figure includes reserves of the People's Bank of China ($23.1 billion) as well as the Bank of China ($25.8 billion). China does not include the latter in its official reserve figures.

factors, partner countries report $9 billion more in Chinese exports than China reports as exports.

According to U.S. data, China's trade surplus with the United States increased from $18.3 billion in 1992 to $22.8 billion in 1993. U.S. exports to China rose 18 percent to $8.8 billion while U.S. imports from China rose 23 percent to $31.5 billion. U.S. consumption of low cost, labor intensive goods produced by China continues to grow rapidly. Footwear, toys, apparel, and plastic goods constituted the fastest growing categories of U.S. imports from China. On the export side, U.S. exports of capital goods are increasing most rapidly. Automobiles, telecommunications equipment, aircraft, and specialized industrial machinery constituted the fastest growing categories of U.S. exports to China.

In 1993, China continued to grow rapidly. China's GDP grew 13.4 percent in real terms while real industrial production rose 30 percent and retail sales rose 35 percent in nominal terms. Rapid growth was caused by high fixed investment and accommodating monetary policy. Nominal fixed investment by state enterprises increased 58 percent in 1993 while broad money increased 24 percent. Loose monetary policy led to high domestic demand and increasing inflation. The retail price index rose 18 percent for the year ending in December 1993 while the cost of living in 35 cities rose 24 percent.

The authorities attempted to slow the economy in July 1993 with a 16-point austerity program. This program achieved some initial results as real industrial production fell from 30 percent for the year ending June 1993 to 16 percent for the year ending October 1993. However, credit problems in state enterprises forced the central government to ease credit. The People's Bank of China reportedly increased base money by 150 billion yuan in September and October.

In the first quarter of 1994, economic activity moderated somewhat but nonetheless remained strong. Real GDP rose at a 12.7 percent annual rate. Industrial production was up 19 percent in real terms for the year ending in March 1994 while nominal retail sales increased 24 percent. The nominal growth of fixed investment by state enterprises declined to 36 percent for the same period. While production has slowed, inflation continues to rise. For the year ending in March 1994, retail prices rose 24 percent while the cost of living in 35 cities rose 25 percent. The government is now attempting to tighten the money supply, largely through administrative measures. The government has also resorted to price controls on basic commodities and services in an attempt to slow inflation.

China's Foreign Exchange System

On January 1, 1994 China unified its dual exchange rates at the more depreciated swap center rate and announced it would abolish swap centers in

favor of an interbank market for foreign exchange. The new, unified exchange operates as a managed float, with the People's Bank of China (PBOC) setting each day's exchange rate according to market conditions and relative to the price for foreign exchange on the previous day. While domestic firms are still required to surrender their foreign exchange, China announced that government approval would no longer be required for purchases of foreign exchange for trade and trade-related current account transactions. Moreover, companies are allowed to purchase foreign exchange automatically from designated banks upon presentation of: 1) an import contract; 2) a request for payment from a foreign institution; and 3) an import license (if required).[2]

On March 26, 1994 the Chinese Government issued new foreign exchange regulations that went into effect on April 1, 1994. In many areas, the new foreign exchange regulations are in line with previous announcements. Chinese firms are permitted to buy foreign exchange for specified purposes upon presentation of required documents. Permitted transactions include purchase of foreign exchange to buy imported inputs, to repay foreign debt, and to remit dividends abroad. However, the Chinese authorities segmented China's foreign exchange market by excluding foreign-funded enterprises from the new interbank market for foreign exchange. While Chinese firms may purchase foreign exchange through designated banks (which in turn trade through the interbank market), foreign-funded firms must use the existing swap centers.

The new regulations maintain the requirement that foreign enterprises balance their foreign exchange earnings and expenditures. Foreign-funded enterprises that have a deficit or surplus of foreign exchange may trade in the swap centers but only with other foreign-funded enterprises. The Chinese authorities have also indicated that the State Administration of Exchange Control (SAEC) must approve individual foreign exchange transactions and has the authority to deny access to foreign exchange for purposes that do not accord with national policy. However, there are no clear public regulations stipulating the conditions under which foreign-funded enterprises can purchase foreign exchange.

Exchange Rate Developments

In 1993, China's administered exchange rate depreciated less than one percent from 5.75 yuan/dollar to 5.80 yuan/dollar. China's more market-oriented swap rate depreciated 19 percent, rising from 7.30 yuan/dollar at the end of 1992 to 8.71 yuan/dollar at the end of 1993.

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[2] In 1992, 53 broad categories of goods accounting for 25 percent of China's total imports were subject to licensing.

On January 1, 1994, China's dual exchange rates were unified at the rate of 8.72 yuan/dollar. The unification represented an effective depreciation of 7.2 percent as enterprises previously importing goods at the administered rate were forced to use the more depreciated swap rate. As of end May, the unified exchange rate had appreciated slightly to 8.68 yuan/dollar. After dropping for several years, China's real effective exchange rate against the dollar has remained steady in the last two years. Nominal depreciation of the renminbi was offset by higher inflation in China than in the United States.

Table 10
China: Nominal Exchange Rate Index
(End of Period)

	1990	1991	1992	1993
United States	100	96.4	80.2	68.9
Japan	100	88.7	73.7	56.7
EC	100	98.9	91.1	84.8

Table 11
China: Real Exchange Rate Index
(End of Period)

	1990	1991	1992	1993
United States	100	97.2	83.9	82.4
Japan	100	99.9	78.8	70.5
EC	100	98.6	93.8	101.3

Exchange Rate Negotiations

On April 21, 1994, the Treasury Department held negotiations with the People's Bank of China in the context of the Exchange System Reform Working Group of the Joint Economic Committee.[3] Treasury welcomed the unification of China's exchange rate and moves to make the renminbi convertible for trade and trade-related transactions. However, Treasury noted that certain measures appeared to be a step backward from China's initial reform plans. In particular, the exclusion of foreign-funded enterprises from the interbank market and the enforcement of foreign exchange balancing requirements could restrict access to foreign exchange. The requirements that foreign-funded enterprises use swap

[3] The Joint Economic Committee is a forum for the U.S. and Chinese governments to exchange views on economic issues of mutual concern. After a lapse of seven years, the Joint Economic Committee was revived in modified form in a meeting chaired by Treasury Secretary Bentsen and Minister of Finance Liu in Beijing on January 21, 1994. Both sides agreed to the formation of new working groups to discuss monetary and banking issues, exchange system reform, and investment.

centers and that the SAEC must approve access to the centers have the potential to act as barriers to trade and thus could increase China's bilateral trade surplus with the United States. The Chinese authorities were urged to eliminate these restrictions as soon as possible. Treasury noted that elimination of restrictions would facilitate China's move toward current account convertibility, improve the efficiency of China's economic system, and promote further reform of the Chinese economy.

Assessment

Treasury welcomes unification of China's exchange rates as an important step that will facilitate China's GATT accession and movement toward full convertibility on the current account. At the same, Treasury remains concerned that restrictions on access to foreign exchange remain. In particular, the denial of foreign funded enterprises' access to the interbank market and the enforcement of foreign exchange balancing requirements could be used to reduce imports, including those from the United States. Moreover, there are no clear public regulations stipulating the conditions under which foreign funded enterprises may purchase foreign exchange. If the Chinese exchange rate comes under pressure, the SAEC could use its authority to deny foreign funded enterprises' access to the swap centers and maintain the stability of the renminbi. Thus, it is Treasury's view that China continues to manipulate its foreign exchange system.

Treasury will continue to negotiate with the People's Bank of China bilaterally and in the GATT accession context to promote further reform of China's exchange system aimed at achieving a market-oriented system of exchange rate determination and foreign exchange allocation.

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 the House 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.